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Tax Insights

Australia and Israel: double tax treaty

Snapshot

On 28 March 2019, Australia and Israel signed the first ever double tax treaty between the two countries, and concurrently signed an accompanying Protocol. The Australian Government stated that the treaty will strengthen the friendship and commercial relationships, and provide greater opportunities for those relationships to grow.

The Australian Treasurer also indicated that the new treaty includes OECD / G20 BEPS recommendations, demonstrating the Australian Government's commitment to tackling international tax avoidance. In that regard, the treaty adopts most of the OECD's recommended treaty changes, in particular in respect of:

- Action 2: Fiscally transparent entities
- Action 6: Treaty abuse, including adoption of the Principal Purpose Test (PPT)
- Action 7: Artificial avoidance of permanent establishment status and
- Action 14: Dispute resolution

The treaty will come into effect after all domestic ratification requirements are completed by both countries.

Australian and Israeli cross border investors should review existing structures and income flows to identify the implications of the treaty.

Detailed comments

Withholding tax rates

The treaty provides for maximum source country taxation as follows:

	Rate	Conditions include
Dividends	Nil	The beneficial owner holds directly less than 10% of the voting power in the company paying the dividends, and the beneficial owner is • A Contracting State or subdivision thereof, including a government investment fund [note 1]; • The Reserve Bank of Australia or the Bank of Israel; • In the case of Australia – a "recognised pension fund" or other resident carrying on complying superannuation activities; or • In the case of Israel – a "recognised pension fund" whose income is exempt or Israeli resident receiving dividends from a pension plan provided by a Provident Fund.
	5%	The beneficial owner of the dividend is a company (other than an Israeli Real Estate Investment Fund) which holds directly at least 10% of the voting power in the company paying the dividends throughout a 365 day period that includes the day of dividend payment.
	15%	All other cases
Interest	Nil	The beneficial owner of the interest is a Contracting State or subdivision thereof, including a government investment fund, the Reserve Bank of Australia or the Bank of Israel [note 1 and note 2].
	5%	The beneficial owner of the interest is an unrelated financial institution.
	5%	The beneficial owner of the interest is [note 2]: • In the case of Australia – a "recognised pension fund" or other resident carrying on complying superannuation activities; or • In the case of Israel – a "recognised pension fund" whose income is exempt or Israeli resident receiving interest from a pension plan provided by a Provident Fund.
	10%	All other cases
Royalties	5%	

- Note 1: In order for a Contracting State or subdivision thereof, or a government investment fund to get the benefit of the treaty provision above, the dividends or interest are to be derived from the investment of monies that are and will remain public funds.
- Note 2: The reduced rate of taxation on interest per the treaty provision above is not operative where the beneficial owner of the interest is in a position to control or influence the key decision-making of the issuer of the debt-claim. In that case, the treaty provides that the rate of tax may be at 10%.

In addition, distributions made by an Israeli REIT to a resident of Australia shall be subject to Israeli tax. Where the Australian resident directly holds less than 10% of the capital in the Israeli REIT, then this tax rate is capped at 15%.

As a matter of Australian domestic law, Australia does not impose a tax on dividends derived by non-residents of Australia, to the extent that the dividend is a franked dividend. Conversely, under Israeli domestic law, Israel will seek to tax any Israeli sourced dividends received by non-residents of Israel.

Alienation of property

Income, profits or gains from the alienation of "immovable property" in a State, or of shares or comparable interest in land-rich entities, may be taxable in the State where the immovable property is

located. Similarly, the alienation of movable property forming part of a permanent establishment in a State may also be taxed in that State.

Treaty Abuse

The treaty is largely consistent with the BEPS Action 6 measures in respect of treaty abuse. The minimum standard has been reflected in:

- A new title and preamble: making it clear that the treaty is not intended to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the Convention for the indirect benefit of residents in third States).
- The adoption of the principal purpose test (PPT) which will deny treaty benefits in respect of an item of income where one of the principal purposes of a transaction or arrangement is to obtain treaty benefits, unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

Permanent establishment

The treaty is consistent with the BEPS Action 7 measures in respect of the new permanent establishment standard. Significantly, the treaty:

- Will deem a PE where a person (other than an independent agent) acting in a contracting State on behalf of an enterprise "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise";
- Ensures that persons who act exclusively or almost exclusively for a closely related enterprise do not qualify as independent agents;
- Narrows the specific activity exceptions by making each of them subject to the condition that the relevant activity is preparatory or auxiliary for the enterprise; and
- Introduces an anti-contract splitting rule to aggregate connected activities by closely related enterprises for the purpose of time based PE tests.

In addition, the treaty will deem a PE to arise if an enterprise of one of the contracting States:

- Carries on supervisory or consultancy activities in the other State for a period or periods exceeding in the aggregate 183 days in a 12 month period in connection with a building site, or a construction or installation project;
- Carries on activities (including the operation of substantial equipment) in the other State in the exploration for, or extraction or exploitation of, natural resources in the other State for a period or periods exceeding in the aggregate 90 days in any 12 month period; or
- Operates substantial equipment in the other State for a period or periods exceeding in the aggregate 183 days in any 12 month period.

Other matters

Other key aspects of the treaty include the following:

- The treaty expressly deals with income derived through fiscally transparent entities or arrangements; and
- A seven year time limit will generally apply for making transfer pricing adjustments, except in cases of fraud, gross negligence or wilful default

Not covered by the treaty

Assistance in the collection of taxes

The treaty does not include an Article requiring the other State to assist in the collection of their respective taxes. From an Australian perspective, very few treaties (6 out of 45 treaties) include an 'Assistance in the collection of taxes' Article. However, Australia's recent treaty practice has been to include such Article (i.e. treaties with New Zealand, France, Finland, Norway, South Africa and Germany). From an Israeli perspective, it is normal treaty practice not to include such an article.

Deemed source rule

Australia's tax treaty with Israel does not include a deemed source rule. Australia's treaty practice is to include such a rule: it provides that income that may be taxed in Australia, under certain Articles of a treaty shall be taken to arise from sources in Australia. However, the April 2019 Federal Budget announced that the Australian Government will amend the *International Tax Agreements Act of 1953* (*ITA Act)* to include a new provision that will deem specific classes of income covered by a tax treaty to have an Australian source. No further details have been released as yet – but it seems that the Australian approach now is that the deemed source rule will be included directly in domestic legislation rather than in a particular treaty.

Interaction with domestic laws

The Protocol clarifies that the following respective domestic laws are not impacted by the treaty

- Measures designed to address thin capitalisation and dividend stripping;
- Measures designed to address transfer pricing;
- Controlled foreign company and transferor trust rules;
- Measures designed to ensure that taxes can be effectively collected and recovered, including conservancy measures;
- Foreign occupational company rules;
- In the case of Australia, the general anti avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* or section 67 of the *Fringe Benefits Tax Assessment Act 1986*;
- In the case of Israel, the general anti avoidance provision in Article 86 of the Income Tax Ordinance 5721-1961.

Commencement

Each country needs to undertake domestic law processes for the treaty to enter into force. After that has occurred, the treaty shall have effect:

- In the case of Australia:
  - In respect of withholding tax on income that is derived by a non-resident, in relation to income derived on or after 1 January next following the date on which the Convention enters into force;
  - In respect of fringe benefits tax, in relation to fringe benefits provided on or after 1 April next following the date on which this Convention enters into force;
  - In respect of other Australian tax, in relation to income, profits or gains of any year of income beginning on or after 1 July next following the date on which the Convention enters into force;
- In the case of Israel:
  - With respect of taxes withheld at source, on amounts paid on or after the first day of January of the calendar year following the year in which the Convention entered into force;
  - With respect of other taxes, on taxes levied for periods beginning on or after the first day of January of the calendar year following the year in which the Convention entered into force.

Next steps

The above summary is high level and general. Specific advice should be obtained in connection with transactions and proposed investments. Australian and Israeli cross border investors should review existing structures and income flows to identify the implications under the treaty.

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