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Overview of the U.S.—Israel Tax Treaty, as Amended by the 1993 Protocol

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INTRODUCTION

On January 26, 1993, the United States and Israel signed a protocol to the income tax convention between the two countries which had been signed on November 20, 1975 (the "Proposed Treaty"). Although the Proposed Treaty had been amended by an earlier protocol signed on May 30, 1980 (the "First Protocol"), and been given the advice and consent of the U.S. Senate, the Proposed Treaty has never been ratified by Israel. It is the intention that the Proposed Treaty signed in 1975, as amended by the First Protocol and the protocol signed on January 26, 1993 (the "Second Protocol"), will become the first Income Tax Treaty between the United States and Israel. The Treaty will enter into force after an exchange of the instruments of ratification has taken place.

The U.S. Treasury Department will prepare a technical explanation of the Second Protocol (a technical explanation of the Proposed Treaty and of the First Protocol have already been prepared) following which the Senate Foreign Relations Committee will conduct hearings on the Proposed Treaty which will be followed by its report and recommendation to the Senate. Israel will proceed with its treaty ratification procedures at the same time.

This article provides a summary overview of the most important provisions of the new Proposed Treaty.

OVERVIEW OF THE TREATY

The General Pattern of the Treaty

The statement issued in the report of the Senate Foreign Relations Committee prior to the Second Protocol indicated that the Proposed Treaty is substantially similar to other recent U.S. income tax treaties, the withdrawn U.S. model income tax treaty, and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). The changes to the Proposed Treaty made by the Second Protocol reflect modifications in U.S. internal law and U.S. treaty policy since the First Protocol was signed and, for the most part, are consistent with other recent U.S. treaties. The Proposed Treaty does, however, contain several new provisions not found in other U.S. tax treaties. It differs from the models in certain respects to reflect Israel's status as a developing country and the United Nations model for tax treaties between developed and developing countries.

The provisions of the Proposed Treaty dealing with taxation of business (Articles 5 and 8) and personal services income (Articles 16 through 19) are essentially the same as in other recent U.S. treaties with other developing countries, as are the provisions dealing with definitional and administrative matters. For example, a resident of one country will not be subject to tax in the other country on business profits unless those profits are attributable to a permanent establishment which the resident maintains in the other country.[1] Similarly, for business visitors from one country temporarily present in the other, the host country may tax the visitors only if certain tests (based on time spent or amounts earned) are met.[2] In addition, the Second Protocol expressly allows the U.S. to impose its Branch Profits Tax on Israeli residents engaged in trade or business in the United States in addition to the regular U.S. taxes.[3]

Noteworthy Highlights of the Treaty Provisions

1. Israel has a system of economic incentives, such as, the Encouragement of Capital Investment Law ("ECIL") whereby it provides certain government grants and guarantees to foreign investors who maintain or achieve the status of an "approved enterprise." The Proposed Treaty recognizes Israel's system of governmental grants and provides in Article 10 that Israeli governmental grants to U.S. shareholders of Israeli corporations which are made subject to the condition that the U.S. shareholders contribute the grants to the Israeli corporations will, at the election of the shareholders,[4] be treated, for U.S. tax purposes,

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[1] Article 8(1) of the Proposed Treaty.

[2] Articles 16, 17, and 18 of the Proposed Treaty.

[3] Article IX of the Second Protocol adding a new Article 14A to the Proposed Treaty.

[4] Article VII of the First Protocol amended Article 10(1) of the Proposed Treaty to make the exclusion elective. Conse-

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as nontaxable shareholder contributions to capital. The Treaty provides that the United States will require a reduction in basis of the assets of the Israeli corporation by the amount of the deemed contribution.[5] The shareholder's basis in the Israeli corporation's stock, however, will not be reduced by the amount of the contributed grant.[6]

2. Article 15 of the Treaty provides the normal general rule that capital gains are taxable in the country of residence and exempt in the source country. However, either country may tax the gain of a resident of the other country derived from the sale or exchange of shares in a corporation of the host country if the resident owned more than 10% of the voting power of the corporation within the 12 month period preceding such sale or exchange.[7] The Treaty originally required ownership of more than 50% of the voting power before tax could be imposed.[8] This position was put into the Treaty at the insistence of Israel.[9]

3. The Second Protocol preserves the foreign tax credit for U.S. taxpayers on the capital gains tax imposed by Israel, as described in the preceding paragraph by treating such gain as Israeli source income.[10] The gain would normally be considered to be U.S. source under §865(h) of the Internal Revenue Code of 1986, as amended (the "Code"), and the U.S. resident would find himself subject to both U.S. tax and Israeli tax in the absence of a foreign tax credit.

4. The maximum rate of withholding tax by source country on dividends received by residents of the other country is lowered to 25% generally and to 12.5% or 15% in the case of dividends received by shareholders having at least a 10% ownership interest.[11] The 15% rate would apply to dividends if the payor is a corporation which is entitled to the reduced rates applicable to an approved enterprise under the ECIL. The 12.5% rate would apply if the paying corporation is not entitled to a reduced rate under the ECIL. The Second Protocol amends Article 12 of the Proposed Treaty to clarify that dividends paid by a U.S. regulated investment company are subject to a 25% withholding tax. Similarly, dividends paid by a U.S. REIT are subject to a 25% withholding tax but only if the recipient is an individual who holds a less than 10% interest in the REIT. All other recipients are subject to 30% withholding tax.

5. The withholding tax in the source country on interest paid to residents of the other country is limited to 17.5%.[12] This higher than normal rate is reduced to 10% in the case of interest received by financial institutions such as, banks, savings and loan institutions and insurance companies.[13] However, all interest guaranteed or insured by a government or agency of either country will be exempt from tax by the other country.[14] This was apparently designed to ensure that there will be no withholding on government guaranteed loans made to U.S. investors under the ECIL. The Second Protocol amends the Proposed Treaty to allow residents of either contracting state to elect to have interest taxed as industrial and commercial profits.[15] The income would then be taxed as business profits under Article 8 of the Proposed Treaty on a net rather than gross basis, but would be subject to tax at the rate of 34% in the U.S. and possibly the branch profits tax of 12.5%, and at the rate of 39% in Israel.

6. The maximum withholding rate on industrial royalties is limited to 15% and the maximum rate on copyright and film royalties is 10%.[16]

7. The Second Protocol adds Article 14A to the Proposed Treaty to deal with the U.S. branch profits tax. In 1986, the United States enacted Code §884 which allows the U.S. the right to tax U.S. branches of foreign corporations which are engaged in trade or business in the United States on their earnings and

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quently, the amount of a grant will be included in the gross income of the U.S. recipient unless the recipient elects under Article 10(1) to exclude it from gross income.

[5] Article 10(1)(d) of the Proposed Treaty, as amended by the First Protocol.

[6] Article 10(1)(c) of the Proposed Treaty, as amended by the First Protocol.

[7] Article X of the Second Protocol amending Article 15(1)(e) of the Proposed Treaty. This exception to the general rule, which is unique to the U.S.-Israel Treaty, was included to accommodate the Israeli domestic rule under which the sale of stock in an Israeli corporation generates gains subject to Israeli tax irrespective of the residence of the seller. The exception, however, imposes objective limitations on the operation of this Israeli domestic rule. Thus, the seller of stock in an Israeli (or U.S. corporation) will be taxed on the gain in Israel (or the United States) only if he owned 10% or more of the corporation's voting stock during the 12-month period preceding the sale.

[8] Prior to its amendment by the Second Protocol, Article 15(1)(e) of the Proposed Treaty provided for taxation of the gain only if the seller, within the 12-month period preceding the sale, owned more than 50% of the corporation's voting stock, and if more than 50% of the fair market value of the corporation's gross assets used in its trade or business were physically located in the corporation's country of domicile on the last day of each of the three taxable years preceding the sale.

[9] While relaxation of the limitations on Israel's right to tax gains may have been envisioned as a device for increasing Israeli revenue, it may serve the opposite purpose by discouraging U.S. investment in Israel.

[10] Article XIII.3 of the Second Protocol adding a new paragraph (4) to Article 26 of the Proposed Treaty.

[11] Article 12 of the Proposed Treaty, as amended by Article VIII of the First Protocol.

[12] Article 13 of the Proposed Treaty.

[13] Article 13(2) of the Proposed Treaty.

[14] Article 13(3) of the Proposed Treaty.

[15] Article VIII of the Second Protocol amending Article 13 of the Proposed Treaty.

[16] Article 14(b) of the Proposed Treaty.

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profits which are not reinvested in the United States. Under the Code, the tax is imposed at the rate of 30%. Article 14A provides that this branch tax may be imposed by the U.S. on the "dividend equivalent" amount, but the maximum rate will be 12.5%. If it is imposed upon branch level interest, the maximum withholding tax rate will be 5%. It is interesting to note the differences in the withholding rate on the branch level interest tax of 5% and the ordinary interest rates of 17.5%.

8. As noted earlier, the provisions of the Proposed Treaty which deal with the taxation of business and personal services income generally follow the patterns of other treaties. For example, a resident of one country will not be subject to tax in the other country on business profits unless those profits are attributable to a permanent establishment which the resident maintains in the other country. It is noteworthy that the definition of what is not a permanent establishment was drafted to recognize Israel's status as a developing country.[17] Also, at Israel's insistence a provision, not typical in U.S. treaties, was included in the Proposed Treaty. Under this provision a U.S. exporter of goods to Israel will be deemed to have a permanent establishment in Israel if either the goods sold in Israel were subjected to substantial processing in Israel, or were purchased in Israel.[18] The same rule applies to Israel exporters to the U.S. Israel originally wanted this provision to follow the United Nations Model that anytime there would be a delivery of goods into a country a permanent establishment would be deemed to exist. The United States refused to go that far.

9. The Proposed Treaty exempts from the excise tax imposed by Code §4371 insurance and reinsurance premiums received by an insurance business conducted by an Israeli resident irrespective of whether such business is carried on in the United States through a permanent establishment.[19] Note that, since Code §4371 tax is a covered tax, insurance and reinsurance premiums not attributable to a permanent establishment would be exempt from tax even in the absence of this special rule.

10. The Proposed Treaty exempts from tax income derived by Israeli or U.S. residents from the operation, in international traffic, of ships and aircraft, and gains derived from the sale or exchange of such ships and aircraft irrespective of Article 8 of the Proposed Treaty (dealing with business profits).[20]

11. Another provision unique to the U.S.-Israel Treaty was introduced by the First Protocol. It provides a citizen or resident of one of the Contracting States with a deduction for contributions to charities created or organized under the laws of the other Contracting State.[21] The deduction is subject to certain limitations including limitations under local law. Thus, a U.S. citizen or resident will be allowed a deduction for U.S. income tax purposes for contributions made to Israeli charities in an amount equal to 25% of the adjusted gross income from Israeli sources.

12. The Second Protocol amends the Proposed Treaty to incorporate a principle similar to Code §877. Under this provision, the United States and Israel retain jurisdiction to tax a former citizen who renounces his citizenship with a tax avoidance purpose and takes up residence in the other state for a period of 10 years.[22]

13. Paragraph 6 of the Exchange of Notes appended to the Second Protocol states that if the United States alters its policy regarding the provision of a tax sparing credit or if the United States reaches agreement on the provision of a tax sparing credit with any other country, the Proposed Treaty shall be promptly amended to incorporate such a provision.

14. The Second Protocol adds a limitation of benefits provision similar to that contained in most of the recent treaties signed by the United States.[23] It provides that the treaty benefits shall not be available to a company 50% or more of whose stock (by vote or value) is owned by one or more individuals who are not residents of a Contracting State. Similarly, the treaty benefits shall not be available to a person 50% or more of whose gross income is used to meet liabilities to persons who are not residents of a Contracting State. There are exceptions which include, among others, exceptions for publicly traded corporations, as well as, for not-for-profit organizations. The Proposed Treaty provides for consultation by the competent authorities where one State proposes to deny the Treaty benefits.

EFFECTIVE DATE OF THE TREATY

The Treaty will be effective on January 1 of the year in which it is ratified provided such ratification takes place prior to July 1 of that calendar year. However, the withholding provisions will not apply until the first of the second month following the date on which the convention enters into force. If ratifica-

[17] *See* Article 5(3) of the Proposed Treaty.
[18] Article 5(4) of the Proposed Treaty.
[19] Article 8(8) of the Proposed Treaty.
[20] Article 9 of the Proposed Treaty.

[21] Article X of the First Protocol adding Article 15A to the Proposed Treaty.
[22] Article V of the Second Protocol amending Article 6 of the Proposed Treaty.
[23] Article 25 of the Proposed Treaty, added by Article XII of the Second Protocol.

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tion takes place after July 1 then the treaty will be effective for January 1 of the year following the date on which the treaty is ratified.

COMMENTS ON THE PROPOSED TREATY

The New U.S.-Israel Income Tax Treaty is not as economically meaningful as one would have hoped for. The factors discussed below cloud the attractiveness of the Treaty.

The Absence of Tax Sparing Credit Provision

The absence of a tax sparing credit provision in the Proposed Treaty is one of its glaring drawbacks because it dilutes the intended effect of Israeli tax incentives on potential U.S. investors in Israel.

The United States alleviates double taxation under its domestic law primarily through the allowance of a foreign tax credit. The foreign tax credit mechanism provides a U.S. investor in Israel a credit against its U.S. tax liability in an amount that equals the U.S. tax attributable to income derived from foreign (*i.e.,* Israel) sources by such investor. The foreign tax credit mechanism also permits an indirect credit for Israeli taxes paid by an Israeli corporation provided the shareholder(s) is a corporation. The indirect foreign tax credit (deemed paid credit) is not available to individuals. As stated above, the foreign tax credit is limited to the U.S. tax attributable to the taxpayer's foreign source income. Thus, if the effective foreign rate of tax is higher than the U.S. tax rate, the U.S. investor in such a foreign country ends up paying the higher foreign tax. This creates a disincentive for U.S. investors to invest in high tax foreign countries.[24] To attract U.S. investment, high-tax foreign jurisdictions may counteract such a disincentive by providing tax incentives in the form of subsidies or reductions, etc. In Israel, for example, ECIL is designed to accomplish this objective. The problem, however, is that under the U.S. domestic law, subsidies or reductions, etc. are not treated as creditable taxes. Consequently, no foreign tax credit is available in the U.S. for the tax sparing amounts (*i.e.,* subsidies, reductions, etc.). For example, a U.S. investor in Israel, whose effective tax rate is reduced through a tax sparing incentive under ECIL, will be entitled to a foreign tax credit only for the amount of tax actually paid (excluding the tax sparing amounts). In short, the objectives of ECIL are frustrated, at least to some extent, by the U.S. domestic foreign tax credit rules.

A credit for tax sparing amounts in the Proposed Treaty would have treated a U.S. investor in Israel as if he paid Israeli taxes at normal rates, when, as a matter of fact, he would have enjoyed the tax incentives that lower the effective Israeli tax rate. In the absence of a tax sparing credit, however, the value of the reductions in Israeli tax rate inures to the benefit of the U.S. Treasury rather than the investor.

High Rates of Withholding Tax

The Proposed Treaty reduces the rate of withholding on dividends, interest, and royalties, but the reduction is not nearly as generous as in other treaties. The withholding tax rates on amounts paid by a U.S. payor are as follows:

	Regular	Treaty Rate
Dividends	30%	25%/12.5%
Interests	30%	17.5%
Royalties	30%	10%-15%

These withholding rates in the Proposed Treaty should have been lower. Many other treaties the United States has entered into exempt interest and royalty payments from withholding tax and reduce the rate of withholding tax on dividends to 5%. Israel itself reduces the withholding rate on dividends under its incentive programs such as ECIL. The high withholding rates included in the Proposed Treaty at Israel's insistence should have been lower because they are an impediment to capital flows between the two countries.

Migration of U.S. Persons to Israel

The Treaty appears to be somewhat insensitive to the migration to Israel of U.S. persons because it incorporates Code §877 in the Proposed Treaty. The migration of the American Jewish person to Israel is a phenomenon that is unparalleled in the world. However, since Americans who become Israeli citizens generally do not migrate to Israel for tax avoidance purposes, the impact of Code §877 incorporation into the Proposed Treaty is likely to be minimal.

Permanent Establishment Definition

The definition of "permanent establishment" in the Proposed Treaty in some respects is more liberal than in other treaties in so far as it recognizes Israel's status as a developing nation. However, at the same time it contains a trap for the unwary exporter of goods that purchases or has goods processed in the other country. Such purchase or processing will cause the exporter of the goods to have a permanent establishment in the other country and also be subject to the branch profits tax. However, this is still less

[24] Since the top tax rate in Israel is 39% as opposed to a 34% tax rate in the United States, there is a disincentive for U.S. investors to invest in Israel.

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burdensome than the United Nations model which Israel was insisting upon.

Economic Incentive Plan

The benefit provided in Article 10 of the Proposed Treaty, which exempts grants from tax in the United States, is designed to recognize Israel's economic incentive plan for encouraging investment. However, the lack of a tax sparing clause, especially if the United States curtails deferral, as proposed by President Clinton, is likely to be a deterrent since U.S. companies will not realize significant tax savings by investing in Israel.

CONCLUSION

Overall, the Proposed Treaty does not really go far enough in providing tax incentives to stimulate trade and investment between the two countries. As stated above, this is primarily due to a lack of a tax sparing provision, the high rates of withholding tax, and the broader U.S. tax base (*e.g.*, currently Israel has no branch profits tax). Moreover, a U.S. taxpayer can avoid the two levels of corporate taxation by electing "S" corporate status. No such elections are available to Israeli residents.

The Israeli private business sector was probably anxious to conclude a new tax treaty with the U.S. due to the fact that it will probably no longer be able to utilize the Netherlands-U.S. tax treaty for investment in the U.S. It appears that perhaps both the United States and Israel could have negotiated a better treaty which would better stimulate the economies of both countries, while still eliminating double taxation. If the United States will not agree to tax sparing in the treaties, at the very least, the withholding tax rates could have been lower.

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