

Direct Taxation of E-commerce Transactions in Israel

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Introduction

The sale of goods and services via the Internet has raised a number of regulatory issues and among them the matter of determining the basis of taxation of such transactions.

This paper will examine the Israeli tax system and its handling of direct taxation of Israeli residents and non-residents.

An overview of e-commerce in Israel will be provided. As is the case with many countries, Israel has also has opted not to enact specific tax rules for e-commerce transactions. We will examine the possible reasons for this inaction.

Since specific rules have not been enacted to date, the subject of direct taxation of e-commerce in Israel will be treated by analyzing the Israeli Income Tax Ordinance, the published circulars of the Israeli Tax Authority and Israel's treaties for the avoidance of double taxation.

In the course of the above, we will examine the various issues arising from e-commerce, such as determining the origin of the transaction, income classification, dual residence and others.

I. E-Commerce – Overview

1. E-commerce transactions – general

Electronic commerce, (i.e., the sale of goods and services via the Internet) is a relatively new way of doing business. In traditional commerce it is fairly simple to ascertain the specifics of the transaction, such as the place of the transaction, and contracting parties. E-commerce, in contrast, occurs in the virtual and borderless world of the Internet, via a network of computers.

The use of the Internet ignores national geographic borders and has enabled businesses to advertise market and sell their products and services using innovative and cost efficient means available in the Internet. These new alternatives have caused businesses to rethink their corporate structure and re-establish their businesses in an effort to create a cost efficient structure. The Internet also provides many businesses with a relatively easy way to manage their business ventures in various countries. For example, a business may manufacture the product in one country and create marketing venues in another country. This grants the company versatility in managing its business. This also means that in order to transport products or services to its customers via the Internet, a business is no longer required to have a fixed place of business.¹

E-Commerce has many advantages – notably the simplicity of the transaction – since the sale does not require the use of intermediaries such as agents, banks and other financial institutions. The Internet also allows for accessibility to a large number of potential consumers simultaneously in many countries. The Internet has undeniably provided companies with an unprecedented and cost efficient way to connect with their customers.

Confusion and uncertainty in the domestic law system, however, have been by-products of the Internet's 'global village' aspect. The new method of commerce raises fundamental regulatory concerns and has required governmental and multinational treatment in areas such as intellectual property, consumer protection, contract law, dispute resolution and, of course, the imposition of tax.²

2. E-commerce in Israel

E-commerce in Israel only started to develop in 1999, and the amount of e-commerce transactions has since increased in a relatively slow pace, in comparison with other advanced economies. At the end of 2005, the market size of e-commerce transactions was estimated at approximately NIS 1.5 billion.³

¹ The Israeli Taxation Quarterly, No. 106: 'Taxation of Internet Transactions – Main Issues in connection with VAT', Shai Dotan and Meir Shimra. <http://www.mof.gov.il/museum/hebrew/internet.htm>. (in the Hebrew language)

² 'Electronic Commerce – Taxation Aspects', Adv.(CPA) Ronen Arviv and Adv. Udi Schuster, http://www.altertax.co.il/article_details.aspx?articleID=1428 (in the Hebrew language)

³ 'Israel: Overview of e-commerce', The Economist Intelligence Unit, Global Technology Forum, September 2006.

According to surveys, a growing number of Israelis have been using the Internet. It is estimated that over 80% of households are currently connected to the Internet, compared with 67% in 2005.⁴

Israelis are being accustomed very quickly to the idea of buying via the Internet, using online stores, and the governmental, banking and investment online services.

The five major Internet service providers (ISPs), providing Internet access in Israel are Gold Lines, Internet Gold, Bezeq International, Barak and Netvision.

The telecommunications industry in Israel has been affected by the increasing convergence of the telecom, Internet and broadcast cable service sectors. In recent years, large telecommunications companies have undergone a restructuring and consolidation process. Recent examples of this can be seen in the ISPs that have entered the telephony market, offering long distance phone calls via the Internet (VoIP -Voice over Internet Protocol). Moreover, cable companies have entered into the domestic telephone market. By 2006 these companies had launched an all inclusive, 'one-stop shop' type of telecom service package, including Internet, broadcast cable and telephone services.⁵

The surge of online advertising is yet another indicator of the Internet's rising popularity in Israel: according to industry estimates, the market size of Internet advertising had reached approximately USD 50M in 2006, constituting more than 5% of the advertising market in Israel. In earlier years, the online advertising market had risen dramatically by 50% in 2003, to USD 21M - 25M, compared with USD 13M-17M in 2002.⁶

The five leading portals in Israel are Walla!, MSN Israel, Y-net, Nana and Tapuz; these leading portals take in over 70% of the advertising revenue.⁷

II. Characterization of E-Commerce Transactions

In order to understand the taxation problems arising from e-commerce, it is necessary to characterize or define e-commerce. To do so, one must first understand how the Internet works.

The Internet is a title for the transferring of information in the form of text, pictures and music from one computer to another computer. The method used to do this is using binary codes transferred from one computer to another and decoded by 'browsers' such as Microsoft Explorer.

When a customer knows which product he wishes to order on the business's website, he must type in an address in the browser on his personal computer, and this address reaches the website. This process of connecting between the customer's wishes to the desired website is done by an Internet service provider (ISP). The customer's request, entered in the desired web

⁴ Ibid.

⁵ Ibid.

⁶ Ibid.

⁷ *The Information Technology Landscape in Israel, 'Electronic Commerce'* – [<http://www.amercian.edu/carmel/nk3791a/Ecommerce.htm>], Page Wunder and Lauren Rapaport]

address, is transferred from the customer's personal computer through the ISP into a server storing all of the website's information.

After receiving the request, an answer is transferred from the website to the consumer using the same path in reverse. The final result is that the consumer receives the contents of the website on his personal computer.⁸

E-commerce transactions can be divided in two main groups:

- Transactions using the Internet for ordering and purchasing tangible products and services (travel tickets, books, etc.) (hereinafter: "Tangible Transactions"). In this case, the Internet is simply a device for purchasing the product, and the product itself is sent by mail or courier, or the service is provided tangibly.
- E-commerce transactions in their pure form, wherein the product or service is intangible and may only be received via the Internet (hereinafter: "Digital Transactions"). Such transactions are for digital goods (software, information, music, etc.) or services (search-engines, games, banking, etc.).

III. Regulation of E-Commerce Taxation in Israel

1. General

As is commonly the case with other countries, the current trend in Israel is not to enact specific laws regulating the taxation of cross-border electronic commerce, but rather to adapt the existing law system to this relatively new medium.⁹

The Israeli Tax Authority (the "Tax Authority") has published circulars referring to e-commerce in connection with double-taxation avoidance treaties, the classification of software transactions, and control and management issues. Often, the Tax Authority has quoted the position of the Organization for Economic Cooperation and Development (OECD), as will be elaborated on in Chapter IV.

There may be several reasons for Israel's non-enactment of specific regulations pertaining to taxation of e-commerce:

- **Recent Tax Reform.** In 2003, Israel enacted a very significant tax reform. This tax reform changed the Israeli tax system from a territorial/remittance-based system of taxation to a personal system, wherein residents are taxed on a world-wide basis and non-residents are taxed on a territorial basis. Fresh with this new world-wide system, the regulator's view may well be that any transaction undertaken by an Israeli resident, regardless in which jurisdiction such transaction is undertaken or which borders it crosses, is *prima facie* subject to tax in Israel.

⁸ See footnote 1 above.

⁹ *The Rise of the OECD as Informal 'world tax organization' through the Shaping of National Responses to E-commerce Tax Challenges*, Yale Journal of Law and Technology (forthcoming), by Arthur J. Cockfield.

- **Parity of Income.** Another reason may be the notion, common to many other countries, that new or additional taxes are not needed in order to regulate e-commerce, since all income should be treated equally, regardless of whether such income is derived via electronic or more 'traditional' commerce methods. It appears that the Tax Authority shares this view. An income tax circular published by the Tax Authority has stated explicitly that for the purposes of classifying certain electronic transactions, the Tax Authority makes no distinction between transactions performed traditionally and electronic transactions (the "Software Circular").¹⁰
- **International Tax Treaties.** Israel's domestic non-regulation may stem from the view that since the nature of the e-commerce transaction is intrinsically cross-border and international, the natural arena for determining taxation of such transactions may be more properly the international forum within the context of international tax treaties. It is in this context that the Tax Authority frequently cites the OECD position on e-commerce taxation,¹¹ since the multinational OECD, in responding to the need for definitive principles on e-commerce taxation, has dealt with issues relating to determination of the source of the transaction, and to income classification.¹²

2. Tax liability according to Israeli Income Tax Ordinance

Israeli tax reform

Israeli tax law has recently undergone major reform when the Knesset (the Israeli Parliament) adopted the *Law to Amend the Income Tax Ordinance (No. 132) – 2002* ("the Tax Reform"), which came into force on January 1, 2003.

Prior to the Tax Reform, the tax system in Israel was based largely on a territorial / remittance basis: Ordinary income was taxed if it was accrued, derived or received in Israel, largely without regard to the residency of the tax payer (i.e., both Israeli residents and non-residents were taxed on this basis).

The Tax Reform changed the tax system in respect of international taxation from a territorial one to a personal one based on residency, i.e. taxation of Israeli residents on ordinary income earned worldwide (as was always the case in respect of capital gains). Non-residents, as before, continue to be taxed on Israeli sourced income only.

The Tax Reform has been followed by a series of related amendments of the Income Tax Ordinance ("the Tax Ordinance") which serve to "fine-tune" the major reform of 2003.

¹⁰ Income Tax Circular 13/2001, published on December 27, 2001. "Classification of income from International Software Transactions", Pg. 1.

¹¹ Israel has recently been admitted to the OECD on the usual trial basis.

¹² For an elaboration on this, see Chapter IV

Who is considered an Israeli resident for tax purposes?

An **Israeli resident** is defined in the Tax Ordinance, in respect of an individual, as a person whose life is centered in Israel. Center-of-life of an individual is determined according to specific criteria set in the Tax Ordinance¹³.

In respect of a body of persons (e.g. a company), such body is resident in Israel if it is incorporated in Israel or if its business and management are controlled from Israel.

Determining the place where income is produced

Setting clear rules for the determination of the source of the income, i.e. the place in which income is accrued, is important in a personal taxation system in order to determine which is the jurisdiction that has the right to enforce its tax rules on its residents. This is also important with regard to entitlement to tax credits against foreign tax payments. Tax credits will be granted on account of foreign taxes paid by an Israeli resident – only if the place in which the income is deemed to be produced or accrued is outside of Israel¹⁴. In the case of non-residents, the determination that the transaction is sourced in Israel is important in order to determine Israel's right of taxation.

The place where certain kinds of income are produced is determined by the Tax Ordinance as follows:

- The source of income with regard to **business income** is determined according to “the place where the income-yielding business activity takes place”.¹⁵
- In respect of payments **for use of an asset** – the place of income is where the asset is used.¹⁶
- In respect of **gain or profit, including royalties that stem from an intangible asset**, the place of income is determined according to the payer's place of residence.¹⁷

Determining place where income is produced in e-commerce transactions

Given the virtual and borderless nature of the sale of e-commerce goods and services, it is difficult to decide where exactly the ‘income-yielding business activity’ actually takes place.

If the e-commerce transaction is between two Israeli residents, the e-commerce nature of the transaction is actually irrelevant since the personal tax regime dictates that residents are taxable, even if the server through which the transaction takes place is situated outside of Israel, and/or the goods/services provided in the transaction are delivered from abroad. For

¹³ The center of life test takes into consideration the financial, economic and social ties of the individual, including: the location of the individual's permanent home, the place of residence of the individual and his family, the location of his regular activities, jobs, assets and investments, clubs, unions and institutions of which he is a member. (Section 1 of the Tax Ordinance)

¹⁴ Israeli tax Authority Circular No. 21/2002, “The Income Tax Reform – International Taxation”.

¹⁵ Section 4A(1) of the Tax Ordinance

¹⁶ Section 4A (6) of the Tax Ordinance

¹⁷ Section 4A (7) of the Tax Ordinance

instance, an Israeli travel agency sells an electronic ticket of a foreign airline to an Israeli resident, via a server based outside of Israel. This transaction will be classified as business income in the hands of the travel agency, which will be taxed accordingly.

What is the situation, however, if part of the sale occurs in a jurisdiction outside of Israel, i.e. one of the parties to the transaction is a non-resident? And is there a difference in such case, if the server is situated outside of Israel or not? Is the source of the income produced by the transaction now shifted to a jurisdiction where the non-resident resides or where the server is located, so that such jurisdiction may claim a right to tax?

3. Application of the above tax rules to Tangible Transactions or Digital Transactions

Tangible Transactions

In transactions which may be characterized as Tangible Transactions (see chapter II above), the e-commerce aspect of the transaction (i.e. the use of the Internet) is only the facilitator for the transaction and not the transaction itself.

Thus when one orders a book from Amazon over the Internet, the entire sale process – order, payment, and delivery – is basically the same as any remote sale processes which had been in use prior to the introduction of the Internet, for example: purchasing a book via the post. As such, there is no difficulty in applying the existing tax rules to such a Tangible Transaction.

In the Amazon example above, the income earned by Amazon is sourced in the place where Amazon has its residence. While Amazon is doing business **with** a book purchaser who resides elsewhere, Amazon is not doing business **in** the place of residence of the purchaser, unless it has a permanent establishment in such place (see below in chapter IV). Therefore, the right to tax ought to be in the jurisdiction where Amazon resides.

The tax liability is no different if the purchaser in one jurisdiction sends a letter, or telephones, with his credit card details, to a bookstore in another jurisdiction and asks that the book be delivered to him by post or courier.

Digital Transactions

In Digital Transactions it is difficult to apply these rules in the same way, mainly because it is more difficult to classify the type of income.

As pointed out above, there are no specific domestic tax provisions in Israel dealing with the classification of income in connection with Digital Transactions in general. Nevertheless, since the object of many Digital Transactions is software – whether as the asset itself which is being sold, or as the platform on which a digital sale is to take place – it is useful to examine the Software Circular¹⁸ which was published by the Tax Authority and deals with classification of income, both in respect of domestic transactions and international transactions

¹⁸ See footnote 10

The Circular may be summarized as follows:

Outright sale and a license transaction

“Outright Sale” is a transaction for the sale of the **total** software asset, including all rights appertaining thereto. “License transaction” is a transaction granting a **license for a limited use** of the software asset. The software asset may be a copyright of the software, or a software copy.

Outright sale of copyright of the software

This is a sale of the copyright itself and all related rights, characterized by a preponderance of the following characterizations:

- Transfer and waiver of the essential share of owner’s copyright.
- Transfer of, or providing access to, the source code.
- Purchaser is entitled to carry out any modifications, adjustments or applications in the software.
- Purchaser is entitled to prepare unlimited copies of the software.
- Purchaser is entitled to publicly distribute the software by sale, lease or loan.
- Purchaser is entitled to exhibit the software publicly.
- No requirements to destroy or return the software after a defined period of time.

Outright sale of copy of the software

This is a sale of a copy of the software usually without any other rights such as copyright (cf. sale of a book), and is characterized by a preponderance of the following characterizations:

- Purchaser buys the copy for his personal use only, or marketing purposes only.
- Period of use is unlimited, or limited for the life period of the copy.
- Length or extent of the use period does not affect the payment.
- No undertaking on the purchaser’s part to return or destroy the copy.
- Copy may be used “as-is”, and requires no special adjustments.
- Purchaser is entitled to transfer the “license” to another person, or copy was purchased under an anonymous license agreement (even if such license includes a prohibition on the transfer of the copy to another person).

License - copyright / copy of software

Any transaction, which does not fall within an outright sale (copyright or copy) transaction, as defined above, is a **license** transaction, either of software copyright or copy, as the case may be.

A high component of support services may indicate that the transaction is a license transaction.

From the above Software Circular, we are able to draw the following conclusions regarding the classification of income generated by software:

If the transaction in question is for **the outright sale of the software** (copyright or a copy of software), then the income may be classified either as:

- Ordinary income from a business, if it is carried on in the ordinary course of business of the seller, and accordingly it will be subject to tax in the place where the business activity, which produces the income, is carried on, i.e. the place where the sale is consummated, where the software is delivered for use;¹⁹ or
- Capital gain, if it is a capital transaction not carried out in the ordinary course of business of the seller, and accordingly it will be subject to tax in accordance with the special provision in the Tax Ordinance dealing with capital gains.²⁰

If the transaction may be classified as **the grant of a right of use** in the software, i.e. a “license”, then the income will be deemed as income from “**royalties**”, or “**income from gain or profit that stem from an intangible asset**”, or “**fees for the use of an asset**” and will be subject to tax in Israel if the **payer** is resident, or the asset is **used**, in Israel.²¹

The above classifications ought to hold true notwithstanding that the services offered via the server may originate from a server situated in a place other than where the business activity took place or where the payer is resident.

International transactions

The above domestic rules are applicable generally, *mutatis mutandis*, to cross border international transactions as well. In such transactions, the classification of income will first be carried out in accordance with the domestic rules, as above, and then the provisions of the relevant convention for the avoidance of double taxation (“tax treaty”), if there is one, will be applied.

In applying the tax treaty, the links, which the cross-border nature of e-commerce typically creates between Israel and other jurisdictions, must also be considered. These links may raise the following issues, among others:

¹⁹ Section 4A(a)(1) of the Tax Ordinance

²⁰ Chapter Five of the Tax Ordinance: Residents are subject to capital gains tax on a world wide basis; non-residents are subject to tax if the asset was situated in Israel or if the asset sold was a right to an asset in Israel. The tax rate for capital gains is fixed at 20%, or 25% if the tax payer owned 10% of more of the asset sold (“substantial shareholder”).

²¹ Sections 4A(a)(7) and (6) of the Tax Ordinance

- Which links, with regard to e-commerce, will be considered as granting the source country right of taxation? (i.e., which link, for example, will constitute a permanent establishment?)
- Dual residence issues – what if the Israeli resident is also considered a resident of the foreign jurisdiction (i.e., the source country)?
- Upon determining that the transaction is, in fact, liable to tax in the source country, then at what rate, and which part of the transaction will be taxed?

Answers to these matters may be found in the tax treaties to which Israel is a party (see below), the OECD commentary on tax treaties and tax circulars published by the Tax Authority.

IV. Tax Treaties

1. General

In general, a tax treaty determines the relative rights of two countries to tax a transaction that – according to the respective domestic tax laws of the two countries – gives rise to a tax liability in both countries. The provisions of tax treaties normally override the domestic laws of both contracting countries.

In determining the relative rights of the two countries, tax treaties set conditions whereby the transaction is deemed to be sourced in one country or the other, as well as the applicable tax rates. Tax treaties also outline a tax credit mechanism in order to avoid double taxation where the tax payer is liable to taxes in both countries. Such treaties also grant exemptions or reduced tax rates on certain income such as royalties, dividends and interest.

Israel is a signatory to 45 tax treaties which are in force.²² Tax treaties were also signed, but not yet ratified, with Portugal and Latvia.

Most of Israel's tax treaties are based on the OECD Model Tax Convention on Income and on Capital ("OECD Model Convention"). Some of the treaties also include provisions from the UN Model Double Taxation Convention between Developed and Developing countries.

After signature, each state needs to ratify the tax treaty. In Israel, the ratification is done by the Knesset and afterwards by the government. After concluding ratification procedures, the Israeli Minister of Finance issues regulations²³ which give effect to the treaty. Under Israeli tax law the provisions of tax treaties override any domestic tax legislation.

²² The countries with which Israel has double tax avoidance treaties, as of November 2007: Austria, Belarus, Belgium, Bulgaria, Brazil, Canada, China, Croatia, Czech Republic, Denmark, Ethiopia, Finland, France, Germany, Greece, Hungary, India, Ireland, Italy, Jamaica, Japan, Latvia, Lithuania, Luxembourg, Mexico, Moldova, Netherlands, Norway, Philippines, Poland, Romania, Russia, Singapore, Slovakia, South Africa, South Korea, Spain, Sweden, Switzerland, Thailand, Turkey, Ukraine, United Kingdom, USA and Uzbekistan.

²³Section 196 of the Tax Ordinance.

2. Applicability of tax treaty rules to e-commerce

Concept of Residence

Tax treaties to which Israel is party are binding on Israeli residents and residents of the contracting country. The residence is determined according to each contracting country's internal law²⁴. What happens, however, in case two countries claim a person / body of persons as resident?

In case of dual residence of a company, this situation is resolved by a "tie-breaker" rule. In most of Israel's tax treaties the tie-breaker rule determines that the country where the company has its effective or actual management is the country in which that company is resident for tax purposes.²⁵ This is in line with the OECD Model Convention²⁶. According to this criterion, the place in which the entity is managed in actual fact and in which substantively all the important strategic decisions are resolved, is the place of effective management and, therefore, tax residence.

The 'place of effective management' criterion is similar to the 'control and management' concept in Israeli tax law. According to the Tax Ordinance, apart from the residence test based simply on incorporation in Israel, a body of person is also resident in Israel if its business and management are controlled from Israel.

The declared policy of the Tax Authority is to include in the concept of 'control and management', not only the place from where the every-day business of a company is carried on, but also the place where the strategic decisions and long-term planning are carried on. This is in line with one of the options suggested by the OECD Model Convention, to wit: the place where the majority of senior executive decisions are taken and where the corporate headquarters are located.²⁷

The Tax Authority, however, has extended the above policy to mean that the place of residence of the persons, who operate the company and/or make the strategic decisions, is the

²⁴ Israeli Tax Authority Circular 8/2002 - 'Permanent Residence in Tax Treaties'. The circular specifies criteria for determining residence of an individual, but such criteria are less relevant for the purposes of this article. According to recent Israeli case law (Israeli District Court: G-Tech Technologies Ltd. vs. Kfar Saba Tax Assessor, (T.A 1255/02) rendered on April 7, 2005), the assessed person (resident of either contracting parties) may request with regard to a specific matter, to enter into the mutual agreement procedure set in the tax treaty. In such case, the application should be filed with the appropriate authority in the residence country. Such authority shall determine the assessed person's claim and whether the imposed tax was in accordance with the treaty. The judgment further held that the mutual agreement procedure set in the tax treaty was part of the auditing procedure and, therefore, the mutual agreement procedure should first be exhausted so long as the residence country's courts have not rendered a final tax judgment.

²⁵ See Israeli Tax Authority Circular 4/2002. Note that this circular deals with the issue of management and control in general, and states in its conclusions that "at this stage" the Circular does not deal with this issue in the context of e-commerce which is currently being examined within the framework of the OECD.

²⁶ Section 4 of the OECD Model Convention: "Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated".

²⁷ *The Rise of the OECD as Informal 'world tax organization' Through the Shaping of National Responses to E-commerce Tax Challenges* Yale Journal of Law and Technology (forthcoming), by Arthur J. Cockfield

place of residence of the company. In other words, if such decisions are made by an Israeli resident, regardless of the place where they are made, the Tax Authority takes the position that the company is resident in Israel.

This is a doubtful extension and position – not as yet challenged in the courts – of the definition of residence of a "body of persons" in the Tax Ordinance. Such definition attributes Israeli residence to any foreign body corporate (body of persons) if "the control and management of its business are exercised from Israel."²⁸ In other words, the **residence** of the person who is exercising the management and control is not relevant. What is relevant is the **place** from where such management and control are exercised. Thus, contrary to the interpretation of the Tax Authority, the exercise of control and management of the business of a foreign company by an Israeli resident, where such exercise takes place outside of Israel, ought not to result in the company being deemed an Israeli resident. Conversely, where a non-resident exercises the management and control of a foreign company from within Israel, such company ought to be deemed resident in Israel.

Moreover, in the Internet age determining the 'place of effective management' may be more complicated. Before the advent of Internet technology, directors held face-to-face meetings in order to make business decisions and resolve operational issues. Current technological advancements, such as video conferencing and email exchanges may cause difficulties in determining place of effective management. Maintaining a physical-head office may no longer be needed as directors and managers, who maintain residences in different jurisdictions, are able to attend meetings without leaving their desks. This increases the difficulty for high-tax countries to assert that corporations are residents of their jurisdictions.²⁹

As the use of new communication technologies opens up the possibility of avoiding residence in high-tax jurisdictions, such as Israel, the ability to escape tax liability, both in respect of domestic law and relevant tax treaty provisions, is made easier. It appears, therefore, that the criterion of 'effective place of management' must be redefined to take into the account the use of new communication devices.

Income classification under tax treaties - general

The domestic rules of income classification which we have examined above (Chapter III, section 2) must now be re-examined in the context of the tax treaties as they apply to e-commerce.

The importance of the classification stems from the fact that the domestic tax laws of most countries and all the tax treaties impose different taxes on various classes of income.

In the context of international e-commerce and tax treaties, it is often important to distinguish between payments classified as 'business profits' and those classified as 'royalties'.

Business Profits

²⁸ Section 1 of the Tax Ordinance.

²⁹ 'E-commerce: the Online Challenge for Tax Rules', Dr. Doron Herman, Adv., S.Fridman & Co., Annual Summary 2000 [http://course_materials/Skira-eCommerce_2000.doc] (in the Hebrew Language)

Income derived from Tangible Transactions is considered **business profits**. Since e-commerce transactions involving on-line advice, communications with technicians, use of database, etc. are considered provision of tangible services rather than know-how, the income derived from these transactions would also be considered **business profits**.

Income derived from Digital Transactions may also result in **business profits**, although where digital goods are downloaded in order to exploit copyright relating to the digital goods, this may be classified as royalties rather than business profits.

The current rules do not distinguish between the methods of transaction – traditional or digital – and make an effort to treat substantively similar sales of services / products in the same manner regarding income classification.

Thus, business profits, which under domestic Israeli rules would normally be taxed at source, under Israel's tax treaties are not taxed at the source country unless a permanent establishment exists (see below).

This is in line with the OECD Model Convention which states that **business profits** may be taxed in the source country “but only so much of them as are attributable to that permanent establishment”.³⁰

Royalties

In the event that the Digital Transaction involves the transfer of the right to use the copyright in a digital product, then the payments will be considered **royalties**.

‘Royalties’ usually pertain to payments for use of copyright and other intangible assets. In most of Israel's tax treaties and in accordance with the OECD Model Convention, the term “royalties” is defined as: “payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan secret formula or process, or for information concerning industrial, commercial or scientific experience.”

In most instances there is a fixed rate of withholding tax deducted by the source country, such rate being less than the normal rate payable under the domestic law. Conversely, the tax treaties typically allow the recipient's country to impose a tax, at the normal tax rate, on the royalty received. Thus in the case of Israel, where an Israeli resident receives royalties from a resident of a treaty country, the Israeli resident will be subject to the full marginal tax rate in case of an individual³¹ or the corporate tax rate in case of company³², subject to a credit for the withholding tax paid in the source country.

Disagreement as to classification

³⁰ Article 7 of the OECD Model Convention: “Business Profits”

³¹ The rate for 2008 is 47%

³² The rate for 2008 is 27%.

When the residence country and the source country do not agree on the classification of the transaction, then there may be a case of double taxation, since the residence country might not recognize the tax that was already paid in the source country, for the purpose of tax credits.

OECD Position

Since cross-border transactions performed via the Internet raise income classification issues, the OECD has offered its position on the characterization of income produced by the e-commerce sale. For software transactions via the Internet, the OECD has distinguished between the underlying copyright in the program and software which incorporates a copy of the copyrighted program. This position is reflected in Software Circular of the Tax Authority, referred to above.

The OECD Commentary on the OECD Model Convention ("the Commentary") now clarifies that e-commerce transfers of all digital products should attract the same treatment as software payments, **and that the technological method of transfer is not relevant.**

Permanent establishment in e-commerce

As discussed above, a tax treaty applies only to the residents of both contracting countries, but for the purpose of apportioning the tax between the two countries, it is the country in which the person receiving the income resides that constitutes the residence country. The source country, by contrast, is determined in most tax treaties according to the place where the income producing activity takes place. The apportionment of the taxes between the residence country and the source country may vary, however, in those cases, where the recipient of the income (the residence country) has some presence in the source country. The issue whether such presence is sufficient to cause a variance in the tax apportionment is settled, typically, in tax treaties by determining whether the recipient of the income has a 'permanent establishment' in the source country, through which he conducts the business that produces the income.

Most tax treaties define permanent establishments, in general, as 'the fixed place of business through which business is conducted', and in particular most of Israel's tax treaties and in the OECD Model Convention define 'permanent establishment' as follows³³:

“The term ‘permanent establishment’ includes especially:

- a) a place of management;
- b) a branch;
- c) an office;
- d) a factory;
- e) a workshop, and
- f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.”

The OECD Model Convention then goes on to exclude certain actions as not constituting a permanent establishment, among them, activities that are of a “preparatory or auxiliary character”.

³³ Article 5, Section 2 of the OECD Model Convention

Dependent agents who have the authority to sign contracts on behalf of a principal company are also deemed permanent establishments.

The Commentary on Article 5 of the OECD Model Convention, which is similar to the typical article regarding permanent establishments in Israel's tax treaties, reads as follows: "The definition, therefore, contains the following conditions...the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependant on the enterprise (personnel), conduct the business of the enterprise in the State in which the fixed place is situated".

Can the situation be different in the case of e-commerce? Can a company have a 'permanent establishment' in a jurisdiction even though it does not own any office premises, nor does it employ any personnel, in the jurisdiction in question?

The Commentary in discussing permanent establishment in relation to **electronic commerce**³⁴, takes the following position:

- No human intervention is required for a permanent establishment to exist.
- A website cannot, in itself, constitute a permanent establishment.
- While a place where computer equipment is located may in certain circumstances constitute a permanent establishment, this requires that the functions performed at that place be significant as well as an essential or core part of the business activity of the enterprise.
- For computer equipment to constitute a permanent establishment it must be:
 - **tangible property** – therefore, the data and software which is used by, or stored on, that equipment will not be considered permanent establishment;
 - **at the disposal of the enterprise** - e.g. the enterprise should own or lease and operate the computer equipment;
 - **fixed** - i.e. located at a certain place for a sufficient period of time; what is relevant is not the possibility of it being moved, but whether it is in fact moved.

Moreover, even where computer equipment is used only for "preparatory or auxiliary activities" (e.g. provision of a communications link – much like a telephone line – between suppliers and customers) and therefore, *prima facie*, may not constitute a permanent establishment, nevertheless "**where such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment**, these would go beyond such preparatory or auxiliary activities."³⁵

Pursuant to the above, the Commentary indicates that a server will constitute a permanent establishment if: (1) the server performs integral aspects of a cross-border transaction;³⁶ (2)

³⁴ Commentary on Article 5, paragraph 42.

³⁵ Commentary on Article 5, paragraph 42.8.

³⁶ Ibid

the server is owned or leased by the non-resident firm;³⁷ and (3) the server is fixed in a location for a sufficient period of time.³⁸

Therefore, installing a server which complies with the above specifications of a permanent establishment, may well attract tax liability in that jurisdiction, for better or for worse.

Notwithstanding the above position of the OECD on servers, there is a school of thought which opposes this position for the following reasons:³⁹

- A server is simply a computer networked to the Internet much like millions of other computers, all of which, therefore, theoretically could be regarded as permanent establishments.
- The specifications required for a server to be a permanent establishment focus on the function of the server, i.e. on its software content. While creating the original software has a high cost, the cost of copying it and moving it from server to server is negligible. Thus to tax in the place where copied software is used in a server, is contrary to the doctrine that income tax should be levied at the place where the value is added or where the goods or services are consumed.
- It is too easy a tool for international tax planning to enable tax avoidance by transferring servers from a high-tax jurisdiction to a low-tax one.
- Contrary to the traditional definition of permanent establishment, which focuses on fixed installations, difficult to move (factories, building sites, etc.), that is not the case with servers which can easily be moved.
- The method to be used by tax authorities to attribute profits to servers is unclear since we are in the realm of cross-border trade in intangible assets. As such, this may lead to double taxation.

As mentioned, however, despite the weight of these arguments against the permanent establishment/server OECD rule, it would appear that the Tax Authority would follow the OECD rule since, to date, it has clearly followed the OECD guidance in tax treaty matters.

Although to date there has been no Israeli jurisprudence regarding the permanent establishment/server issue itself, the courts have also adopted the OECD commentary as an inherently necessary interpretive tool. Such adaptation is exemplified in recent Israeli case law⁴⁰, which held as follows:

“The position of the [OECD] organization, although it is not binding on the Israeli courts, does have great persuasive and interpretive value; among other reasons, because it expresses the attitudes of the countries that are members in the organization, and sets forth the desired interpretation for countries requesting to join the organization. Clearly it is enough that one of the contracting parties is a member of the organization in order to cause an expectation between two contracting states of a treaty based on the OECD model, that such treaty will be

³⁷ Commentary on Article 5, paragraph 42.3.

³⁸ Commentary on Article 5, paragraph 42.4.

³⁹ See *The Rise of the OECD as Informal 'world tax organization' Through the Shaping of National Responses to E-commerce Tax Challenges*, Yale Journal of Law and Technology (forthcoming), by Arthur J. Cockfield

⁴⁰ District Court Decision 005663/07, Yanko-Weiss Holdings vs. Holon Tax Assessment Officer, dated December 30, 2007

interpreted according to the [OECD] commentary, as these are published from time to time. Uniform interpretation by the courts of the contracting states in implementing tax treaties based on the OECD model, is an actual necessity that is inherent in the implementation of the treaty, that is in itself a contractual act that becomes law within countries that ratify the treaty...⁴¹

V. Taxation of Income of Non-residents in E-commerce Transactions in Israel

A non-resident of Israel is defined in the Tax Ordinance as a person who is not a resident as defined in the Tax Ordinance.⁴² Non-residents are taxed in Israel on income accrued or produced in Israel.⁴³

The criteria for determining whether income was accrued or produced in Israel differ with regard to different types of income: **Business income** - depends on the place in which the income producing activity takes place, whereas **royalties from an intangible asset** are determined according to the place of residence of the payer.

Thus the same source rules which apply to Israeli residents,⁴⁴ apply conversely to taxation of non-residents in Israel.

For example: If a non-resident company has a permanent establishment situated in Israel, then income from its e-commerce transactions which constitute **business profits** will be taxable in Israel, regardless of whether the payer is an Israeli resident or non-resident, and notwithstanding the fact that the tax treaty between Israel and the country where the non-resident company is resident exempts business profits from tax in Israel.

Another example: If a non-resident company has no permanent establishment in Israel, and the transaction involves the payment of **royalties** to the non-resident company, nevertheless, such royalties, payable by an Israeli resident, will also be taxable in Israel.

Once the non-resident's tax liability is determined according to the Tax Ordinance as in the two above scenarios, then Israel will be deemed the 'source country' for the purposes of the application of the tax treaty between Israel and the country of residence of the non-resident.

The analysis in Chapter IV with regard to tax treaties and income classification is also relevant, *mutatis mutandis*, in the case of taxation of non-residents.

⁴¹ Ibid, pg. 8

⁴² For the definition of an Israeli resident, see Chapter III, section 2

⁴³ Section 2 of the Tax Ordinance

⁴⁴ See Chapter III, section 2

Conclusion

By and large, the taxation of e-commerce in Israel is not regulated by any tax provisions which specifically relate to e-commerce.

Thus one must look at the general taxation provisions of the Israeli Income Tax Ordinance and apply these to e-commerce transactions, be they Tangible Transactions or Digital Transactions. This relates particularly to the issues of residence and classification of income.

Because of the cross-border nature of most e-commerce transactions, tax treaties play an important role in determining the tax liability of these transactions. While here, too, the text of the law normally does not regulate the taxation of e-commerce specifically, nevertheless, thanks to the OECD and its Commentary of the OECD Model Convention, we have certain guidance to the taxation of e-commerce. Israel, by and large, has adopted this guidance.

The Israel Income Tax Authority has also published definitive rules for classifying software transactions, both domestically and internationally and has postulated that for the purpose of classifying income and applying the rules which correspond to each class of income, there should be no difference between traditional transactions and e-commerce ones. The OECD has stated a similar position.

We have seen that in the case of direct taxation Israel has chosen, similarly to other countries, to classify e-commerce transactions as to their substance rather than technical form, and not to afford e-commerce transactions special treatment differing from traditional ones.

Notwithstanding the above position of the Tax Authority, it is difficult to believe that there will be no specific Israeli tax legislation in the future dealing with certain aspects of e-commerce. E-commerce is still relatively new, but considering Israel's very prominent role on the global hi-tech scene, and the high percentage of Israeli residents who use computers, there will be a steady rise in e-commerce activity. This fact, together with ever-increasing number of Israeli companies who are developing e-commerce, will force the Tax Authority, sooner or later, to confront the subject of taxation of e-commerce with specific legislation.
