New Tax Convention Signed Between Canada and the State of Israel

September 23, 2016

The changes resemble recommendations made by the Organization for Economic Co-operation and Development in its 2014 Model Tax Convention

Introduction

On September 21, 2016, a new income tax convention between the Government of Canada and the Government of the State of Israel (the "New Convention") was signed. The changes are intended to provide for greater access to capital and support Israeli and Canadian investments. The changes resemble recommendations made by the Organization for Economic Co-operation and Development ("OECD") in its 2014 Model Tax Convention.

Changes to Withholding Tax Rates

Dividends

Rates

The withholding rates on cross-border dividends have been changed as follows:

- a reduction from 15% to 5% for dividends paid to a company that is the beneficial owner of the dividends and holds directly or indirectly at least 25% of the capital of the company paying the dividends; and
- the current withholding rate of 15% continues to apply for dividends paid in any other case.

Exemptions

The following dividend payments are exempt from withholding tax under the New Convention:

- Pension Plans: Dividends paid to an organization that was constituted and is operating exclusively to administer or provide benefits under a pension plan. This exemption only applies if:

- the organization is the beneficial owner of the shares on which the dividends are paid, holds those shares as an investment and is either generally exempt from tax in the other Sate or its income is not subject to tax in the other State;
  - the organization does not hold directly or indirectly more than 10% of the capital or 10% of the voting power of the company paying the dividends; and
  - each recognized pension plan provides benefits primarily to individuals who are resident in the other State.
- Dividends to Israeli/Canadian Government or Central Bank: Dividends paid to a resident who is the Israeli or Canadian Government, any political subdivision or local authority thereof, or the Central Bank of Israel or Canada. This exemption only applies if the resident is the beneficial owner of the dividends and does not hold directly or indirectly more than 25% of the capital or 25% of the voting power of the company paying the dividends.

Branch Profits Tax

The maximum branch profits tax under the New Convention that can be imposed on a company resident in one country but operating through a Permanent Establishment of the other country (e.g. the withholding rate imposed by Canada on an Israeli company operating in Canada through a Permanent Establishment) has also been reduced to 5% (from 15%). The branch profits tax is treated similar to a dividend paid by a subsidiary to its parent company.

Real Estate Investment Fund (REIT) Distributions

The New Convention imposes a maximum withholding of 15% on gross distributions made by REITs resident in Israel to a Canadian resident. This maximum withholding only applies when the beneficial owner of the distributions is a resident of Canada and directly holds less than 10% of the capital of the REIT.

For greater certainty, the New Convention also states that this maximum withholding does not affect the taxation of the REIT in respect of the profits out of which the distributions are made.

Interest

Rates

The withholding rates on cross-border interest have been changed as follows:

- a reduction from 15% to 10% if the beneficial owner of the interest is a resident of Israel or Canada; and
- 5% for payments of interest where the beneficial owner of the interest is a financial institution that is dealing at arm's length with the payer. This 5% rate is only relevant to interest payments received from an Israeli borrower, since there is currently no withholding tax imposed under the Income Tax Act (Canada) on interest paid by a Canadian borrower to an arm's length lender.

Exemptions

Interest that arises under the following circumstances is exempt from withholding tax under the New Convention:

- Pension Plans: Interest paid to an organization that was constituted and is operating exclusively to administer or provide benefits under a pension plan. This exemption applies subject to circumstances similar to those outlined above for withholding tax on dividend payments made to organizations administering pension plans.
- Interest Beneficially Owned by Israeli/Canadian Government or Central Bank: Interest arising in Israel or Canada that is beneficially owned by a resident who is the Israeli or Canadian Government, any political subdivision or local authority thereof, or the Central Bank of Israel or Canada.
- Interest Paid on Loans to Israeli/Canadian Government or Central Bank: Interest arising in Israel or Canada, and paid by the Israeli or Canadian Government, any political subdivision or local authority thereof, or the Central Bank of Israel or Canada in respect of indebtedness, if the interest is beneficially owned by a resident of the other State.

Royalties

Rates

The withholding tax rate on royalties has been reduced from 15% to 10% if the beneficial owner of the royalties is a resident of Canada or Israel.

Exemptions

The following royalty payments are now exempt from withholding tax if the recipient is a resident of Israel or Canada and is the beneficial owner of the royalties:

- royalties for the use of or the right to use, computer software, patents or for information concerning industrial, commercial or scientific experience (not including any such royalties provided in connection with a rental or franchise agreement).

Anti-Avoidance Rules Applicable to Withholding Rates

The New Convention contains various anti-avoidance provisions which could limit the treaty relief that is available. Specific anti-avoidance rules related to withholding on dividends, interest and royalties have been added to the New Convention. These provisions result in residents of Israel or Canada losing entitlement to treaty relief when transactions and relationships are designed with the intent of exploiting treaty withholding benefits as a main purpose.

Investments in Real Estate: Avoidance of Canadian Capital Gains Taxation

Israeli residents can no longer avoid Canadian capital gains taxation on the sale of shares of a corporation where the corporation holds Canadian real property indirectly through a subsidiary. Under the current rules, gains on the disposition of shares of a corporation are taxed where the property of that corporation was held as a direct investment in real property situated in Canada. The top tier corporation would not have been subject to Canadian taxation if the top tier corporation only held shares of a subsidiary corporation, even though the value of the subsidiary corporation was principally derived from Canadian real property. The New Convention will now tax gains from the disposition of shares where the shares derive more than 50 % of their value directly or indirectly from property situated in Canada during the specified time period.

Income From Employment: "Remuneration" Now Includes Stock Options

For the purposes of calculating income from employment under the New Convention, the meaning of "remuneration" has also been clarified to include stock-option benefits. The changes signify the intention of both States to clarify this point, and remove any ambiguity that stock option benefits would be included in the calculation of employment income taxed under the New Convention.

Residency

The New Convention has been drafted with a view to protecting both contracting states' tax base. It includes a more stringent corporate residency test in cases where the company is incorporated in one jurisdiction but has so called effective management in the other jurisdiction. This test will require Canadian and Israeli Competent Authorities to decide the residency of corporations and trusts through a mutual agreement. In the absence of such mutual agreement, that resident is not able to claim treaty relief.

Professional Services

The entire "Professional Services" Article that exists in the current Convention has been removed in the New Convention. Instead of this Article, the definition of "business" under the New Convention has been changed to include professional services. As a result, the profits of a professional services business are now subject to Article 7 – "Business Profits". This means such profits are only taxable in the country the professional services business is resident in, unless that business carries on business in the other country through a Permanent Establishment.

Permanent Establishments

As noted, a business enterprise that is resident in one country (e.g. Israel) will only be taxable in the other country (e.g. Canada) if that enterprise maintains a Permanent Establishment in the other Country. The following changes to the definition of a "Permanent Establishment" under the New Convention are made:

- Construction Projects: Construction, building, or installation sites no longer constitute a Permanent Establishment if they last 12 months or less. Previously, a Permanent Establishment would exist if it continued for more than 6 months. As well, this article now provides relief if the project is classified as an "installation project"; and
- Oil and Gas: While the prior definition included any places of natural resource extraction, the New Convention has been changed to specifically include an oil or gas well to the definition of a Permanent Establishment.

Information Exchange

The information exchange provisions of the New Convention have also been tightened to allow for more transparency. The provisions reflect the standard developed by the OECD for the exchange of information.

Coming Into Force: You Still Have Time

The New Convention is not currently in force, and requires that both Canada and Israel notify each other that the proper procedures required by their laws have been completed. Once the notification is made, source withholdings under the New Convention will become applicable to amounts paid or credited on or after the 1st day of January of the calendar year following the year in which the New Convention enters into force. For all other taxes, the New Convention becomes applicable on the first taxation year beginning on or after January 1st of the calendar year following the year in which the New Convention enters into force. When the New Convention comes into force, it will replace the current Convention that was signed in 1975. Israeli residents looking to implement transactions using the current Convention (such as the avoidance of real estate gains under the provisions of the current Convention) should do so prior to the coming into effect of the New Convention.

By

Daniel Lang, Joelle Kabouchi

Expertise

Tax, Tax Disputes & Litigation

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749