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Providing services to a foreign resident – is he entitled to zero-rate VAT?

Article 30(a)(5) of the Israeli VAT Law provides zero-rate VAT for the rendering of services to a foreign resident, and it states, as follows:
"These are transactions for which the tax will be at a zero rate:
(5) providing services to a foreign resident, except for a service determined by the Minister of Finance in this regard; no service shall be deemed to be provided to a foreign resident when the subject of the agreement is the actual rendering of the service, in addition to the foreign resident, also to an Israeli resident in Israel, to a partnership in which most of the rights are held by partners who are residents of Israel or to a company that for the purposes of the Income Tax Ordinance is considered to be a resident of Israel, unless it is a service for which the consideration constitutes part of the value of the goods stipulated in article 129 to 133T of the Customs Ordinance, as applicable; "
The term "foreign resident" is defined for the purposes of this article, as follows:
"In this article, "foreign resident" refers to a foreign resident as defined in article 1 where he located outside of Israel and has no business or activity in Israel, ...".
Where article 1 of the Law defines "foreign resident" -
"Foreign-resident"–

1) **Regarding an individual – an individual who permanently resides outside of Israel;**
2) **With regard to a corporate entity—a corporate entity registered or incorporated only outside of Israel;"**

In other words, the rendering of services to such a foreign resident is entitled to VAT at the rate of zero. Notwithstanding, the VAT Law and the regulations pursuant to it have three exceptions to the application of VAT at a zero rate by virtue of this article, which can render the said rule meaningless, and in fact turn it into an exception, so that the rendering of services to a foreign resident will be subject to VAT at the full rate and not zero-rate VAT.

1. **The first exception**: It is set out in the body of article 30(a)(5), according to which "**no service shall be deemed to be provided to a foreign resident when the subject of the agreement is the actual rendering of the service, in addition to the foreign resident, also to an Israeli resident in Israel."**

This exception stipulates, in effect, that where a service is provided to a foreign resident, and the service is also provided to an Israeli resident in Israel, the service shall be subject to full VAT.

Interpretation of court rulings to the phrase "**Also to an Israeli resident in Israel**"

I. The ruling in America Israel Camp Exchange (A.I.C.E.) Ltd. v. the Tel Aviv Regional VAT Director (Civil Appeal 37473-05-12), discussed the issue as to whether the appellant's transactions relating to the recruitment of Israeli candidates for work in summer camps in the United States (recruitment of Israeli employees for a foreign-resident company, to work outside of Israel) – after examining the circumstances of the case, the court ruled that the services provided to the foreign resident shall be charged VAT at the full rate since a substantial service was also provided to Israeli residents – the recruits who "benefitted" from the service. In the court's words: "**The evidence, the minutes of the hearing, the motions and the summaries indicate that service was provided to candidates who are residents of Israel and this service was not negligible or incidental. The meetings were intended to serve the foreign company, the summer camps (outside of Israel), and the candidates themselves. Therefore, the conditions for eligibility for a zero tax rate under article 30(a)(5) of the Law are not met."** And "the **fact that only a foreign resident pays for a particular service does not necessarily lead to the conclusion that the service is not provided to an Israeli resident. The fact that a service is provided at the invitation, request or demand of a foreign resident does not necessarily lead to the conclusion that the service is not provided to an Israeli resident."**

II. The ruling in the case of Tibisi Invest-Georgia Ltd. v. the Dan Region Value Added Tax Director (Civil Appeal 28788-11-15) discussed the question of the VAT rate, full VAT or zero-rate, in respect of the rendering of services by an Israeli subsidiary of a Georgian bank, which was engaged in locating and recruiting customers in Israel for the bank. After discussing the objectives of article 30(a)(5) of the VAT Law, the honorable judge ruled that in any case of providing hybrid services to a foreign resident and to an Israeli resident, the entitlement to zero-rate VAT will be denied. The court ruled that the services are subject to full VAT.

III. In the ruling in the matter of Etgal Holdings Ltd. v. the Tel Aviv VAT Director (Civil Appeal 55642-10-12), the question arose as to whether services for recruiting Israeli investors for foreign private investment funds operating outside of Israel are entitled to zero-rate VAT. The court ruled that "**taking into account the background to the amendment of the law, at present, after the amending of the law, there is no point in the artificial separation made by the appellant between the "beneficiary" of the service and the "recipient" of the service. It is enough for the "beneficiary" of the service to be an Israeli resident in order to charge the service provider VAT. ..... In terms of the totality of the evidence and testimonies, it appears that as part of the**

engagement agreement with the funds, the appellant provided investors with a wide range of services, which included a variety of actions, for which it received compensation only from the funds. .... With regard to the actions carried out by the appellant and their scope, and relying on the indications brought before the court, it cannot be said that this was an indirect benefit of the investors, contrary to the claim of the appellant. .. In any event, in light of the interpretation of article 30(a)(5) of the VAT Law, the intensity of the benefit from the service is of no importance and the fact that the investors receive service from the appellant is sufficient to require the appellant to pay VAT."

This is not enough, an additional condition for applying VAT at the rate of zero is found in regulation 12A(a) of the VAT Regulations -

2. **The second exception:** The second exception is set out in regulation 12A(a) of the VAT Regulations, whereby "**no zero rate shall apply to a service provided in respect of an asset located in Israel unless the service provider proves, to the satisfaction of the Director, that the consideration of the service constitutes part of the value of the goods set out in articles 129 to 133T of the Customs Ordinance.[1]"**

In other words, a service provided in respect of an asset located in Israel will be subject to full VAT and will not benefit from zero-rate VAT.

Legal precedent determined that the definition of the term "asset" in the VAT Law is broad enough to include any proprietary right having economic value. Therefore, it was held that both the right to defend oneself in an Israeli court (Civil Appeal 9303/03 Adv. Yaakov Mossel v. the Petah Tikva VAT Director) and the right to sue in Israel (the right to sue following a road accident of a foreign resident in Israel – the right to sue in a legal proceeding in Israel) are rights whose place of enforcement is in Israel and therefore the service provided in connection with them is a service provided in connection with an asset located in Israel – which is taxable at the full VAT rate. In another case (Civil appeal 1058/07 N.D.L.A. Consulting and Services Ltd. v. the Tel Aviv 3 VAT office), the scope was further expanded, and it was held that services provided to obtain a pre-ruling from the Israeli tax authorities are services in connection with an asset in Israel, where the asset is the right to pay correct tax in Israel – and therefore the services are subject to full VAT.

3. **The third exception: The** third exception is set out in regulation 12A(c) of the VAT Regulations, whereby **"zero rate VAT shall not apply to a service provided to a foreign resident when the subject of the agreement <u>is the rendering of service to another foreign resident during his stay in Israel...</u>";**

[1] This regulation shall not apply: (1) because the asset in respect of which the service is provided is a vessel, aircraft or receptacle within the meaning of the Customs Convention on Receptacles and the Signature Protocol; (2) because the purpose of the service is the export of the goods from Israel; (3) because the asset for which the service is provided is fuel imported to Israel for storage or transmission by pipeline, including unloading, loading and adding additives, provided that the asset is actually exported;

The first two conditions listed above have an exception (hereinafter: **"the exception**"): the last part of article 30(a)(5) of the VAT Law and regulation 12A(a) of the Regulations state "**unless it is a service the consideration for which constitutes part of the value of the goods set out in articles 129 to 133T of the Customs Ordinance, as the case may be;"**

i.e., if the service provided to the foreign resident is part of the value of goods imported into Israel, then the service will be taxed at the rate of zero.

In this regard, the Professional Department published an Interpretation Directive – Interpretation Directive 2/96, Rendering of Service to Foreign Residents – VAT Liability –

2. <u>Services related to the import of goods</u>

The provisions of the last part of article30(a)(5) and Regulation12A(a) are intended to prevent economic double taxation (to prevent a situation in which final tax is paid twice on the same component of service).

Common services accompanying the import of goods into Israel are as follows:

I. Advertising Services – An Israeli dealer provides advertising services to a foreign resident (manufacturer) whose products are imported to Israel.

Situation A: The foreign resident directly engages the Israeli advertiser and pays it the consideration for the service.

Situation B: The importer engages the Israeli advertiser and receives participation from the manufacturer abroad in advertising the imported product (in foreign currency).

<u>In situation A, it is assumed that the price of the advertising service is included in the value for customs purposes of the imported goods, and therefore the service will be taxed at a zero rate.</u>

In situation B, the Israeli advertiser will issue to the importer a tax invoice for the service (which will serve the importer as documentation regarding the deduction of input tax) and on the other hand, the amount of the manufacturer's participation in the advertising expenses incurred by the importer – in an amount not exceeding the actual amount of advertising expenses – <u>will be taxed by the importer at a zero rate.</u>

II. Sales Promotional Service – "Agent Fee"

An Israeli dealer operates in Israel to promote the sales of the imported product and receives a foreign currency commission from the foreign resident manufacturer (import agent commission). It is assumed <u>that the price of the said service constitutes part of the customary price under article 131 of the Customs Ordinance and therefore the service will be subject to zero-rate tax</u>.

III. Assembly / installation service in Israel

According to the contractual agreement between the manufacturer abroad and the purchaser of the goods in Israel, the manufacturer undertakes to supply a finished product. When the product is imported to Israel disassembled or the installation of the product is required on the premises of the purchaser of the goods in order to turn it into a finished product, the manufacturer abroad orders the services of an Israeli dealer for the purpose of performing the above activities (assembly, installation, etc.), and pays him the compensation in foreign currency.

In the case described above, the service provided by the Israeli dealer to the supplier of goods abroad will be taxed at the full rate. According to Brussels' classification and assessment guidelines, the price of services in Israel (assembly/installation, etc.) is deducted from the importer's total contract with the supplier.

....

IV. Service during the warranty period

According to the contractual agreement between the manufacturer abroad and the purchaser of the goods in Israel, the manufacturer is obligated to provide a "warranty period" for the product (a fixed period of time during which the manufacturer undertakes to make the necessary repairs to the imported product at its own expense).

.....

In the event that the importer receives reimbursement of expenses for the aforementioned repair services, the receipt will be taxed at a zero rate, because it is assumed that the price of the service is included in the value for customs purposes of the goods imported under the Customs Ordinance.

In other words, according to the approach of the VAT Authority, advertising and sales promotional services provided to a foreign resident in connection with goods imported to Israel (sold by the foreign resident to an Israeli importer / customers in Israel) are entitled to zero-rate VAT since it is assumed[2] that these services are included in the value of the imported goods. The same applies to warranty services.

In this context, it should be noted that the VAT Authority expanded this provision in Decision No. 7/11, in which it was determined that the exception would also apply to the import of **intangible goods** – provided that the services are included in the value of the intangible goods.

A ruling was handed down in July 2022 in the matter of Hagshama Cosmi Project Management Ltd. v. VAT Tel Aviv and the Central Region (Civil Appeal No. 21657-11-19), which dealt with a company that provided recruitment and employment services of sales attendants to points of sale at duty-free stores at Ben Gurion Airport which sold products of foreign manufacturers. Such sales were reported as being subject to zero-rate VAT. According to the appellant, although the services were provided in respect of an asset located in Israel, the consideration

[2] It is recommended that the foreign company provide a declaration to the Israeli dealer (service provider) that the services are included in the value of the imported goods.

for the services constitutes part of the value of the goods sold in duty-free stores, since foreign manufacturers take into account the cost of services in determining the price of their products, and hence the exception to the exceptions exists. The VAT Director claimed, *inter alia*, that since the goods are sold without VAT (zero duty-free VAT), the services are subject to full VAT. The court did not accept the position of the VAT Authority that the imported goods be subject to VAT. According to the court, Regulation 12A(a) does not include a requirement for the existence of an actual value added tax charge as a condition for the application of the exception to the exception.

It should also be noted that article 30(a)(2) of the VAT Law provides zero-rate VAT on "**the sale of an intangible asset to a foreign resident**." As noted above, the definition of "asset" that also includes "intangible asset" for the purposes of the VAT Law is broad and includes virtually any right having economic value. In this context, we would add that the task of classifying the transaction as a "service" or "sale" is not at all simple, but its importance is sometimes crucial. Needless to say, classifying a service provision transaction as the sale of intangible goods will be entitled to a zero tax benefit, without being required to meet the conditions set forth in article 30(a)(5) of the Law.

In conclusion, the VAT rate in relation to the rendering of services to the foreign resident is one of the most complex and complicated issues in the VAT Law. Since there are no treaties to prevent double VAT, it is crucial to conduct a careful examination of the classification of the transaction in all its aspects in order to determine the tax rate that will apply. Doing so would certainly be in line with the proverb “an ounce of prevention is better than a pound of cure”.

Please do not hesitate to contact us for any questions or clarifications on the matter.

Sincerely,
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