EXPLANATORY MEMORANDUM TO

THE DRAFT DOUBLE TAXATION RELIEF AND INTERNATIONAL TAX ENFORCEMENT (ISRAEL) ORDER 2019

2019 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Revenue and Customs (HMRC) and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Order brings into effect arrangements set out in a Protocol ("the 2019 Protocol") made by the Government of the United Kingdom and the Government of Israel. The 2019 Protocol amends the existing arrangements between the two Governments for the Avoidance of Double Taxation with respect to Taxes on Income ("the 1962 Double Taxation Convention (DTC)").

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 The territorial application of this instrument includes Scotland and Northern Ireland.

3.3 In accordance with section 505 of the Taxation (International and Other Provisions) Act 2010 this instrument covers the entire United Kingdom and the territorial application of this instrument is not limited either by the Act or by the instrument.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the United Kingdom.

4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

5.1 The Financial Secretary to the Treasury, Mel Stride, has made the following statement regarding Human Rights:

"In my view the provisions of the Double Taxation Relief and International Tax Enforcement (Israel) Order 2019 are compatible with the Convention rights."

6. Legislative Context

6.1 The Order is being made to give effect in United Kingdom legislation to the 2019 Protocol, which has been signed by the two Governments. The arrangements in the 2019 Protocol are specified in the Schedule to the Order, and are given domestic legislative effect. The Order does not implement European Union legislation.

7. Policy background

What is being done and why?

7.1 DTCs aim to prevent income or gains being taxed both in the territory in which they arise and the territory in which the recipient is resident. They do this by allocating the taxing rights that each treaty partner has under its domestic law over the same income and gains and/or by providing relief from double taxation. They provide additional protection for taxpayers by specific measures combating discrimination in tax treatment. More generally, DTCs benefit the taxpayer by ensuring certainty of treatment and, as far as possible, by reducing compliance burdens.

7.2 They protect the Exchequer by including provisions to combat tax avoidance and evasion. For example, measures providing for the exchange of information between revenue authorities make it more difficult for residents of both territories to evade taxation by concealing assets offshore.

7.3 Like all of the United Kingdom's DTCs and protocols related to them, the 2019 Protocol largely follows the approach adopted in the Organisation for Economic Cooperation and Development's (OECD) latest *Model Tax Convention on Income and on Capital* ("OECD Model"). In doing so it encourages and maintains international consensus on the appropriate tax treatment of cross-border economic activity and thus promotes international trade and investment.

7.4 The Government keeps all of the United Kingdom's DTCs under review to ensure that they are in line with current policy. The current DTC with Israel was signed in 1962. The DTC was last updated in 1970 to introduce limits to the tax payable on dividends and capital gains. Updating the DTC now to follow many of the latest provisions in the OECD Model Convention will make the DTC easier for businesses to understand, remove obstacles to cross-border trade and investment and reflect changes in policy and legislation in the United Kingdom since the earlier DTC was signed. References to the 1962 DTC throughout this Explanatory Memorandum include the 1962 DTC as it stood following modification by the 1970 Protocol.

7.5 In particular, the 2019 Protocol introduces the minimum standards recommended by the OECD/G20 Business Erosion and Profit Shifting (BEPS) project, which are designed to prevent DTCs from being abused by people trying to reduce their tax liability where the DTC is not intended to apply. The BEPS project created a single set of consensus-based international tax rules to protect against tax avoidance while offering increased certainty and predictability to taxpayers.

7.6 The 2019 Protocol also makes important changes to the allocation of taxing rights that significantly improve the position for businesses in the United Kingdom. Under the existing DTC, United Kingdom companies cannot access reductions in the amount of Israeli tax on dividends paid from Israel to the United Kingdom, and United Kingdom pension schemes cannot access reductions in the amount of Israeli tax on dividends or interest. Once the DTC is amended, United Kingdom companies will benefit from a reduction to 5% Israeli tax on dividends and a reduction to 10% Israeli tax on interest arising in Israel. United Kingdom pension schemes will be exempt from Israeli tax on both dividends and interest. The 2019 Protocol also provides for an exemption from Israeli tax on royalties.

7.7 The 2019 Protocol is reciprocal, so the same applies to payments from the United Kingdom to Israel.

The following paragraphs in this section explain the main changes introduced by the 2019 Protocol to the 1962 DTC.

7.8 Article 1 modifies the preamble of the 1962 DTC to include a statement that the United Kingdom and Israel intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. This statement is one of the elements of the minimum standard on preventing treaty abuse agreed under Action 6 of the OECD/G20 BEPS project.

7.9 Article 2 introduces a new Article I to the 1962 DTC. The new article introduces a rule determining the treatment of income or gains derived by or through an entity that is treated as transparent in either the United Kingdom or Israel. This provision ensures that treaty benefits are granted in appropriate circumstances, as well as protecting against some tax avoidance using hybrid entities. The new article also clarifies that the DTC does not prevent the United Kingdom or Israel from taxing their own residents, except for in specified circumstances. This provision ensures that a DTC cannot be used in arrangements designed to circumvent domestic anti-abuse rules. Both new rules were introduced to the OECD Model following the BEPS project.

7.10 Article 3 modifies Article I of the DTC by updating the taxes which are the subject of the DTC. These changes reflect amendments to domestic law in Israel.

7.11 Article 4 amends Article II of the DTC by introducing a measure to determine the residence of persons other than individuals who would otherwise qualify as a resident of both territories. Under the DTC the competent authorities will determine the residence status of such persons by mutual agreement, whereas under the 1962 DTC such matters were determined on the basis of the place of effective management of the person. This change was introduced to the OECD Model following the BEPS project and prevents companies manipulating their tax residence for tax avoidance purposes.

7.12 Article 4 also amends the definition of a permanent establishment (PE) in Article II of the DTC, including rules on construction sites and an expanded list of activities that will not be considered to constitute a PE. It also includes a rule that prevents companies fragmenting their activities in order to avoid the PE threshold. This rule was recommended by the BEPS project. The United Kingdom and Israel agreed not to adopt other amendments to the definition of PE recommended by the BEPS project. The Government believes that these additional changes would have a disproportionate effect on commercial transactions and are unnecessary in the light of changes to the transfer pricing guidelines also introduced by the BEPS project.

7.13 Article 4 also introduces additional defined terms for the purposes of the DTC. These accommodate changes elsewhere in the DTC, notably the deletion of Article XII of the 1962 DTC through Article 13 of the 2019 Protocol, and align the DTC more closely to the OECD Model.

7.14 Article 5 replaces Article III of the DTC. This Article determines the taxation of business profits earned by a resident of the United Kingdom or Israel. This provision is updated to align with the OECD Model.

7.15 Article 6 inserts an additional paragraph in Article IV of the DTC. The new provision is in the OECD Model and seeks to prevent the double taxation of profits earned through transactions between associated enterprises.

7.16 Article 7 replaces Article VI of the 1962 DTC. It provides that dividends paid by a company in one territory to a resident of the other territory may only be taxed at 5%

in the territory of source if that resident holds 10% of the share capital (subject to certain ownership requirements) and at 15% in other circumstances. The 1962 DTC provided for 15% taxation in the territory of residence of the company paying the dividend, but only where dividends were subject to tax in the territory of residence of the beneficial owner of the dividend.

7.17 Article 7 also introduces provisions that dividends paid to pension schemes are exempt from taxation in the territory of residence of the paying company and maintains the UK’s right to tax dividends paid by a real estate investment trust at 15%.

7.18 Article 8 replaces Article VII of the 1962 DTC. The 1962 DTC provided that the taxation of interest in the territory in which it arose was limited to 15%. New Article VII provides that interest may be taxed at 10% in the territory in which it arises, with some exceptions. Those exceptions are that interest may be taxed at 5% in the territory of source if paid to a bank resident in the other territory and there will be no taxation in the territory of source if the interest is paid to or by the Government, a political subdivision, a local authority or the Central Bank of the United Kingdom or Israel, to a pension scheme resident in the other territory or in relation to specified corporate bonds. In addition, Article 8 provides that a resident of the United Kingdom or Israel that is taxed on interest in the other territory may elect to be taxed on a net basis in the territory from which that interest is paid.

7.19 Article 9 replaces Article VIII of the 1962 DTC and provides that royalties paid from one territory to a resident in the other shall only be taxed in the territory in which the recipient is resident. The 1962 DTC provided that the territory from which the royalty was paid could tax that royalty at 15%. The article is more generally updated to more closely align with the OECD Model.

7.20 Article 10 modifies the 1962 DTC to align the taxation of capital gains more closely to the OECD Model.

7.21 Article 11 amends the definition of ‘immovable property’ in Article IX(2) of the 1962 DTC. Article 11 also deletes words in Article IX(4) that became otiose following the deletion of Article XII of the 1962 DTC through Article 13 of the 2019 Protocol.

7.22 Article 12 replaces Article XI in the 1962 DTC with a simplified provision. The treatment of pensions that fall within that Article is maintained; such pensions are taxed solely in the territory in which the individual receiving that pension is resident.

7.23 Article 13 deletes Article XII of the 1962 DTC relating to the provision of professional services and other independent activities. This update reflects the OECD Model. The activities referred to in Article XII of the DTC are within the scope of Article III, as amended by Article 5 of the 2019 Protocol.

7.24 Article 14 deletes references to a ‘fixed base’ in Article XIII of the 1962 DTC. These words are no longer required following the changes made by Article 13 of the 2019 Protocol.

7.25 Article 15 follows the approach of the OECD Model article to ensure that income not dealt with elsewhere in the DTC will be taxable only in the territory in which the beneficial owner is resident. This approach does not change that taken in Article XVII of the 1962 DTC. Article 15 includes additional provisions clarifying the treatment of income paid out of trusts and estates and excess amounts paid because of a special relationship.

7.26 Article 16 further specifies the conditions of the 1962 DTC under which double taxation shall be eliminated in each country to reflect changes in the domestic laws and treaty practice of both territories.

7.27 Article 17 expands Article XIX of the 1962 DTC to reflect the latest OECD Model and provides for the exchange of certain information between the two territories in compliance with international standards.

7.28 Article 18 updates Article XX of the 1962 DTC which describes how disputes on application of the DTC will be resolved. The updated Article XX is in accordance with the minimum standard on improving dispute resolution agreed under Action 14 of the OECD/G20 BEPS project. Changes from the 1962 DTC include a deadline of three years for a person to present their case to a competent authority, confirmation that mutual agreements will be implemented notwithstanding time-limits in domestic law and a provision confirming that the competent authorities may consult to eliminate double taxation in cases not covered by the DTC.

7.29 Article 19 modifies the "Limitation of relief" article of the 1962 DTC by introducing the "principal purpose test" (PPT) which aims to deny treaty benefits to those seeking to take advantage of the provisions of the DTC to secure a result which is contrary to their object and purpose. The PPT is one of the minimum standards on preventing treaty abuse agreed under Action 6 of the OECD/G20 BEPS project.

7.30 Article 20 describes how the 2019 Protocol will enter into force and when the provisions of the Protocol will subsequently enter into effect.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 An informal consolidated version of the 1962 DTC will be published on the HMRC pages of the gov.uk website on entry into force of the 2019 Protocol.

10. Consultation outcome

10.1 HMRC regularly consults with external interested parties, including business representatives about the United Kingdom's tax treaty network.

10.2 No representations were made on the 1962 DTC during our consultation in 2018, although external parties were notified that the UK was in negotiations with Israel through the HMRC website in 2014. As explained in paragraph 7.4, the 2019 Protocol will bring benefits to UK businesses, contribute to international efforts to tackle tax avoidance and evasion and reflect other general changes in policy and legislation in the United Kingdom and Israel since the 1962 DTC was signed.

11. Guidance

11.1 General guidance on the operation of the UK's double taxation agreements can be found on the HMRC pages of the gov.uk website at:

https://www.gov.uk/hmrc-internal-manuals/international-manual/intm150000

or in the Double Taxation Relief Manual at:

https://www.gov.uk/hmrc-internal-manuals/double-taxation-relief

This Manual will be updated once the 2019 Protocol enters into force.

12. Impact

12.1 There is no, or no significant, impact on business, charity or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information and Impact Note has not been prepared for this instrument as it is secondary legislation enacting a Double Taxation treaty. DTCs do not introduce new tax burdens; rather, they provide relief from tax and thus are of benefit to business both large and small. Taxpayers may have to make a claim to HMRC or Israel's fiscal authority in order to benefit from the DTC.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses.

13.2 No specific steps are proposed to minimise the impact of the requirements on small businesses (employing up to 50 people).

13.3 The basis for the final decision on what action to take to assist small businesses is that the DTC only applies if they have taxed income arising in Israel. As with other businesses, the impact is negligible. No special approach for small businesses is therefore necessary.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is that both Governments will keep the Protocol scheduled to the Order under consideration to ensure that they continue to meet the policy objectives set out above in Section 7.

14.2 The Order does not include a statutory review clause. In accordance with section 28(3)(a) Small Business, Enterprise and Employment Act 2015 there is no requirement to make provision for review of any secondary legislation that makes or amends provision imposing, abolishing or varying any tax, duty, levy or other charge.

15. Contact

15.1 John Stokes at HM Revenue and Customs, Telephone: 03000 588 827 or john.stokes@hmrc.gov.uk can be contacted with any queries regarding the instrument.

15.2 Fiona Hay, Deputy Director for Business, Assets and International, at HM Revenue and Customs can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Rt Hon Mel Stride MP, Financial Secretary to the Treasury and Paymaster General can confirm that this Explanatory Memorandum meets the required standard.