Client Alert

Foreign Source Income Allocation - New Immigrant Exemption

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Last week, the Central District Court issued a Civil Appeal rejecting a Veteran Returning Resident's argument regarding the allocation of Israeli and foreign source income deriving from his compensation by a foreign company.

The facts of the case involve a developer turned manager who returned to Israel in July 2007, following a significant period of foreign residence. For more than ten years prior to the return the taxpayer worked for EMC Computer Systems company in the UK. In July 2007, the taxpayer moved back to Israel, retaining his position as finance manager and contract with his UK employer, and continued to work with four foreign markets and the Israeli market. Nevertheless, he physically worked from the Israeli office during this time.

The appeal relates to the taxpayer's allocation of income for tax years 2007-2011. During this period, the taxpayer paid tax in Israel on 36.68% of his worldwide compensation (20% of salary and bonus, and 65% of commissions), taking the position that the remainder of his income was exempt as foreign sourced income. The taxpayer claimed that a portion of his income was derived from "assets" developed outside of Israel (financing and marketing methods developed by him while working abroad). The taxpayer allocated another portion equally between Israel and the four foreign markets he supervised.

The ITA rejected the taxpayer's allocation on the basis that it was arbitrary, instead determining that he should have allocated his foreign source income based on the number of days spent working outside Israel during these years.

The Appeals Court ultimately sided with the ITA due to the taxpayer's failure to produce evidence supporting his position, and concluded that the taxpayer's income generates from a service contract, not an asset. The Court begins its analysis by explaining that the term "asset" should be interpreted broadly to enable the legislative intent of the new immigrant exemption:

"…the provisions of section 14(a) of the Ordinance relating to income "sourced from assets outside of Israel" should be interpreted broadly…work methods, sales methods, financial products, and different mechanisms developed by a returning resident during his period of residence outside of Israel should be deemed "assets" for the purposes of the section 14(a) exemption so long as the assets are the property of the returning resident, or the income has a real nexus to them…"

Nevertheless, the Court emphasizes that the burden of proof is on the taxpayer to substantiate that he has an asset outside of Israel from which his income derives, and holds here that the taxpayer failed to produce any evidence supporting his position. The Court also holds that the new immigrant status can commence from midyear even where he spends more than 183 days of that tax year in Israel.

The relevant takeaway here is that if new immigrant choses to implement a method of income allocation other than the conservative number of days method, or takes the position that income derives from an asset, he must have documentation to substantiate that method: e.g., an employment contract that clearly identifies compensation and its basis of computation as distinct from services income.

In light of this case, it would be prudent to advise with counsel whether your income allocation method is viable and substantiated by contractual language.