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Israel Tax Authority Opens Window for Disclosing Assets Located Outside Israel That Generate Income Taxable in Israel: Implications in Israel and the United States

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On November 15, 2011, the **Israel Tax Authority (ITA)** issued a notice (the “Notice”) that establishes a **new voluntary disclosure initiative** (the “Program”) with respect to assets located, and income derived, outside of Israel (“Foreign Assets”). This Program is similar to voluntary disclosure programs in other **OECD** countries, including the United States. A day later, on November 16, 2011, the Acting Director of the ITA, sent a letter to the Chair of the Israeli Bar (the "Letter”), and urged him to circulate the Notice to members of the Bar. The Notice and the Letter emphasized that two of the reasons for initiating the Program in Israel were the enhanced exchange of information among countries in recent years and the diminishing bank secrecy restrictions in many countries. Obviously, the fact that Israel became a member of the OECD also played a key role in the decision to initiate the Program.

In general, with respect to Foreign Assets, the income from which was not reported to the ITA (and taxed accordingly), the ITA will waive penalties, interest and in some circumstances, indexation to CPI, for Israeli taxpayers wishing to join the program. Participation in the Program will also immunize the taxpayer from any criminal liability with respect to the unreported income from the Foreign Assets. The Program will end on June 30, 2012 and the ITA stated that it does not expect to extend it beyond this date. The Program only applies to income derived on Foreign Assets located outside Israel; for any unreported income derived from assets located in Israel, the general rules under the I**srael Tax Ordinance (ITO)** continue to apply. Until December 31, 2002, the tax regime in Israel was generally a “territorial based” regime (with very limited “residency-based” features). Beginning January 1, 2003, in accordance with Amendment Number 132 to the ITO, taxpayers that are considered “residents” of Israel as defined in Section 1 of the ITO generally were subject to tax on their worldwide income regardless of where the income was derived, earned or received. As a result, income derived by a resident of Israel from assets located overseas should have been reported by the Israeli resident in Israel beginning with the 2003 tax year. Taxpayers who were unaware of the transformation of the Israel tax regime into a residency-based regime, and who did not report income from Foreign Assets, will be able to submit an application (“Application”) to participate in the Program. The Application must include all the relevant facts and be submitted to a special committee (the "Committee") that will be established for this particular purpose, and will be comprised of four senior ITA executives.

The Notice provides a non-exclusive list of circumstances which may be eligible for the Program:

1. Unreported income derived from Foreign Assets which were received by way of inheritance or gift from a foreign resident.
2. Unreported income derived from Foreign Assets which were purchased using funds derived from income
earned in Israel or overseas, whether or not such income was taxed in Israel.
3. Income from Foreign Assets which would be subject to tax in Israel beginning 1/1//2003 as a result of the
transformation of the Israeli tax regime into a residency-based regime.

The Notice further provides that the Program will not apply to assets and income generated or derived as a result of a criminal offense classified as a "crime" under the Israeli Criminal Law. In addition, if the taxpayer is already under audit in Israel, s/he generally cannot be admitted into the Program with respect to the same item that is the subject of the audit.

If an Application meets the Program's requirements, the Committee will approve it and, by virtue of such approval, the taxpayer will become immune from criminal liability with respect to the items presented in the Application. The Committee will then review the Application and assess a civil tax liability. The Committee may also seek to sign an agreement with the taxpayer. If the Committee deems it necessary, it may request additional information or documents from the taxpayer, and has the right to summons the taxpayer for a hearing.

If an Application does not satisfy the Program requirements, it will not be accepted; nevertheless (and most importantly), any information included in the rejected Application may not be used in any criminal or civil proceeding against the taxpayer.

In sum, the relief provided by the Program is significantly more generous than the relief provided in any other voluntary disclosure situations not eligible for the Program. (A prior voluntary disclosure procedure was established in April 2005). First, if a taxpayer participates in any voluntary disclosure not eligible for the Program, civil penalties, interest and indexation generally are not waived (the only main benefit of the disclosure outside the Program is presumably the elimination of criminal penalties and liability). Second, in any voluntary disclosure outside the Program, any information included in an application may be used against the taxpayer in civil (but not criminal) proceedings. Thus, there is a clear incentive for taxpayers satisfying the requirements of the Program to disclose under the Program to eliminate criminal exposure, penalties and interest on the Israeli tax underpayment.

For Israeli residents who are also U.S. citizens or possess a U.S. green card that was not surrendered, and who failed to report the income from Foreign Assets in the U.S., there is a U.S. tax exposure as well. Depending on the circumstances, these dual U.S. and Israeli taxpayers could face criminal exposure in the U.S. and face U.S. income tax, penalties and interest. Similarly, Israelis who perform services in the U.S. and earn income in the U.S. are subject to U.S. tax as non-residents. Failure to report this income also can have serious consequences in the U.S.

Like the Israeli Program, the U.S. also allows voluntary disclosure of a taxpayer's noncompliance. The U.S. voluntary disclosure program will eliminate exposure to U.S. criminal prosecution. Unlike the Israeli Program, however, tax, penalties and interest are not forgiven as part of the U.S. voluntary disclosure process. There is no end-date to the voluntary disclosure process in the U.S. as there is for the Israeli Program and the U.S. voluntary disclosure is broader in that it covers all noncompliance derived from domestic or foreign income, including the failure to file or properly complete information returns.

Many of the qualifying factors for the Israeli Program appear in the U.S. voluntary disclosure program as well. A U.S. taxpayer cannot be under audit or criminal investigation and the IRS cannot have received third party information about the taxpayer's noncompliance. Completing a voluntary disclosure in the U.S. requires the filing of accurate and complete amended or delinquent tax returns, appropriate information returns, and any missing or corrected foreign bank account reports.

Given the enhanced information exchanges among tax authorities around the globe and the diminished bank secrecy restrictions, Israeli residents reporting income from Foreign Assets, including U.S. assets, should coordinate their entry intothe Program in Israel with U.S. tax counsel in order to assess their U.S. tax exposure and to consider making a U.S. voluntary disclosure as well.

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