



Harris Consulting & Tax Ltd

August 15, 2010

Attn:

The Sheshinsky Commission

- The Commission For The Review of Fiscal Policy Regarding Natural Oli & Gas Resources in Israel

C/O The Israeli Treasury

fiscalpolicy@mof.gov.il

Dear Commission Members

RE: ISRAELI OIL AND GAS FISCAL POLICY

We are honored to submit to you herewith our comments and recommendations regarding Israeli oil and gas taxation. We are writing in English due to the keen interest felt abroad on this subject. We will be pleased to meet and discuss these aspects further in Hebrew.

BACKGROUND

Now that large quantities of gas have been discovered off the coast of Israel, Israeli taxation rules in this regard must be examined because they are not in good shape. Surprisingly, the main issue is whether Israel has any right to tax it. If so, what is the tax treatment?

The UK faced the same dilemma in the 1960s when oil was found in the North Sea. Did it have any right to tax this enormous source of income?

ASSUMED OBJECTIVES

Any new oil and tax regime needs to impose taxes clearly and modestly, whilst encouraging rapid natural resource exploration and exploitation.

TIMETABLE FOR COMMENTS

We understand that the Sheshinsky Commission is looking into the subject and is expected to submit its findings to the government by October 31, 2010. The public is invited to submit comments to the Sheshinsky Commission by August 15, 2010. This is an open letter to the Sheshinsky Commission. There are a number of issues that need to be addressed:

WHERE IS ISRAEL?

The Israeli Income Tax Ordinance states that income accruing or derived in Israel is subject to Israeli income taxation. So where is Israel? Can Israel tax income from a gas field around 100 kilometers off the Mediterranean coast? This is, of course, a politically loaded question, but we'll do our best to keep to Israeli and international taxation considerations.



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Here's how the term Israel is defined in Section 1 of the Israeli Interpretation Ordinance: "Including its coastal waters." Here's how coastal waters are defined in Section 3 of the Interpretation Law, 1981: "The 12- nautical-mile-wide band of sea along the length of Israel's coast."

So there seems little doubt that income attributable to business done onshore in Israel or within 12 nautical miles from the Israeli coast falls within Israel's territory for tax purposes.

The issue is less certain beyond 12 nautical miles on the continental shelf. Here's how Section 1 of the Israeli Underwater Territories Law, 1953, defines the underwater territory falling within the territory of the State of Israel:

(a) "The territory of the State of Israel shall include the seabed and the subsoil of the underwater areas adjacent to Israel's coast, which are outside the territorial waters, wherever the depth of the water facilitates the exploitation of natural resources in those areas.

(b) Nothing stated in subsection (a) above shall affect the characterization of the water above those underwater areas, and outside Israeli territorial waters, as high seas."

This means that the State of Israel may claim territorial rights regarding a seabed area that is located beyond its territorial waters, wherever it is possible to exploit natural resources in those areas (i.e., on the continental shelf in practice). The Underwater Territories Law, 1953, also emphasizes that the waters above the underwater areas represent high seas.

The Geneva Convention on the Continental Shelf (1958) dealt with the issue of countries' sovereignty over the continental shelf and indicated the applicable customary international law. The Geneva Convention prescribes in Articles 2 and 3 the following: "The coastal State exercise over the continental shelf sovereign rights for the purpose exploring it and exploiting its natural resources. The rights of the coastal State over the continental shelf do not affect the legal status of superjacent waters as high seas, or that of the air space above those waters."

Accordingly, Israel does not have "sovereignty" over the area of the underwater shelf, merely "sovereign rights," which are restricted rights for purposes of exploiting natural resources. Therefore, the seas above the continental shelf and outside of the territorial waters of the State are viewed as high seas that are not.

WHAT DOES ALL THIS MEAN FOR AN OPERATOR?

It would appear that the current Israeli Underwater Territories Law, 1953, is in accordance with the Geneva Convention.

Exploitation of natural resources on or below the seabed any distance off the Israeli coast falls within Israeli sovereign rights.

Nevertheless, there are other situations. There are also many uncertainties that the Sheshinsky Commission will need to address.



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CORPORATE TAX ISSUES FOR THE SHESHINSKY COMMISSION

Following are some corporate tax issues we hope the Sheshinsky Commission will address:

Sovereign rights: It is unclear to some whether “sovereign rights” include taxation rights. The Israel Tax Authority claims that sovereign rights include taxation rights.

- **Recommendation:**

- Clarify by law whether sovereign rights include taxation rights.

Which taxes: If sovereign rights include taxation rights, does this apply to all taxes: income tax, VAT, customs, etc?

- **Recommendation:**

- Clarify by law that all Israeli taxes apply to oil and gas operations conducted within the area of Israel’s sovereign rights.

Revenue royalty: Presumably, the petroleum commissioner will claim that Israel has full sovereign rights to collect the royalty (tax?) of 12.5 percent of oil and gas revenues.

The rate currently is subject to debate. The resulting rate needs to be in harmony with the income-tax system; the royalty must be deductible as an income tax expense of the operator.

- **Recommendations:**

- Charge a royalty comparable with the international average.
- If the present 12.5% royalty rate were to rise, balance this with income tax breaks (see below)

Continental shelf: How far does the Israeli continental shelf extend? For example, does it extend all the way to Gibraltar?

- **Recommendation:** Clarify the extent of Israel’s continental shelf (area of Israel’s sovereign rights).

Exploration: There is a difference between exploration (looking for oil or gas) and exploitation (after commercial quantities are found, extracting and selling them). The current Israeli Underwater Territories Law, 1953, refers to natural-resource exploitation but is silent about exploration.



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This implies Israel has never claimed any sovereign rights over exploration of/below the seabed more than 12 nautical miles off the Israeli coast. Is income from exploration on and above the seabed more than 12 nautical miles off the Israeli coast exempt from Israeli taxes?

- **Recommendations:**

- Define the extent of the continental shelf for tax purposes.
- Clarify that drilling must be vertically on areas of Israel's sovereign rights, not diagonally into any other country's area of sovereign rights.
- Clarify the Israeli tax treatment of exploration activities

Above seabed: Are all activities above the seabed on a ship or a rig more than 12 nautical miles off the Israeli coast (i.e., on the high seas) exempt from Israeli taxes under Israeli and international law? Or if the legs of the rig are anchored on the seabed, can Israel tax them? This question applies to a wide variety of oil and gas activities above the seabed on the high seas: exploration, exploitation, processing (you can't put crude oil in your car, it needs processing; so does gas), sending food and other supplies to the rig by ship, etc.

- **Recommendations:**

- Clarify the Israeli tax treatment of all activities conducted above the seabed in areas of Israel's sovereign rights
- Typically Israel's tax treaties allow only the country where ships operated in international traffic are effectively managed to tax the resulting income

Pipelines: With regard to pipelines for shipping oil or gas ashore from the sea, is the resulting income taxable to the extent a pipeline is buried in the seabed and exempt to the extent a pipeline is above the seabed more than 12 nautical miles off the Israeli coast?

- **Recommendation:**

- Clarify the Israeli tax treatment of transactions and income relating to pipeline activities above and below the seabed in areas of Israel's sovereign rights.



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Aerial activities: Are aerial activities (clearly above the seabed) more than 12 nautical miles off the Israeli coast exempt from Israeli tax, such as helicopter supplies to oil and gas rigs.

- **Recommendations:**

- Clarify the Israeli tax treatment of transactions and income of aerial activities.
- Typically Israel's tax treaties allow only the country where aircraft operated in international traffic are effectively managed to tax the resulting income

Transfer Pricing: What are the applicable transfer pricing rules for allocating income between different activities and locations if they are carried out by different entities in a group? Section 85A of the Income Tax Ordinance requires market pricing in the case of international transactions, but this assumes we know where "Israel" is (see above). Also different methodologies exist.

- **Recommendation:**

- Clarify that the principles of Section 85A shall apply when quantifying profit attributable to transactions between entities within areas of Israel's sovereign rights and related entities outside those areas.

Tax breaks: Since oil and gas are extremely important to the State of Israel, should the State grant tax reductions or exemptions for oil and gas activities? In the past they were said to be available, but now they generally are not, under the Law for the Encouragement of Capital Investments, 1959.

Depletion and amortization allowances are available for oil and gas under the Israeli Petroleum Law, 1952, but these partly accelerate depreciation, which would be claimed sooner or later anyway.

- **Recommendations:**

- Grant income tax breaks under the Law for the Encouragement of Capital Investments, 1959 for Approved Enterprises and Privileged Enterprises.
- Allow appropriate rates of accelerated depreciation for items of equipment based on their useful lives— high wear and tear and multiple shifts per day are expected.
- Allow accelerated depreciation on second hand imported equipment as if it were newly acquired and put into service.
- Determine whether fixed asset grants will be granted – they will of course reduce the depreciable cost of the assets so financed.



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- This may help smooth the way for any adjustment of the 12.5% royalty ate.

Tax treaties: These are the joker in the pack. Israel's tax treaties with 50 other countries contain differing definitions of "Israel" and "permanent establishment," with differing tax consequences. A permanent establishment is, in principle, a fixed place of business or a dependent agent; in practice, it is hard to know if a ship or helicopter operation falls into these categories.

It might be argued that tax treaties cannot impose an Israeli tax liability where none existed before, without each country involved agreeing to this. On the other hand, it might be argued that tax treaties merely clarify things. In practice, review is needed on a case-by-case basis where a treaty applies.

- **Recommendation:**

- Whenever negotiating or renegotiating Israel's tax treaties, clarify whether the principles herein shall apply.

Equipment: Issues arise. If the equipment is, for example, 10 years old when equipment is imported into Israel, and the depreciation rate is 15% on a straight-line basis, does that depreciation start when the equipment is first put into service in Israel (now), or abroad (10 years ago, considered fully depreciated)?

- **Recommendations:**

- Allow appropriate rates of accelerated depreciation for items of equipment based on their useful lives— high wear and tear and multiple shifts per day are expected.
- Allow accelerated depreciation on second hand imported equipment as if it were newly acquired and put into service.

Withholding taxes: Israeli banks are required to withhold 25% tax at source from payments remitted abroad, unless an exemption or tax-treaty relief is requested upfront from the Israeli payor's tax office. This applies to the operation as a whole, as well as interest, royalty, leasing and rental payments (e.g., ship and aircraft chartering, unless the ship or aircraft are operated in international traffic).

This effectively subjects the foreign recipient to an immediate tax audit, to the intense annoyance of everyone, unless the foreign recipient forces the Israeli payor to absorb the withholding tax. If it does, the result may be 33.3% withholding tax on a grossed up basis (a net-of-tax payment of \$100 equates to \$133.33 before the withholding tax). If withholding tax is circumvented, the payor cannot deduct the expense and may incur penalties, etc. This also does not encourage international cooperation.



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- **Recommendations:**

- Do not impose withholding tax on loan interest and leasing payments made regarding items on the continental shelf. Such withholding tax is often difficult to credit abroad due to their high level (up to 25%).
- Alternatively, withhold tax at the regular corporate rate on the gross payments minus related costs – as already permitted for interest under a few of Israel's tax treaties (e.g. Article 13(2)(b) of the US-Israel tax treaty).

WHAT ABOUT THE WORKERS?

Many employees and management personnel in the oil and gas sector will be experienced expats from abroad.

The Sheshinsky Commission will need to address a number of issues including those discussed below

When the personnel work at sea, they will face the same above-mentioned Israeli tax uncertainties.

If they are resident in a different country to their employing company, will they be taxed in Israel? (Partial answer: Yes, if they are US residents under the US-Israel Tax Treaty; No, under most other tax treaties, if certain conditions are met and they are present under 183 days in Israel, as defined in the relevant tax treaty).

If they come ashore to rest in Israel (e.g., two weeks working at sea, two weeks resting in an Israeli port city), will they be exempt? Or should they take their rest in another nearby country? Other issues come to mind, too. Will Israeli and foreign employees enjoy National Insurance Institute coverage, for example, following a work accident on an oil or gas rig at sea? Will foreign personnel readily receive work permits? Will the 20% foreign-workers payroll levy be imposed? Will foreign pension contributions (for example, to a US 401k plan) be recognized for Israeli tax deduction or credit purposes? Will there be double taxation in Israel and abroad of stock-option benefits? Will Israeli resident personnel enjoy the special tax deductions and tax rates for overseas work if they work on a rig, ship or aircraft?

- **Recommendations:**

- Allow expats from abroad easy access to work permits.
- Define work on the Continental shelf/areas of Israel's sovereign rights to include work on a rig, ship or aircraft in these areas.
- Grant approved specialist status for foreign expats working on the continental shelf under Section 50 of the Law for the Encouragement of Capital Investments, 1959. A maximum tax rate of 25% thereunder will be the same as that granted to foreign sportspersons and foreign journalists.



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This is needed as the work may be arduous and Israel is perceived to be a danger zone for oil and gas workers.

- Allow Israeli residents working on the continental shelf to claim the deductions and tax rates applicable to work done abroad, as an incentive to accept such arduous work.
- Clarify whether national insurance cover is available for Israeli and foreign resident workers on the continental shelf. If it isn't, don't collect national insurance contributions.
- Recognize foreign pension plans and stock option plans for Israeli tax purposes.

A SHORT SUMMARY

To sum up, the Sheshinsky Commission will need to address the above-mentioned issues and plenty more (e.g., residency, tax registration and administration, VAT accounting, etc.) if the new oil and tax regime is to raise taxes whilst encouraging rapid natural resource exploration and exploitation.

We will be happy to discuss the above further with you.

Yours very truly

A handwritten signature in black ink, appearing to read 'LEH' or 'LH', written in a cursive style.

Leon Harris, CPA (Israel)

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