High-Frequency, High Complexity: Taxation of a Cross-Border HFT Structure

A US–Israel-Canada Case Study

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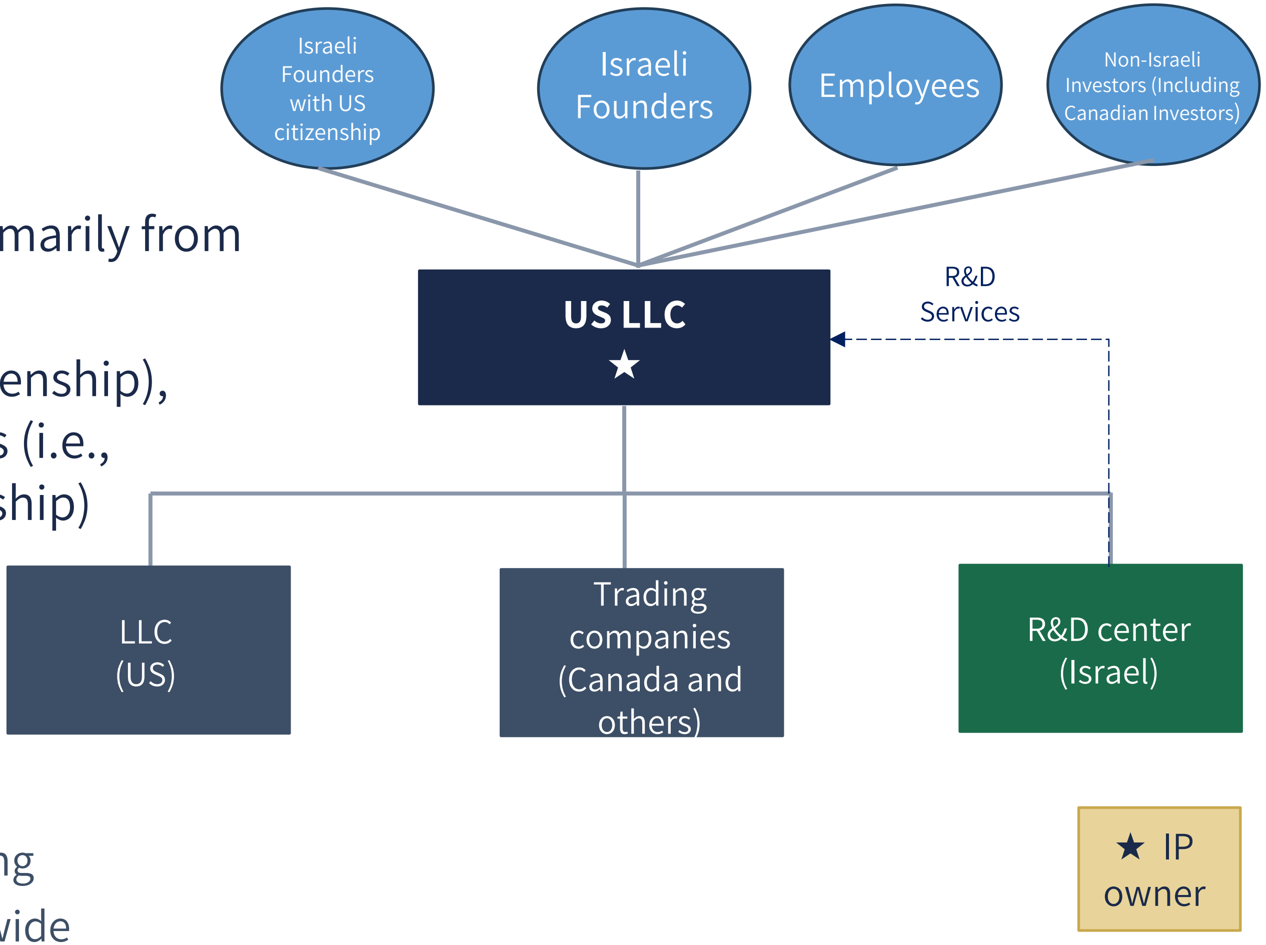
Structure Overview

The Group

- US LLC – parent entity and IP owner.
- Management & control exercised primarily from Israel, other than US CEO.
- Israeli founders (some with U.S. citizenship), employees, and non-Israeli investors (i.e., Canadian Investors with U.S. citizenship) own interests.
- Wholly-owned subsidiaries:
  - US LLC – U.S. trading
  - Israeli subsidiary – R&D operations
  - Canadian subsidiary – Canadian trading
  - Additional trading subsidiaries worldwide



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Israeli Tax Framework – Key Concepts

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Management & Control	• Companies that are managed & controlled from Israel are considered Israeli tax residents under Israeli tax law. • M&C is determined by the location of the actual decision making (daily management and strategic management may be analyzed). • <u>Risk</u>: US LLC with Israeli M&C being treated as an Israeli resident, triggering taxation of its worldwide income (current corporate tax rate 23%). Treaty protection is questionable.
Transparency and foreign tax credit	• Unless a specific election is made by the rightsholder, Israel treats US LLCs as opaque. • Namely, distributions from the LLC are considered as dividends rather than income distribution. • <u>Risk</u>: timing and classification mismatch does not allow Israeli taxpayers to credit their U.S. tax liability against their Israeli tax liability.
Transfer Pricing (TP)	• Israel's TP rules generally follow OECD arm's length principles. • Intercompany transactions (R&D services, IP, loans) must be priced at fair market value. • IP developed in Israel may be considered as owned by the Israeli developer, even if financed by a non-Israeli affiliate, depending on a DEMPE analysis.

U.S. Tax Framework – Key Concepts

Taxation of LLCs

Foreign Tax Credits

- U.S. persons generally get foreign tax credits for income paid to foreign country to prevent double taxation.
- Credit capped at US tax that would have applied to same income. Unused credits carried back 1 year or forward 10 years.
- Cap calculated separately for categories ("baskets") of income – passive, general, GILTI, and treaty-resourced, and can't offset the other.

Effectively Connected Income (ECI)

- U.S. citizens and residents are subject to tax on their worldwide income.
- Non-U.S. persons are taxed in the US on U.S. sourced income: certain passive income (FDAP), income effectively connected to a US trade or business (ECI), and sale of US real property.
- All other U.S. source income other than the above is outside U.S. tax for non-U.S. persons.

Corporate Tax Residency

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Canadian Tax Framework – Key Concepts

Taxation of the LLC's Income

Foreign Tax Credits

- May be available in situations where more than 10% interest is held in U.S. LLC

Withholding

- If withholding is applicable subsection 126(1) of the Canadian tax act may provide a deduction for non-business income tax paid
- However, where a Canadian Corporation owns 10% or more of the voting stock of the U.S. LLC, the U.S. LLC is considered a foreign affiliate ("FA") and the system shifts from a foreign tax credit system to a surplus regime
- Instead, the dividend is designated by the FA as a dividend paid out of a specific "surplus" account. To the extent the FA is earning investment income the dividend would likely be payable out of its "taxable surplus"
- A dividend paid out of "taxable surplus" will effectively provide a deduction from Canadian tax equal to the amount of foreign tax payable on the income

Current Structure – General Tax Analysis

- U.S. tax analysis:
  - The U.S. LLCs are transparent, and the income passes through and is allocated to the members (the "partners") for U.S. tax purposes.
  - Non-U.S. persons: the LLC does not have ECI in the U.S. As such, income allocated to non-US persons is exempt from U.S. tax and can be distributed tax-free.
  - U.S. persons: subject to tax on the LLC's income at the applicable marginal tax rates, even if the income is not distributed.

- Israeli tax analysis:
  - The Israeli subsidiary is subject to tax on its services income at the rate of 23%.
  - Dividends distributed from the Israeli subsidiary are subject to withholding tax at the rate of 30%.
  - The Israeli members are subject to tax only on actual distributions, as dividends income (up to 35%).

Current Structure – Canadian Tax Analysis

- Canadian Subsidiary/U.S. LLC Analysis
  - Tax at the rate of 25% is imposed on taxable dividend or capital dividend distributed by a corporation resident in Canada to a non-resident person (including corporation)
  - Under article IV(1) of the Canada-U.S. Tax Treaty, the U.S. LLC will not qualify as a U.S. resident because it is a fiscally transparent entity for U.S. purposes and not liable for U.S. Tax. Treaty relief is generally unavailable
  - Article IV(6) of the Canada-U.S. Tax Treaty addresses fiscally transparent entities and offers reduced withholding rates. However, as the U.S. LLC is not fiscally transparent in Canada, it will not be entitled to the reduced rates
  - Therefore, dividends paid from the Canadian subsidiary to the U.S. LLC will be subject to a withholding rate of 25%

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Current Structure – Canadian Tax Analysis *(Cont'd)*

- U.S. LLC/Canadian Investor tax analysis:
    - **Individual Investor:**
        - Receives a distribution from a non-resident corporation:
            - Amount is treated as a foreign dividend
            - Included in income and taxed at marginal rates (53.53% effective rate)
            - Foreign tax relief may be available with respect to U.S. withholding taxes.
    - **Canadian Corporate Investor (<10% interest):**
        - Distribution treated as a foreign dividend, Taxed as investment income (50.17% effective rate, subject to refundable tax mechanics)
        - Foreign tax relief may be available with respect to U.S. withholding taxes
        - Distributions to individual shareholders will be subject to additional tax

Current Structure – Canadian Tax Analysis *(Cont'd)*

- U.S. LLC/Canadian Investor tax analysis:
  - **Canadian corporate investor (≥10% interest):**
    - May be a FA depending on % equity interest
    - **Surplus system:**
      - To the extent LLC qualifies as a FA, distributions may benefit from the surplus regime under section 113
      - Potential deductions depending on surplus characterization (e.g., taxable surplus)
      - Distributions to individual shareholders will be subject to additional tax
    - **Key issue: hybrid mismatch**

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Current Structure – Mismatch and Potential Solutions

US View: LLC is transparent	≠	Israeli and Canadian View: LLC is Opaque

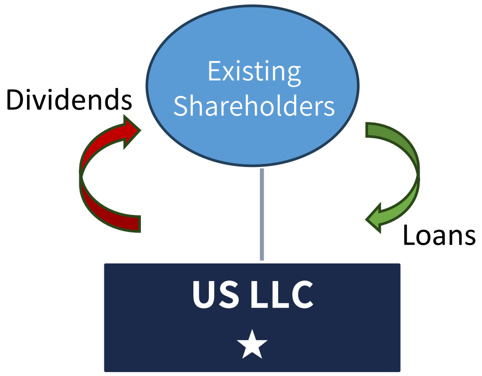
Timing Mismatch: US taxes income annually as ordinary income; Israel and Canada tax upon distribution as a dividend → double taxation risk without a mechanism to align

- Potential solutions:
  - **check the box on the US LLC to be treated as US corp:**
    - Pros: no mismatch on income timing
    - Cons: Two U.S. tax layers instead of one
  - **Elect to treat LLC as transparent for Israeli tax purposes**
    - Pros: no mismatch on income timing
    - Cons:
      - Marginal tax rate applies in Israel (up to 50%); Potential mismatch on income classification
      - No similar mechanism applies in Canada

Current Structure – Mismatch – Implemented Solution

US View: LLC is transparent ≠ **Israeli and Canadian View: LLC is Opaque**

Timing Mismatch: US taxes income annually as ordinary income; Israel and Canada tax upon distribution as a dividend → double taxation risk without a mechanism to align



LLC Makes an Annual Distribution

The LLC distributes a dividend each year sized to match income allocated to each member for US tax purposes. This triggers an Israeli and Canadian taxable event, aligning Israeli and Canadian taxation timing with the US accrual.

Members Loan Back to LLC

Dividend proceeds are immediately re-contributed to the LLC as a loan.

Transfer Pricing Implications?

Current Structure – Additional Issues & Discussion Points

1 Management & Control Risk

LLC managed from Israel → potential Israeli tax residency of the LLC and taxation of worldwide income.

2 IP Ownership – TP Exposure

IP developed by Israeli R&D subsidiary but exploited by U.S. parent creates TP challenges.

3 Israeli CFC

The Israeli rightsholders argue that the LLC is not considered a CFC as its income originates from business activity

Israeli Tax Framework – Preferred Technological Enterprise Regime (PTE)

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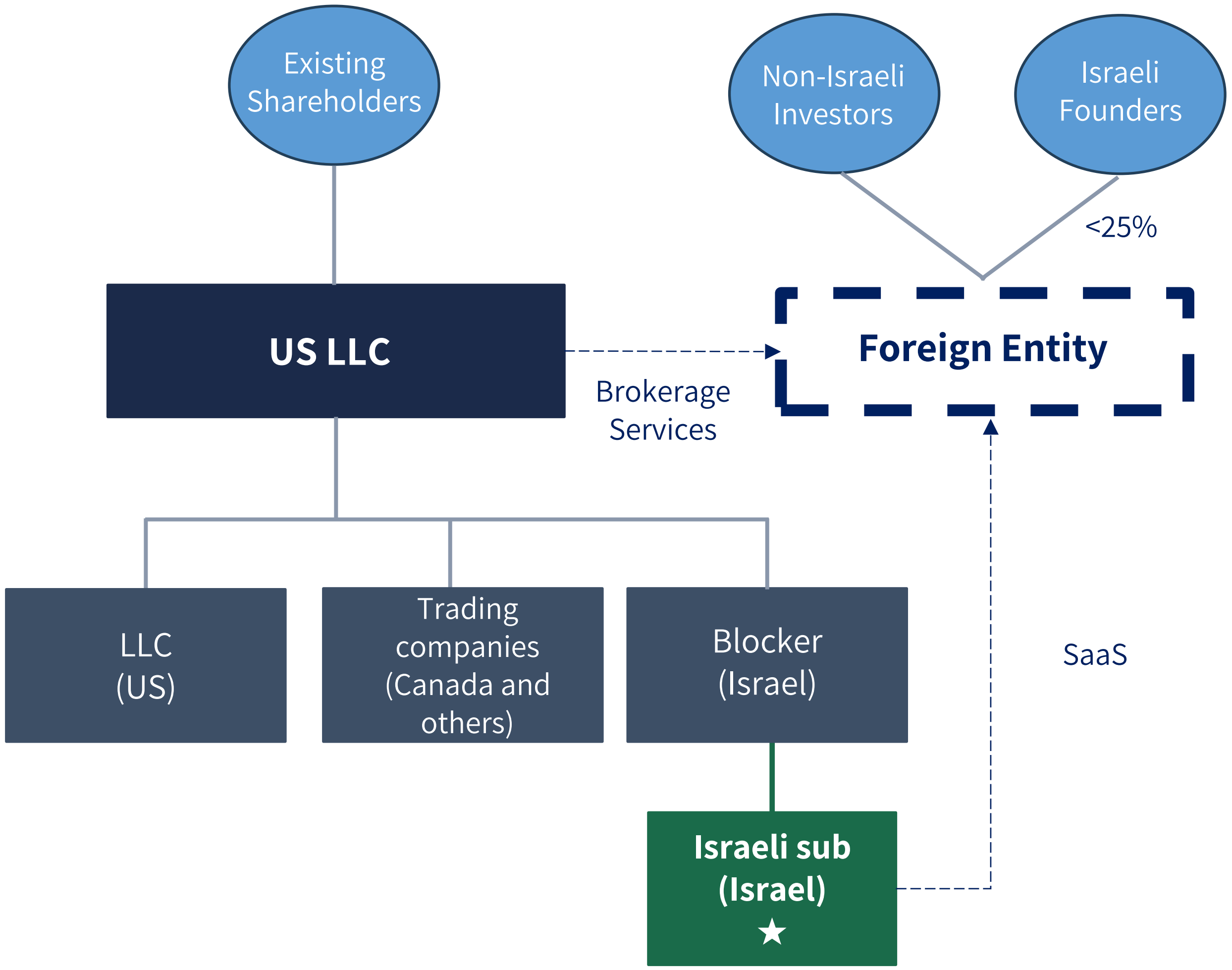
What is it?

- A reduced corporate tax rate regime for companies incorporated in Israel that meet certain conditions and derive income from qualified intellectual property.
- The PTE regime applies to qualifying income (PTI) that includes royalties, income from IP-embedded product and certain IP capital gains.
- The PTI should be "related" to Israel under a "Nexus formula".
- The relevant tax rates (for a company located in a non-preferential zone):

23%	16%	12%	6%
Standard Corporate Rate	Preferred Enterprise	Preferred Tech Enterprise	Special Tech Enterprise

- Withholding tax rate on dividends: 20% withholding, may be reduced to 4% (vs. 25–30% standard).

Proposed Structure – IP Migration to Israel and PTE



Proposed Structure – Potential Benefits

- ✓ Israel R&D may qualify as PTE (PTI subject to 12% corporate tax)
- ✓ Dividends distributed from Israel R&D's PTI are subject to 20% WHT (or less)
- ✓ Reduced TP risk – IP owner and R&D performer are the same entity
- ✓ Reduces management & control exposure due to reduced profits at the LLC
- ✓ Significantly reduces the U.S.-IL mismatch and the annual dividend distribution
- ✓ No Israeli CFC exposure as the U.S. LLC is not controlled by Israeli residents

Proposed Structure – Potential Challenges

- ! Brokerage services are likely to create U.S. ECI
- ! Rightsholders may be required to file US tax returns (unless reverse CTB or blocker is added)
- ! IP transfer is likely to trigger U.S. tax liability for U.S. resident members
- ! Pillar II exposures?

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