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Challenges in taxation of oil and gas partnerships

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Recent years have seen a significant increase in publicly raised capital on the stock market by partnerships engaged in oil and gas exploration, which presents challenges due to existing tax legislation in Israel.

In general, partnerships are not subject to income tax, as they are pass-through entities whereby each partner is taxed on its share of income from the partnership. However, the legislature granted oil and gas partnerships the discretion to elect whether to be taxed as a partnership or a company.

The main tax advantage for oil and gas partnerships to elect to be taxed as a partnership is that a partnership is transparent for tax purposes and its income and expenses are taxable at the partner level. Accordingly, in the first years of the oil and gas partnership's activity, the partnership's large drilling and search expenses and use the losses incurred during those years is attributable pro-rata to its partners based on their holding percentage in the partnership. However, alongside the apparent tax advantage there are also several disadvantages.

In order to facilitate the tax collection process, the legislature stipulated in the Natural Resources Tax Law (5771-2011) that the general partner of the oil and gas partnership (rather than the limited partners) will be responsible for payment of taxes applicable to the partners, based on the partnership's taxable income and the identity of the limited partners. The taxes will be paid by the partnership, regardless of whether it made distributions to the partners. Further, the law establishes that tax proceedings will be administrated only by the general partner and not by the partners, and that any additional taxes due will be paid by the partnership.

However, until the tax audit process is concluded, partners who owned interest in the partnership during the tax year that is under audit and who should have borne the actual tax liability for that year, may have sold their partnership interest. Consequently, new partners who did not own interest in the partnership during the audited year may now become liable for taxes of partners who owned interest in the partnership during the audited year. Hence, the process established in the law creates a distortion under which present partners will pay additional tax for past partners who benefited from the partnership's profits in a particular year.

The court is currently deliberating on possible ways to solve this distortion in the framework of two originating motions submitted by oil and gas partnerships which encountered this problem.

In addition, the Israeli Tax Authority is leading efforts to pass an amendment to the Income Tax Regulations (Rules for Calculation of Tax for the Holding and Sale of Participation Units in an Oil Exploration Partnership) (5749-1988). The amendment would enable oil and gas partnerships to be taxed as partnerships (ie, as pass-through entities) only until they have taxable income and from such point forward the oil and gas partnership would be taxable as a company for all intents and purposes. If this amendment passes, it could resolve the above-described distortion, because in a company, in contrast to a partnership, the applicable tax is a liability of the company itself and therefore eliminate the problem of tax-shifting between partners from different periods.

Nonetheless, if this amendment passes, it will increase the effective tax liability of partners that are tax-exempt entities pursuant to Section 9(2) of the Israeli Income Tax Ordinance (New Version), 5721–1961, which have reported their allocable share of income from oil and gas partnerships as an exempt income. In the interim, the Israeli Tax Authority has recently published a draft list of reportable transactions for 2020, which includes a requirement that a tax-exempt entity reporting its income from oil and gas partnership as an exempt income, should specifically disclose such a position in its tax return as a reportable transaction.

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