State of Israel

Income Tax Reform

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Please notice,

The following review (written in a presentation format) is a general overview of the reform in Israel. This synopsis does not include all details or applicable criteria. It is in no way intended to serve as substitute or formal interpretation of the law. For all purposes, the binding version is that of the law itself as exists at any given time.

Main Aspects of the Tax Reform

Reducing the tax burden on employment income
Taxation of foreign income
Taxation of the capital market
Tax relief for foreign residents & new residents
Encouraging business and technology entrepreneurs
Real Estate Tax Reform (starting: Nov. 7, 2001)

1. Reducing direct taxation rates on income

- **Gradual reduction of tax rates starting January 1, 2003**
- **Final status from January 2008 onward**
- **Most tax reduction – in middle income brackets**

Current Status*

- **Monthly gross income of $2,150 is taxed at an overall marginal tax rate of 50%**
- **Monthly gross income bracket of $3,870-$7,150 is taxed at an overall marginal tax rate of 60%**
- **Tax rate on monthly gross income in excess of $7,150 declines to 50%**

*
To this end overall tax rate is inclusive of social security payments

Policy Targets

Following Reform

- As of January 1, 2008, the marginal tax rate inclusive of social security on a monthly income of $7,150 will amount to 49%.
- Until January 1, 2008 gradual reduction of tax rates.

2. Taxation of foreign income

Frame of Discussion

- Taxation of Income derived in Israel by non residents.
- Taxation of Income derived abroad by residents of Israel.

Bases of taxation:

From Personal Method → Territorial Method

Highlights - International Taxation

- Transition to a world wide taxation
- Determination of residence
- Source Rules
- Foreign "Vocation Company"- taxed in Israel
- Foreign corporations controlled by Israeli residents- taxation in Israel
- Off-setting foreign losses
- Foreign Tax Credit
- Transfer Pricing
- "Exit tax" levied on Israeli individuals changing their residency

Transition to a Personal Tax Base System

"Income Tax shall be payable, subject to the rules of this Ordinance, for each tax year, at the rates specified below, on the Income of the Israeli resident derived or accrued in Israel or abroad and on Income of foreign residents derived or accrued in Israel from these sources: …"

This Article brings Israeli residents to be taxed on Income derived in Israel or abroad. Foreign residents will be taxed on Income accrued in Israel.

Definition of "Israeli Resident" for Individuals:

Israeli resident (Individual) - the "Center of Life" rule:

The basic rule for determining residency of individual is the center of life rule, witch takes into account family relationships, economic and social ties.

"Presumptions"

An Individual's center of life is presumed to be in Israel in the tax year if -

- He was present in Israel 183 days or more during the tax year; or
- He was present in Israel at least 30 days during the tax year and his accumulated periods of stay in the tax year and in the two previous years was 425 days or more.

The presumptions may be rebutted by either Individual or Assessing officer.

Authority to determine residence for classes of Individuals

The Minister of Finance is given power to determine that Individuals who would have been deemed Israeli residents according to the presumptions, would not be presumed so, and vise versa.

Examples: athletes, artists, diplomats, journalists.

Definition of "Israel Resident"- for a body of Persons

Broadening the current definition to include -

- Body of Persons Incorporated in Israel
- Body of Persons Control and Management of whose business are exercised in Israel.

Source Rules (for determining Income location)

Article 4a, and 89(d) set rules for determining the location of accrual of income (Income location)

The purpose of determining the location of income is to determine in what cases a resident of Israel shall be entitled to foreign tax credit and in what cases a foreign resident will be charged tax in Israel.

The Source Rules

- Business Income - The place where the Income bearing business activity is exercised.
- Transaction or incidental deal of a commercial character - The place where the transaction or deal is made,
- Income from vocation - the place where the service was provided.
- Employment Income - the place where the work was preformed
- Interest, discounts and linkage differentials - place of residence of the payer
- Rental fees and Payment for usage - the place where the asset was used
- Income or profit, including Royalties derived from Intangible Property - place of residence of payer
- Allowance paid for employment - place of residence of payer
- Other allowance - place of residence of payer
- Agricultural Income - location of the income bearing asset.
- Dividend - place of residence of the body of persons paying the Dividend.

The Source of Capital Gain shall be located in Israel if either:

- The alienated asset is in Israel
- The asset is outside of Israel but is a right, direct or indirect, to an asset in Israel – with regard the portion of the consideration derived from the asset in Israel.
- The asset is a share or a right to a share in an Israeli body of persons.
- The asset is a right in a foreign body of persons, that owns a right, direct or indirect, to an asset in Israel, with regard the portion of the consideration derived from the asset in Israel.

Foreign Vocation Company - Article 5 (5)

A foreign body of persons that fulfills all of the following:

- The company is a “close company” according to article 76(a) of the

Ordinance (the company is controlled by up to 5 members);
- 75% or more of the means of control are held directly or indirectly by individuals residents of Israel;
- Most of the controlling members or their relatives carry on a vocation on behalf of the company;
- Most of the company's income or profits are derived from a vocation.

- Income accrued by an FVC from activities preformed by a controlling member himself, through his relative or through a company under his control, in the professions determined by the Minister of Finance - shall be taxed in Israel as income accrued in Israel.
- With regard its income from vocation or employment, an FVC will be deemed to have control and management of its business exercised in Israel.

Controlled Foreign Corporations

Taxation of Controlled Foreign Corporations held by Israeli residents:
A new Article 75b was added, setting rules for controlling members, residents of Israel, who holds at least 10% of the means of control in a company of which most of its income or profits are passive and more than 50% of the controlling means are held by Israeli residents.

<u>“Controlled foreign corporation” fulfills all of the following:</u>
- Foreign resident body of persons;
- More than 50% of the “means of control” in that body are held by Israeli residents (directly or indirectly);
- Most of the company’s income or profits are passive (not from business/ vocation);
- The company’s shares are not traded on a stock exchange;
- The rate of tax on the company’s passive income in the source country does not exceed 20%.
- <u>The date for examining the holding rate</u>
- End of tax year; or
- Any one day during the tax year and the following tax year

<u>“Profits”:</u>
- Income after deductions (including taxes) and set offs, provided that no dividends were paid that year to share holders.

- The profits are calculated according to the tax laws of the foreign holding company's country of residence except in cases where the place of residence is not in a "reciprocal country" in which case the profits will be calculated according to accepted accounting rules in Israel.

"Controlling Member"

- **A resident of Israel (including an Israeli Citizen resident of "the area") holding at least 10% of the means of control in the company.**
- **Adjustments for dividend distribution and capital gains.**
- **Tax credit granted at time of actual dividend distribution, or at time of sale**.

Rules for setting off foreign losses - Article 29

- Foreign losses are considered as though accrued from a single country;
- Foreign losses are set off against foreign income;
- Losses from passive activity distinguished from business and vocation losses;
- Exception: excess loss from foreign business of which control and management are from Israel, is permitted to be set off against income accrued or derived in Israel. The outcome of this set off: chargeable income from foreign business- is considered income accrued in Israel up to the amount of the set off loss.
- Capital loss from sale of asset abroad: shall be set off first against foreign capital gain.

Foreign tax credit -The basket method:

- Tax credit shall be granted according to the "basket method": each source of income from all foreign countries shall be summed up separately.

- "Foreign income from a certain source": all income accrued abroad from the same type of source, one of which is listed as a taxable income source in articles 2, 3, 89 and part E3 (capital market).

Tax credit rules :

- Foreign tax credit shall be granted to Israeli residents only.
- Foreign taxes shall offset Israeli tax levied on the same income, while separating income from different sources.

- No credit will be given for income exempt from tax in Israel.
- Foreign tax credit on income from a certain source will not exceed the amount of tax chargeable in Israel that source of income.
- Access foreign tax can be carried up to 5 years forward.

Transfer pricing in International Transactions

- Adopting the arm’s - length principle.
- Setting the framework for determining and adjusting transfer pricing.
- Authority grunted to the Minister of Finance to make rules.
- Gives the assessees a possibility of reaching advance pricing agreement.

An Individual that ceased to be a resident of Israel

- “Exit” tax levied on an individual who ceased to be a resident of Israel.
- Possibility of deferring the tax payment to the time of actual sale.
- Value calculated according to linear method.

3. Capital Market

Capital Gains on sale of tradable securities

The Rule:
As from January 1, 2003, tax shall be levied on sale of tradable securities by individuals and companies to whom the Law of Adjustments doesn't apply.

Exceptions:
Foreign investors will remain exempt from capital gain tax on the sale of shares traded on the Israeli stock exchange.

Calculation of Profit from Sale of Securities

- Tax charged on profits accruing after the Determining Date.
- When selling securities purchased before the Determining Date, The assessee can choose between 2 options for calculating the original cost:
  - Average value of the security on the last three trading days of 2002.
  - Actual cost price of the security.

Tax Rates on Sale of Securities Traded on the Israeli Stock Exchange

The Rule:
15% tax rate upon sale provided that:
- No financing expenses were deducted.
- The sale is not to a “relative”.

Exception:
10% rate on sale of non-linked securities.

Tax Rates on Sale of Foreign Securities

- Capital gain from sale of foreign securities traded on foreign exchanges that have been purchased from the beginning of 2007 and on shall be charged at a tax rate of 15%.
- Sale of foreign traded securities until the end of the year 2006 shall be charged at a tax rate of 35%.

- Sale of foreign traded securities purchased before 1.1.2007 and sold after 1.1.2007 – tax rates shall be applied following linear division of the gain.

Tax Rates on Interest Income

- Tax charged at a rate of 15% on interest received by an individual in the following cases:
  - Interest on linked bonds issued after May 8, 2000.
  - Interest paid on foreign traded securities during 2007 and on. (35% for interest paid before that)
  - Interest from approved savings programs opened after May 8, 2000.
  - Bank deposits out of Israel - made in institutions operating according to their domestic law.
- Tax charged at 10% on interest received by an individual, if the asset is not linked.
- All other interest shall be charged at the marginal tax rate.
- No interest expenses shall be deducted from interest Income.

Dividend Income

- Dividends received by individuals - no change in present law - 25% tax rate.
- Dividends from foreign traded securities:
  - Until the end of 2006 - 35% tax rate,
  - From 2007 – 25% tax rate.
- Dividends received from outside of Israel by corporations (including dividend from foreign traded securities) shall be charged 25% tax.

Tax rates on passive income received by Israeli residents

Description of income	Source of income	Interest	Dividend	Capital Gain	Comment
Shekel deposit	Israel	10%			Non-Linked
Shekel deposit	Israel	15%			Linked
Foreign Currency deposit	Israel	15%			20 year exemption for qualified deposits of new residents. Exemption for qualified deposits of non residents.
Foreign Currency deposit	Foreign	15%			5 year exemption for new residents & returning resident.
Non-tradable Shares or bonds	Foreign/ Israel	50%	25%	25%	
Tradable Shares or bonds	Israel	15%	25%	15%	

Description of income	Source of income	Interest	Dividend	Capital Gain	Comment
Tradable share or bond 2003-2006: 2007 and on:	Foreign	 35% 15%	 35% 25%	 35% 15%	Shares held before 2007: linear calculation based on real gain over time period. Capital gains: 10 year exemption for new residents &returning residents.
Trust Fund Unit 2003-2006: 2007 and on:	Foreign		 35% 25%	 35% 15%	Shares held before 2007: linear calculation based on real gain over time period. Capital gains: 10 year exemption for new residents &returning residents.

4. Foreign residents & new immigrants

Tax relief for foreign residents

- Tax exemption for foreign residents In Venture Capital Funds:
  Investment by foreign investors through Venture Capital Funds is tax-exempt in accordance with prior approval.

- Exemption from capital gain tax:
  - Exemption from capital gain tax on the sale of shares in a qualifying "Research & Development company".
  - Exemption from capital gain tax on the sale of tradable securities.

Tax relief for "Olim" (new immigrants)

- "New immigrant" – Individual who was not a resident of Israel and became a resident of Israel.

- "Returning Resident" – Individual who left Israel, lived continuously outside of Israel, and returned to Israel not sooner than 3 years after having ceased to be a resident of Israel.

- Reduction of tax on pension:
  - Reduction of tax on pension received by a new immigrant of Israel, on account of employment or work in a foreign country (including self employment).
  - The tax rate shell not to exceed the tax that would have been paid on that same pension, if he would have remained a resident of said country.
  - The relief is not limited to any maximum periods.
  - This relief is also granted to those who came to Israel before the amendment of the tax law.

5 year tax exemption on passive income:

- Interest, dividends, allowances, royalties and rental income accrued from assets outside of Israel that were owned before becoming a resident, are exempt for 5 years.

    - This relief is extended by transitory provisions.

- Tax exemption on passive income for returning residents
    - Returning residents are entitled to a relief on passive income, provided the bearing assets were purchased abroad, after they ceased to be residents of Israel.
    - This relief is extended by transitory provisions.

- 4 year exemption on business income:
    - Income from a business owned by a new immigrant during 5 years before he became resident of Israel is exempt from tax for 4 years after the change of residence.
    - This relief applies whether or not the new resident continues to participate actively in the business.

- Temporary provision:
    - Applies to individuals who became residents of Israel and who are controlling members and managers of an approved enterprise as defined in the Law for Capital Encouragement.
    - Exemption from tax during the tax years 2003-2006 on income from interest, dividend and rent, subject to certain conditions.

- Additional relief for foreign investors:
    - The Minister of Finance is authorized to make regulations intended to give additional relief to foreign investors in an approved enterprise, who have subsequently become new Israeli residents.

- Relief for capital gain of new immigrants:
    - Exemption from capital gain tax for assets sold within 10 years of becoming a resident.
    - Applies to assets outside of Israel owned before becoming a resident.

- Relief for capital gain of returning resident
    - Exemption from capital gain tax for assets sold within 10 years becoming a resident.
    - Applies to assets acquired abroad after ceasing to be an Israeli resident.

- Partial relief for sale after the period of relief:
    - Assets sold after 10 years of becoming a resident shall be entitled to a partial relief, calculated according to relative periods.

5. Encouraging Business & Technology Entrepreneurs

Encouraging Business & Technology Entrepreneurs

Reduction of capital gain tax rates:
Capital gains from the sale of capital assets other than tradable securities, shall be reduced to 25% for both individuals and corporations (similar to the reform in real estate taxation).

Linear Reduction:
The reduced tax rate shall apply to all sales occurring after January 1' 2003, on a proportional part of the profit, calculated linearly.

Shares and options for employees:
Options or shares given to employees shall be considered as income only upon their sale (provided the securities were deposited with a trustee approved by the Assessing officer).
The issuing company may choose either method of taxation when issuing the securities:
Method A - **Revenue Income** - The employee is deemed to have received employment income; the employer may deduct expenses.
Method B - **Capital Income** - The employee is taxed as having received capital gains (25% tax); the employer may not deduct the expense.

The "look through" Company
- Replacing the "Family Company".
- The chargeable income and losses of the "look through" company shall be charged in the hands of the shareholders, according to their share of the rights to profits.
- The "look through" company is an Israeli resident and its shareholders are Israeli individual residents.

Venture Capital Funds:
The exemption for foreign residents shall be expanded by lowering the criteria.

Investment of foreign residents in R&D companies:
Such investment, by way of issuing shares shall be exempt from capital gain tax upon realization.

Exemption on traded securities:

Foreign investors will remain exempt from capital gain tax on the sale of shares traded on the Israeli stock exchange.

Foreign investments:

Encouragement of foreign investments under the Encouragement of Capital Investments Law.

6. Real Estate Tax Reform
General

In addition to the Income tax reform, the taxation of Israeli real estate was also recently changed pursuant to the Real Estate Taxation Law (Appreciation, Sale and Acquisition) (Amendment 50) 2002, effective from November 7, 2001.

The main aims were to simplify the legislation, remove certain distortions and reduce tax rates in order to stimulate the Israeli real estate market.

Capital Gains

- Inflation-adjusted gains on the sale of real estate:
  - Time based portion of gain derived after November 7, 2001- “land appreciation tax” at a rate of 25%
  - Gains derived before then remain taxable at regular rates (individuals - up to 50%, companies - 36%).
- The resulting tax liability will be further reduced by 20% if the real estate is either sold or was purchased in the period from November 7, 2001 to the end of 2 002. A 10% reduction will apply if the sale purchase occurs in 2003.
- Special land appreciation tax rates of 12% - 24% for real estate acquired up to 1960 will be phased out.
- The grant of a real estate option will no longer be considered a taxable sale, subject to certain conditions.

Other Transaction Taxes

Maximum rate of “acquisition tax” payable by purchasers of residential homes reduced from 5% to 4.5% in the period from November 7, 2001 to the end of 2002 and to 4.75% in 2003.

“Sale tax” of 2.5% payable by sellers of real estate repealed for residential homes on November 7, 2001. The sales tax was repealed for non-residential real estate that was acquired after November 7, 2001. The sales tax in effect for non-residential real estate acquired before November 7, 2001 but will now be deductible for land appreciation tax purposes.

Finance Expenses

Inflation-adjusted mortgage interest relating to real estate acquired after November 7, 2001 will now be deductible for land appreciation tax purposes, i.e. upon sale of the real estate.

Real estate entity

- Upon a sale of a "real estate entity" whose assets are mainly Israeli real estate, liabilities of the entity will now be deductible for land appreciation tax purposes.
- The liabilities will remain non-deductible for acquisition tax purposes.
- Tax free reorganization rules have been expanded.
- The issue of additional shares by a real estate entity will no longer expose existing shareholders to land appreciation tax on their dilution, nor will acquisition tax apply.

Tax deferred "rollover"

- A tax deferred "rollover" will apply to real estate sold in the period from November 7, 2001 to the end of 2003
- Condition: the proceeds are reinvested within 12 months before or after the sale in a business property or development land.
- Other tax deferred rollovers are available for agricultural land, residential homes in the same period.
- Detailed conditions apply in each case.

Redevelopment projects

In redevelopment projects, an exemption will be available to residential home owners that exchange their home for a replacement home in the new project.

Combination deals

If land owners exchange part of their land in the period from November 7, 2001 to the end of 2003 with a constructor in exchange for building services ("combination deals"), tax on the exchange may be deferred until the completion of construction, or sale of remaining land rights, whichever occurs first.

Approved Rental Buildings

Tax rates of 10% - 18% will apply to income and gains derived by **companies** from certain "approved rental buildings" if at least half the floor space is designated for residential rental for at least 5 years.
A 25% tax rate will apply to **individuals**.

Approval is obtainable from the Israeli government's Investment Center.