TAX MANAGEMENT
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FOREIGN INCOME

Business Operations in Israel

by

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This Portfolio revises and supersedes previous versions of 7180 T.M., *Business Operations in Israel*.

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TAX MANAGEMENT
PORTFOLIOS™

FOREIGN INCOME

Business Operations in Israel

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Business Operations in Israel*, No. 7180, gives businesses (in particular, American businesses) and their professional advisers the technical tax and corporate data, as well as the general background information they should have in order to properly evaluate a proposed commitment in Israel and to cooperate fruitfully with Israeli counsel and CPAs. The Portfolio analyzes the Israeli income tax structure in depth and pays particular attention to the important Law for the Encouragement of Capital Investments.

Israeli tax law and forms of business organization are based on English law. American practitioners will find few concepts strange to them. Throughout this Portfolio, an effort has been made to emphasize those aspects of Israeli law and practice which differ from their American counterparts.

The Worksheets contain, among other material, a model articles of association updated and compatible with the Companies Law. The Detailed Analysis analyzes the problems confronting persons contemplating an investment or a business in Israel. A guide to the Detailed Analysis is provided by a Table of Contents.

This Portfolio may be cited as Rafael, 7180 T.M., *Business Operations in Israel*.

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DETAILED ANALYSIS

I. Introduction

A. *General Background*

1. *The Country*

The State of Israel is located in the Middle East. To the southwest, Israel borders the Arab Republic of Egypt, to the east, Jordan and Syria, and to the north, Lebanon. A coast of 188 km along the Mediterranean Sea forms the western boundary of Israel. The northern part of the country is mountainous, while the southern part of the country is an arid desert comprising more than 60% of the country.

Israel administers an additional area, namely parts of the West Bank (apart from the areas under Palestinian autonomy, as discussed below). An accord of September 1993 with the Palestine Liberation Organization (PLO) established self-government in major parts of the West Bank and the Gaza Strip. On July 25, 1994, Israel signed a peace treaty with the Hashemite Kingdom of Jordan.

Israel has a population of approximately 9.88 million people as of March 2024, excluding the administered territories in the West Bank. Approximately 73% of the population is Jewish, with the rest of the population largely composed of Arabic communities. More than 90% of the population lives in urban areas.[1]

As the capital, Jerusalem is the seat of Israel's government, parliament, and Supreme Court, and also the largest city, while Tel-Aviv is the financial center of Israel. Hebrew is the official language while Arabic is a recognized state language with a special status. The Israeli new shekel (NIS) is the official currency.

2. *The Government*

Israel is a parliamentary democracy,[2] consisting of legislative, executive, and judicial branches. Its institutions are the presidency, the Knesset (parliament), the government (cabinet of ministers), and the judiciary. The system is based on the principal of separation of powers, in which the executive branch (the government) is subject to the support of the legislative branch (the Knesset) and the independence of the judiciary is guaranteed by law.

Israel's government is headed by a prime minister, who must enjoy the support of the Parliament at all times. In national elections, voters elects a party rather than a specific candidate. The votes for a party are allocated based on the number of votes it obtained. Representation is therefore proportional. The president designates a member of parliament who in their opinion can form a government that will enjoy the support of the legislature to form such a government. The government and the prime minister take office once the support of the parliament has been obtained. General elections are held every four years. The prime minister is entitled to dissolve the parliament,[3] and thus call for general elections.

B. *Sources of Law*

1. *Sources of Law*

The legislative authority in Israel is the "Knesset," which is the Israeli parliament.[4] It is comprised of 120 members. Generally, legislation can be initiated by the Government or by the members of the Knesset.

Government bills are discussed in the Knesset in three stages called "readings" before becoming law, whereas private bills introduced by members of the Knesset are given four readings. Government bills are published in the Official Gazette of Government Bills and are presented to the Speaker of the Knesset, who places the bills on the Knesset table. During the first reading, the plenum holds a debate about the bill, in which all members of the Knesset are allowed to participate, and at the end of the debate the Knesset decides whether the bill should be removed from the agenda or not. To the extent the bill is removed from the agenda, an identical or similar bill will not be discussed in a preliminary reading during the following six months. To the extent the bill is approved in the first reading, it is assigned and discussed in the appropriate Knesset committee. The committee can decide to prepare the bill for the second and third readings, or to propose to the Knesset that the bill be removed from the agenda as well as to suggest amendments to the bill.

In the second reading, after the committee has completed its work, the Knesset discusses the bill, including any reservations that may have been provided with respect to the bill. If there are no reservations, the Knesset will vote on each article of the bill as was drafted by the committee. The Government is entitled to withdraw a government bill at any point until the voting during the third reading. This vote usually occurs immediately after the vote on the bill's articles in the second reading. However, if there were reservations, the vote may be postponed by a week. During the third reading, the Knesset votes on the final version of the bill as a whole as it was approved in the second reading, with no discussion beforehand. After passing the third reading, the bill is published in the Official Gazette and becomes a law.

Israel does not as yet have a constitution. Since the Constituent Assembly and the first Knesset were unable to draft a constitution, the Knesset started to legislate basic laws on various subjects. It is intended that once all the basic laws are enacted, together they will constitute, with an appropriate introduction and several general provisions, the constitution of the State of Israel.

[1] Unless mentioned otherwise, the data in this chapter was gathered from the Central Bureau of Statistics (www.cbs.gov.il).

[2] Basic Law: The Knesset, s. 1.

[3] Basic Law: The Government, s. 29.

[4] The Knesset, https://main.knesset.gov.il/EN/Pages/default.aspx.

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There are different opinions regarding the question of the superiority of the basic laws over other laws. Some claim that the basic laws are not superior to ordinary laws, unless they include a specific stipulation to the contrary. They base their positions on the argument that, since a basic law is passed by an ordinary majority (i.e., a majority of those voting), such a majority cannot grant superior status to a piece of legislation. Others claim that the superiority of basic laws stems from the fact that they are the product of the Knesset acting as the Constituent Assembly, and that from their mere definition as "basic laws" one may conclude that they are constitutionally superior.

The Israeli current legislation does not provide a direct answer in a situation where there is a contradiction between a basic law and an ordinary law. The situation has not yet been addressed in any law, but the High Court of Justice has dealt with this issue un several rulings providing that basic laws are superior to ordinary laws and that a provision of an ordinary law may be null and void to the extent that it contradicts the provisions of a basic law.[5]

The primary source that may be used to interpret a certain law are the "explanatory notes" published along with the law's bill. In addition, the Knesset committees' protocols may also be used to determine the intention of legislators and to review the discussion that took place during the legislative process. Professional literature published by law professionals and the Israeli Courts' rulings may also be used to interpret Israeli laws.[6]

2. The Court System

Israel is a unitary state with a single system of general law courts. There are three levels of courts: the Supreme Court, District Courts, and Magistrates' Courts. The latter two are trial courts, while the Supreme Court is essentially an appellate court, which also operates as the High Court of Justice. However, there are no jury trials in Israel, as cases are heard by professional judges.

a. Magistrate's Courts

The Magistrates' Courts are the basic trial courts of the Israeli system. They have jurisdiction in criminal matters where the accused is charged with an offense that carries with it a potential punishment of up to seven years imprisonment. In civil matters, these courts have jurisdiction in matters up to NIS 2.5 million. These courts also have jurisdiction over the use and possession of real property. Magistrates' Courts also act as traffic courts, municipal courts, family courts and small claims courts.

b. District Courts

District Courts are the middle level courts of the Israeli judiciary. They have jurisdiction in any matter that is not within the sole jurisdiction of another court. In criminal matters, District Courts hear cases where the accused faces more than seven years imprisonment. In civil cases, District Courts' jurisdiction extends to matters in which an amount of more than NIS 2.5 million is in dispute. District Courts also hear cases dealing with companies and partnerships, arbitration, prisoners' petitions, and appeals on tax matters. District Courts hear appeals of judgments of the Magistrates' Courts and also sit as Administrative Courts with respect to certain administrative matters, as provided under the Courts of Law for Administrative Issues Law, 2000.

In 2010, a Financial Court was established as the financial department of the District Court in Tel Aviv. The Financial Court handles civil and criminal financial cases. It has exclusive jurisdiction with respect to indictments regarding offenses under the Securities Law, certain civil cases arising with respect to the Companies Law and the Securities Law, including, inter alia, derivative claims and class actions, and administrative appeals against the Israel Securities Authority, the Tel-Aviv Stock Exchange and the Registrar of Companies.

c. Supreme Court

The Supreme Court has jurisdiction to hear criminal and civil appeals from judgments of the District Courts. Cases that begin in the District Court are appealable, as of right, to the Supreme Court. Other matters may be appealed only with the Supreme Court's permission.

d. High Court of Justice

The Supreme Court also sits as the High Court of Justice. This function is unique to the Israeli court system because as the High Court of Justice, the Supreme Court acts as a court of first and last instance. The High Court of Justice exercises judicial review over the other branches of government and has powers in matters in which it considers it necessary to grant relief in the interest of justice and which are not within the jurisdiction of any other court or tribunal.

As a High Court of Justice, the Supreme Court hears over a thousand petitions each year. Often these cases are high-profile ones challenging acts of top government officials. Through its jurisdiction as a High Court of Justice, the Supreme Court upholds the rule of law and enforces human rights.

3. Arbitration

In 1968, the Knesset legislated the Arbitration Law, and in 2018 it came into force.[7] The law applies to both domestic and international arbitrations held in Israel. Israel has several well-established arbitration institutions, including the Israel Chamber of Commerce, the Tel Aviv Chamber of Commerce, and the Israel Bar Association. Arbitration is recognized and accepted in Israel as an effective alternative to litigation for resolving commercial disputes.

The Israeli Arbitration Law grants parties the freedom to agree on the arbitration process through an arbitration agreement, which can include the selection of arbitrators, the applicable rule, and the language of the arbitration. If the parties cannot agree on the selection of the arbitrator, the court can assist

[5] Civil Appeal 6821/93 *Bank Hamizrahi Hameuhad Ltd. v. Migdal Kfar Shitufi* (Nov. 9, 1995); HCJ 6055/95 *Sagy Tzemah v. The Minister of Defense* (Oct. 14, 1999); HCJ 1715/97 *The Bureau of Investment Managers in Israel v. The Minister of Finance* (Sept. 24, 1997); HCJ 2605/05 *The Law and Business Center v. The Minister of Finance* (Nov. 19, 2009).

[6] *See* Aharon Barak, Interpertation in Law (Nevo Publishing); C.A. 165/82 *Kibutz Hatzor v. the Assessing Officer of Rehovot* (May 6, 1985); HCJ 693/91 *Dr. Michael Efrat v. Director of Population and Immigration in the Ministry of the Interior* (Mar. 29, 1993).

[7] The Arbitration Law, 1968.

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them.[8] If the parties did not agree on the different procedural matters, the arbitrator can determine those matters.

The Israeli legal system encourages arbitration and minimal judicial intervention in the process. The courts play a supportive role by providing assistance and enforcing arbitral awards, but they generally refrain from interfering with the substantive issues of a dispute. This allows the parties to have autonomy and come to an efficient resolution of the dispute. Once the court approves the arbitral award, it has the same legal standing as a court judgment, and it can be enforced through the Execution Office.

In recent years, Israel has increased international arbitration cases, particularly in sectors such as technology, finance, and energy. Various arbitral institutions provide administration services to parties engaged in arbitration in Israel.

[8] The Arbitration Law, 1968, s. 8.

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II. Operating a Business in Israel

A. In General

Israel's attractive investment climate is attributable to a combination of factors. Its labor force is comprised of highly skilled employees who are thoroughly familiar with the latest American, Russian and Western European technologies, as well as a readily available reservoir of trained manual workers. At the same time, Israeli workers earn approximately half the wages of their counterparts in the United States.

Israel provides ample opportunity for the conduct of research and development (R&D) in such internationally renowned institutes as the Weizmann Institute, the Technion, the Hebrew University, the Beer Sheeba University, Bar Ilan University, and the University of Tel Aviv. It has a modern infrastructure and offers a wide range of technical and industrial support services. Israel is conveniently located at the crossroads of three continents and offers direct access to both the Mediterranean Sea and the Indian Ocean. Its cities are modern, and English is a true second language. Moreover, as Israel is a society of immigrants, one can readily find people with affiliations to almost any country in the world and with remarkable linguistic abilities.

1. Trade Agreements

On May 11, 1975, Israel and the European Union (EU) entered into a free trade agreement.[9] A new agreement was signed in 1995, which entered into force on June 1, 2000.[10] The new agreement is aimed at reinforcing the free trade area between the EU and Israel.

Regarding industrial products, the agreement provides that customs duties on imports and exports, including those of a fiscal nature, and any charges having equivalent effect, are prohibited.[11] The Agreement provides further that a greater liberalization of trade in agricultural products will be established progressively.[12]

Quantitative restrictions on imports or exports and all measures having equivalent effect are prohibited.[13] Products originating in Israel and exported to the EU will not be accorded more favorable treatment than that which the Member States of the EU apply among themselves.[14] The parties are to refrain from direct or indirect fiscal discrimination between products and like products of one party originating in the other party.[15] Also, exported products may not benefit from repayment of indirect internal taxation in excess of the amount of indirect taxation imposed on them directly or indirectly.[16] Products deemed to originate in one party are: products entirely produced in that party; and products produced in that party which contain materials not entirely produced there, provided that the said materials have undergone sufficient working and processing in that party.[17]

The agreement does not void import or export restrictions that can be justified in light of public morality, public policy or public security; the protection of health and life of humans, animals or plants; the protection of national treasures possessing artistic, historic or archaeological value; and the protection of intellectual, industrial or commercial property or any rules regarding gold and silver, provided such restrictions are not used as a means of arbitrary discrimination or disguised restrictions on trade between the parties.[18]

The agreement defines various activities as inconsistent with it, insofar as they are likely to hinder trade between the parties.[19] Among these are:

(i) The exploitation of a dominant position in the entire area of a party or in an important part thereof by one or several enterprises;

(ii) Any public support that distorts or is likely to distort competition by favoring certain enterprises or products; and

(iii) Any agreements or coordinated practices between enterprises aimed at distorting, restricting or preventing competition with respect to the production or barter of goods.

The agreement addresses the difficulties which may arise as a result of its implementation and also sets out the measures that can be taken to deal with them. The difficulties are as follows:[20] (a) dumping; (b) importation of a particular product in significant quantities that seriously harms or is likely to harm domestic producers or a sector of the economy, or importation that could bring about serious deterioration in the economic situation of a region; and (c) exportation that causes re-export towards a third country against which the exporting party maintains restrictions on exports, such as quantitative restrictions or export duties, or leads to a serious shortage, or threat thereof, of a product essential to the exporting party. In those cases, before taking any measures, the party in question is obliged to supply the Association Committee with all relevant information to find an agreed solution.[21]

On April 22, 1985, Israel and the United States entered into a bilateral Free Trade Zone Agreement, which came into force on September 1, 1985.[22] The agreement calls for the bilat-

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[9] *Accord Entre L'Ei`tat d'Israel et La Communautei`e Ei`conomique Europei`ene*, 1975.

[10] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995.

[11] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 8.

[12] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 11.

[13] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, ss. 16–17.

[14] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 18.

[15] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 19(a).

[16] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 19(b).

[17] Protocol 4 to the Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, Art. 2.

[18] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 27.

[19] Euro-Mediterranean Agreement between the EU and the State of Israel, s. 36.

[20] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, ss. 22, 23 and 24.

[21] Euro-Mediterranean Agreement between the EU and the State of Israel, 1995, s. 25.

[22] Agreement on the Establishment of a Free Trade Area between the Government of Israel and the Government of the United States of America, 1985.

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eral progressive abolition of all customs, levies and duties on products that "originate" in one country and are exported to the other. In accordance with the 1985 agreement, Israel allows the duty free import of all U.S. products exported to it, as of January 1, 1995.[23] Neither party may impose licensing requirements on items exported by the other party, unless licenses issued under such requirements are: automatically approved; necessary to administer a quantitative ceiling on exports justified under the agreement; or necessary to administer restrictions in conformity with the agreement.[24] Neither party may impose, as a condition of the establishment, expansion or maintenance of investments by nationals or companies of the other party, requirements to export any amount of production resulting from such investments or to purchase locally produced goods and services. Moreover, neither party may impose requirements on investors to purchase locally produced goods and services as a condition for receiving any type of governmental incentives.[25] These conditions do not prohibit "buy-back" clauses in government procurement contracts. An important feature of the agreement was Israel's undertaking therein to abolish export incentives and subsidies then granted by it within a six-year period (see 2., below).

The agreement applies to any article if: (i) that article is wholly the growth, product, or manufacture of a party or is a new or different article that has been grown, produced or manufactured by a party; (ii) that article is exported directly from one party to the other party; or (iii) the sum of the cost or value of the materials produced by the exporting party, together with the direct costs of processing operations, is not less than 35% of the appraised value of the article at the time it enters the other party.[26]

Israel has entered into other Free Trade Agreements with: EFTA (Iceland, Liechtenstein, Norway, and Switzerland) (1992); Canada (1996); Turkey (1997); Mexico (2000); Mercosur (Argentina, Brazil, Paraguay, Uruguay) (2005); Colombia (2013), Panama (2018), Ukraine (2019), United Kingdom (2019), United Arab Emirates (2022), all of which lay down rules of origin, provide for a 0% customs rate on most products, and incorporate most of the principles of the 1994 General Agreement on Tariffs and Trade (GATT), to which Israel is a party. Also, Israel has entered into a Trade Agreement with Jordan in 1995, which was upgraded in 2004, and Qualified Industrial Zone Agreements (QIZ) were signed with Jordan (1997) and Egypt (2004).

The removal of customs duties exposes the parties to the risk of dumping. In Israel, the power to prevent or reduce this risk was given to certain ministers in their respective responsibilities — in most cases to the Minister of Industry and Commerce (now part of the Ministry of Economy) together with another Minister responsible for the matter under consideration (for example, agriculture). (See C.1.a.(2), below, regarding dumping and unfair competition.)

The trade agreements with the United States, Canada, the EU, Mexico and Mercosur make Israel a unique natural commercial bridge between North America, South America and Europe for the Israeli manufacturing of products made with North American know-how and their marketing in the EU. Creative and careful planning can achieve significant indirect tax savings. The trade agreement with Mexico allows 80% of Israel's exports to enter Mexico tax-free and, thus, compete with goods originating from the United States and entering Mexico tax-free.

Israel has a wide network of double taxation agreements that, inter alia, limit the rates of taxes on income derived from Israel and the relevant treaty partner country. For a complete list of Israel's tax treaties and other tax-related agreements, including the texts and information on signature, entry into force and effective dates, see *Bloomberg Tax International Tax Treaties* and the website of the Ministry of Finance.[27]

2. Government Incentives

a. In General

Israel has devised an elaborate system of incentives, whose aim is to attract both local and foreign investment.

For these purposes, the country is divided into different zones (as further discussed in II.A.2.b., below),[28] with the most rewarding financial incentives being made available to entrepreneurs locating their enterprises in the least developed of these zones.[29] The incentives are designed to encourage investments in manufacturing[30] facilities, tourism, housing projects, industrial rental buildings, rental dwelling units and agriculture, and to attract foreign specialists. Based on various criteria, these incentives include for instance:

(i) cash grants (for investments in fixed assets);

(ii) accelerated depreciation;

(iii) subsidies towards the cost of essential infrastructure;

(iv) government cost-sharing for approved R&D projects;

(v) subsidized rental facilities for industrial premises in development zones;

[23] Agreement on the Establishment of a Free Trade Area between the Government of Israel and the Government of the United States of America, 1985, Annex 1.

[24] Agreement on the Establishment of a Free Trade Area between the Government of Israel and the Government of the United States of America, 1985, Art. 12.

[25] Agreement on the Establishment of a Free Trade Area between the Government of Israel and the Government of the United States of America, 1985, Art. 13.

[26] Agreement on the Establishment of a Free Trade Area between the Government of Israel and the Government of the United States of America, 1985, Annex 3.

[27] https://mof.gov.il/en/InternationalAffairs/InternationalTaxation/Pages/AvoidanceDoubleTaxationTreaties.aspx.

[28] Law for the Encouragement of Capital Investments, 1959, s. 40D. As detailed below, the Law for the Encouragement of Capital Investment was revised in 2011 (Amendment 68). Under the revised law, the country is divided into "Zone A" and "Zone B" and is no longer divided into three zones. However, as detailed in II.A.2.c., below, the previous version of the Law may still be applicable under certain circumstances.

[29] Law for the Encouragement of Capital Investments, 1959, Ch. 6.

[30] The term "manufacturing" is not defined in the Law for the Encouragement of Capital Investments. However, Law for the Encouragement of Capital Investments, sec. 51 provides that "manufacturing activity" includes the manufacturing of software and the development of products. Industrial Research and Development for foreign residents will be approved as a "manufacturing activity" if it is approved by the Office of the Chief Scientist in the Ministry of Industry, Trade and Labor.

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(vi) grants for the purchase of such premises;

(vii) tax concessions;

(viii) the right to repatriate profits and principal in foreign currency;

(ix) government subsidies for training courses;

(x) insurance for foreign trade risks;

(xi) exemption from customs duties and purchase tax on goods imported for export; and

(xii) a zero rate of value added tax (VAT) on goods and services exported from the country.

The tax concessions and tax-related benefits are dealt with in XIV. below. This chapter is an overview of different types of incentives given by the force of legislation.

b. Incentive Zones

The Encouragement Laws determine the scope of incentives depending on the type or size of investment as well as its location in Israel. According to governmental policies and decisions, higher priority zones will enjoy greater benefits and reliefs. For instance, Development Zone A offers the greatest incentives, while Development Zone B offers somewhat lower incentives.[31] Zone A includes low socio-economic municipalities with an unemployment rate of more than 10%. It also includes the city of Jerusalem (regarding high tech companies), spatial industrial zones in the north, in the south and in the city of Jerusalem, minorities' settlements and settlements near the Gaza strip. Development Zone B includes municipalities with a higher socio-economic level than Zone A and with an unemployment rate of more than 8%.

c. Law for the Encouragement of Capital Investment, 1959

The Law is aimed at encouraging capital investment and economic entrepreneurship, while giving priority to technological innovation as well as to business activity in national priority zones, to achieve the following aims: (i) increase the manufacturing capacity of the Israeli economy; (ii) enhance the competitiveness of the Israeli business sector in global markets; and (iii) create an infrastructure for new and lasting employment.

The incentives under the law are provided mainly to industry, high tech, renewable energy, tourism, R&D services for foreign residents, foreign investments, and residential rentals.

The Law specifically denies its benefits to companies engaged in mining natural resources and to government corporations. The rationale denying the benefits to mining companies is that they cannot in any case relocate their operations outside Israel. The rationale lying behind the denial of the benefits to government corporations apparently lies in the fact that they cannot relocate their activities abroad without government authorization and therefore do not require encouragement.

The incentives the Law provides may be divided into two main programs:

(i) Tax Benefits Program — administered by the Israel Tax Authority. In general, under this program prior approval is not required from any authority. Accordingly, a company complying with the criteria stipulated in the Law can claim the tax benefits in its tax returns. However, to obtain greater certainty, a company may apply to the Israeli Tax Authorities for an advance (or pre) ruling to verify and ascertain that it meets the criteria necessary for the tax benefits.

(ii) Grants Program — administered by the Authority for Investments and Development of the Industry and Economy as well as the Administration of Tourism Investments. The enterprise concerned must be approved by the relevant government authority as an Approved Enterprise to be entitled to the grant. Under the program, a grant-in-aid is accorded only to an enterprise located in Israel's priority zones.

The main difference between the two programs is that in the Tax Benefits Program, the State provides "enhanced" concessions applying to income generated from the establishment or expansion of the enterprise, while in the Grants program, the State shares the risk involved in executing the investment by offering the enterprise an actual grant in the process of its establishment or expansion. Moreover, the Tax Benefits Program does not require annual budget approval, while the Grants Program is limited to the annually approved sum in the Budget Law.

In general, the Grants Program is available side by side with the Tax Benefits Program, except for a company that operates in the tourism sector.

For further information regarding the Law for the Encouragement of Capital Investment, see XVII.A., below.

d. Law for Encouragement of Knowledge-Intensive Industry (Temporary Provision), 2023

The Law for Encouragement of Knowledge-Intensive Industry aims to keep Israel an attractive country for investment, especially in technology, and replace benefits previously granted to R&D companies. This Law, which applies until the end of 2026, prescribes tax benefits for investors in high-tech companies incorporated in Israel, where they also maintain their center of activity. Companies which meet the criteria of initial technological income and investments will be entitled to tax benefits in several different tracks. For further discussion, see XVII.B., below.

e. Law for the Encouragement of Capital Investment in Agriculture, 1980

The purpose of this Law is to promote and develop the domestic agricultural industry, the export of agricultural products and technology and to maintain agriculture as a viable and valuable sector in the Israeli economy. According to the Law, agricultural factories are entitled to tax-free grants, accelerated depreciation, enhanced deductions and other tax benefits. For further information, see XVII.A.5, below.

[31] The Law for the Encouragement of Capital Investments, 1959, appendix II. In the past, the Law divided the country into three zones. The previous division may still apply with respect to certain companies.

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f. Law for the Encouragement of Construction of Housing for Rent, 2007

The combination of a high demand for housing and a low supply of housing solutions in Israel in recent years compelled the government to offer the construction and housing sector various constructors reliefs and benefits, provided that builders allocate new buildings for rent. Among the benefits offered by this Law are certain tax exemptions and accelerated depreciation. For further discussion, see XVII., below.

g. Law for the Encouragement of Investment in Renewable Energy (Tax Benefits for Production of Electricity), 2016

This Law exclusively encourages small and private manufacturers to produce electricity not for commercial purposes but for residential use. In order to persuade taxpayers, the Law offers several benefits, such as exemptions from certain bureaucratic procedures, tax credits, lower tax rates, or enhanced deductions.

h. Law for the Encouragement of Investment (Capital-Intensive Companies), 1990

As a means to support local entrepreneurship and the domestic capital market from abroad, the Law offers major benefits to foreign investors whose capital investment exceeds a certain threshold. According to the Law, to avail of the tax benefits and special status, a company must invest most of its profits in specified fields and infrastructure related activities.

i. Israel Innovation Authority

(1) General

The Israel Innovation Authority was established by the Law for the Encouragement of Research Development and innovative Technology in Industry, 2015, which replaced a former version of this law from 1984. The Law aims to encourage collaboration between industry and academic institutions. Its main purpose is to create an advanced and innovative environment in order to enhance the use of human capital in industrial projects and develop the competitiveness of Israeli industry in the global market. The authority encourages, promotes, supports and assists various technological innovation initiatives by, inter alia, providing financial support to entrepreneurs.[32] The Authority includes the following divisions: Startup Division, Growth Division, Technological Infrastructure Division, Advanced Manufacturing Division, International Collaboration Division and Societal Challenges Division.

The incentives accorded as part of the programs detailed below are subject to the approval of the Israel Innovation Authority.

Most of the programs require a payment of royalties from the income derived from the sale of a product, developed as part of or derived from the approved project, including related services,[33] as of the sale of the first product.[34] The royalties are also to be paid when the product is one component of the final product.[35] The royalties are paid to the State of Israel (via the Israel Innovation Authority) for its financial support. The total amount of the royalties is capped at the sum of the incentive provided by the Authority, together with annual interest.[36] In case the Israel Innovation Authority approves the transfer of production rights from Israel abroad, a higher royalty ceiling applies, ranging from 120% to 300%, depending on the rate of the transferred rights.[37]

The rates of the royalties — which are based on several factors, such as the turnover of the company, its area of activity, and the location of the manufacturing — are as follows:

(i) For a small-scale company: 3%, i.e., a company whose turnover during the 12 months preceding the date of application did not exceed USD 70 million;[38]

(ii) For a large-scale company: 5%, i.e., a company whose turnover during the 12 months preceding the date of application exceeded USD 70 million;[39]

(iii) For a company in a sector of traditional industry whose manufacturing activities are carried out in Israel: 1.3%;[40]

(iv) If the product was manufactured as part of an approved R&D project, including prototypes, additional royalties are to be paid, equal to the ratio of the received grant to the total R&D expenses;[41] and

(v) An additional 1% is paid when the revenues are derived from manufacturing carried out abroad.[42]

Furthermore, royalties are to be paid from the proceeds received from the sale of equipment used for the approved project.[43]

(2) Incentives for Startup Companies and Entrepreneurs

(a) Tnufa Incentive Program

The Tnufa incentive program is aimed at supporting startup companies and entrepreneurs with a proven concept and with a business feasibility of a technological project, to protect their intellectual property, and to advance the project to a stage

[32] Law for the Encouragement of Research, Development and Technological Innovation in Industry, 1984, s. 5A. For further information on the incentive programs see the Israel Innovation Authority website: www.matimop.org.il/.

[33] Law for the Encouragement of Research, Development and Technological Innovation in Industry, 1984, s. 21.

[34] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 2(b).

[35] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 5.

[36] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 2(a).

[37] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 10.

[38] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 3(a)(1).

[39] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 3(a)(2).

[40] Appendix D of the Benefit Program No. 1: The R&D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 3(a)(3).

[41] Appendix D of the Benefit Program No. 1: The R & D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 6.

[42] Appendix D of the Benefit Program No. 1: The R & D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 3(b).

[43] Appendix D of the Benefit Program No. 1: The R & D Fund, "Provisions Regarding the Rate of Royalties and Rules for Their Payment," S. 7.

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where it will be able to raise substantial funding for continued development and commercialization.

As part of the Tnufa Incentive Program, a grant of up to NIS 200,000 is provided for a period of two years and calculated as a percentage of the approved budget — up to the rate of 85%. The grant is subject to approval by the Israel Innovation Authority.[44]

The following are eligible to apply for the grant:

(i) An individual entrepreneur who is at least 18 years of age and an Israeli resident that permanently lives in Israel; and

(ii) A company incorporated in Israel for the purpose of executing the project, held directly and solely by individuals who are Israeli residents. Moreover, the company may not have had turnover since its incorporation and the funding it raised may not have exceeded NIS 400,000.

(b) Incubators Incentive Program

Eighteen technological incubators and one bio-technological incubator, owned by private investors selected through a tender, operate in Israel (as of 2022). The incubator provides the entrepreneurs with comprehensive assistance, including infrastructure, administrative services, technological and business guidance, and legal advice.

The goal of the Incubators Incentive Program is to support entrepreneurs with an applied innovative technological concept for establishing startup companies, raising capital from private investors and commercializing their concept into a commercial product.

As part of the Incubators Incentive Program, and with respect to projects in technological incubators, a grant of up to NIS 3.5 million is provided to the entrepreneur for a period of two years. The amount of the grant depends on the field of the project (technology, biotechnology, clean-tech, cyber, medical equipment or the pharmaceutical industry) and the geographical location of the incubator (area lacking priority or national priority area), and is calculated as a percentage of the approved budget — up to the rate of 85%. The grant is subject to the approval of the Israel Innovation Authority. The supplementary funding is given by the technological incubator.

An additional grant for the third year of up to NIS 1.25 million is accorded to the entrepreneur where certain conditions are met. The amount of the additional grant also depends on the field of the project and the geographical location of the incubator.[45]

Projects in bio-technological incubators may be eligible for a higher grant — up to NIS 6.9 million for a period of three years.[46]

(c) Early-Stage Companies Incentive Program

The Early-Stage Companies Incentive Program is designed for startup companies and intended to provide an incentive to private investors for product development and initial market penetration. The program includes three sub-programs: standard program, minorities program and ultra-orthodox program.[47]

Companies that meet all the following conditions are eligible for the grant accorded under the standard program:

(i) It is incorporated in Israel during the four years prior to the submission of the application;

(ii) Its business activity is conducted solely for operating and commercializing the project;

(iii) The turnover of the company during the 12 months preceding the date of application did not exceed NIS 750,000, and the total turnover as of incorporation did not exceed NIS 1 million;

(iv) The funds raised by the company during the 12 months preceding the date of application did not exceed NIS 3 million (in the case of a biotechnology company, NIS 4.5 million), and the total funding did not exceed NIS 6 million (in the case of a biotechnology company, NIS 9 million); and

(v) It is not in a state of receivership or liquidation, its bank account is not limited, and it does not owe money to the Israel Tax Authority or to the Israel Innovation Authority.

Within the framework of the standard program, a grant may be accorded for a maximum period of two years. The amount of the grant is capped at 5 million NIS or at a rate of 50% of the expenses for R&D, marketing, commercialization and other activities (for companies operating in a national priority area or in the area surrounding the Gaza Strip — 60% or 75%, respectively), whichever is lower.

Applications for preferred incentives under the minorities and ultra-orthodox programs can be made in the first two years:

(i) 1st year: total budget is up to NIS 2.5 million and the conditional grant is 75% of the approved budget.

(ii) 2nd year: total budget is up to NIS 4.5 million and the conditional grant is 70% of the approved budget.

Once the approval is received, the company is obliged to raise the supplementary capital for the project, within six months of the date of approval.

(d) Clean-Tech — Renewable Energy Technology Center

The Renewable Energy Technology Center, located in the Eilat region in the southern part of Israel, is aimed at supporting technological and R&D projects in the renewable energy and energy efficiency fields. The center is operated by a licensee

[44] Israel Innovation Authority, Procedures for Incentive Program No. 9: Tnufa — Providing Assistance to Start-Up Technological Entrepreneurs (last updated: August 19, 2019).

[45] Israel Innovation Authority, Incentive Program No. 3: Technological Incubators.

[46] Israel Innovation Authority, Incentive Program No. 22: Bio-Technological Incubators.

[47] Israel Innovation Authority, Incentive Program No. 23: Early-Stage Companies.

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from the private sector,[48] comprised of strategic investors and a research institute.

The financial support is provided to projects which are carried out in the Center via the following three programs:[49]

(i) Primary Stage Program: The financial support provided by the program is aimed at assisting projects, which involve collaboration between the Center and a research institute, to reach the initial feasibility stage. A grant of up to 66% of the approved budget is accorded, for a maximum period of two years, coupled with an exemption from the payment of royalties to the Authority.

The maximum budget allocated to *all* the projects participating in the Primary Stage Program (for a maximum period of two years each) is NIS 2 million.

(ii) Advanced Stage Program: The financial support provided is designed for companies in the pre-seed and seed stages, which carry out their project in the Center. A grant at the rate of 60% or 85% of the approved budget (subject to a maximum of NIS 2.125 million) for a maximum period of two years. The supplementary funding is provided by the Center.

(iii) Testing Areas Program: A grant at the rate of 50% of the approved budget, for a maximum period of three years, is provided for the establishment of areas and required infrastructures designated for conducting experiments and demonstrating the technological feasibility of the products. The grantee is exempted from payment of royalties.

The maximum budget allocated to *all* the projects participating in the Testing Areas Program is NIS 4 million.

(3) Incentives for Mature and Growth Companies

(a) R&D Fund Incentive Program

The R&D Fund incentive program is aimed at strengthening and promoting the Israeli economy by supporting and encouraging technological innovation. This is the main incentive program in which financial support is provided to commercial companies in all areas of activity, for the development of new products or for the upgrade of existing technology.

As part of the program, a grant at the rate of 20%, 30%, 40% or 50% of the R&D expenditures is provided.[50] The aforementioned rate is significantly based on the extent of the original production carried out in Israel.[51] Companies operating in a national priority area or in the area surrounding the Gaza Strip, may be eligible for an additional grant at the rate of 10% or 25%, respectively.[52] At the request of the applicant, a loan may be given in lieu of a grant.[53]

(b) Generic R&D Incentive Program

The program is aimed at supporting and strengthening long-term and generic R&D activity carried out by large Israeli companies, to create new knowledge and a technological infrastructure, for use in the design, development or production of many innovative products. The program is also designed for supporting and encouraging the development of an initial ethical R&D activity in the pharmaceutical industry.

As part of the program, a grant is accorded at a rate of up to 50% of the R&D expenditures, however not more than NIS 65 million, coupled with an exemption from the payment of royalties.[54]

Eligible for the grant are large companies: (i) with a turnover of USD 100 million derived from their production activities in Israel; and (ii) with total R&D expenditures that exceed USD 20 million, or alternatively, that employ at least 200 employees for their R&D activity in Israel.[55] The grant is provided for plans that involve long-term R&D activity or collaboration between a large company and another Israeli company carried out through technical and business integration.[56]

(c) Business R&D for Agriculture

The program is aimed at supporting projects for the development of agricultural products intended for sale and export, such as end products from flora and fauna and agricultural inputs. As part of the program, a grant at the rate of 20%, 30%, 40% or 50% of the R&D expenditures is made.[57] Companies operating in a national priority area or in the area surrounding the Gaza Strip, may be eligible for an additional grant at the rate of 10% or 25%, respectively.[58] At the request of the applicant, a loan may be given in lieu of a grant.[59]

(d) Greenhouse Gas Emissions Reduction

As part of the inventive program, a grant is accorded to entrepreneurs for projects in the realms of energy efficiency and reduction of greenhouse gas emissions.[60]

The grant is at the rate of 20% of the project expenses. However, the total amount of the grant for all the applications of a single entrepreneur, in one calendar year, is capped at NIS 3 million.[61]

An additional grant is provided for a first commercial installation of a product which is based on technology of an Is-

[48] For information on the licensee see: capitalnature.com.

[49] Israel Innovation Authority, Incentive Program No. 14: The Technological Center for Renewable Energy in the Negev and Arava.

[50] Israel Innovation Authority, Incentive Program No. 1: R&D Fund, S. 25(a).

[51] Israel Innovation Authority, Incentive Program No. 1: R&D Fund, S. 25(b).

[52] Israel Innovation Authority, Incentive Program No. 1: R&D Fund, S. 25(c).

[53] Israel Innovation Authority, Incentive Program No. 1: R&D Fund, S. 30.

[54] The Ministry of Economy and Industry, the General Director, Support for Long Term R&D Activity of Large R&D Companies, S. 5–6.

[55] The Ministry of Economy and Industry, the General Director, Support for Long Term R&D Activity of Large R&D Companies, S. 2.1.

[56] The Ministry of Economy and Industry, the General Director, Support for Long Term R&D Activity of Large R&D Companies, S. 4.2.

[57] Israel Innovation Authority, Incentive Program No. 32: Business R&D in Agriculture, S. 3(a).

[58] Israel Innovation Authority, Incentive Program No. 32: Business R&D in Agriculture, S. 3(a).

[59] Israel Innovation Authority, Incentive Program No. 32: Business R&D in Agriculture, S. 3(a).

[60] The Ministry of Economy and Industry, the General Director, Support for Investments in Projects of Energy Efficiency and Reduction of Greenhouse Gas Emissions, s. 4.1.

[61] The Ministry of Economy and Industry, the General Director, Support for Investments in Projects of Energy Efficiency and Reduction of Greenhouse Gas Emissions, s. 4.3.

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raeli company provided that the product and the technology are wholly owned by the Israeli company and are expected to reduce greenhouse gas emissions.[62]

The additional grant is at the rate of 20% of the project expenses. However, the total amount of the additional grant for all the applications of a single entrepreneur, in one calendar year, is capped at NIS 3 million.[63]

The entrepreneur is obliged, inter alia, to invest in the project an amount ranging from NIS 800,000 to NIS 2 million.[64]

(e) Petroleum Substitutes for Transportation

The program is aimed at expanding the sources of funding for Israeli companies operating in the field of petroleum substitutes for transportation, while leveraging government investment through cooperation with Israeli and international private investors.[65]

Petroleum substitutes for transportation are technologies that are designed to reduce the global consumption of petroleum for transportation.[66]

As part of the program, a loan is accorded to the company, subject to a parallel investment of a private investor, made in cash and in consideration of the issuance of the company's shares.[67] The investment must be made along with the submission of the application for the loan.[68]

The loan is at a rate of 50% of the investment. However, the minimum amount of the loan is NIS 750,000 (subject to a parallel investment in the amount of NIS 1.5 million) and the maximum amount is NIS 12 million (subject to a parallel investment in the amount of NIS 24 million).[69] The cumulative maximum amount of loans accorded to a single company is NIS 30 million (subject to parallel investments in the amount of NIS 60 million).[70]

The repayment of the loan can be made in two ways:[71]

(i) directly by the company by payment of royalties from its income;

(ii) by the investor — instead of the company — in consideration for an issuance of additional shares of the company.

A company that meets all of the following conditions is eligible for the loan accorded under the program:[72]

(i) Incorporated in Israel;

(ii) Its business activity is conducted in Israel and its main activity is industrial R&D and the implementation of innovative technologies in the field of petroleum substitutes for transportation;

(iii) The funds raised by the company prior to the date of the application did not exceed US$ 50 million;

(iv) A private investor (Israeli or foreign) invested or intends to invest in the company's capital as part of the incentive program;

(v) Following the issuance of the shares to the private investor made under the incentive program, the investor holds, directly or indirectly, less than 50% of the issued share capital of the company;

(vi) The company presented a detailed and applicable R&D program in the field of petroleum substitutes for transportation;

(vii) The company employs a team of employees with the necessary education or experience required for industrial R&D and implementation of innovative technologies in the field of petroleum substitutes for transportation;

(viii) The investor and the company are not in a state of receivership or liquidation; their bank account is not limited; and they do not owe money to the Israel Innovation Authority.

(f) R&D for Space Technology

The program is aimed at encouraging R&D in the field of space technology, inter alia, for the development of Israeli startup companies and technological solutions in the space technology field, and for strengthening knowledge and technological development capacity of Israeli space industry by providing financial support to R&D space products projects such as satellites and space launch products.[73]

A company that meets all of the following conditions is eligible for the grant accorded under the program:[74]

(i) Registered in Israel;

(ii) Is not considered as a public utility company or as a foreign company;

[62] The Ministry of Economy and Industry, the General Director, Support for Investments in Projects of Energy Efficiency and Reduction of Greenhouse Gas Emissions, s. 3.9.

[63] The Ministry of Economy and Industry, the General Director, Support for Investments in Projects of Energy Efficiency and Reduction of Greenhouse Gas Emissions, s. 4.4.

[64] The Ministry of Economy and Industry, the General Director, Support for Investments in Projects of Energy Efficiency and Reduction of Greenhouse Gas Emissions, s. 5.9.

[65] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 1.3.

[66] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 2.10.

[67] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 6.1.

[68] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 6.2.

[69] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 6.7.

[70] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 6.8.

[71] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, ss. 6.3–6.5.

[72] Israel Innovation Authority, Incentive Program No. 21: Encouragement of Investments in Backed Venture Capital Companies in the Field of Petroleum Substitutes for Transportation, s. 4.

[73] Israel Innovation Authority, Incentive Program No. 24: Encouragement of R&D for Space Technology.

[74] Israel Innovation Authority, Incentive Program No. 24: Encouragement of R&D for Space Technology. s.4.

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(iii) Has not been granted any financial support by the government or by the Israel Innovation Authority for the development of any component included in the application;

(iv) Is not in a state of receivership or liquidation, its bank account is not limited, and it does not owe money to the Israel Innovation Authority.

The rate of the grant is calculated as a percentage of the approved budget, as follows:[75]

(i) For an approved project of a big-scale company, i.e., a company whose turnover during the calendar year preceding the date of the application was equal or exceeded US$ 100 million, the rate of the grant is 50% of the approved budget.

(ii) For an approved project of a small-scale company, i.e., a company whose turnover during the calendar year preceding the date of the application was less than US$ 100 million, the rate of the grant is 85% of the approved budget for products designed for operation in space, and 60% for other products.

The applicant is required to raise the supplementary capital for the project from another investor who is not the Israeli government or the Israel Innovation Authority.[76]

At the request of the applicant, a loan may be given in lieu of a grant.[77]

(4) Incentives for Technological Infrastructure Companies

(a) MAGNET Consortia

The MAGNET Program supports the industrial R&D of generic pre-competitive technologies. The term "generic pre-competitive technologies" refers to a broad spectrum of common technologies, components, materials, design and manufacturing methods that have wide-ranging industrial application. The program is based on collaboration between industrial companies, including foreign companies, and between them and Israeli academic institutions.[78]

The program offers a grant of up to 66% of the approved budget for an industrial company.[79] A research institution is eligible for a grant of up to 80% of the approved budget, while the supplementary funding is provided by the consortium of the industrial companies.[80] The grantee is exempted from the payment of royalties.[81]

(b) MAGNETON

The Incentive program encourages the transfer of technological knowledge from research institutions to corporations for the development of industrial products. The program is based on a collaboration between an Israeli industrial company and a research institution. The program offers a grant of up to 66% of the approved budget for an industrial company, capped at NIS 3.4 million.[82]

The grantee is exempted from the payment of royalties.[83]

(c) NOFAR

The Incentive program focuses on increasing the using of academic research for commercial industrial purposes which do not meet the conditions of the MAGNETON incentive program.

The program offers a research institution a grant of up to 90% of the approved budget, during a period of one year, for conducting research intended for industrial use. The grant is capped at NIS 550,000 or at NIS 700,000 if the research is conducted in collaboration with two academic institutions or more.[84] The supplementary funding is provided by an industrial-business entity as well as professional support and guidance.[85]

The grantee is exempted from the payment of royalties.[86]

(5) Incentives for Advanced Manufacturing — Encouraging Innovation in the Low-Technology Industry

The incentive program is aimed at encouraging R&D and innovation in low-tech companies to maintain the competitiveness of the Israeli industry in the global market.[87]

The program is designed for Israeli companies in the manufacturing industry that meet one of the following two conditions:[88]

(i) More than 50% of the company's turnover during the year preceding the date of application was derived from the industrial production of products in low-technology or medium-low technology industries.

(ii) Moreover, on the date of application:

(1) The percentage of production employees is at least 30% of the total number of employees, but not less than three employees; and

[75] Israel Innovation Authority, Incentive Program No. 24: Encouragement of R&D for Space Technology. s.6.1.

[76] Israel Innovation Authority, Incentive Program No. 24: Encouragement of R&D for Space Technology. s. 6.2.

[77] Israel Innovation Authority, Incentive Program No. 24: Encouragement of R&D for Space Technology. s. 7.

[78] Israel Innovation Authority, Incentive Program No. 5: Encouragement of the Development and implementation of Generic Technologies — MAGNET, s. 1.

[79] Israel Innovation Authority, Incentive Program No. 5: Encouragement of the Development and implementation of Generic Technologies — MAGNET, s. 5.

[80] Israel Innovation Authority, Incentive Program No. 5: Encouragement of the Development and implementation of Generic Technologies — MAGNET, s. 5.

[81] Israel Innovation Authority, Incentive Program No. 5: Encouragement of the Development and implementation of Generic Technologies — MAGNET, s. 7.

[82] Israel Innovation Authority, Incentive Program No. 6: Encouragement of the Transfer of Technologies from Academy to Industry — MAGNETON, s. 5.

[83] Israel Innovation Authority, Incentive Program No. 6: Encouragement of the Transfer of Technologies from Academy to Industry — MAGNETON, s. 9.

[84] Israel Innovation Authority, Incentive Program No. 7: NOFAR — Application of Academic Research for Industry, s. 5.

[85] Israel Innovation Authority, Incentive Program No. 7: NOFAR — Application of Academic Research for Industry, s. 4.

[86] Israel Innovation Authority, Incentive Program No. 7: NOFAR — Application of Academic Research for Industry, s. 7.

[87] Israel Innovation Authority, Incentive Program No. 36: Encouraging technological innovation in the manufacturing industry, S. 1.

[88] Israel Innovation Authority, Incentive Program No. 36: Encouraging technological innovation in the manufacturing industry, S. 2.1.

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(2) The rate of R&D employees is at most 10% of all employees, but not more than 25 employees.

The program includes two sub-programs:

(i) R&D for Manufacturing Industry Program: This program is aimed at encouraging companies to promote and implement technological innovation or R&D processes by developing innovative products as well as improving and developing existing products or production processes. Under this sub-program, a grant at the rate of 30% to 50% of the R&D expenditures is provided. An additional grant of 10% is made if the program is implemented in a national priority area or if 20% of the approved budget is carried out by an industrial research institute.[89] At the request of the applicant, a loan may be given in lieu of a grant.[90]

(ii) Preparatory Program: This program is aimed at assisting the company in preparing for the implementation of an R&D program and to characterize additional fields in which the company can improve its products and production processes. The budget for this program is capped at NIS 75,000 and the grant is at the rate of 66% of the total budget, and support for 75% of the approved request's budget which is capped at NIS 100,000.[91] The grantee is exempted from payment of royalties.[92]

j. Prerequisites for Incentives

(1) The Tax Benefits Program

To be entitled to the tax incentives under the tax benefits program, an enterprise must be owned by a company registered in Israel, the business of which is controlled and managed in Israel, and must not be a "family company," a "transparent company" or a kibbutz. The company must keep admissible books and records and file all reports required under Israeli law. The company and its functionaries must not have been convicted of tax felonies during the 10-year period prior to the period of benefits.

The 2011 law specifically denies its benefits to companies engaged in mining natural resources and government corporations. The rationale denying the benefits to mining companies is that they cannot move their operations outside Israel. The rationale behind the denial of the benefits to government corporations apparently lies in the fact that they cannot transfer their activities abroad without government authorization and, therefore, do not require encouragement.

A Beneficial Enterprise must meet the following conditions to be eligible for the tax benefits: (i) the enterprise must be a tourist facility; (ii) the enterprise must be competitive and contribute to the gross domestic product; however, if it fails to do so in certain years, the enterprise will be deprived of the tax benefits only during those years in which it did not meet the criterion and not the entire period of benefits; (iii) 25% of its guests in the tax year or in the tax year and in the last two tax years, on average, are foreign residents; and (iv) a minimum capital investment — the size of such an investment is derived from the value of the productive assets of the enterprise at the end of the year preceding the one in which capital was first invested. The minimum amount to be invested is NIS 300,000 in case of a new enterprise. In case of an expansion of an existing enterprise, the minimum amount is NIS 300,000 or a percentage of the value of productive assets, as follows: up to NIS 140 M — 12%; above NIS 140 M and up to NIS 500 M — 7%; above NIS 500 M — 5% of value of productive assets, based on original cost, less depreciation according to the Depreciation Regulations, 1941, and linked to the cost of living.

The tax benefits are calculated by the "turnover growth" method in accordance with which the beneficial income is fixed by the ratio of the current turnover to the "basis turnover," reflecting the average turnover during the three or two years, prior to the beginning of the "year of election" (depending on the period of investment). The "year of election" is the year with respect to which the company informed the tax authorities that it chose to make use of the tax benefits program.

The exemption from company tax is for a period of: 10 years from the beginning of the period of benefits for an enterprises located in Zone A; six years for enterprises located in Zone B; and two years for enterprises located in Zone C. Notwithstanding these provisions, if a company distributes dividends out of income earned during the exemption period, it will be liable for company tax on the distributed amount at the same beneficial rate (usually 25%) that would have applied to its income had it not opted for the alternative benefits. The company tax is levied at the company level before applying the 20% or lower treaty rate tax on dividends, as opposed to the ordinary 30%/25% tax levied on dividends distributed out of profits derived from enterprises that are not Approved or Beneficial Enterprises.

A Preferred Company is entitled to greater benefits in the benefit period. A Preferred Company is defined similarly to a Beneficial Company and must have a Preferred Enterprise which is an industrial enterprise which meets the criteria of competitiveness laid down by the Law and which contributes to the domestic national product or is a competitive enterprise in the field of renewable energy. Preferred income of a Preferred Company is subject to a 9% or 16% company tax in 2014 (depending on the zone in which the Preferred Enterprise is located). Dividends paid from the Preferred Income are subject to a 20% withholding tax. Income of a Special Preferred Enterprise is subject to a 5% or 8% company tax.

(2) Prerequisites for Incentives — The Grants Program

To be entitled to a grant-in-aid and the additional tax incentives under the grant-in-aid program, an enterprise must be owned by an Israeli company, a cooperative, a foreign corporation registered in Israel or a limited partnership, whether Israeli or foreign (excluding an Israeli partnership of individuals and except for government companies and partnerships whose partners are government companies), or by anyone approved by the Investment Center (the statutory body charged with the admin-

[89] Israel Innovation Authority, Guidelines and Procedures for Incentive Program No. 36A, S. 7.

[90] Israel Innovation Authority, Appendix A to the Incentive Program No. 36: Encouraging technological innovation in the manufacturing industry, S. 9.

[91] Israel Innovation Authority, Guidelines and Procedures for Incentive Program No. 36B, S. 7.

[92] Israel Innovation Authority, Guidelines and Procedures for Incentive Program No. 36B, S. 11.

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istration of the Law for the Encouragement of Capital Investments, 1959).[93]

As noted above, the project undertaken by the enterprise must receive the approval of the appropriate government authorities[94] and must be economically beneficial to both the investor and the Israeli economy. Until 1984, only products and processes that were specified in a list compiled by the Investment Authority were eligible for "approved" enterprise status.[95] As of 1984, this list is no longer binding and each application for approved enterprise status is considered on its own merits.

k. Approved Enterprises Grants-In-Aid

Once approved, an enterprise is entitled to an investment grant, which is a percentage of the investment in the fixed assets that varies according to the zone. In Zone A, the percentage is 20% (in some cases) and in Zone B, 10% (in most cases). With effect from 1986, an approved enterprise situated in Zone C is no longer entitled to any grant.

The following table provides further details of the grants as a percentage of investment in fixed assets.

	Priority Region		
	A	B	C
Industrial Project	20	10	—
Tourist Lodging Facility	20	10	—

A grant is not taxable, but it is deducted from the basis of the assets in calculating the depreciation allowed for income tax purposes.[96]

In addition to its entitlement to a grant-in-aid, a preferred enterprise is subject to a preferential rate of company tax. In general, a company can enjoy the grant-in-aid program side by side with the tax benefit program, except for a company operating a tourist enterprise.[97]

Since 1985, enterprises are no longer accorded loans bearing subsidized rates of interest.

Section 40C of the Law for the Encouragement of Capital Investments, 1959 determines the special rate of the grant accorded to an approved enterprise located in the Negev (the South). The rate of the grant for investments in fixed assets for enterprises established in the Negev is significantly higher (up to 30%).[98]

l. Employment Grant Program

To enhance the benefits under the revised Law for the Encouragement of Capital Investments, the government established an additional program designed to increase employment in the outlying areas of Israel as well as specific centers suffering from a high rate of unemployment.

Support will be granted for the establishment or expansion of industrial plants, telephone call centers, computer service support centers, and logistic centers. To be eligible for this program, enterprises must employ a minimum number of workers at a minimum wage, as detailed below. To receive the support offered to employees, employers will have to compete with each other. Twice a year, employers will be invited to bid for the support. The maximum amount of support that will be granted will be 15% of the cost of the average monthly wage of the additional employees in all areas of the country, including minority and ultra-orthodox communities, but no more than NIS 120,000 per employee for the entire period. In minority and ultra-orthodox communities, employers paying wages below NIS 6,750 will be entitled to support of no more than 60,000 NIS; the total average support per employee in each allotment round may not exceed 100,000 NIS. The eligible areas comprise Priority Development Zones "A" and "B" and designated towns with minority populations (Arab, Druze, Circassian) and the Ultra-Orthodox Jewish population. The enterprise must pay its employees the following minimal wages: (i) in the minorities and ultra-orthodox towns, the minimum statutory wage; (ii) in all other eligible areas, average monthly wages of 6,750 NIS. The enterprise must employ a minimum number of workers, depending on the zone and the program (i.e., whether a new plant or an expansion).

m. Placing of High-Tech Employees in Traditional Industries

The Ministry of Industry, Trade and Employment initiated program to encourage the modernization and implementation of the industrial R&D abilities of traditional industries. The program is designed to encourage traditional industrial companies to hire High-Tech managers for one year, to help implement innovation and launch R&D. The Office of the Chief Scientist (the "Chief Scientist") will finance up to 66% of the wages of an approved worker (i.e., a worker approved for purposes of this program) for 12 continuous months, subject to a limit approved by the Chief Scientist. There is an option to obtain financing of up to 33% of the wages of a second approved worker.

To participate in the program, a candidate must have a B.A. in engineering, electronics, software, or exact or natural sciences, and professional experience of five years as one of the following: (i) a CEO of a company that engaged in industrial R&D to the extent of 10% of its income (or at least $300,000 per year); or (ii) a product development manager of at least five workers in the High-Tech industry.

To participate in the program, a company must meet the following criteria:

(i) It must have been incorporated in Israel and must derive income from traditional industry or from both industry and other fields;

(ii) Its R&D expenses must have been less than 7% of its sales and fewer than 20% of its workers must have been R&D workers in the year preceding the request;

[93] Law for the Encouragement of Capital Investments, 1959, s. 22.

[94] Law for the Encouragement of Capital Investments, 1959, s. 2.

[95] The list was quite detailed and comprised products and processes in the following categories: food; textiles and leather; chemicals and minerals; metals; electricity and electronics; and light industries.

[96] Law for the Encouragement of Capital Investments, 1959, s. 43A; Income Tax Ordinance, 1961, s. 21(b).

[97] Law for the Encouragement of Capital Investments, 1959, s. 40K.

[98] At the same time an amendment to the Income Tax Ordinance was enacted, to encourage internal immigration to the Negev, which granted inhabitants of the Negev a tax credit ranging from 5% to 25%.

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(iii) Its sales in the year prior to the request must have been between NIS 10 million and 100 million NIS;

(iv) It must have at least 20 workers (in full-time employment);

(v) It must not have received a grant from the Chief Scientist during the five years preceding the request; and

(vi) It must not be a subsidiary company of a multinational corporation.

n. Industrial Facilities

Industrial buildings used for manufacturing facilities are available in industrial parks, research institutes and development towns. Partial reimbursement of infrastructure expenses is available for new industrial facilities erected in development zones, according to a table published annually by the Ministry of Industry and Commerce.

o. Research and Development — The Bi-National Industrial R&D Foundation and Similar Foundations

The Bi-National Industrial Research and Development Foundation (BIRD-F)[99] established by Israel and the United States[100] and equally funded by each of them, supports R&D projects submitted jointly by a U.S. and an Israeli firm (a U.S. company and its Israeli subsidiary may be eligible). The fund allocates grants. If the project is successful, the grant is converted into a loan to be paid back in the form of royalties; the royalties (at rates of 2.5%–5%) are limited to a maximum of 150% of the grant. If the project is unsuccessful, the grantee need not repay the amounts received. There are three types of grants. The first type, which is limited to US$ 30,000, is awarded for executing preliminary technical or marketing studies. The support of the Foundation is contingent on the signing of an agreement by the parties covering the entire period of project implementation.

The second and third types of grants are subdivided into two basic groups:

(i) Full scale projects (i.e., projects with a budget of US$1 million–US$2 million over a period of two to three years) qualify for a 50% grant; and

(ii) Mini projects (i.e., projects with a budget of up to US$ 200,000 for a maximum of one year) qualify for a grant of up to US$ 100,000 or 50% of their outlay, whichever is less. R&D expenses eligible for coverage by a grant are salaries, materials, professional consultations, subcontractors, marketing promotion costs, trips abroad and specific equipment for the project's use.

The Canada-Israel Industrial Research and Development Foundation (CIIRD-F) is similar to the BIRD-F. It was established in 1995, and is designed to develop Canadian-Israeli cooperation in the domain of industrial R&D.

In addition, bi-national agreements and similar agreements designed to enhance mutual industrial R&D projects have been entered into between Israel and Belgium, Canada, China (PRC and Hong Kong), Finland, France, Germany, India, Ireland, Italy, Korea (ROK), the Netherlands, Portugal, Singapore, Spain, Sweden, and the United Kingdom. According to these agreements, each government is required to fund up to 50% of expenses incurred by its local company engaged in such a project. Israel is also a full participant in the European Commission's Fifth Framework Program for Research and Technological Development and takes part in the European EUREKA initiative.

p. Export Marketing Assistance and Export Insurance

The Ministry of Industry and Commerce provides Israeli exporters with a special incentive regarding marketing activities abroad. Exporters of several categories of products (for example, industrial goods, professional services, software and films) are entitled to the support of the "Export Marketing Encouragement Fund," which reimburses up to 50% of the expenses incurred by these exporters on the collection of market information, the preparation of certain advertising material, participating in international exhibits and conventions, product promotion,[101] the registration of patents, brand names and trademarks abroad,[102] and many other types of expenses — all pertaining to the marketing of the exported products abroad. The Fund also reimburses expenses incurred on the hiring of marketing experts and in search of strategic alliances abroad. The assistance of the Fund is subject to the approval of a detailed marketing plan submitted by the exporter, and is limited to two years. Furthermore, the Fund may curtail or withhold its support should the exporter fail to execute the approved marketing plan.

q. Program for Establishment of R&D Centers for International Finance

In August 2010, the Ministry of Commerce, Industry and Employment announced a program to create and develop a new growth engine in the finance sector by encouraging international financial institutions to create Israeli R&D centers that will serve the international financial industry.

The program will apply to a multinational corporation that meets the following criteria:

(i) Its business center is outside Israel and it does not perform R&D in Israel;

(ii) Its annual income in the year prior to the application is US$ 10 billion; and

(iii) It operates in the financial field.

The multinational corporation must apply for approval of a perennial operational framework, which has to include, among others:

(i) Perennial operating plan to finance R&D for five years, which includes the expected budget and employees;

(ii) An undertaking to employ at least 25 Israeli R&D employees until the end of the first year, 50 employees until

[99] www.birdf.com. For more details regarding similar foundations, see www.matimop.org.il.

[100] Bi-National Industrial Research and Development Foundation Law, 1978.

[101] For more details, see www.tamas.gov.il; www.export.gov.il.

[102] For more details, see http://index.justice.gov.il/En/Units/ILPO/Pages/default.aspx.

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the end of the second year and 80 employees as of the end of the third year;

(iii) Details regarding the management of the financial R&D center;

(iv) Details regarding the expected projects, the investments and the place at which the project will take place; and

(v) Commitment that the corporation and its controlling shareholders will safeguard the rights of the employees.

A committee has been set up to examine the applications.

The operations will be undertaken by financial R&D centers for a period that will not exceed the approved period. In any case, the approved period will not exceed five years. At least 90% of the financial R&D center's employees have to be Israeli citizens. The company may subcontract the projects, in which case 90% of the subcontractor's employees must be Israeli citizens.

The governmental support for the projects will be 40% of the total budget that will be approved by the committee in the first and second years, 30% in the third and fourth year and 25% in the fifth year. Projects in rural areas will be entitled to governmental support of 50%, 40% and 35%, respectively. There will not be any requirement for a royalty refund of the governmental support.

The program will not finance: (i) operations that receive support from funds or other governmental support; or (ii) a multinational corporation or financial R&D center in receivership or in bankruptcy.

r. Program to Encourage Traditional Industry

This program, which ended on December 31, 2012, was intended to encourage traditional industry to integrate new technologies. A Traditional Industry Company is a company active in the field of traditional industry according to the Israeli Central Bureau of Statistics. Such a company was required to comply with two criteria to be entitled to the new benefits. It was required to: (i) operate in a field defined by the Central Bureau of Statistic; and (ii) invest in R&D a sum equal to up to 7% of its income in the year prior to the application (excluding companies with income exceeding NIS 10 million). A company in this program was exempt from royalties repayment as of September 1, 2009, until December 31, 2012.

Other benefits were:

(i) Companies in the traditional industry field were able to present R&D projects throughout the year;

(ii) A grant of at least 50% of the direct R&D expenses of the project;

(iii) R&D projects for production processes and R&D for products manufactured for the local markets were approved under certain conditions;

(iv) Expenses for the innovation of one prototype were eligible for the grant even if part of the future production process;

(v) A budget of up to NIS 500,000 for development of molds that were part of the production line were eligible for the grant;

(vi) Expenditure of up to NIS 250,000 for the purchase of know-how that is an integral part of the R&D plan was eligible for the grant on condition that the purchase was made in the approved R&D year and was not from an interested party;

(vii) Expenses for hiring of academic or high-tech employees, employed for spotting ideas or submitting R&D projects, for companies that apply for the first time were retroactively eligible for the grant for up to six months;

(viii) Exception from the wage ceiling applied to returning academicians employed as senior R&D employees was allowed;

(ix) Expenses for wages of up to three employees if they do not reach 10% of the rate of workforce were eligible for the grant; and

(x) Companies applying for the first time were exempt from some digitized reporting duties.

The projects were subject to the financing procedures of the R&D fund.

s. BIRD Fund for R&D Plans

The Binational Industrial Research and Development Fund ("BIRD Fund") is a binational program for promoting industrial R&D between the United States and Israel. The BIRD fund will support U.S. and Israeli companies' joint R&D activities by participating in up to 50% of their development budget until commercialization is reached. The program principles are:

(i) Technological innovation in a wide spectrum of technologies, e.g., life sciences, electronics, electro-optics, software, renewable energy, internal security, etc.

(ii) There are two kinds of projects:

(a) Complete project — for a project whose development budget exceeds US$ 400,000 the BIRD fund will finance up to 50% of the project's costs but no more than US$ one million; and

(b) Mini project — for a project whose development budget does not exceed US$ 400,000 the BIRD fund will finance up to 50% of the project's costs but no more than US$ 200,000.

(iii) The contribution of each participating company will not be less than 30% of the total budget of the project.

(iv) The grants will be repaid to the BIRD fund as royalties on future sales of the developed product at the following rates: (a) 5% from the sales of the product; (b) 30% of the income from rights of use; or (c) 50% of the income from the sale of the intellectual property. The maximum return will be 100%–150% according to the following criteria:

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Years Since End of Project	Return
1	100%
2	113%
3	125%
4	138%
5 and more	150%

Should no sales be achieved due to technological or marketing failure, the grant will not be refunded.

Every company registered in the United States or in Israel is entitled to participate. The two companies have to have the ability to characterize, develop, produce and sell the product, and at least one of the companies must have the technology or the developed product's intellectual property.

t. "One Hundred Million" Program

To increase the trade volume with India and China, the Industry, Commerce and Employment Ministry initiated a fund to aid Israeli companies in establishing a market in those countries, as follows:

(i) The fund will fund up to 50% of the logistical costs for operating an office up to 200,000 NIS per year, for three years.

(ii) The fund will fund up to 50% of the costs of a local advisor up to 300,000 NIS per year, for three years.

(iii) The fund will fund up to 50% of costs for posting a company's employee up to 500,000 NIS per year, for three years.

(iv) The fund will provide a one-time grant in the amount of up to 50% of the expenses for proving the local implementation of the technology and for a refinancing account in India or China, up to NIS 400,000.

The fund's committee may approve one or more grants.

The grants are conditioned on: (i) annual turnover of NIS 15-200 million in the year before the year in which the application was submitted; (ii) total annual exports amount to at least 10% of sales; (iii) annual exports to China and India do not exceed NIS 20 million per year; (iv) the company does not receive additional support from the government; and (v) the company did not employ in the period of six months prior to the application more than five employees in the target market.

The fund's committee will consider the following criteria in making the grant: (i) financial stability; (ii) technological and marketing abilities; (iii) management quality; (iv) three-year commitment; (v) product suitability for target markets; (vi) increase of sale potential in target markets; and (vii) contribution to the Israeli economy.

A company that will receive the grant will have to pay royalties at the rate of 3% on added Chinese and Indian income.

u. Life Technologies Agreement

Certain grants are available under an agreement signed between the Chief Scientist and the American multinational corporation Life Technologies. The agreement is designed to encourage joint R&D projects between Israeli companies and Life Technologies.

According to the agreement, the Chief Scientist will provide a grant of up to 50% of the approved budget of the R&D project. In addition, companies located in Zone A are eligible for an additional grant of 13%.

Additional assistance is offered by Life Technologies by way of professional advice, laboratory equipment, etc.

v. R&D Start-Ups

The Office of the Chief Scientist has established an additional program in order to support start-up companies engaged in research and development activities. According to the program, such companies may apply to the Chief Scientist to receive a grant of up to 50% of the approved R&D costs to the extent that the following conditions are met:

- The company's turnover is less than NIS 500,000;
- The company has not yet received any financial support from the Office of the Chief Scientist;
- The company was incorporated not more than three years prior to the submission of the application;
- The company did not raise more than NIS 2 million;
- The company did not raise more than NIS 1 million during the year prior to the submission of the application; and
- The company's expenditures meet certain requirements provided by the Office of the Chief Scientist.

3. Restrictions on Foreign Investment

There are no restrictions on the investment of foreign capital in Israel. The Ministry of Defense, however, does sometimes limit the participation of foreign investors in military industrial enterprises to 49% of the invested capital and voting rights. Furthermore, the Bank of Israel's consent is required for the acquisition of 5% or more of the voting rights of an Israeli bank. The acquiring of real property leasehold rights by a nonresident corporation where the owner is the Land Administration Authority requires the latter's approval. A prior permit is required for the acquisition of control in certain companies (for example, Bezeq, the Israeli Communications Company, and El Al Israeli Airways). It should also be noted that a tourist may not work in Israel without a work permit, which is issued by the Ministry of the Interior on the basis of an application explaining the special circumstances for which the permit is required.[103] The granting of work permits to foreigners is unusual except in the cases of "approved specialists," discussed at XVII.B.3., below, and foreign workers engaged in agricultural or nursing institutions.

[103] Entry to Israel Regulations, 1954, s. 13.

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B. Currency and Exchange Controls

1. In General

In the past, Israel enforced severe foreign exchange controls designed to direct the flow of foreign currency and maintain its reserves. In October 1977, these provisions were greatly relaxed and a gradual liberalization policy has been implemented since then. There is no longer an official rate of exchange and the exchange rate of the Israeli currency is determined by market fluctuations. Prior to the introduction of free foreign currency trading, massive demand for foreign currency often exhausted the foreign exchange reserves, which inevitably led to a devaluation of the local currency and resulted in the purchasers achieving speculative gains. This is no longer the case since the currency adjusts to the market with only slight intervention from the Bank of Israel.

The Currency Control Law, 1978, which was abolished in the Bank of Israel Law, 2010, governed all foreign currency transactions, as well as all transactions between residents and nonresidents. The Law prohibited a resident from entering into any transaction with a nonresident or from engaging in any transaction involving foreign currency.[104] In addition, the Law prohibited the export of assets from Israel,[105] the import of Israeli currency into Israel[106] and the holding of foreign currency and foreign securities by local residents.[107] With respect to real estate located in Israel, a resident could not enter into a transaction with a nonresident and a local resident was prohibited from entering into a transaction with respect to real estate located outside Israel.[108]

At first sight, the Law seemed to prohibit almost every transaction involving a foreign currency or to which a foreign resident is a party. However, the Law authorized such transactions if they were entered into in accordance with a permit issued by the Bank of Israel.[109] In an effort to liberalize the foreign exchange controls, a general permit was issued in 1978, and had since been amended numerous times. In May 1998, a general permit was issued in lieu of the much-amended 1978 permit.[110] Under section 2 of the 1998 general permit, any transaction that required approval under sections 2 through 6 of the Currency Control Law, 1978 (the holding of foreign exchange, transactions in real estate with a nonresident, the importation of Israeli currency, the alienation of assets from Israel and any transaction in foreign currency or with a nonresident) was permitted under the terms and conditions of the general permit. The 1998 general permit applied to all residents and nonresidents. However, the 1998 general permit was terminated due to the enactment of the Bank of Israel Law, 2010.

The 1998 general permit permitted all transactions in foreign currency, foreign securities and foreign real estate and transactions with foreign residents including transactions with foreign residents in Israel, with a few exceptions regarding institutional investors and foreign residents engaged in futures transactions. Accordingly, Israeli residents could freely transact in foreign currency, inside or outside Israel, and from a practical point of view were not subject to any restrictions. Foreign residents could enter into transactions regarding assets located in Israel in foreign as well as local currency, subject to minor exceptions. The repatriation of capital or income did not require any special permit.

Subsequent to the issuance of the 1998 general permit, and to manage and monitor monetary policy effectively, the Currency Control Law, 1978, was amended accordingly. The permit required wide compulsory reporting to the Controller on certain transactions and on the holding of foreign currency abroad. Simultaneously, the Law mandates secrecy obligations on the Controller's employees.

Despite the far-reaching reform of the foreign exchange controls regime of May 1998, some restrictions were still in force, as follows:

(i) An Israeli bank was required to distinguish between resident and nonresident accounts. When a nonresident account is opened, the holder must declare his/her citizenship (as was defined in the Currency Control Law, 1978) in addition to all other information required by law.

(ii) The Regulations concerning the management of bank accounts of residents applied to both local and foreign currency accounts but, as a bank policy, some banks choose to differentiate between the two types of accounts.

(iii) Foreign residents held nonresident accounts, foreign currency accounts and nonresident local currency accounts.

According to definitions in the Currency Control Regulations (Definition of a Foreign Resident), 1998, residents of areas under the control of the Palestinian Authority were considered nonresidents. Due to the significant volume of transactions between the Palestinian Authority and Israel, banks were required to record such transactions and classify them as transactions with nonresidents.

Due to the legislation of the Bank of Israel Law, 2010, the Currency Control Law, 1978 and the Currency Control Permit, 1998 were abolished and their provisions were replaced by the Bank of Israel Law, 2010. However, according to the Bank of Israel Decree (Information Regarding the Development of Foreign Currency in Israel), 2010, Israeli financial institutions must report to the Bank of Israel, inter alia, with respect to the following:

(i) Any transaction between an Israeli resident and a foreign resident;

(ii) Any transaction performed by an Israeli resident in a foreign currency;

(iii) Any transaction performed by a foreign resident in ILS; and

(iv) Any Israeli securities held on behalf of a foreign resident or foreign securities held on behalf of an Israeli resident if the value of such securities is more than US$100,000.

[104] Currency Control Law, 1978, s. 2.
[105] Currency Control Law, 1978, s. 3.
[106] Currency Control Law, 1978, s. 4.
[107] Currency Control Law, 1978, s. 6.
[108] Currency Control Law, 1978, s. 5.
[109] Currency Control Law, 1978, s. 9.
[110] Currency Control Permit, 1998, s. 9(a).

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2. Prohibition of Money Laundering Law

In accordance with the resolutions of the Organization for Economic Co-Operation and Development (OECD) of July 2000 and to avoid the imposition of sanctions by the OECD members, the Israeli parliament enacted the Prohibition of Money Laundering Law, 2000.

The Law defines "Money Laundering" as the execution of a transaction involving an asset originating directly or indirectly from an offense, used to commit an offense, or enabling the commission of an offense, with the object of concealing or disguising its source, the identity of the owners of the rights therein, its location, or its movements, or the performance of a transaction with respect to such asset.

Under the Law, money laundering is a criminal offense that carries with it a sanction of imprisonment for up to 10 years. Pursuant to the Law, the Governor of the Bank of Israel issued the Prohibition of Money Laundering Decree (Duties of Identifying, Reporting and Managing of Bank Records), 2001.

The decree prohibits the opening of unidentified bank accounts and orders banks to report to the authorities:

(i) Any withdrawal or deposit of any amount exceeding NIS 50,000;

(ii) Any transaction involving the account and exceeding NIS 50,000, including the transfer of cash abroad;

(iii) Any currency exchange in excess of NIS 50,000;

(iv) Any issue of a cashier's check in excess of NIS 200,000, excluding a cashier's check of up to NIS one million given as a loan for housing;

(v) Any purchase of travelers checks in an amount that exceeds NIS 50,000;

(vi) Any deposit of checks in foreign currency in excess of NIS one million; and

(vii) Any transfer of currency in excess of NIS one million.[111]

In addition to the above, the Prohibition of Money Laundering Decree (Duties of Identifying, Reporting and Managing of Bank Records), 2001 stipulates, inter alia, that banks are required to report any extraordinary transaction[112] and:

(i) Any transaction that appears designed to bypass the restrictions set forth above;

(ii) The frequent use of the bank's safe by a large group of people with no obvious cause;

(iii) Any case in which it seems that the owner of the account is managing the account for another person without giving notice thereof; and

(iv) Any transaction that:

- was conducted by a proxy, not being an approved account signatory;
- involves the withdrawal of cash close to its deposit,
- is not in the normal course of business;
- involves the transfer of cash from or to an unidentified source;
- is an atypical transaction;
- is of an extraordinary scope;
- constitutes repeated unexplained transactions with an identical source; or
- involves a large number of deposits by a party other than the owner of the account.

Banks are exempt from reporting these transactions if the executor of the transaction concerned is one of the following:

(i) Public institution;

(ii) Bank or a credit card company;

(iii) Israeli Post Office Bank;

(iv) Insurance company, as defined in section 1 of the Supervision of the Insurance Business Law, 1981;

(v) Member of the stock exchange;

(vi) Provident fund; or

(vii) Mutual fund.

The Law requires a person entering or leaving Israel to report the amount of money carried by the person if it exceeds NIS 100,000, or NIS 1,250,000 if the person entered Israel with an immigrant's visa under the Law of Return.

The Israel Money Laundering Prohibition Authority, which is the Israeli Financial Intelligence Unit (FIU) in the Ministry of Justice and was renamed the Israel Money Laundering and Terror Financing Prohibition Authority by the Prohibition on Financing Terrorism Law in 2005, has as its main purpose assisting in the investigation and prevention of money laundering and terror financing related crimes.

3. Secrecy

All returns and reports filed with the Controller are confidential and may not be used in any proceedings except criminal proceedings, and then only pursuant to the instructions of the Governor of the Bank of Israel.

C. Trade and Commerce Regulations

1. Imports and Exports

a. Imports

(1) Permits

The Imports and Exports Ordinance, 1979 grants the Minister of Industry and Commerce wide powers with respect to the import and export of goods. Section 2 of the Ordinance provides that the Minister may, by order, make such provision as the Minister thinks expedient for prohibiting or regulating the importation of goods into Israel, their export, their transport along the coast or their loading on ships, in general or in relation to any specified classes of cases and subject to such exceptions, if any, as may be made by or under the order. The

[111] Prohibition of Money Laundering Decree (Duties of Identifying, Reporting and Managing of Bank Records), 2001, s. 8.

[112] Prohibition of Money Laundering Decree (Duties of Identifying, Reporting and Managing of Bank Records), 2001, s. 9(b).

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Minister is also entitled to prescribe by order that a person importing or wishing to import goods into Israel make a deposit in favor of the Treasury in such place, in such amount, at such rate, at such time, for such period, on such conditions and in such manner as prescribed by the order, and the Minister may prohibit clearance of any goods from customs unless a deposit was made with respect thereto. Indeed, until January 1988, when the deposit rate was set at 0%, a one-year deposit was required.[113] The rationale for the deposit was to increase the price of imports by the rate of the denied interest and the devaluation of the deposit. By a special Order, the Minister has prescribed that no goods may be imported into Israel without an import license.[114]

At first sight, the Ordinance and the Order issued pursuant to it seem to prohibit the importation of any goods into Israel without a specific license. However, the statutory framework was not as strict as it seems, for the Minister of Industry and Commerce has, by another special Order, allowed the importation of numerous goods into the country without a special import license having to be obtained (except for certain goods as provided in the schedules attached to the Order).[115] Most articles imported into Israel do not require the special permission of the Minister.[116]

Imports from countries that bar or curtail the import of Israeli goods require a permit.[117] A list of such countries is published by the Minister of Economy and includes, among others, most Arab countries and a number of the former Soviet Union states (CIS). It does not include any country from Western Europe, or North, Central or South America.

(2) Dumping and Unfair Competition

A special law was enacted in 1991 to prevent dumping. The Levies on Commerce Law,[118] was formulated so as to keep its provisions within the boundaries set by the international treaties (including the GATT International Subsidies Agreement) to which Israel is a party.

The Law, which is based on similar legislation in other industrialized states, empowers a Minister to impose a levy, by way of an order, on the import or export of goods to and from Israel, on the possession of goods and on the rendering of services, if in his/her opinion the levy is necessary to achieve certain prescribed objectives, such as:

- The prevention of an adverse change in the balance of payments or in the state's foreign currency reserves;
- An adjustment of the production of demand for and consumption of agricultural goods, including the prevention of a surplus or the price-discounting of such goods;
- The protection of local production against competing imports;
- The prevention of the exhaustion of natural resources; and
- The taking of economic measures against a state breaching an agreement or arrangement with Israel.

The Law's underlying principle is that, where the prices of goods or services are influenced by an intervening state granting benefits to its exporters or producers, the importing state is entitled to protect its own industry by way of imposing a dumping or an equalizing levy that will offset the benefits' influence. A dumping levy is imposed with respect to a "certain type of goods imported from the State where the goods were produced or from other states to be determined in an order, or that were manufactured by producers or supplied by suppliers mentioned in an order."[119]

An equalizing levy is imposed on "goods the origin of which is the manufacturing state where the price of goods is supported."[120]

An order imposing a levy is in effect for three years, or for a shorter period if so provided,[121] and an importer that is required to pay the levy is entitled to submit to the officer in charge a request for the reconsideration of the order.[122]

b. Exports

(1) Permits

The same Ordinance that authorizes the Minister of Industry and Commerce to impose a general prohibition or restrictions on the import of goods into Israel, the Import and Export Ordinance, 1979, permits the Minister to regulate the export of goods from Israel.[123] Under section 2 of a special Order of the Minister of Industry and Commerce,[124] any commercial export of goods from Israel is permitted, except the export of goods listed in the schedules attached to the Order which require certain permits or approvals.

The exporter is required to file a number of documents. Foremost among these is the export entry known as Number 9. In this entry, the exporter lists the type of the exported articles, his/her name and number, the agent dealing with the matter, general information regarding the purchaser, the export license (where required), the consideration and the manner of its payment, the packaging, weight and quantity of the goods, the category of the articles in the customs tariff and other pertinent data. Other documents include the port authority documents, shipping documents, the certificate of origin customarily issued by one of the chambers of commerce, the insurance certificate, and the bill of lading. In some instances, a certificate of quality is required to ensure that the exported goods meet the standards set by the government authorities responsible for encouraging exports.

[113] Import and Export Ordinance (New Version), 1979, s. 3; Import of Goods (Deposits) Order, 1986, s. 2.
[114] Import Licenses Order, 1978, s. 2.
[115] Free Import Order, 2014, s. 2.
[116] As set forth in s. 2 of the Free Import Order, 2014.
[117] *See* Office of Economy Guidance No. 2.4 dated Dec. 30, 2013.
[118] Replacing the Prevention of Dumping Law, 1977.
[119] Levies on Commerce Law, 1991, s. 24.
[120] Levies on Commerce Law, 1991, s. 25.
[121] Levies on Commerce Law, 1991, s. 27(a).
[122] Levies on Commerce Law, 1991, s. 29.
[123] Import and Export Ordinance (New Version), 1979, s. 2.
[124] Free Export Order, 2006. *See also* Import and Export Order (Inspection of Exporting of Two-Useful Goods, Services and Technology), 2006.

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(2) Military

Of special importance is a specific Law regulating the export of military equipment and military know-how.[125] The Law prohibits the export of any military equipment, services involving military know-how, and the rendering of advice or engagement in brokerage activities with respect to the above. A person may engage in the export of military equipment or services involving military know-how, or in an advisory or brokerage capacity once the person has received the applicable permit as provided under the Law. However, it should be noted that an exemption from the aforementioned permit is available under the Control of Defense Export Regulations (Exemption from Defense Exporting Permit), 2008 which apply mostly with respect to initial marketing activities and not with respect to actual exporting.

2. General Regulation of Business

a. Regulation of Competition

The Restrictive Trade Practices Law, 1988, also known as the Antitrust Law, which replaced the former law of 1959, governs the main aspects of state regulation of market competition. The former law was rarely enforced, especially with regard to cartels. However, in recent years, the Restrictive Practices Controller, who operates under the Law, has been remarkably active and is involved in all of the large-scale transactions conducted in Israel. In the past few years, the number of criminal charges as well as the severity of penalties under the Law has increased dramatically. The decisions of the Controller and the judgments of the Court of Restrictive Practices (in effect, the District Court of Jerusalem), published periodically as of 1994, form the Israeli precedent-based competition law, applying and interpreting the provisions of the Law. The Law has civil, administrative, and criminal aspects.

(1) Monopolies

A "monopolist" is defined in the Economic Competition Law, 1988, as "A person whose share of the total supply of assets or the total purchase thereof, or the total provision of services or the total purchase thereof, exceeds half; or a person who holds significant market power with regard to the supply of assets or purchase thereof or with regard to the total provision of services or purchase thereof."[126] For purposes of this definition, the following are regarded as one person: (i) a company and its subsidiaries; (ii) the subsidiaries of one company; and (iii) a company and the person controlling it.[127] A monopoly can relate to the whole country or a particular region[128]

Like the European approach to monopolies, and unlike the US approach, the Israeli regulation of monopolies concentrates on the prevention of such monopolies' abuse of their dominant market position. The regulation has a two-tiered structure: first, the Director-General declares that a company is a monopoly in the Official Gazette and on the website;[129] thereafter, certain supervisory means are used to regulate the company's activities.[130] A monopoly may not unreasonably deny any person the supply of the goods or services with respect to which the monopoly exists.[131] In 1996, section 29A was added to the Law, prohibiting monopolies, among other things, from abusing their market position by manipulating prices, supply and contracting terms.

If the Director-General sees that as a result of a monopoly business competition is being harmed or the public is being harmed, he may give the monopolist instructions to prevent the harm.[132] The following factors can all give rise to harm to business competition or harm to the public: the price of an asset or a service; the quality of an asset or a service; the quantity of assets or the scope of a service; the supply of, the regularity of or the terms with respect to an asset or a service; and barriers to access to a sector or to movement within a sector.[133]

The Court may direct the holder of a monopoly to prevent such deleterious effects. Where prevention by means of appropriate controls proves impossible, the Court may order the division of the monopoly into two separate companies, either by the transfer of part of the shares to a separate entity, in accordance with the monopoly's choice, or by the incorporation of a new company to which a part of the monopoly's assets is transferred.[134]

(2) Mergers

Section 314 of the Companies Law, 1999 provides that mergers between companies require the sanction of the shareholders' meeting and the approval of the board of directors of each merging company. The Economic Competition Law, 1988 also applies to mergers if any one of the following conditions is fulfilled:

(i) As a result of the merger, the merging companies will control 50% or more of the relevant market or the companies will hold significant market power;

(ii) The combined sales turnover of the merging companies in the year preceding the merger exceeded NIS 360 million;[135] or

(iii) One of the merging companies is a "monopoly."[136]

[125] The Law for the Control of Defense Export, 2007.

[126] Economic Competition Law, 1988, s. 26.

[127] Economic Competition Law, 1988, s. 26(f).

[128] Economic Competition Law, 1988s. 26(b).

[129] Economic Competition Law, 1988, s. 26(a1).

[130] Restrictive Trade Practices Controller's Declaration of a Monopoly: "Yediot Aharonot," Apr. 1995. In this decision the Controller ruled that a daily newspaper with a circulation of more than 50% of the market, although narrowly defined to include only daily newspapers in Hebrew, is a monopoly in that market. In other cases, the Controller refused to declare the Tel-Aviv Stock Exchange to be a monopoly, in spite of it being the only permitted stock exchange in Israel, in light of the restrictions and regulations imposed by the special securities legislation on it (see II.C.2.d.), which renders the regulation under the Restrictive Trade Practices Law, 1988, unnecessary. *See also* T.R.C. 1/93 *The Restrictive Trade Practices Controller v. Dubek*, Restrictive Trade Practices 2 (1996), p. 194; D.C.R. 21953/02 *Pelephone Communications v. Megurim Yezum*, Taggidim F-1, 666 (2009).

[131] Economic Competition Law, 1988, s. 29.

[132] Economic Competition Law, 1988, s. 30(a).

[133] Economic Competition Law, 1988, s. 30(c).

[134] Economic Competition Law, 1988, s. 31.

[135] According to the Restrictive Trade Practices Regulations (Registration, Publication and reporting of transactions), 2004, s. 9(2) provides that, in addition, the turnover of at least two of the companies participating in the merger should be more than NIS 10 million (per company).

[136] Economic Competition Law, 1988, s. 17(a).

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In the event that one of the merging companies conducts business both in Israel and abroad, these provisions apply only with respect to its sales turnover in Israel, or its portion of production, selling, marketing or purchasing of the article in Israel, or its portion in rendering or receiving the service in Israel.[137]

The Law provides that no merger to which it applies is allowed unless notice thereof was given to the Controller of Restrictive Practices and his/her approval, whether conditional or not, was granted thereto.[138] The Controller will object to the merger or lay down conditions with respect to its implementation if there is reason to believe that the merger might substantially affect competition or be detrimental to the public at large by increasing the prices of goods or services, by decreasing the quality of goods or services or by affecting the marketing of the goods or services in the relevant business field.[139] Once the Controller's approval is granted, any individual, corporation or consumers' organization that may be affected by the merger, has the right to petition the Court of Restrictive Trade Practices, which may, upon petition, approve, modify or overturn the Controller's decision.[140] The Law further provides that the Controller's approval of a merger is not to be granted without consultation with a committee specially appointed for this purpose.[141] Notwithstanding the above, a merger between a company and its subsidiary does not require the consent of the Controller, even in cases that allegedly contravene the Economic Competition Law, 1988.

Except as provided for in the Companies Law, 1999,[142] and the Economic Competition Law, 1988, mergers are not supervised by any other authority. Until the end of 1993, tax-free mergers required the sanction of a special committee created under the Law for Encouragement of Industry (Taxes), 1969. Thereafter new merger relief provisions came into force, as part of Chapter E2 of the Income Tax Ordinance, which deals with reorganizations (see the relevant discussion in IV., below).

A draft bill to amend the Income Tax Ordinance was published in November 2024. Among other things, the draft would reduce the required holding rate in a share-for-share merger under Section 103 from 80% to 70%. In addition, to ease the conditions regarding size ratios in mergers, a merger would be allowed when the size ratio between the two merging companies does not exceed 19:1 (instead of 9:1) and the rights held by shareholders of the smaller company are at least 5% (instead of 10%) of the merged company's rights, provided prior approval is obtained.

(3) Restrictive Trade Practices

The Economic Competition Law, 1988, prohibits persons that carry on a business from entering any arrangement expressly or implicitly designed to restrict any one of the parties thereto in a way that may distort business competition between or among such parties or between such party or parties and an individual that is not a party to the arrangement. Within the meaning of the Law, an arrangement may be written or oral, expressed or implied, and with or without legal effect. More specifically, a practice is regarded as restrictive when the restraint relates to one of the following matters:[143]

(i) The price to be offered, paid or demanded;

(ii) The profit to be derived;

(iii) The division of the market, whether in its entirety or a part thereof, according to the place of business or to the people or class of people with whom business will be conducted; or

(iv) The quantity, quality or type of assets or services.

A corporation's determination of a policy for its members or for a particular class thereof that may prevent or reduce business competition between them, whether or not binding on them, is deemed to be a cartel, and the corporation and every member thereof is deemed to be a party to the cartel.[144] An individual who knowingly conducts business in the framework of a cartel is deemed to be a party thereto.[145]

Regulations in effect as of 2006 decree that any related person (i.e., a person that controls a party to a restrictive agreement) will be deemed a party bound by any restrictions imposed on the first-mentioned party.[146]

The Law excludes a number of arrangements that would otherwise be "restraints" from becoming cartels.[147] Foremost among these are:

(i) An arrangement imposing restraints all of which are prescribed by law;

(ii) An arrangement imposing restraints relating to the use of any patent, design, trademark, copyright, performers' right or cultivators' right, if the parties thereto are the owner of the asset (i.e., the right) and the licensee, and provided that if the right must by law be registered, it was indeed so registered;

(iii) An arrangement between someone granting a right with respect to immovable property and someone purchasing the right;

(iv) An arrangement imposing restraints, all of which relate to the local growing or marketing of fruits, vegetables, field crops, milk, eggs, honey, cattle, poultry or fish, not including industrial products thereof, where all the parties thereto are producers or wholesale distributors of the commodities;

(v) An arrangement the parties to which are a company and its subsidiary;

(vi) An arrangement imposing restraints with respect to international transportation, whether via air or sea, if all the parties thereto are air or marine carriers or international aviation or shipping corporations approved for this pur-

[137] Economic Competition Law, 1988, s. 18.

[138] Economic Competition Law, 1988, s. 19. Accordingly, Companies Law, 1999, s. 322 provides that no merger will take place unless the Controller of Restrictive Practices removes his opposition to the merger.

[139] Economic Competition Law, 1988, s. 21(a).

[140] Economic Competition Law, 1988, s. 22(b).

[141] Economic Competition Law, 1988, s. 24(a).

[142] And also in the Companies Regulations (Mergers), 2000.

[143] Economic Competition Law, 1988, s. 2.

[144] Economic Competition Law, 1988, s. 5.

[145] Economic Competition Law, 1988, s. 6.

[146] Rules of Restrictive Trade Practices (Directives General Definitions), 2006. s. 2.

[147] Economic Competition Law, 1988, s. 3.

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pose by the Minister of Transportation. Nevertheless, a 2007 Amendment substantially narrowed the wide statutory exemption enjoyed by international air carriers by addressing arrangements entered by them. Several types of arrangements, including code-sharing arrangements, require the prior approval of the Controller or of the Court of Restrictive Trade Practices, unless they are exempted by a Published Block Exemption. Under the amendment, in any one of the following cases, the specific approval of the Controller will be required: an arrangement in which both parties are Israeli air carriers; an arrangement between air carriers, of which at least one is Israeli and at least one is foreign; and an arrangement between air carriers none of which are Israeli, but at least one of which has activity or representation in Israel, provided that one of the major issues of the arrangement is air transport to or from Israel, and the restrictions in the arrangement concern the activity, or abstaining from activity, in Israel, of any of the parties. The Restrictive Practices Controller's approval will not be required in the latter two cases: if the arrangement was approved by the Ministers of Foreign affairs and Transportation for purpose of preventing harm to Israel's international relations; or to assure the continuance of flight rights between Israel and other countries;

(vii) An arrangement by virtue of which the seller of an entire business is obligated to the purchaser thereof to refrain from conducting the same type of business, if such an obligation is not contrary to reasonable or accepted standards; and

(viii) An arrangement to which a trade union or an employee's union is a party and that imposes restraints, all of which relate to the employment and conditions of employment of employees.

Before a cartel is established or joined, the approval of the Court of Restrictive Practices must be obtained.[148] Every person, corporation or organization that considers itself aggrieved by a cartel may lodge with the Court its opposition to the approval. The Court may approve a cartel, in whole or in part, and on such conditions and for such a period of time as it may deem fit, provided the existence of the cartel is not contrary to the public interest. In considering the public interest, the Court examines, among other factors, whether there exists a reasonable need for the cartel with respect to the following matters:

(i) The efficiency of the production and marketing of the goods and services, their quality and the consumer price;

(ii) The ensuring of an adequate supply of the goods and services to the public;

(iii) The prevention of unfair competition that is likely to restrain competition in the supply of the goods or services by a person that is not a party to the arrangement;

(iv) The enabling of the parties to the cartel to obtain a supply of the goods or services under fair conditions from a person that controls a significant percentage of the supply, or to supply an article or service to a person as aforesaid under reasonable conditions;

(v) The protection of the existence of an entire economic branch considered advantageous to the Israeli economy;

(vi) The ensuring of the continuance of enterprises as a source of employment in areas where substantial unemployment may occur as a result of the closing down of enterprises or the reduction of their capacity; and

(vii) The improving of the balance of payments by the reduction of the cost of imports or by the increasing of exports.[149]

Under section 15A of the Restrictive Trade Practices Law, 1988, which entered into force in 2000, the Controller may issue "rules" that exempt parties to a restrictive agreement from the need to obtain the court's approval for the restrictive agreement. Exemptions have been issued for: (i) distribution agreements;[150] (ii) franchise agreements;[151] (iii) exclusive purchase agreements;[152] (iv) R&D agreements;[153] (v) agreements that have a negligible effect on commercial competition;[154] (vi) joint loan arrangements;[155] and (vii) joint ventures between non-competitive parties.[156] Most of the aforementioned rules contain conditions as to the enjoyment of the exemptions by competitive parties and other specific conditions.

In reinstating the rationale for classifying an arrangement as a restrictive trade practice, the Supreme Court has held that the public welfare should be given utmost consideration in this matter.[157]

In the *Extel*[158] case, it was held that the mere fact that an arrangement was declared restrictive does not nullify the arbitration clause contained therein. In the *Land Assessors*[159] case, the Court held that the fixing of a maximum price in a tender offer does not constitute a restrictive arrangement. Similarly, in the *A. M. Chanuyot (Yerushalayim)*[160] case, it was held that the grantor of a concession may fix a maximum price for the service granted thereunder and such a restriction does not constitute a restrictive arrangement. Under regulations promulgated in 2004, the Controller administers a register in which all restrictive arrangements, mergers, and monopolies are registered. The Controller has also issued a circular that sets forth the ad-

[148] Economic Competition Law, 1988, ss. 4 and 7(a).

[149] Economic Competition Law, 1988, s. 10; T.R.C. 445 *I.C.P. v. The Restrictive Trade Practices Controller*, Restrictive Trade Practices 1 (1995), p. 298.

[150] Rules of Restrictive Trade Practices (Exemption for Exclusive Distribution Agreements), 2001.

[151] Rules of Restrictive Trade Practices (Exemption for Franchise Agreements), 2001.

[152] Rules of Restrictive Trade Practices (Exemption for Exclusive Purchase Agreements), 2001.

[153] Rules of Restrictive Trade Practices (Exemption for R&D Agreements), 2001.

[154] Rules of Restrictive Trade Practices (Exemption for Agreements Which Have Negligible Effect on Commercial Competition), 2006.

[155] Rules of Restrictive Trade Practice (Exemption for Joint Loan Arrangements, 2018.

[156] Rules of Restrictive Trade Practices (Exemption for Joint Ventures), 2001.

[157] F.H. 4465/98 *Tivol v. Shef Hayam*, P.D. 56(1) 56.

[158] C.A. 6233/02 *Extel Ltd. v. Kalma Way Aluminum and Glass Marketing*, P.D. 58(2)635.

[159] M.A.A. 6464/03 *Land Assessors Ass'n v. The Ministry of Justice*, Takdin Elion 2004(1), 1191.

[160] C.A. 3700/98 *A.M. (Chanuyot) Yerushalayim v. Municipality of Jerusalem*, P.D. 57(2), 590.

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ministrative procedure regarding requests for pre-rulings and the way they will be dealt with.

In a civil torts action launched by three foreign aviation companies against Aviation Services Ltd.[161] and its three shareholders that, during the relevant period, were the major fuel distributors in Israel (Aviation Services was the result of a horizontal cooperation between the fuel distributors and was at the time the sole supplier of jet fuel and refueling services to airlines), the Court ruled in favor of the plaintiffs, determining that the corporation was an illegal restrictive arrangement, and that the horizontal cooperation strengthened Aviation Services' market power and enabled it to charge the plaintiffs non-competitive prices, while discriminating against the national airline. The Court ordered payment of damages of more than US$ three million.

(4) Enforcement Measures

A person that becomes a party to a cartel that did not receive Court approval or was not accorded a temporary permit or an exemption from the duty to obtain the Court's approval is liable to penalties.

Penalties are also imposed on persons that violate any other provision of the Law.[162] Such penalties may reach up to NIS 100 million with respect to certain corporations.[163]

A special remedy is available to people that sustain damages as a result of a contravention of the provisions of the Law or of any direction or order issued or made under it. Such persons may claim damages in tort.[164] As of 1996, any person thus aggrieved may file a class action in the name of the group of persons that sustained damages therefrom.

As of 2006, class action suits are governed by the Class Action Law. Pursuant to this Law, a class action suit in antitrust matters may be submitted not only by a person (individual or corporation) having an interest in the lawsuit, or a consumers' association, but also by a public authority that acts in that field on behalf of a group of people for whom such lawsuit raises substantial questions of fact or law that are common to all the members of the group.

The Restrictive Practices Authority implemented an immunity leniency program under which any person or entity will be granted full immunity from criminal prosecution by being the first to come forward and provide all known information with respect to the restrictive arrangement to which the person was a party.

(5) The Pre-Ruling

As of August 2004, pursuant to authority granted under section 43A of the Economic Competition Law, 1988, the Restrictive Practices Controller established detailed procedures to be followed in the four cases in which a pre-ruling will be granted: (i) with respect to the approval of a merger or an exemption from a restrictive agreement; (ii) with respect to the legality of a future transaction or activity that the Law has not addressed; (iii) with respect to the Restrictive Practices Controller's position on complex economic issues (such as market definition); and (iv) with respect to his/her interpretation of the Law.

(6) Reliance Protection in Criminal Proceedings

Section 34(s) of the Penal Law, prescribes that a defendant in a criminal procedure is immune from criminal liability in the case of a mistake in the interpretation of the law, provided his/her mistake was reasonably unavoidable. In *Tagar*,[165] the Supreme Court dealt with the extent of immunity in the case of an advocate's or counselor's advice regarding the interpretation of a criminal provision in the Economic Competition Law. The Supreme Court held in *Tnuva*[166] that, for a person to be entitled to rely on counselor's advice: (i) the advice must be based on a complete set of facts; (ii) the counselor must be a professional in the field of his/her specific advice; (iii) except in rare cases, the advice must have been given in writing; (iv) where there was a possibility of obtain a pre-ruling from the competent authority, and the defendant nevertheless chose to rely on counselor's advice, it must be more likely than not, that the mistake was reasonably unavoidable; and (v) the reliance must have been made in good faith. However, in *Tagar*, the Supreme Court held that, if a pre-ruling from the competent authority was available, the reliance protection should not be automatically denied and each case should be examined on its merits.

It should be noted that the Supreme Court decisions are not limited to the Economic Competition Law and therefore they may be relevant in other legal areas.

b. Restrictive Covenants — Employee-Employer

Restrictive covenants with respect to employees terminating their employment have been upheld by the courts when the covenants have been found to be reasonable in their restrictions. Unreasonable restrictions have been disregarded and held to void the entire covenant. The reasonableness of a restriction depends, among other factors, on its geographical scope, its term of duration, the scope of activities bound by it and the consideration received therefor.[167] Since the introduction of the Basic Law: Freedom of Occupation in 1992, such restrictions have been subject to enhanced scrutiny by the courts. These precedents try to achieve a balance between the employee's freedom of occupation and the former employer's legitimate rights.[168] A guiding decision of the Labor Court of Appeal held that restrictive covenants should be upheld by the courts only: if they are needed to protect the employer's confidential information; where the employer invested in the employee's special training; where consideration was given for the employee's agreeing to the restriction; or in severe cases of a breach of obligations.[169] This decision renders it difficult for employers to enforce restrictive covenants, though restrictive covenants are still common practice in employment agreements.

[161] C.S 1114/99 *Tower Air v. Aviation Services Ltd.*, PDA 37-7, 469 (2007).

[162] Economic Competition Law, 1988, s. 47.

[163] Economic Competition Law, 1988, s. 50D.

[164] Economic Competition Law, 1988, s. 50.

[165] C.A. 5679/05 *The State of Israel v. Tagar*, Taagidim D-4,627 (2007).

[166] C.A. 845/02 *The State of Israel v. Tnuva*, Taagidim D-4, 585 (2007).

[167] C.A. 396/74 *Tromasbest v. Zachai*, 30(1) P.D. 793; C.A. 566/77 *Dicker v. Moch*, 32(2) P.D. 141; C.A. 310/79 *Varshavski v. Ilan*, 34(2) P.D. 743; H.C.J. 1683/93 *Yavinplast Ltd. v. The State Labor Court*, 47(4) P.D. 702; C.A. 2600/90 *Elite v. Sarenga*, P.D. 49(5) 796.

[168] C.L.A. 3-110/94 *Sherut Machlaka Rishona Ltd. v. Koskas*, L.J. 26, 451.

[169] E.A. 164/99 *Frumer v. Redguard Ltd.*, Takdin Artzi, 99(2), 115.

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In addition, the Israeli Supreme Court ruled that an agreement under which an employee is not entitled to any compensation or royalties with respect to his/her participation in the development of intellectual property (IP) should not necessarily be interpreted as a waiver of his/her legal rights with respect to the IP.[170]

c. Price Controls

Under the Control of Prices of Commodities and Services Law, 1996 (which superseded most of the Control of Prices of Commodities and Services Law, 1957), a number of important restrictions are imposed on the conduct of a business. Pursuant to the Law, price controls may be set, as indeed they have been, for a number of articles.

The prices of these articles may not be increased except with the special permission of the Minister of Industry and Commerce or another designated Minister.[171]

The Control of Prices of Commodities and Services Law, 1996 sets out the circumstances in which a commodity or a service will come under price control (for example, if its producer is a monopoly in terms of the Restrictive Trade Practices Law, 1988; if its production enjoys state subsidies; if the product or service is vital and public welfare requires such control; or if price controls are needed to ensure the achievement of national economic goals).[172] Normally, price controls are maintained with respect to basic foods and certain other basic commodities (for example, bread, dairy products, meat, coffee, tea, eggs and public transportation fares).

The 1996 Law also prohibits entities from deriving excessive profits from the provision of commodities or services, whether or not a maximum price or profit was set under the Law.[173] The display of prices (including on foodstuffs marked for scanners), which must include the VAT and any other compulsory payment levied on the sale, is mandatory.[174] A seller is not entitled to refuse unreasonably the sale of a "controlled commodity."[175] The acquisition of "controlled commodities" for purposes of storing them or delaying their sale is illegal.[176] A seller may not condition the sale of a "controlled commodity" on the purchaser's agreement to buy another commodity from the seller.[177] Both the 1957 and 1996 laws carry with them heavy criminal sanctions for violation of their most pertinent provisions.[178]

d. The Law for the Promotion of Competition and Reduction of Concentration, 2013

In December 2013, the Israeli legislature promulgated the Law for the Promotion of Competition and Reduction of Concentration, 2013. The purpose of the law is to promote competition and reduce concentration in the Israeli economy. The Law for the Promotion of Competition and Reduction of Concentration, 2013 includes, inter alia, the following provisions:

1) Provisions that determine situations that will require regulators to take into account considerations with respect to market concentration and industry competition;

2) Rules that restrict the establishment of pyramid structures (through holding companies) and the dissolution of current pyramids within a limited period of time; and

3) Provisions with respect to separation of major financial and non-financial institutions.

e. Securities Regulation

Transactions in securities are regulated by the Securities Law, 1968. For purposes of the Law, the term "securities" means certificates issued in a series by a company, a cooperative society or any other corporate body that confer the right of membership or participation in it or a claim against it. It includes certificates of participation in joint investments, mutual funds, and certificates conferring a right to acquire securities whether bearer or registered, but does not include securities issued by the government that: (i) do not grant a participation or membership right in a corporation and are not convertible into securities according such rights; and (ii) are issued under a special law.[179] For purposes of the Law, a "company" includes a foreign company.[180] The Law established the Securities Authority,[181] which consists of 13 members appointed by the Minister of Finance, partly from the public and partly from state employees, including one employee of the Bank of Israel.[182] See further under III.B., below.

(1) Public Offering of Securities

Under the Law, a person may not offer securities to the public other than under a prospectus, the publication of which has been permitted by the Authority.[183]

Section 15B of the Law exempts the following offerings from the requirement of an offering prospectus: (i) an offering of securities to the employees of a corporation as a remunerative incentive; (ii) the offering of traded securities in the course of trading; and (iii) the offering of securities by a nonreporting corporation, as provided in the regulations enacted with respect thereto.

The prospectus is very similar to that required in the United States by the Securities and Exchange Commission (SEC), under the Securities Act, 1933. Any item of information that is likely to be of importance to a reasonable investor and any particular information specified by the Minister of Finance must be included in the prospectus. The prospectus may not contain any misleading information.[184] A permit for the publication of the prospectus by the Authority does not constitute a verification of the information contained in the prospectus, or a cer-

[170] P.C.A 3564/12 *Dr. Nimrod Bayer v. Plurality Ltd. (in liquidation)* (Aug. 1, 2012).

[171] Control Commodities and Services Law, 1957, s. 5; Control of Prices of Commodities and Services Law, 1996, s. 12.

[172] Control of Prices of Commodities and Services Law, 1996, s. 6.

[173] Control of Prices of Commodities and Services Law, 1996, chapter 7.

[174] The Consumer Protection Law, 1981, s. 17A.

[175] Control of Commodities and Services Law, 1957, s. 22.

[176] Control of Commodities and Services Law, 1957, s. 22A.

[177] Control of Commodities and Services Law, 1957, s. 23.

[178] Control of Commodities and Services Law, 1957, s. 39, and Control of Commodities and Services Law, 1996, s. 34.

[179] Securities Law, 1968, s. 1.

[180] Securities Law, 1968, s. 1(2).

[181] Securities Law, 1968, s. 2.

[182] Securities Law, 1968, s. 3.

[183] Securities Law, 1968, s. 15.

[184] Securities Law, 1968, s. 16(b); C.A. 2103/07 *Avihu Horovitz v. The State of Israel*, Taagidim F-1, 545 (2009).

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tificate of the reliability or completeness of that information, or an expression of opinion as to the quality of the securities offered.[185] A person signing a prospectus (i.e., the issuer and each of its directors, and the underwriter or offeror) is liable to a person that acquires securities from the offeror and to a person that sells or acquires securities on the Stock Exchange or elsewhere in accordance with the prospectus, for damages caused to that person where the prospectus contained misleading information.[186] Similar liability is imposed on a person rendering an opinion, report or certificate included or referred to in the prospectus with that person's prior consent. The liability of that person is limited to damages caused by misleading information in the opinion, report, certificate or approval rendered by that person (as opposed to other information given in the prospectus).[187] A person who acquired securities from the offeror in accordance with the prospectus and did so in reliance on misleading information included in it may cancel the acquisition and demand the refund of the money paid, provided the person does so within a reasonable time after becoming aware of the fact that the information was misleading or after the publication of an immediate report by the company that issued the securities, and by not later than two years after the acquisition.[188]

In 2005, certain provisions of the Israeli Securities Law were substantially revised to allow a company that is traded for a period of at least one year from the initial public offering (IPO) to file a "shelf" registration under which the company will be able to offer securities generally to the public within a period of 24 months from the date on which the prospectus (a "Shelf Prospectus") was filed.

By utilizing a Shelf Prospectus, a company may make available to the public a variety of securities (such as debentures, convertible debentures, shares and options to either one of the foregoing) suitable to meet the ever-changing market trends and effectuate the actual registration of any of them and raise the necessary funds from the public at any particular moment during the 24-month period at its discretion.

The initial process involving the filing of a Shelf Prospectus is similar to that for a regular prospectus,[189] except that a company is not required to include in a Shelf Prospectus all the conclusive information regarding the offering and the terms of the various securities to be offered,[190] and such information may be decided on and made public at the actual time the company decides to offer a particular number of securities from the total made available under the Shelf Prospectus.

Following the publication of the Shelf Prospectus, the conclusive information with respect to each particular offering is to be filed separately in an immediate report that includes all the relevant information with respect to the offering, inter alia:

(i) The type of securities offered, the number to be offered, and the percentage they constitute of the share capital of the company (on an outstanding and on a fully diluted basis);

(ii) The rate of interest and other relevant terms of the debentures (if applicable);

(iii) The exercise price of the options and the exercise period with respect thereto;

(iv) The terms of the underwriting arrangement (if any) determined with the underwriter with respect to that particular offering; and

(v) Any material information concerning the company as of the filing date of the Shelf Prospectus.

Once such a report is published and filed it is deemed for all purposes to be part of the Shelf Prospectus, and the company may raise the funds from the various investors within hours after its publication (whereas a minimum of five trading days must lapse after the publication of a regular prospectus before the company may raise any funds under the prospectus).

The process may be repeated until all securities allocated by the company have been offered to the public or until 24 months have elapsed from the date on which the Shelf Prospectus was filed. To be eligible to issue a Shelf Prospectus, the issuer must: (i) be a reporting entity that has duly reported to the Stock Exchange for a period of at least 12 months; and (ii) not be delinquent in that it or any of its officers have been convicted of any offense relating to reporting requirements.

A 2008 amendment allows dual listed companies to publish a Shelf Prospectus with regard to commercial notes, which will be valid for a period of 12 months. Prior to the amendment, dual listed companies were not permitted to offer securities in Israel by means of a Shelf Prospectus.

The requirement to issue a prospectus does not apply to the allotment of bonus shares, where the persons entitled to the bonus shares have no choice as to whether to accept them, as these are not offered to the "public." Bonus shares are defined as shares allotted for no consideration to all the shareholders of a company, on a pro rata basis.

An offer of securities to the public requires the approval of the Minister of Finance or of the person appointed by the Minister of Finance for that purpose. However, the Minister of Finance may not refuse to grant such approval unless it appears that the offer, its terms or its timing is or are contrary to the economic policy of the government. The Authority will not grant a permit for the publication of a prospectus until the offer has been approved by the Minister of Finance,[191] but a blanket authority was granted in 1987.

The Law further provides that a person may not offer debentures to the public unless a trustee for the holders of the debentures is appointed by the issuer of the debentures.[192] The trustee must be a company registered in Israel, the main objective of which is the carrying out of trust activities.[193] The trustee represents the holders of the bonds in any matter arising from

[185] Securities Law, 1968, s. 21.

[186] Securities Law, 1968, s. 31(a).

[187] Securities Law, 1968, s. 32.

[188] Securities Law, 1968, s. 35(a).

[189] That is to say, all the requirements in connection with the inclusion of financial statements that are not older than five months (measured from the date of the prospectus), legal opinions, comfort letters, etc.

[190] That is to say, there will be no need to finalize and determine the number of securities to be offered, the exercise price, the rate of interest or the commission to be paid to the underwriters.

[191] Securities Law, 1968, s. 39.

[192] Securities Law, 1968, s. 35B.

[193] Securities Law, 1968, s. 35C.

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the obligations undertaken towards them.[194] The issuer must present the trustee with copies of all reports that, as an issuer, it must submit to the Authority and copies of any documents forwarded to the shareholders or debenture holders, and must respond to the trustee's reasonable requests for any other information.[195] The trustee is prohibited from purchasing debentures of the series it is holding as a trustee for itself.[196]

A corporation that offered securities to the public under a prospectus and the securities of which are traded on the Stock Exchange must submit to the Authority, the Registrar of Companies and the Stock Exchange periodic reports as long as any of its securities are in the hands of the public. In certain circumstances, the submission of an immediate report relating to significant events may also be required. The same rule applies to holders of substantial interests in such companies.[197] The Authority may direct the Stock Exchange to cease trading in the securities of a company that failed to submit reports, or failed to submit them in the required manner, until a proper report is submitted.

In March 2001, the "Barnea Committee" published its recommendations regarding the reform of the reporting duties. The implementation of the Committee's recommendations started with the reports for 2004. The detailed information contained in the periodical reports is similar to that contained in a prospectus. The reports include: forecasts; information on the basic activities of the corporation in different geographical areas; aspects of the corporation's business, not included in the financial reports (for example, the names of customers who contribute more than 10% of the income); and information concerning the intangible assets of the corporation.

Among its other recommendations, the Committee recommended:

(i) That no synopsis be included in a prospectus;

(ii) That the civil liability of the corporation and of its advisors with respect to information contained in the prospectus apply to information in periodical reports;

(iii) That the legal opinion in the prospectus focus on the corporation's authority to offer the securities; and

(iv) That the exemptions from rendering information be curtailed.

All these recommendations were implemented.[198]

An amendment to the Securities Regulations (Details, Structure and Form of Prospectus), prescribes that a reporting company may be exempted from providing the description of its business in a prospectus if it had already done so in its annual report in the previous year and in its quarterly reports published since the annual report, provided that all material changes are described in the prospectus. Previously, a company was required to describe its business fully in a prospectus. This exemption does not apply to IPOs of companies. Similarly, the amendment also permits a reporting company to use its previously filed financial reports for purposes of a prospectus rather than having to prepare a special financial report for the prospectus.

A draft bill published in November 2024 suggests that Section 16A of the Income Tax Ordinance should be amended to include a provision authorizing the Minister of Finance to establish regulations granting a tax exemption or reduction to foreign residents with respect to certain income derived from investments in securities or other financial assets that satisfy specified criteria, or from the management of such investments.

(2) Regulation of Stock Exchange Operations and Trade in Securities

The Securities Law regulates stock exchanges by prohibiting a company from operating a stock exchange except under a license granted by the Minister of Finance after consultation with the Authority and with the approval of the Knesset Finance Committee.[199] A license is granted only where:

(i) The company concerned and any company of which it is the controlling shareholder engage solely in occupations permitted to a stock exchange under section 45C of the Securities Law;

(ii) The company's articles of association do not include provisions that may prejudice its proper and fair management;

(iii) The company has articles of association in accordance with section 46 and the articles have been approved by the Ministry and Minister of Finance;

(iv) The company has the technical skills to operate in the securities trading system in a way that will ensure its stability;

(v) The company has paid the fees required by section 55A; and

(vi) The company meets the requirements regarding equity, deposit insurance and guarantees, as determined by the Minister of Finance in accordance with the guidance of the authority or in consultation and with the approval of the Knesset Finance Committee. The Minister is authorized to give different instructions to different companies applying for a license.

A 1990 Amendment[200] vested in the stock exchange the power to set rules for the registration of securities. The amendment was made in response to a district court decision holding that the stock exchange overstepped its authority by providing that a certain minimum capital must be held by owners of "founders' shares" entitling them to 50% of the voting rights in the company.[201]

According to the Amendment[202] the rules may refer, inter alia, to:

[194] Securities Law, 1968, s. 35I.

[195] Securities Law, 1968, s. 35J.

[196] Securities Law, 1968, s. 35K.

[197] Securities Law, 1968, ss. 36, 37. The legislation regarding reporting obligations has evolved substantially in volume and includes, among other legislation, Securities Regulations (Periodical and Immediate Reports), 1970; Securities Regulations (Financial Annual Reports), 2010; Securities Regulations (Periodical and Immediate Reports of Foreign Corporations), 2000.

[198] By means of special regulations.

[199] Securities Law, 1968, s. 45A.

[200] Securities Law (Amendment No. 11) 1990.

[201] D.A. 272/89 *Nimrodi Land Development Ltd. v. The Tel-Aviv Stock Exchange Ltd.*, 1989/90 (2) P.M., 89.

[202] Securities Law, 1968, s. 46.

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(i) The type of company that will have shares eligible to be registered for trade (with respect to its activity, duration, financial results and turnover and the value of its assets and obligations);

(ii) The type of the shares eligible for registration for trade (with respect to their characteristics and minimum total value on registration, and the minimum amount of shares to be held after registration for trade);

(iii) The ratio of the price of securities issued to the price of the company's securities on the stock exchange;

(iv) The registration for trade of securities allotted in a private offering; and

(v) The barring of any transaction by a certain holder or by a certain class of holders — for a prescribed period.

Furthermore, the stock exchange will not register securities for trade unless certain conditions with respect to equal voting rights are met[203] and it may provide in its articles that the board of directors may refuse to register securities for trade if in its opinion there exists a substantial conflict of interest between the company and a controlling shareholder, or between the company and a company under the control of a person controlling the former company, provided such a decision is adopted by the majority of the board with at least 66% of the directors present and the company having been given an opportunity to state its case before the board.[204]

A contravention of the Law entails heavy fines and may bring a five-year term of imprisonment.[205] A special amendment to the Law prohibits the use of inside information in dealing in securities. The Law broadly defines the terms "insider" and "inside information." An insider is presumed to have used inside information unless the insider proves that the inside information was not available to the insider at the time of the transaction.[206]

The Companies Law used to provide that a holder of securities could bring a class action if his/her cause of action derived from the owning, possession, purchase or sale of the securities.[207] As of 2006, the class action provisions in the Companies Law and other laws were abolished and integrated into the Class Action Law, which lays down uniform rules regarding class actions.

3. Licensing and Franchising

a. Patents

Under the Patents Law, 1967, the owner of a patentable invention is entitled to apply for the grant of a patent with respect to the invention.[208] The Law provides that "an invention, whether a product or a process, in any technological field[209] that is new, useful and susceptible of industrial application and that involves an inventive step is a patentable invention."[210] An invention is deemed new if it has not been published in Israel or abroad prior to the application date by written, visible, audible or means of any other description, in such a manner that a man of the art can perform it in accordance with the details thus made known.[211] Certain publications do not affect the grant of the patent, namely: a publication without the consent of the inventor, followed by an application for the patent within a reasonable time after the publication became known to the applicant; or a display in an industrial or agricultural exposition in Israel, or in a recognized exhibition in one of the "member countries,"[212] official notice of which was given to the Registrar of Patents before the opening.[213] Patentability will not be affected by the publication of a description of the invention at the time of an exhibition nor by use of the invention for the purposes of an exhibition at the place of the exhibition, provided an application was filed within six months after the opening of the exhibition. Publication by way of a lecture by the inventor before a scientific society or by way of the publication of such a lecture in the official transactions of the society does not affect patentability, provided that the Registrar was given notice of the lecture before it was delivered and that the patent application was filed within six months after the publication.[214]

No patents are granted for a method of therapeutic treatment of the human body or for new varieties of plants or animals, except microbiological organisms not derived from nature.[215] If a patent application is filed in Israel for an invention, where the owner or his/her predecessor in title has already filed an application in Israel or in one of the member countries of the Union for the Protection of Industrial Property under the Paris Convention for the Protection of Industrial Property, the owner of the invention has the right to request that the date of the preceding application be deemed the date of the application filed in Israel. The following conditions, however, must exist:

(i) The application in Israel must be filed within 12 months after the filing of the preceding application and, if more than one preceding application was filed, the application must be filed within one year after the date of the earliest application;

(ii) The claim for the priority right must be made not later than two months after the filing of the application in Israel; and

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[203] Securities Law, 1968, s. 46B.

[204] Securities Law, 1968, s. 46(b).

[205] Securities Law, 1968, ss. 53, 54. *See also* C.A. 6020/12 *The State of Israel v. Eyal Eden* (Apr. 29, 2013) and C.S. 8256-05-11 *The State of Israel v. Efraym Kadatz* (July 5, 2012).

[206] Securities Law 1968, ch. 8A(1).

[207] Companies Law, 1999, s. 207.

[208] Patents Law, 1967, s. 2.

[209] The phrase "in any technological field" was added in 1999, in accordance with the international Agreement on Trade Related Aspects of Intellectual Property Rights Including Trade in Counterfeit Goods (also known as the TRIPS Agreement).

[210] Patents Law, 1967, s. 3. The discovery of a new possible use for an existing production is deemed to be an inventive step for purposes of the Patents Law, 1967, s. 3; C.A. 244/72 *Plantex Ltd. v. The Welcome Foundation Ltd.*, 27(2) P.D. 19; and C.A. 804/89 *Landau v. Luach Laizer Masach Rav Tachlity Ltd.*, 46(2) P.D. 295. Furthermore, a new combination of known ideas is also considered an inventive step — C.A. 314/75 *Lipski Ltd. v. Manor*, 32(1) P.D. 205. For a thorough analysis, see C.A. 345/87 *Hughes Aircraft Co. v. Kaiser Aerospace & Electronics Co.*, 44(4) P.D. 45.

[211] Patents Law, 1967, s. 4.

[212] Countries that the Foreign Affairs Minister has officially declared to be members of the Union for the Protection of Industrial Property by virtue of the Paris Convention for the Protection of Industrial Property, 1883, as amended in Stockholm in 1967.

[213] Patents Law, 1967, s. 6.

[214] Patents Law, 1967, s. 6(b)(3).

[215] Patents Law, 1967, s. 7.

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(iii) A copy of the specifications filed with the preceding application and of the drawings accompanying such specifications must be filed with the Registrar and it must appear to the Registrar that the invention described in the preceding application and the invention for which a patent is sought in Israel are *prima facie* identical in substance.[216]

A patent application is filed with the office of the Registrar of Patents in a prescribed manner and must be accompanied by the prescribed fee.[217] The specifications should contain a title by which it is possible to identify the invention, a description of the invention, with such drawings as may be necessary, and a description of the manner of performing the invention so that a person skilled in the art will be able to perform it accordingly.[218] After the application is filed, it is published by the Registrar at the expense of the applicant, along with information regarding any preceding application filed for that patent.[219] The Registrar examines the application and grants the patent, provided it meets all the requirements of the Law.[220] The grant of the patent is entered in a special register and a certificate to that effect is given to the owner.[221] However, the examination of the application for the grant of the patent does not constitute a guarantee that the patent is valid, and the State or its employees bear no responsibility due to the mere grant.[222]

A patentee owning an invention that is an improvement on or a modification of the invention for which the patent was granted may request that the patent for the second invention be granted to him as a patent of addition.[223]

A patentee is entitled to prevent any other person from unlawfully exploiting the invention for which the patent was granted, whether in the manner defined in the claims or in a similar manner and involving the main features, as defined in the claims of the invention that is the subject matter of the patent.[224] This preventive right was the issue of several precedents concerning the pharmaceutical industry: the generic pharmaceuticals' producers attempt to initiate a pre-commercial production "test production," aimed at facilitating the exploitation of patented products once the patent term is over, was held to be an unlawful exploitation of the patent.[225] In 1998, the Law was amended[226] to allow for "experimental production" in noncommercial quantities of a patented product. As a counterbalance to the above, the amendment allows for an extension of the original patent term to be granted by the Registrar of Patents for medical products, until such time as all authorization procedures are completed for production and marketing of the product or for a longer period of up to five years. The patentee must apply for the extended period no later than 60 days after the product was registered under the Pharmacists' Regulations.[227]

The term of a patent is 20 years from the date of application.[228] A patentee may apply for an amendment of the patent specifications for purposes of clarifying or eliminating a mistake made in the specifications or the registration of the claims.[229] The Registrar may revoke a patent on the application of the patentee,[230] or on the application of any other person, on any ground on which the grant of a patent may be opposed.[231]

A patentee, or the owner of an invention who has applied for its patent, may grant in writing an exclusive or nonexclusive license to exploit the invention.[232] An exclusive license under a patent confers on the holder an exclusive right to act as if the holder were the owner of the invention and prohibits the patentee from exploiting it in Israel.[233] A nonexclusive license under a patent confers the right to exploit the invention only to the extent and subject to the conditions prescribed in the license.[234] A license under a patent is not effective with respect to any person other than the party who is licensed unless it has been registered in accordance with the Law.[235]

Many foreign companies register their patents in Israel and Israel has become the scene of intense patent litigation.

b. Trademarks and Trade Names

The Trade Marks Ordinance (New Version), 1972 governs the protection of registered trademarks. A "trademark" is defined as "a mark used, or intended to be used, by a person in relation to goods that the person manufactures or deals in." The "mark" itself may be of letters, numerals, words, devices or other signs, or combinations of these, whether two dimensional or three dimensional. The Ordinance also recognizes a "certification mark," which is defined as "a mark intended to be used by a person other than a person carrying on a business, to certify the origin, components, mode of manufacture, quality or any other characteristics of goods in which the person is interested, or to certify the nature, quality or type of service in which the person is interested." The Ordinance likewise recognizes a "service mark," which is a mark used, or intended to be used, by a person in relation to a service rendered by him.[236] In 1999, following Israel's accession to the Agreement on Trade Related Aspects of Intellectual Property Rights Including Trade in Counterfeit Goods (the TRIPS Agreement), a definition was added: "a well-known trade mark" — a mark that is well-known in Israel, owned by a citizen of a member country, a permanent resident of a member country or an owner

[216] Patents Law, 1967, s. 10.
[217] Patents Law, 1967, s. 11.
[218] Patents Law, 1967, s. 12.
[219] Patents Law, 1967, s. 16(a).
[220] Patents Law, 1967, s. 17(a).
[221] Patents Law, 1967, s. 36.
[222] Patents Law, 1967, s. 37.
[223] Patents Law, 1967, s. 44.
[224] Patents Law, 1967, s. 49. *See* C.A. 804/89 *Landau v. Luach Laizer Masach Rav Tachlity Ltd.*, 46(2) P.D. 295; C.A. 47/87 *Hasam Maarachot Hagana Aminot Ltd. v. Bachri*, 45(3) P.D. 194; and C.A. 407/89 *Tzuk-Or Ltd. vs. Car Security Ltd.*, P.D. 48(5) 661; C.A. 7614/96 *Zchori Ubanav Taasiyot v. Regba*, 53(3) P.D. 721.
[225] C.P. 1512/93 *The Wellcome Foundation Ltd. v. Teva Taasiyot Pharmatsabetiot Ltd.*, Takdin Mehozi 94(2), 197; P.C.A. 886/93 *Eli Lilly and Co. v. Teva Taasiyot Pharmatsabetiot Ltd.*, P.D. 47(2) 105.
[226] The Patents Law (3rd amendment), 1998.
[227] C.A.R. 2826/04 *Registrar of Patents v. Recordati Ireland Ltd.*, TK-EL 2004(4), 635.
[228] Patents Law, 1967, s. 52.
[229] Patents Law, 1967, s. 65.
[230] Patents Law, 1967, s. 73(a).
[231] Patents Law, 1967, s. 73B.
[232] Patents Law, 1967, s. 84.
[233] Patents Law, 1967, s. 85.
[234] Patents Law, 1967, s. 86.
[235] Patents Law, 1967, s. 87.
[236] Trade Marks Ordinance (New Version), 1972, s. 1; *see also* C.C. 48511/07 *Dr. Dov Klein v. Proportsya P.M.C. Ltd.* (Sept. 18, 2011).

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of an active industrial plant in a member country (even if the mark is not registered or used in Israel).

To enjoy the exclusive right to use a mark as a trademark, a person must apply for registration of the mark under the provisions of the Ordinance.[237] No mark is eligible for registration as a trademark unless it is adapted to distinguish the goods of the proprietor of the mark from those of other persons (unless it has a "distinctive character").[238] A trademark may be limited in whole or in part to one or more specified colors[239] and must be registered with respect to particular goods or a particular class of goods.[240] The Ordinance contains a long list of marks ineligible for registration, which include:[241]

(i) Marks referring to some connection with the president of the State or his/her household or to presidential patronage or marks from which any such connection or patronage might be inferred; flags and emblems of foreign states or international organizations and any mark resembling any of these; public armorial bearings; official signs or seals used by any state to indicate control or warranty and any sign resembling any of these; and any sign from which it might be inferred that a proprietor enjoys the patronage of or supplies goods or renders services to a head of state or government, unless it is proved to the Registrar that the proprietor of the mark is entitled to use it;

(ii) Marks displaying the words "patent," "patented," "by royal letters patent," "registered," "registered design," "copyright," "to counterfeit this is a forgery" or words used to like effect;

(iii) Marks that are or may be injurious to public policy or morality;

(iv) Marks likely to deceive the public;

(v) Marks containing false indications of origin, or marks containing any representation that may insinuate such origin;

(vi) Marks that encourage unfair trade competition;

(vii) Marks identical or similar to emblems of exclusively religious significance;

(viii) Marks on which the representation of a person appears, unless the consent of that person has been obtained;

(ix) Marks identical to another mark belonging to a different proprietor that is already on the register with respect to the same goods or description of goods, or so nearly resembling such a mark as to be calculated to deceive;[242]

(x) Marks consisting of numerals, letters or words that are in common use in trade to distinguish or describe goods or classes of goods or marks that bear direct reference to the character and quality of goods, unless the marks have distinctive character;

(xi) Marks the ordinary signification of which is geographical or surnames, unless represented in a special manner or unless having a distinctive character;

(xii) Marks identifying wines or other alcoholic beverages that include a false geographical indication;

(xiii) Marks similar or identical to another well-known trademark (whether registered or unregistered) that may lead to their association with other goods; and

(xiv) Marks similar or identical to another well-known registered trademark (including a trademark in relation to different goods) that insinuate a connection to that trademark and/or those goods and as a result of the use of which the owner of the registered trademark may be harmed.[243]

The Registrar may refuse to register a mark identical to or resembling the name or business name of another person or containing a name identical to or resembling it if the mark is likely to deceive the public or to cause unfair competition.[244] The Registrar may not refuse to register a trademark registered as a trademark in its country of origin, unless one of the following conditions exists:

(i) Registration of the mark in Israel will infringe on rights acquired in Israel by another person;

(ii) The mark lacks distinctiveness;

(iii) The mark consists exclusively of signs or indications that may serve in trade to designate the kind, quality, quantity, place of origin, intended purpose, time of production or value of goods;

(iv) The mark is customary in current language or is established in Israeli *bona fide* trade practices;

(v) The mark is contrary to public order or morality; or

(vi) The mark is likely to deceive the public.[245]

An application for registration must be filed with the Registrar, who may refuse to accept it if it fails to meet the requirements of the Ordinance.[246] The Registrar's refusal is subject to appeal to the District Court.[247] When an application has been accepted, whether absolutely or subject to conditions or limitations, the Registrar, as soon as possible after such acceptance and at the expense of the applicant, publishes the application as accepted, specifying every condition and limitation subject to which it has been accepted.[248] Any person may, within three months, or within such other time as may be pre-

[237] Trade Marks Ordinance (New Version), 1972, s. 7.
[238] Trade Marks Ordinance (New Version), 1972, s. 8.
[239] Trade Marks Ordinance (New Version), 1972, s. 9.
[240] Trade Marks Ordinance (New Version), 1972, s. 10.
[241] Trade Marks Ordinance (New Version), 1972, s. 11.
[242] A trademark is considered to be deceitful if it is likely to mislead the ordinary public so that it is unable to distinguish the products of the parties. In the event that the trademark is so considered, the fact that the other proprietor hardly uses his trademark is of no significance, and the new trademark will not be eligible for registration. Furthermore, a proprietor of a trademark may oppose the registration of an identical or similar trademark even though his trademark is not registered in Israel. H.C.J. 476/82 *Orlogad Ltd. v. The Patents, Designs and Trademarks Registrar*, 39(2) P.D. 148, and F.H. 376/90 *Anheuser-Bush Inc. v. Budejovicky Budvar, Narodni Podnikceske Budejovice*, P.D. 46(4) 843; C.A. 6181/96 *Yigal Cardi v. Bacardi & Co.*, P.D. 52(3) 276; C.A. 11487/03 *August Storck KG v. Alpha Intuit Food Products Ltd.*, P.D. 62(4) 1; C.A. 563/11 *Adidas Salomon v. Galal Yasin* (Aug. 27, 2012).
[243] Trademarks Ordinance (New Version), 1972, s. 11.
[244] Trademarks Ordinance (New Version), 1972, s. 12.
[245] Trademarks Ordinance (New Version), 1972, s. 16(a).
[246] Trademarks Ordinance (New Version), 1972, s. 18.
[247] Trademarks Ordinance (New Version), 1972, s. 19.
[248] Trademarks Ordinance (New Version), 1972, s. 23.

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scribed, from the date of publication, file with the Registrar a note of opposition to the registration of the mark. If the applicant sends a counter statement, the Registrar furnishes a copy of it to the person noting his/her opposition and may, after hearing the parties, if so required and considering the evidence, decide whether, and subject to what conditions, registration is to be permitted.[249] The Registrar's decision may be appealed to the Supreme Court.[250]

The registration of a trademark is valid for 10 years from the date of the filing of the application[251] and may thereafter be extended for a period of 10 years from the expiration date of the original registration or its renewal.[252]

The registration of a person as the proprietor of a trademark accords that person the exclusive right to the use of the trademark in every manner relating to the goods for which it is registered.[253] A registered trademark may be assigned by its proprietor or passed by operation of law, either with or without the goodwill of the business concerned in the goods for which it has been registered.[254] A transfer of a trademark requires registration[255] and the Registrar may refuse to register the assignment if the use of the trademark by the assignee might mislead the public or be contrary to the public interest. The same applies to the grant of a license to use the trademark.[256] Case law provides that the lack of registration denies the license any effectiveness until registered. If the parties did not intend to register the license, the agreement is deemed illegal. Further, the license does not confer any proprietary rights.[257] In the event of a breach of a trademark, the assignee of a registered license does not have a right to sue the infringer, since this right pertains solely to the owner of the trademark.[258]

Where Israel is a party to an agreement with a foreign state for the mutual protection of trademarks, any person who applied for protection of a trademark in that state, or his/her legal representative or assignee, is entitled to the registration of his/her trademark under the Ordinance prior to other applicants, provided the person files his/her application within six months from the date on which the person applied for protection in the foreign state.[259] A person who filed an application for the registration of a trademark in a "Union State,"[260] or his/her legal successor, may apply for the registration of the mark in Israel and enjoys priority over an application for registration filed after the date of filing of the application abroad.[261] The application must be filed within six months of the date of filing of the first application for registration of the mark.[262] Applications for the registration of foreign trademarks are made in the same manner as ordinary applications under the Ordinance.[263]

The Ordinance applies its important provisions relating to trademarks to service marks.[264] Similarly, a certification mark may be registered if the Registrar is satisfied that the proprietor of the mark is competent to certify the characteristics to be designated by the mark.[265] A certification mark may be registered even if it lacks distinctiveness.[266] However, a certification mark may be transferred only with the permission of the Registrar.[267]

c. Designs

A person whose product incorporates an original design may protect the product for 25 years.[268]

An application for the registration of a design may be filed with the Registrar of Patents and Designs who may, at his/her discretion, refuse to register the design and must so refuse if the design is unlawful or is contrary to public order.[269] The registration is *prima facie* proof of the design's validity.[270] A design may be registered with respect to several classes of products and, after being registered, may be further registered with respect to other classes even though it is no longer original or new.[271]

An application for the registration of a design must specify the class of products with respect to which the design is to be registered. If the design relates to several classes of products, the competent authority will divide it into several design applications, so that each application covers one design.[272] The application for registration must specify the product or products with respect to which the design is registered. If the design relates to a specific product, drawings of the design must be filed with the application. If it relates to a set of products, each drawing must demonstrate the different arrangements for the use of the design with respect to each different product.[273]

An objection to the registration of a design may be brought before the Registrar, who at that time must notify the applicant in writing of the details of the objection. In the event the applicant fails to respond to the objection within three months, the applicant is deemed to have withdrawn his or her application.[274] If a response was submitted, the Registrar gives the applicant written notice of his or her decision on the matter. The applicant may request notice of the reasons for the decision for purposes of lodging an appeal before the District Court.[275]

[249] Trademarks Ordinance (New Version), 1972, s. 24; H.C.J. 460/87 *Fuji Electronics M.F.G. Co. v. Patents Designs and Trademarks Registrar*, 42(1) P.D. 485.

[250] Trademarks Ordinance (New Version), 1972, s. 25(a).

[251] Trademarks Ordinance (New Version), 1972, s. 31.

[252] Trademarks Ordinance (New Version), 1972, s. 32.

[253] Trademarks Ordinance (New Version), 1972, s. 46.

[254] Trademarks Ordinance (New Version), 1972, s. 48.

[255] Trademarks Ordinance (New Version), 1972, s. 49; *see also* C.A. 18/86 *Mifaley Zechuchit Israeliyim Ltd. v. De Saint Gobain*, 45(3) P.D. 224.

[256] Trademarks Ordinance (New Version), 1972, s. 50.

[257] C.A. 364/74 *Davidovich v. Miromit Ltd.*, 29(1) P.D. 703; C.A. 650/80 *Ampisal (Israel) Ltd. v. Náimi*, P.D. 37(3), 780.

[258] C.A. 650/80 *Ampisal (Israel) Ltd. v. Náemi*, 37(3) P.D. 780.

[259] Trademarks Ordinance (New Version), 1972, s. 54(a).

[260] A Union State is a member of the Union for Protection of Industrial Property under the Paris Convention for the Protection of Industrial Property, including a territory to which the convention has been extended under Convention, Art. 16.

[261] Trademarks Ordinance (New Version), 1972, ss. 54 and 55(a).

[262] Trademarks Ordinance (New Version), 1972, s. 55(b).

[263] Trademarks Ordinance (New Version), 1972, s. 56.

[264] Trademarks Ordinance (New Version), 1972, s. 2.

[265] Trademarks Ordinance (New Version), 1972, ss. 3 and 14(a).

[266] Trademarks Ordinance (New Version), 1972, s. 14(b).

[267] Trademarks Ordinance (New Version), 1972, s. 14(c).

[268] Designs Law, 2017, s. 39.

[269] P.C.A. 1510/04 *New Light v. Or-Ad*, Dinim Mehozi 39(9) 408 (2009).

[270] P.C.A. 2455/91 *Raz v. Arpal Aluminium Ltd.*, 91(3) Takdin 1991, 2882, and D.C.A. 27444/97 *Aloni v. Réem*, 97(3) Takdin Mehozi 1034.

[271] Designs Law, 2017, s. 19.

[272] Designs Law, 2017, s.19(e); Designs Regulations, 2019, s. 29.

[273] Designs Regulations, 2019, s. 14.

[274] Designs Law, 2017, ss. 29 and 30; Designs Regulations, 2019 s. 33.

[275] Designs Law, 2017, s.106; Design Regulations 2019, s. 62.

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Once a design is registered, the Registrar publishes an announcement specifying the applicant's name and the design's number, class and date of registration, and the purpose of the product with respect to which it was registered.[276]

d. Business Names

A special Ordinance of 1935 deals with the registration of business names. The Ordinance requires the registration of names of firms that do not include all the names of the individuals comprising the firm or the corporate bodies interested in the firm.[277]

Comment: As a practical matter, few businesses register under the Ordinance.

Protection for a name is afforded by the Companies Law, 1999, which prohibits a company from using the name of another corporate body.[278] A similar provision guarantees that a partnership will not be registered in the name of another partnership or in the name of an existing company.[279] Registration of a company, therefore, provides partial protection for its name and enables it to enjoin others from using it.[280]

e. Industrial Know-How

For the most part, industrial know-how is protected by the agreement revealing the know-how to the user, not by a special law. An employee who discloses secrets of an employer is guilty of a criminal offence punishable by law.[281] Moreover, it is common for employment agreements to stipulate that all know-how revealed to an employee must be kept secret, thus making it possible to enjoin the employee from using trade secrets or industrial know-how gained during the term of his/her employment. The Supreme Court has held that the obligation of confidentiality is implied in the relationship established between an employer and an employee.[282]

A decision of the Labor Court of Appeal held that restrictive covenants should be upheld by the courts only where they act to protect the employer's confidential information. In the absence of such needs, the freedom of employment prevails over the freedom of contracts.[283]

f. Copyrights

Israel is a member of the Bern Union and a signatory to the Universal Copyright Convention. Israel's former copyright law was based on the United Kingdom Copyright Act, 1911, as amended after Israel's attainment of statehood. Protection was afforded to any literary, theatrical, musical or artistic work (including drawings of industrial products)[284] and to computer software for the life of the creator and an additional 70 years thereafter.[285] A creator was accorded a moral right that enabled the creator to enjoin holders of copyrights of his/her work from omitting his/her name and from making substantial changes in the literary work concerned.[286] If his/her right was infringed, the owner was entitled to compensation.[287]

The Copyright Law, 2007 came into force as of May 2008. The 2007 Law includes a list of four categories of protected works of art: literary works, dramatic works, musical creations, and artistic creations, provided that they are original. Computer programs are also protected under this Law. Fair use is not deemed a breach of a copyright. Foremost among fair use are self-instruction, research, review, journalism and education by an educational institution, etc. To examine whether the use of a work is "fair use," the court may consider the following: the purpose of the use and its nature; the nature of the work; the scope of the use qualitatively or quantitatively in relation to the entire work; and the use's influence on the value of the work and on its potential market. The Law prescribes that the creator is the primary owner of the work. Nevertheless, if an employer or the State orders a work, it will be the primary owner. Copyrights are alienable solely in writing. The protection is granted to the creator for his/her lifetime and 70 years thereafter. The protection of a copyright in a record is 50 years as of its creation. The Law added a right (the moral right), which is the right of the creator for the term of the copyright to have his/her name appear on his/her creation in the appropriate scope and nature, and protects the creator from any action that might cause harm to his/her dignity or good reputation. The moral right is a private right and is not alienable. In the case of infringement, the Law prescribes compensation of NIS 100,000 without the need to prove damage.

Copyrights need not be registered; as Israel is a signatory to the international agreements referred to above, the protection is automatically available, without the necessity of application, to Israeli residents and citizens and to residents or citizens of other countries that are members of the Bern Union or signatories to the Universal Copyright Convention.[288]

g. Performers' Rights

The Performers' Rights Law, 1984 accords performers the right that the following not be done without their consent:

(i) A fixation (i.e., the preservation of a performance by any means in a manner making it possible to hear, see or reproduce the performance);

(ii) A reproduction (i.e., the making of a copy of a fixation or a substantial part thereof); or

[276] Designs Law, 2017, s. 31.

[277] Registration of Business Names Ordinance, 1935, s. 3.

[278] Companies Law, 1999, s. 27.

[279] Partnerships Ordinance (New Version), 1975, s. 10(b).

[280] Companies Law, 1999, ss. 27, 29, 30.

[281] Penal Law, 1977, s. 496.

[282] C.A. 155/80 *Rav Bariach Ltd. v. Amgar*, 35(1) P.D. 817; C.A. 1371/90 *Damti v. Ganor*, 42(4) P.D. 847. The most prominent decision reestablishing the obligation of confidentiality, recognizing the importance of trade secrets and balancing both of the above against the freedom of occupation, as stated in the Basic Law: Freedom of Occupation, 1992, can be found in H.C.J. 1683/93 *Yavin-Plast v. The Labor Court*, 47(4) P.D. 702; E.A. 164/99 *Frumer v. Redguard Ltd., Takdin Artzi*, 99(2), 115; C.A. 6601/96 *Aes Systems Ltd. v. Moshe Saar*, 54(3) P.D. 850.

[283] E.A. 164/99 *Frumer v. Redguard Ltd., Takdin Artzi*, 99(2), 115; C.A. 1588/02 *Paz Gas Jerusalem Ltd. v. Raphi Ganon, R.P. Takdin* 2002(4), 251.

[284] C.A. 8152/06 *Maabdot Yam Hmeleh v. Deblio*, Dinim Mehozi 39(8) 997 (2009).

[285] The Law was applied by the British authorities in Palestine according to the King's Order in Council on the Copyright Law, 1911, 1924. Copyright Law, 1911, ss. 1, 3; Copyright Ordinance, 1934, s. 5(4). *See* Amendment to the Copyright Ordinance, 1981; Copyright Ordinance, s. 5(6).

[286] P.C.A. 2687/92 *Geva v. Hevrat Walt Disney*, 48(1) P.D. 251; C.C. (T.A.) 931/92 *Tele-Event Ltd. v. Arutzei-Zahav, Shutfut Reshuma*, Dinim-Mehozi 26(6), 885.

[287] C.A. 592/88 *Sagi v. Ninio*, 46(2) P.D. 245.

[288] C.A. 513/89 *Interlego A/S v. Exin-Lines Bros. S.A.*, 48(4) P.D. 133.

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(iii) A broadcast of a performance (i.e., a transmission or dissemination to the public by wire, wireless or in any other way, of sounds or images or a combination of these).[289]

Nonetheless, the performer may not enjoin acts referred to above that constitute fair use of the performance for purposes of study or teaching on a nonprofit basis or for purposes of research, criticism or review, or a journalist's summary.[290]

The Law further stipulates that the performer has a right to reasonable royalties for any reproduction or broadcast of his/her performance[291] and the right that his/her name be mentioned in any such reproduction or broadcast.[292]

A performer whose right has been infringed is entitled, *mutatis mutandis*, to all the civil remedies available under the Law to the holder of a copyright in a similar event.[293]

The rights accorded by the Law expire after 70 years from the end of the year in which the original performance occurred and after 25 years from the year in which a broadcast was transmitted. Where the performer is an employee and the performance is given in the course and as a consequence of his/her service with his/her employer then, unless otherwise provided by agreement, the latter enjoys the protection accorded by the Law for the first 15 years of the periods referred to above and the former enjoys protection for the remaining years.[294] The Law does not apply to performances outside Israel.[295] Its provisions can be suspended by appropriate stipulation.[296]

h. Breeder's Rights

The Breeder's Rights Law provides protection regarding developments in the fields of plant breeding. A plant may be protected if it is registered and: (i) it is a new species;[297] (ii) it has uniform basic attributes; and (iii) its basic attributes are stable, provided that its attributes and description are preserved on reproduction. A species is deemed new if it varies in at least one basic attribute from any other known species, at the time of registration.

An application for a breeding right is filed with the office of the Registrar of Breeder's Rights in the Agriculture Ministry. "Fair use" of a registered breed is the use of a protected breed, which does not require approval of the owner and is not considered a violation of the breeder's right. The Law defines in its schedule various uses as fair uses, for example, research, science, laboratory tests, and private nonbusiness activities. Moreover, the use of reproductive material of a protected breed is allowed without the owner's permission for experiments towards the development of new species.

The rights accorded by the Law expire after 20 years from the time of registration. As for fruit trees, vitis, forest trees, and other perennial plants, the rights are valid for 25 years from the time of registration.

i. Non-Protected Rights

The Supreme Court held in *Ashir*[298] that a right that for some reason was not protected under the intellectual property laws might be protected under the Unjust Enrichment Law. *Ashir* dealt with a company that developed a product that had not been registered as a patent or as a design. Another company duplicated the product and, as result, made profits. The majority opinion held that the provisions of intellectual property laws do not limit the scope of the Unjust Enrichment Law. Furthermore, the intellectual property laws do not prevent restoration under the Unjust Enrichment Law. The Supreme Court held that, to be entitled to relief under the Unjust Enrichment Law, there must be proven elements of duplication and imitation as well as of unfair competition.

D. Immigration Regulations

Residents, whether temporary or permanent, may work in the country without a special work permit. Nonresidents may not work in the country without obtaining a special permit issued by the Ministry of Interior. These permits are issued under special circumstances and are not granted as a matter of course.

The Foreign Workers Law of 1991 sets forth the terms for receiving an employment permit for a foreign worker and also imposes duties on the employer with regards to employees, such as providing health care insurance coverage and suitable housing arrangements. The employer may deduct these expenses from the salary of an employee, but no more than the maximum amount set forth in the relevant regulations.

As for asylum seekers and illegal immigrants, the employer is obliged to make a monthly deposit, which in part is deducted from the employee's salary and in part is paid by the employer. The deposit will serve as a guarantee for the departure of the employee from Israel, on the date on which the employee must leave Israel. This can be determined by a final court judgment or a notice from the Minister of Interior or the Head of Population, Immigration and Border Authority in the Ministry of Interior.

It should also be noted that in recent years, a number of different provisions have been enacted to deal with the influx of asylum seekers and illegal immigrants who arrived in Israel, mainly from South Sudan and Eritrea, and to regulate the different aspects of their stay (including detention) in Israel. Some of these provisions were declared void by the Israeli High Court of Justice on the basis of unconstitutionality, such as the period of time that the asylum seekers and illegal immigrants may be held in a detention facility.

Note: Foreign workers in Israel were subject to a payroll tax over and above income tax and national insurance. This levy was imposed on employers and generally at the rate of 20%, but at 15% for foreign workers engaged in industry, construction, or certain restaurants and at 0% for those engaged in the agricultural sector. On February 2, 2022, the Knesset passed a law repealing the foreign workers' levy with effect from January 1, 2022 (Israeli Economic Recovery Law (Amendment 20) 2022, Book of Laws 2956).

[289] Performers' Rights Law, 1984, s. 2.
[290] Performers' Rights Law, 1984, s. 4.
[291] Performers' Rights Law, 1984, s. 3A.
[292] Performers' Rights Law, 1984, s. 4A.
[293] Performers' Rights Law, 1984, s. 5.
[294] Performers' Rights Law, 1984, ss. 10, 10A, 11.
[295] Performers' Rights Law, 1984, s. 13(a).
[296] Performers' Rights Law, 1984, s. 16.
[297] C.A. 2909/98 *Tarovot Htzafon Ltd. v. Hazera Ltd.* (1939) P.D. 54-3, 652 (2000).
[298] C.A.R. 5768/94 *Ashir v. Forum*, P.D. 52-4, 289 (1998).

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E. Labor Relations

Israeli employees earn less than their counterparts in the United States and Western Europe. The average monthly salary as of January 2024 was NIS 12,536 (Israeli employees only).

Employment costs consist of payments made directly to the employee and of fringe benefits that represent approximately 35% of the payments made directly to the employee. Salaries are comprised of various elements and the uninitiated may find it extremely difficult to comprehend the entire system of wage structuring in Israel. The most important items included in the salary are set out in 1. to 14., below.

1. Basic Salary

The basic salary is the salary to which an employee is entitled according to his/her grade, seniority and personal status (family allowance). There is a general pay scale that applies to all administrative and clerical employees in the public service, and a similar scale for technicians and engineers. Other employees are "linked" to pay scales adopted for employees in another economic sector. Production workers paid on a daily basis are also paid based on a scale that is negotiated separately by each industry. It is common in such industries to use incentive plans or piece rates to increase the employees' salary.[299] Executives in private industry are usually employed based on personal contracts negotiated directly between them and their employers. The family allowance has lost its importance over the years, mainly as a result of the child allowances paid to families with minor children by the National Insurance Institute, regardless of the level of the family's income.[300]

Amendment 24 to the Wage Protection Law, which came into force in February 2009, requires an employer to include additional information in the pay slips of its employees, including, among other items, general data regarding the employee (name, I.D., term of employment, etc.) and also specific details regarding the salary, such as: (i) for salaried employees, the scope of their employment, and for wage earners, the basis on which their wages are to be determined; (ii) the calendar period covered by the pay slip, and the number of actual work days, vacation days, and sick days taken; (iii) detailed information on salary paid; (iv) deductions from salary, such as income tax, social security, health tax, provident funds, and the sum of all deductions; (v) payments for the employee's social benefits; and (vi) the updated legal minimum wage per month or hour.

[299] Most of these scales are legally based on collective agreements that have special legal status according to the Collective Agreements Law, 1957.

[300] National Insurance Law (Consolidated Version), 1995, s. 66.

2. Cost-of-Living Allowance

All employees receive a cost-of-living allowance to protect their wages from the drastic effects of inflation. Since the commencement of the government's austerity plan in July 1985 (which consisted in part of a temporary wage freeze), the rate of inflation in Israel has been sharply reduced. The cost-of-living allowance is based on a highly elaborate system and is payable periodically based on the increase in prices as reflected by the official consumer price index. The allowance does not compensate for the entire effect of inflation, and if a periodic rate of inflation does not reach a certain minimum, the compensation is deferred to the next period. The last cost-of-living allowance was paid in 2004.

3. Overtime

The minimum overtime pay is 125% of the usual rate for the first two hours of overtime a day and 150% thereafter;[301] however, an employer may grant leave in lieu of the additional compensation.[302] A special permit from the Minister of Labor is required for overtime employment, which is otherwise forbidden. A general permit, issued by the Minister, allows all employers to employ their employees to the extent of 12 hours overtime a week, provided such overtime does not exceed four hours a day. Working on holidays or days of rest entitles employees to at least 150% of the usual hourly rate.[303] Special permission of the Ministry of Labor and Social Affairs must be obtained for employees to work on holidays or days of rest.[304]

Employers are obliged to maintain a record of their employees' working, overtime and rest hours, either by mechanical means, digitally or electronically, or by having their employees sign daily timesheets to be approved by the employer.[305] The obligation is imposed on the employer but requires the cooperation and participation of the employee. In case of a claim made by an employee for unpaid wages, the burden of proof lies with the employer, if the required records of the hours of work which the employee performed were not maintained.[306]

In 2013, the Israeli Supreme Court ruled that the Hours of Work and Rest Law, 1951 does not apply to non-Israeli therapists and therefore they are not entitled to overtime pay.[307]

4. Shift Work

A shift premium is not accorded under the law, but rather by virtue of collective agreements or extension orders. Usually, for second shift work (3–11 p.m.), an employee is entitled to a premium at a rate of about 20% increase over the basic salary; for third shift work (11 p.m.–7 a.m.), the increase customarily rises to 40%–45%.

[301] Hours of Work and Rest Law, 1951, s. 16(a).

[302] Hours of Work and Rest Law, 1951, s. 16(b).

[303] Hours of Work and Rest Law, 1951, s. 17(a).

[304] Hours of Work and Rest Law, 1951, s. 12(a).

[305] Hours of Work and Rest Law, 1951, s. 25.

[306] Wage Protection Law, 1958, s. 26B.

[307] A.D.S.C. 10007/09 *Yolanda Gloten v. The National Labor Court* (Mar. 18, 2013).

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5. Productivity Bonus

Many collective agreements, particularly in the industrial sector, provide for increases in salaries based on increases in productivity. In many cases, the criteria of productivity for the bonuses are not updated.

6. Thirteenth Month

In many industries (especially financial services and computer services), it is common to pay a "thirteenth month" salary in two equal parts on the eve of the Jewish New Year and at Passover in the spring. Financial institutions sometimes pay a "fourteenth month" salary as well.

7. National Insurance

Israelis must be insured by the National Insurance for old age benefits, survivors' insurance, maternity insurance, pay while on call to the military reserves and workman's compensation insurance.[308] In addition, under the State Health Insurance Law, 1994, all Israeli residents are covered by state health insurance, entitling them to a prescribed list of medical services. The medical services are provided by several health care funds (*Kupot Holim*), and each resident is free to choose membership in any of them. The state health insurance contribution is paid as part of the National Insurance contributions, and the health care funds offer extended services for an additional fee.

The following table details the contributions to the National Insurance and to Health Insurance (as of 2023):

[308] National Insurance Law (Consolidated Version), 1995, s. 335.

	Wage Earners					
	Up to 60% of Average Wage (7,122 NIS)			**Over 60% of Average Wage (7,122 – 47,465 NIS)**		
	Employee	**Employer**	**Total**	**Employee**	**Employer**	**Total**
National Insurance	0.4%	3.55%	3.95%	7%	7.6%	14.6%
Health Insurance	3.10%	—	3.10%	5%	—	5%
Total	3.50%	3.55%	7.05%	12%	7.6%	19.6%
	Self-Employed					
	Up to 60% of the Average Salary (7,122 NIS)			**Over 60% of Average Wage (7,122 – 47,465 NIS)**		
National Insurance	2.87%			12.38%		
Health Insurance	3.10%			5%		
Total	5.97%			17.83%		

National Insurance Premiums are limited to a monthly income not exceeding a specified statutory ceiling (NIS 47,465 as of 2023), i.e., they are not entirely progressive.

8. Severance Pay, Provident Funds, Pension Funds

Under Israeli law, an employee is entitled to severance pay in the event of dismissal after more than one year of employment. In special circumstances, an employee is entitled to severance pay when resigning (i.e., the resignation of an employee after giving birth, resignation following a stay in a woman's shelter, resignation due to health conditions, relocation or a significant deterioration of employment conditions).[309] In the case of an employee's death, severance pay is payable to specified heirs.[310] An employee is not entitled to severance pay on voluntary resignation;[311] however, in such cases, most employers still pay the amount to which the employee would have been entitled had the employee been honorably dismissed. It should be noted that the severance pay provision paid over to a pension fund (see below) cannot be refunded to the employer.[312]

Severance pay is based on the last monthly salary of the employee. It is computed by multiplying the last monthly salary paid to the employee by the number of years in the employment of the employer.[313] Employees who are paid on a daily basis receive severance pay based on two weeks' salary for each year of employment.[314] In computing severance pay, special benefits are not taken into consideration, except where otherwise provided in a collective agreement, or where they are in effect disguised salaries.[315]

Most collective agreements provide for the deposit of money by employers and employees in provident and pension funds. Generally speaking, the employer pays an amount equal to $8^{1}/_{3}$% of the monthly salary into the fund to cover future sev-

[309] Severance Pay Law, 1963, ss. 1, 6, 7, 7A, 8 and 11.

[310] Severance Pay Law, 1963, ss. 4 and 5.

[311] But when Severance Pay Law, 1963, ss. 6–11 apply, a resignation is considered a dismissal.

[312] Severance Pay Law, 1963, s. 26.

[313] Severance Pay Law, 1963, s. 12.

[314] Severance Pay Law, 1963, s. 12.

[315] H.C.J. 105/87 *The Hebrew University of Jerusalem v. The National Labor Court*, 42(3) P.D. 556; H.C.J. 567/87 *Gunik v. The National Labor Court*, 42(4) P.D. 693.

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erance pay. The employer and the employee each contribute a percentage of the monthly salary to provide for a future pension fund or to provide for the accumulation of the contributions in a provident fund, which will be made available to the employee upon the termination of his/her employment. The retirement and severance pay of senior executives is usually covered by special insurance policies taken out by the employer for the benefit of the employee.

An Extension Order of pension funds by the Minister of Industry Trade and Labor came into force as of January 1, 2008. This Order requires all employers and employees in Israel to pay certain amounts, being a percentage of the monthly salary, into a fund to cover future severance pay. The Order does not apply to employees for whom pension funds have already been established.

The following table sets forth the contributions to pension funds:

Year	Employer	Employee	Severance (Employer)	Total
1.1.2008	0.833%	0.833%	0.834%	2.5%
1.1.2009	1.66%	1.66%	1.68%	5%
1.1.2010	2.5%	2.5%	2.5%	7.5%
1.1.2011	3.33%	3.33%	3.34%	10%
1.1.2012	4.16%	4.16%	4.18%	12.5%
1.1.2013	5%	5%	5%	15%
1.1.2014	6%	5.5%	6%	17.5%
1.7.2016	6.25%	5.75%	6%	18%
1.1.2017 – onwards	6.5%	6%	6%	18.5%

9. Advanced Education Fund

Some collective employment agreements call for contributions by both employers and employees to specially designated funds designed to allow employees to save for refresher courses, including traveling abroad to update professional standards and techniques. Normally employees contribute 2.5% of their salary, while the employer contributes 7.5% of the regular salary. Special tax breaks make these funds particularly attractive.

10. Annual Vacation and Convalescence Pay

An employee is entitled by law to paid annual vacation, ranging from 16 to 28 days depending on the work tenure.[316] The amount of the annual vacation pay is equivalent to the employee's regular salary, i.e. the salary the employee would have earned had the employee been working during the vacation.[317] Periods of vacation may not be accumulated; however, with the employer's consent, an employee may choose to have a vacation of at least seven days and add the remaining period to the next two years' vacation.[318]

An employer must pay each employee who has completed one year of service "convalescence pay,"[319] which is intended to cover part of the employee's costs during the annual vacation. The entitlement ranges from five to 10 convalescence days, depending on the work tenure. The value of each day is NIS 378 in the private sector and NIS 449 in the public sector (as of 2023). The entitlement is based on collective agreements or extension orders.

11. Sick Leave Pay

An employee is entitled to sick leave to the extent of one and a half days per month, which may be accumulated provided that they do not exceed a total period of 90 days.[320] Where an employee is entitled to sick leave, a statutory deduction is made from his/her salary.[321]

Other laws entitle employees to sick leave on account of accumulated sick leave. Thus an employee is entitled to sick leave[322] on the illness of a child living with him (eight to 16 days; in case of a severe illness, 90 to 110 days); for pregnancy and birth (seven days);[323] on the illness of a spouse (six days; in case of a malignant disease — and subject to completion of one year of employment — 60 days);[324] and on the illness of a parent or spouse's parent who has reached 65 years of age (six days).[325]

12. Commuting Allowance and Company Cars

As a rule, most employers reimburse their employees for their traveling expenses to and from work. Executives are gen-

[316] Annual Vacation Law, 1951, s. 3.
[317] Annual Vacation Law, 1951, s. 10.
[318] Annual Vacation Law, 1951, s. 7(a).
[319] Originally, convalescence pay was given to cover the employee's costs for staying in a "convalescent home," to recover from an illness or injury, or simply to relax. However, today convalescence pay is mandatory and is intended to cover an employee's vacation costs regardless of whether the employee stays in a convalescent home or goes on vacation.
[320] Sick Pay Law, 1976, s. 4.
[321] Sick Pay Law, 1976, s. 2.
[322] Sick Leave (Leave for Illness of Child) Law, 1993.
[323] Sick Leave (Leave Due to a Spouse's Pregnancy and Childbirth) Law, 2000.
[324] Sick Leave (Leave Due to Illness of Spouse) Law, 1998.
[325] Sick Leave (Leave Due to Illness of Parent) Law, 1993.

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erally provided with a car or are reimbursed for all their costs in maintaining their own cars. In computing the related tax liability, each Israeli resident is entitled to a quarter of a credit point with respect to transportation to the place of employment.

13. Military Duty

Workers of military age are called up to reserve duty for up to 30 days, and in extreme cases for up to 60 days a year. Though employers are not required to make up the difference between an employee's regular salary and the amounts paid by the National Insurance with respect to such service, it is customary to pay employees their normal wages even during their military duty.

In August 2008, a Reserve Service Law[326] took effect. According to the law, an employee who served one to five days will receive an extra 40% of the reserve service emolument (which is calculated according to the employee's wages). An employee who served more than five days will receive an extra reserve service emolument in the amount of the daily emolument. The emolument will be paid by the employer and will be refunded by the National Insurance. If employers will receive less than they actually paid, they will be able to set off the balance due from the employee's' salary.

An employee who served 10 days or more is eligible for an additional emolument, which is paid directly by the ITA.[327] In the case of 32 days of service or more, an employee is also eligible for a special emolument, which is paid directly by the IDF.[328]

14. Minimum Wages Law

The Minimum Wage Law, 1987 protects an employee's right to fair wages by providing that wages may not fall below a specified minimum amount. The designated minimum wage is a percentage of the average wage on April 1, each year, as adjusted according to the Law (NIS 5,880.02, as of 2024). The Law also applies to teenagers under 18 years of age by virtue of regulations promulgated under it, but such teenagers are entitled to a lower minimum wage — ranging from 70% to 83% of the regular minimum wage — depending on their age.[329] Noncompliance with the law is a criminal offense and a noncompliant employer risks imprisonment for up to six months for each underpaid employee.[330]

15. Assurance of Income Law

Under the Assurance of Income Law, 1980, Israeli residents aged 25 years or more are entitled to a monthly allowance provided they belong to one of the following categories: persons who are not able to work and earn their living or are unemployed; persons who are over retirement age; parents providing for at least one child who is not yet two years old, or widowed mothers providing for their children; persons who are mainly occupied in caring for an ailing spouse or a child who needs constant care; women who stay in a women's shelter, etc.[331]

16. Salary Cap in a Financial Company

According to a new law that entered into force in 2016, a payment of salary to senior employees or executive officers in a financial corporation (such as banks and insurance companies) that exceeds NIS 2.5 million a year requires approval from the compensation or audit committee and board of directors. In a public corporation the approval of the general meeting is also required.[332] In any case, a salary that is more than 35 times the lowest salary in the company may not be approved.[333] The amount of the salary over NIS 2.5 million is considered as a non-tax-deductible expense.[334]

17. Retirement Age

The retirement age is 67 for men and 65 for women.[335] The employer may terminate the employment relationship once the employee — man or woman — turns 67.[336] If the employee asks to continue working after the aforementioned age, the employer must consider the employee's request in good faith and exercise his/her discretion based on the individual circumstances of the request.[337]

18. Anti-Discrimination Legislation

Employment discrimination of an employee or job candidate based on the following criteria is prohibited: sex, sexual orientation, marital (personal) status, pregnancy, fertility treatments, in vitro fertility treatments, parenthood, age, race, religion, nationality, country of origin, geographical place of residence, ideology, political affiliation or reserve service.[338] Discrimination required by the character or nature of the position is not considered as unlawful discrimination.[339]

In addition, males and females who are employed by the same employer and in the same place of work are entitled to equal pay for the same or equivalent work.[340]

F. Financing the Business

1. Banking

Israel has a modern banking system with nearly 1,000 branch offices. Most banks have their head offices in Tel Aviv; however, they all have regional offices in the major cities. The larger banks have offices abroad and maintain correspondent banks in those foreign countries in which they have not yet established branches. The commercial banks provide checking account services, accept time deposits and offer a wide range of savings accounts with the principal of the amount deposit-

[326] Reserve Service Law, 2008.

[327] Reserve Service Law, 2008, s. 18.

[328] Reserve Service Law, 2008, s. 19.

[329] Minimum Wage (Working Youths and Apprentices) Regulations, 1987, ss. 2 and 4.

[330] Minimum Wage Law, 1987, s. 14.

[331] Assurance of Income Law, 1980, s. 2.

[332] Compensation of Officers in Financial Corporations Law (Special Approval and Non-Deductible Expense for Tax Purposes of Irregular Compensation), 2016, s. 2(a).

[333] Compensation of Officers in Financial Corporations Law (Special Approval and Non-Deductible Expense for Tax Purposes of Irregular Compensation), 2016, s. 2(b).

[334] Income Tax Ordinance, 1961, s. 32(17).

[335] Retirement Age Law, 2004, s. 3.

[336] Retirement Age Law, 2004, s. 4.

[337] W.A. 209/10 *Weinberger v. Bar-Ilan University* (2012).

[338] Equal Opportunities in Employment Law, 1998, s. 2(a).

[339] Equal Opportunities in Employment Law, 1998, s. 2(c).

[340] Equal Pay for Male and Female Workers Law, 1996, s. 2.

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ed sometimes linked to the consumer price index. Saving accounts with fixed nominal interest are also available. In addition, the banks make regular long-term loans in accordance with prevailing market conditions. Usually a short-term loan will take the form of a line of credit on a secured basis. The borrower pays only for the credit actually used and the interest is computed on a daily basis. The banks handle security transactions for their customers and for their own account on the Tel-Aviv Stock Exchange and perform such services on foreign exchanges as well. They underwrite and distribute issues of shares.

In 2004, a special committee known as the "Bachar Committee" was set up to improve the competitive nature of the Israeli capital market, which suffered from the very dominant position of the banks in all its sectors: mutual funds; provident funds; underwriting etc. The committee recommended that: (i) a bank or a person who controls a bank should not control, directly or indirectly, any provident or mutual fund; (ii) no bank in its capacity as an underwriter should act as a "pricing underwriter" with regard to large scale borrowers; (iii) a law should be enacted governing supervision and enforcement in the provident funds sector; (iv) two new disciplines should be defined in the financial industry — advisors and retailers/distributors — and the two should be *totally* separate; and (v) banks that do not own a provident fund or an insurer should be allowed to sell life insurance and pension products. These recommendations were enacted into law in 2004 and began a massive sale of funds (mutual and provident) by the commercial banks, mainly to insurance companies.

Until October 1983, the banks "regulated" the prices of their shares on the Tel-Aviv Stock Exchange and investors reaped handsome profits. A wave of selling brought an end to this practice after the banks could no longer afford to purchase their own shares. A special agreement was entered into with the government pursuant to which long-term holders of the shares received a guaranteed price and return on their shares (converting them in essence into debentures). Subsequently, a special Investigation Committee was appointed by the government in 1985, to investigate the economic effects and legality of this "regulation." The committee's findings, published in April 1986, established that the banks had improperly "regulated" the prices of their shares by resorting to illegal practices. The committee recommended significant changes in the capital market. Only a few of these were implemented (for example, no bank advice on investments in shares in which the bank has an interest). The "bank bail-out" cost taxpayers US$ 7.5 billion. Special measures were taken to avoid a *de facto* nationalization of the banks, including the enactment of a special law designed to guarantee the banks' independence while state-owned and a privatization process, which is being implemented gradually.

In 2005, the government sold its shares in Israel Discount Bank Ltd.; although the government sold most of its shares in Bank Leumi Le, Israel still holds approximately 6% of the bank's shares, which are expected to be sold in the near future.

Furthermore, the banks were required to divest themselves of most of their real assets, as part of the effort to lessen the centralization of the economy.

2. Bank of Israel

As of July 2008, the NIS is traded internationally as Israel has become a member of the International CLS Bank System.

Israel's central bank is the Bank of Israel. In 2010, the Bank of Israel Law, 1954 was abolished and replaced by the Bank of Israel Law, 2010. This bank is the only issuer of currency in the country[341] and, as Israel's fiscal agent,[342] holds the government's basic deposits, and holds and manages the country's reserves of foreign currency and gold.[343]

Compulsory and other deposits from banks are maintained with the Bank of Israel.[344] The bank controls the volume of credit through its rediscount role and by the imposition of a liquidity ratio on the commercial banks.[345] The bank also implements the government's economic policy by directing credit to the preferred economic sectors. Furthermore, the Bank of Israel supervises all banks and financial institutions and periodically carries out audits of the commercial banks.[346] All banks must publish their certified balance sheets in a daily newspaper and must furnish the bank controller with current information.[347]

3. Finance and Credit

Most business and private credit financing is obtained from the commercial banks. The insurance companies also provide loans. Finally, the "gray market" offers high risk debtors' loans at very high interest rates. This market derives its liquidity from enterprises with surplus cash, which extend credit to "gray lenders" against strong bank guarantees, and is for the most part unregulated. Nonetheless, limited regulation of non-bank credit is provided by the Interest Law, 1957,[348] which limits interest rates chargeable to a statutory ceiling, determined from time to time by the Bank of Israel, and sets a minimum interest accrual term of three months, and by the Law for the Regulation of the Non-Bank Credit, 1993,[349] which imposes a disclosure liability and makes other requirements of the lender.

[341] Bank of Israel Law, 2010, ss. 41, 44.
[342] Bank of Israel Law, 2010, s. 48.
[343] Bank of Israel Law, 2010, s. 36.
[344] Bank of Israel Law, 2010, s. 36.
[345] Bank of Israel Law, 2010, ss. 36, 38.
[346] Bank of Israel Law, 2010, s. 39.
[347] Banking Ordinance, 1941, s. 10.
[348] Interest Law, 1957.
[349] Law for Regulation of Non-Bank Credit, 1993.

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III. Forms of Doing Business in Israel

A. Principal Business Entities

The principal business organizations in Israel are companies, partnerships (general and limited) and sole proprietorships.

1. Companies

A company limited by shares, whether private or public, is very similar to the company or the corporation known to investors from common law countries.[350] A company is managed by a board of directors; however, the sanction of a special majority of the shareholders is required in some instances (for example, in the case of an alteration of the share capital, a change in the rights attached to shares, mergers and liquidations). A company must have articles of association.[351] Each company has the right to determine its own articles of association, which are considered a contract between the company and its shareholders and between the shareholders themselves.[352] Traditionally, a company's objectives were stated very broadly to prevent the application of the *ultra vires* doctrine, in accordance with which an act failing to come within the enumerated objectives of a company was considered void.[353] Under the Companies Law, 1999, a company may define specific objectives or one or two general objectives, for example, "every lawful objective" or "every lawful objective, except … ."[354]

- A public company is a company whose shares are listed for trade on the Stock Exchange or held by the public as a result of an offer accompanied by a prospectus (as defined in the Securities Law, 1968).
- A private company is defined as a company that is not a "public company."[355]
- The minimum number of shareholders in a private company is one[356] and, in a public company, two.[357]

a. The Companies Law

The Companies Ordinance, the main statute that governed corporate law in Israel, underwent numerous amendments between its original enactment in 1929 and 1999, whereupon the new Companies Law, 1999 was enacted, with effect from February 1, 2000. The 1999 law replaced most of the Companies Ordinance, 1929; notable exceptions remain in the sections concerning debentures and liquidation, and the sections regarding companies incorporated under the Companies Ordinance, 1929. Some of the more significant provisions of the 1999 law are:

(i) The law requires an ordinary majority to amend a company's articles of association (unless the company's articles of association provide for a special majority), whereas the Companies Ordinance, 1929, required a three quarters majority for the same purpose;

(ii) The law allows companies greater freedom in defining their share capital to allot shares with no par value;

(iii) The law imposes on all shareholders, whether controlling or not, the duty to act *bona fide* in the best interests of the company, thus imposing a duty substantially similar to the duty imposed on directors by the Companies Ordinance, 1929;

(iv) The law establishes a presumption that all shares are transferable, unless provided otherwise in a company's articles of association, but grants shareholders in a private company a right of first refusal with respect to the transfer of shares in the company, in light of the importance of the shareholders' identity in private companies;

(v) The law permits companies to buy their own shares. These shares are considered "dormant" while in the company's possession and regain their rights once returned to shareholders; and

(vi) To prevent the dilution of the minority shares when the majority shares in a company are sold, the law obliges the purchaser of a majority interest to make a bid to all shareholders in a company, on the same terms and conditions as those on which the majority shares were sold. The shareholders may accept, accept with reservations or reject the bid. If the majority of the shareholders fully accept the bid, the purchaser must buy the shares of all the accepting shareholders (including those who accepted with reservations).

On September 15, 2024, an amendment to the Companies Law was published that added a provision authorizing the Registrar of Companies to delete a company from the registrar's records. The amendment also regulates the process and conditions for the exercise of the deletion authority, the consequences of deletion, and the manner and conditions for the reinstatement of a company that has been deleted in appropriate cases.[358]

b. Incorporation and Registration

Incorporating a company in Israel is relatively simple. All incorporators must file with the Registrar an application according to section 1 of the Companies' Regulations (Reports, Registration and Forms), 1999, and, in addition thereto, articles of association and a declaration of the "first" directors, declaring their willingness to act as the first directors of the company;[359] a verification of the identity of signers of the articles pro-

[350] Companies Law, 1999, which repealed the Companies Ordinances (New Version), 1983 and 1929, excluding the chapters on liens and liquidation, which remain valid in the 1983 Ordinance.

[351] Companies Law, 1999, s. 15.

[352] Companies Law, 1999, s. 17.

[353] Companies Ordinances (New Version) 1983, ss. 55, 56.

[354] Companies Law, 1999, s. 32.

[355] Companies Law, 1999, s. 1.

[356] Companies Law, 1999, s. 3.

[357] According to Companies Law, 1999, 8th chapter, 3rd part, if a bid for the only class or for all the classes of the shares of a public company is received and accepted, the public company becomes a private company.

[358] The amendment to the Income Tax Regulations published in September 2024 introduces a number of significant changes, particularly concerning the reporting obligations for new immigrants and Veteran Returning Residents. Starting from January 1, 2026, new immigrants and Veteran Returning Residents will be required to report their income earned outside Israel. While they remain exempt from taxes on this income, they are still required to report it. (For more detail, see XV.C.).

[359] Companies Law, 1999, ss. 8, 9, 23.

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vided by an attorney;[360] and a power of attorney executed by the incorporators, authorizing their attorney to handle the registration and to amend the documents being filed for the registration, as the Registrar may require. A short form must also be filed to allow for the entry of the data with respect to the new company into the computer maintained by the Registrar of Companies. Further particulars required to register a company are: (i) the proposed name of the company; (ii) the location of the company's registered office; (iii) the particulars of the shareholders; (iv) a declaration of each shareholder of his/her competence to found a company and to hold its shares; and (v) particulars of the company's capital.[361] The Registrar accords the company a certificate of registration, which serves the same purposes as the corporate charter in the United States.[362] The number on the certificate is a specific number assigned to the company and is later used in all its correspondence with the Registrar and the tax authorities.

The Attorney General issued instructions to all government agencies to accept only Hebrew and Arabic documents. Correspondence in English will not be accepted.

c. Reports

A private company must file an annual report with the Registrar that must include: the names of all its shareholders and directors and various details with respect thereto; data about the share capital of the company; and the total obligations secured by pledges undertaken by the company.[363] In addition, a private company must file a report on the occurrence of any of the following: (i) a transfer or allotment of shares;[364] (ii) a change in the composition of or a new appointment to the board;[365] (iii) amendments to the articles of association, including, inter alia, the alteration of the company's name or capital;[366] (iv) the lack of an auditor;[367] and (v) a merger.[368]

A public company must report annually to the Securities Authority, to the Stock Exchange on which its shares are listed for trade, and to the Registrar.[369] The annual report must include, inter alia: (i) an audited financial report;[370] (ii) the directors' report on the state of the company's business;[371] (iii) a profit and loss account;[372] (iv) a report on the use made of the consideration received for securities sold to the public under a prospectus;[373] (v) a list of investments;[374] (vi) a list of changes in investments;[375] (vii) the profit and loss accounts of subsidiaries;[376] (viii) a list of loans;[377] (ix) a list of payments to office holders;[378] and (x) a list of benefits accorded to interested parties.[379] A public company must file an immediate report with the Registrar on the occurrence of any of the following: (i) a resolution to change the company name; (ii) a change of the company's registered office; (iii) a merger; (iv) a transformation of the company from a private to a public company; and (v) the issuance of a liquidation order or a decision on a voluntary liquidation.[380] Every company (except for those with a turnover of less than NIS 615,408) must appoint an independent auditor entitled to practice his/her profession in Israel who must audit the financial statements.[381] In addition, public offerings of shares or other securities by public companies come under the aegis of the Securities Law, 1968, which was modeled after similar United States laws.[382]

All reports of both public and private companies are open to the inspection of the public.

d. Fees

The Companies Regulations (Fees), 2001 prescribe the following fees in force with respect to 2023:

Types of Fees	Amounts (NIS)
Registration of a company[383]	28,36
Online registration of a company[384]	2,324
Review of the company record or other statutory records[385]	68
Merger plan[386]	2836
Annual Fee	1,614
Reduced annual fee (paid before February 28)[387]	1,215

In addition to the above, stamp duty was imposed on the allotment of shares. The duty was fixed at 1% of the par value of the shares or the price paid for them, whichever was higher. The stamp duty was abolished in 2005 and is no longer in force. A nominal fee is charged for the publication of the notice of registration in the official gazette.

e. Shares

The share capital of a private company may be divided into different classes of shares.[388] Indeed, it was common in Is-

[360] Companies Law, 1999, s. 23.
[361] Companies Regulations (Reports, Registration and Forms), 1999.
[362] Companies Law, 1999, s. 10.
[363] Companies Law, 1999, s. 141; Companies Regulations (Reports, Registration and Forms), 1999, s. 4 and form No. 5.
[364] Companies Law, 1999, s. 140(5), (6).
[365] Companies Law, 1999, s. 140(4).
[366] Companies Law, 1999, s. 140(1).
[367] Companies Law, 1999, s. 140(3).
[368] Companies Law, 1999, s. 140(7).
[369] Companies Law, 1999, s. 142; Securities Law, 1968, s. 36; Securities Regulations (Periodical and Immediate Reports), 1970, s. 7.
[370] Securities Regulations (Periodical and Immediate Reports), 1970, s. 9.
[371] Securities Regulations (Periodical and Immediate Reports), 1970, s. 10.
[372] Securities Regulations (Periodical and Immediate Reports), 1970, s. 10A.
[373] Securities Regulations (Periodical and Immediate Reports), 1970, s. 10C.
[374] Securities Regulations (Periodical and Immediate Reports), 1970, s. 11.
[375] Securities Regulations (Periodical and Immediate Reports), 1970, s. 12.
[376] Securities Regulations (Periodical and Immediate Reports), 1970, s. 13.
[377] Securities Regulations (Periodical and Immediate Reports), 1970, s. 14.
[378] Securities Regulations (Periodical and Immediate Reports), 1970, s. 21.
[379] Securities Regulations (Periodical and Immediate Reports), 1970, s. 22.
[380] Companies Law, 1999, s. 145.
[381] Companies Law, 1999, ss. 154–159.
[382] Securities Law, 1968, s. 15(a). See II.C.2.d.
[383] Companies Regulations (Fees), 2001, s. 2, appendix (1).
[384] Companies Regulations (Fees), 2001, s. 2, appendix (1).
[385] Companies Regulations (Fees), 2001, s. 2, appendix (3).
[386] *Id.*, s. 4, appendix (8).
[387] *Id.*, s. 5, appendix (9), (10).
[388] Companies Law, 1999, s. 285.

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rael, before the Companies Law, 1999 was enacted, to make use of different classes of shares to ensure control or to grant block-voting rights. Thus, there was often a minority shareholder who received 26% of the voting shares so that the minority shareholder was able to block resolutions that required the sanction of 75% of the participating voting shareholders.[389] Under the Companies Law, 1999, a regular majority is sufficient for the passing of any resolution, unless otherwise provided for by the articles of association.[390] Preferred shares, redeemable preference shares, founders' shares, management shares, bonus shares and other shares are frequently used to regulate the relations between the different shareholders. Shares are often divided into class "A" and class "B" shares, with one class granting preferential voting or other rights, while being equal to the other class of shares with respect to all other matters. Unless otherwise specified in the articles of association, each share carries one vote.[391] Shares need not have a par value.[392] If the shares have no par value, the number of shares must be specified in the articles of association. Section 46B of the Securities Law provides that a public company must have only one class of shares, according to the shareholders equal voting rights based on the nominal value of their shares. A company is entitled to purchase its own shares but may not use resources in excess of the amount it is entitled to distribute as a dividend (see f., below).[393] A treasury share carries no rights and is considered a "dormant share" as long as the company owns it.[394]

f. Dividends

A company may distribute a dividend only out of its profits[395] ("the profit test"), and subject to the company's ability to pay off its current and prospective debts ("the payment test"). If passed, this two-tier test entitles a company to make a "permitted distribution." The court may grant its approval of a distribution that fails to meet the conditions of the profit test, provided there is no reason to believe that the distribution will prevent the company from meeting its current and future obligations.[396] A company may purchase its own shares without the court's sanction only out of funds from which it could make a "permitted distribution."[397]

Comment: It is unclear whether a company may distribute as dividends profits arising from a revaluation mandated by the International Financial Reporting Standards (IFRS). Some argue that these profits are not distributable because they fail to create a real cash flow, while others claim they are distributable because they represent the true profits of the company. The Securities Authority has not published its opinion on this matter.

g. Charges

All charges created by a company must be registered with the Registrar of Companies.[398] Under Israeli law, a company may also create a floating charge, which differs from a fixed charge in that the company creating the floating charge may continue selling its assets and creating additional fixed charges with priority over the floating charge.[399] However, once the company goes into liquidation or the holder of the floating charge secures a court order appointing a receiver, the floating charge crystallizes and becomes a fixed charge on the unencumbered assets still possessed by the company on the date of crystallization.[400] The floating charge accords preference with respect to unsecured creditors; however, a fixed charge ensures its holder greater preference unless otherwise expressly provided, i.e., such a charge enables its holder to recover his/her debt before any other creditor, even if it was created after the floating charge and with full awareness thereof, unless the document creating the floating charge prohibited the creation of new charges, in which case the floating charge will prevail.[401]

To be valid a charge must be registered with the Registrar of Companies. The Supreme Court has held that a delay in registering a charge will render it invalid in case of a liquidation preceding the registration.[402]

h. Directors

The directors of a company are under two major constraints:

(i) The duty to use care: a director must exercise his/her powers and fulfill his/her role using care and skill, i.e., a director must exercise the same care as can be expected from a reasonable director in the same position and in the same circumstances[403] (previously the skill criterion was that of a reasonable person). The main tasks of the board under this duty are: to determine the company's policy; to supervise the implementation of the company's policy;[404] to supervise management; to represent the shareholders' interests; and to appoint the general manager;[405] and

[389] Under Companies Ordinance (New Version), 1983, s. 47, there were three kinds of resolutions, whereas under the new law the "default" resolution is the common resolution.

[390] Companies Law, 1999, s. 85.

[391] Companies Law, 1999, s. 82(c).

[392] Companies Law, 1999, s. 34.

[393] Companies Law, 1999, s. 302.

[394] Companies Law, 1999, s. 308.

[395] Companies Law, 1999, s. 302(a), (b). *See also* D.A. 49615-04-13 *Ronen Lahav v. IDB Development Co. Ltd.* (Nov. 6, 2013).

[396] Companies Law, 1999, s. 303(a).

[397] *See also* D.L. 48081-11-11 (TA) *Reuven Rosenfeld v. Ilan Ben Dov* (Mar. 17, 2013).

[398] Companies Ordinance (New Version), 1983, s. 178(a).

[399] Companies Ordinance (New Version), 1983, s. 1, defines "floating charge" as "a charge on all or part of assets and undertakings for the time being of the company, in the varying condition in which they happen to be from time to time, but subject to the power of the company to create specific mortgages or charges on all or any part thereof." C.A. 143/87 *Tfachot Bank Lemashkantaot Le Israel Ltd. v. Nofim Mifalim Calcaliyim Ltd.*, 43(4) P.D. 749; C.A. 542/85 *Hmoaza Hyisraelit Le Yezur Veshivuk Kutna Ltd. v. Ata Hevra Le Textile Ltd.*, 42(4) P.D. 559; C.A. *Habar Shefa Mazon LaDarom Ltd. v. Adv. Meron*, 54(4) P.D. 132.

[400] C.A. 353/62 *Hart v. The Official Receiver*, 17(1) P.D. 496; C.A. 522/72 *The State of Israel v. Konsey Nehasim Shel Hahevra Walltex Ltd.*, 22(2) P.D. 393; C.A. 4752/92 *Makat Ltd. v. Hahevra Lebituach Sikuney Sachar Huts*, 51(2) P.D., 214.

[401] Company's Ordinance (New Version), 1983, s. 169; C.A. 603/71 *Bank Leumi Ltd. v. Palestine Britain Bank Ltd.*, 26(2) P.D. 468; C.A. 542/85 *Hmoaza Hyisraelit Le Yezur Veshivuk Kutna Ltd. v. Ata Hevra Le Textile Ltd.*, 42(4) P.D. 559.

[402] C.A. 2388/04 *Reggis v. Gavriel Trabelssi, CPA, Trustee of Dan Rolider Ltd.*, Dinim Elyon 96, 408 (2009).

[403] Companies Law, 1999, s. 253; C.A. 333/59 *Rotlevy v. Barshai*, 14 P.D. 1156.

[404] Companies Law, 1999, s. 92.

[405] Companies Law, 1999, s. 250.

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(ii) The fiduciary duty: broadly stated, this is the duty to act *bona fide* in the best interests of the company and includes: the duty to refrain from doing anything likely to create a conflict of interests between the director's personal interests, his/her other offices and the company's interests;[406] the duty to refrain from competing with the company's business;[407] and the duty to disclose to the company any information that pertains to its affairs and that came into the director's possession by virtue of his/her office.[408]

It was held, for example, that directors are under a fiduciary duty when exercising their power to allot shares[409] or when making gifts.[410] The fiduciary duty is exercised with respect to the company as a whole but may also be imposed in favor of a specific person.[411]

The strictness of the duties imposed on directors in the 1991 amendment to the Company's Ordinance (New Version), 1983, and adopted with almost no changes in the Companies Law, 1999, is balanced by the authority granted to a company to include in its articles of association provisions permitting it to insure or indemnify its officers for failure to comply with the requirements set down in the articles. A company may insure some or all of its officers with respect to one or more of the following:[412]

(i) A breach of the duty of care towards the company or any third party;[413]

(ii) A breach of the fiduciary duty towards the company, provided the officer acted in good faith and had reasonable grounds to assume his/her action would be in the company's best interest;[414] and

(iii) Any financial liability that might be imposed on the officer in favor of a third party with respect to an act performed as a consequence of serving as an officer of the company.[415]

An amendment to the Companies Law allows a company to indemnify its directors for reasonable litigation expenses, including attorney's fees, incurred as a result of an inquiry or a procedure conducted by the authorities as long as no criminal consequences persist.[416]

Insurance of a wider scope is invalid.[417] A company may also incorporate in its basic documents provisions enabling it to indemnify an officer[418] with respect to: a financial obligation imposed on him in favor of a third party by a court judgment, including a compromise judgment or an arbitrator's award approved by a court;[419] reasonable legal expenses, including attorneys' fees, expended by or charged to the officer or adjudged against the officer by a court in an action lodged against the officer by the company or on its behalf by another person; or in a criminal charge in which the officer was proved innocent,[420] provided that in all cases the obligation or expenses arose as a result of the officer's holding the office.

The Law invalidates any insurance provision or indemnification undertaking with respect to: (i) the violation of the duty to act with circumspection, whether intentional or resulting from indifference; (ii) an act intended to make unlawful personal gains; or (iii) any fine imposed on a director.[421]

If a director becomes aware of any violation of a law or instance of mismanagement, the director has a statutory duty to summon a board meeting and to report the violation of law or instance of mismanagement.[422] The Law vests a director with the authority to engage — in special circumstances — an expert (lawyer, auditor, etc.) at the company's expense, to enable him to fulfill his/her duty.[423]

Personal liability is imposed on directors by specific provisions of the Law.[424] A director may also be held responsible under other laws. Thus, a director was held to be under the duty to conduct *bona fide* negotiations, as generally prescribed by section 12 of the Contracts Law, 1973, although the director acted for the company and not on their own behalf.[425]

Section 239 of the Companies Law, 1999, provides that a public company must appoint at least two external directors. To qualify for such an appointment, a director must be a resident of Israel with no economic interest in the company or in an affiliated corporation, and with no material relations with it or any of its affiliates.[426] Sections 240(b)–(e) provide that a person with interests conflicting with those of the company, a member of the board of directors of the Stock Exchange, or a person who is, or was during the two years preceding his/her appointment as an external director, a director or an officer of the company or an affiliated corporation, may not serve as an external director.

An amendment to the Companies Law, 1999 imposes a duty on a public company to include in its board of directors a minimal number of directors that possess financial or accounting expertise. In addition, the amendment requires at least one of the external directors to possess financial or accounting expertise.[427]

A 2008 Amendment to the Companies Law requires directors of public companies to have the skills to perform their duties taking into account the special needs of the company and its size.

A public company is required to establish a Review Committee that is appointed by the board of directors from among

[406] Companies Law, 1999, s. 254(a)(1).
[407] Companies Law, 1999, s. 254(a)(2).
[408] Companies Law, 1999, s. 254; C.A. 817/79 *Kosoy v. Feuchtuanger Ltd.*, 38(3) P.D. 253; F.H. 29/84 *Kosoy v. Feuchtuanger Ltd.*, 38(4) P.D. 505.
[409] C.A. 667/76 *Glickman v. Barkai*, 32(2) P.D. 281; C.A. 54/96 *Holander v. HaMemad HaHadash*, 52(5) P.D. 673.
[410] C.C. (T.A.) 3479/69 *Bergman v. Coor*, 1974(2) P.M. 95.
[411] Companies Law, 1999, s. 254(b).
[412] Companies Law, 1999, ss. 259–261.
[413] Companies Law, 1999, s. 261(1).
[414] Companies Law, 1999, s. 261(2).
[415] Companies Law, 1999, s. 261(3).
[416] Companies Law, 1999 (Amendment No. 3), s. 260.
[417] Companies Law, 1999, s. 258(c).
[418] Companies Law, 1999, s. 260.
[419] Companies Law, 1999, s. 260(a)(1).
[420] Companies Law, 1999, s. 260(a)(2).
[421] Companies Law, 1999, s. 263.
[422] Companies Law, 1999, s. 257.
[423] Companies Law, 1999, s. 266.
[424] For example, Companies Law, 1999, s. 256(a) provides that cases of breach of the fiduciary duty by a director are to be regarded, mutatis mutandis, as a breach of contract.
[425] F.H. 7/81 *Penidar v. Kastro*, 37(4) P.D. 673.
[426] Companies Law, 1999, s. 240.
[427] Companies Law (Amendment No. 3), 2005.

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its members, and must include all the external directors and exclude the chairman of the board or any other officer employed by the company.[428] Private companies may appoint such a committee at their option, which, if appointed, has to meet, *mutatis mutandis*, similar requirements.[429] The committee reviews the company's financial results in consultation with its auditor; points out failures in the company's business management and proposes means to rectify them; approves acts or contracts with the company where the personal interests of an officer are involved; and accords prior approval to transactions that are substantial for the company, that deviate from market conditions, or that are outside the scope of the company's ordinary course of business. A transaction that is not approved or that is carried out contrary to the terms of the approval will be void.[430] A public company must nominate, after seeking the Review Committee's recommendations, an internal controller whose main task is to ensure that the company's affairs are carried out diligently, that it abides by the law and that its business is conducted with integrity.[431]

A 2011 Amendment of the Companies Law was enacted to: (i) suggest a corporate governance policy; (ii) clarify some matters regarding the external directors and the committees in which their participation is required; and (iii) implement the provisions applicable to controlling shareholders to shareholders that have a personal interest in the way the company is managed.

(i) The first schedule of the Companies Law includes a recommended corporate governance policy to be adopted by companies. The recommended corporate governance policy provides *inter alia*: (1) the minimal number of independent directors; (2) the gender of the directors; (3) denial of office to directors that are subject to the CEO; (4) a qualification program for new directors; (5) an annual meeting of the Board for discussing the company's business, without the presence of the CEO; (6) an annual meeting of the Audit Committee with the internal auditor and the external auditor and without the participation of the officers that are not Audit Committee members; (7) appointment of external directors; and (8) voting at the General Meetings via the internet.

(ii) The Audit Committee must discuss discrepancies; decide if some actions are essential or exceptional; examine the internal auditor's working plan and functioning; examine the external auditor's extent of work and their compensation; and devise a framework to deal with workers' complaints. In addition, some restrictions were enacted regarding the qualification for office in the Audit Committee.

(iii) A transaction with controlling shareholders and with a company controlled by controlling shareholders is subject to approval. For purposes of such approval: (1) the majority has to include the votes of the majority of the shareholders that are not controlling shareholders nor have a personal interest in the appointment; or (2) the total votes against the approval must not exceed 2% of the participating shareholders.

(iv) In addition, the Companies Law imposes a financial sanction on certain breaches regarding the actions of the directors and officers.

Amendment No. 20 of the Companies Law promulgated certain provisions with respect to remuneration policies of public companies. According to the amendment, public and certain related companies are obligated to establish a "compensation committee" which will, inter alia, provide its recommendation to the Board with respect to the company's compensation policy; review of previous policies provided by the committee; and approve the company's officer's terms of employment. Generally, the "compensation committee" is comprised of at least three directors and includes all the company's external directors.

i. Shareholders

Shareholders, as such, are not bound to duties similar to those binding directors. Their rights and duties are determined in the Companies Law, 1999, in the articles of association and in any other applicable law.[432] When exercising their rights, a shareholder must act in good faith as is customary in such cases. A shareholder must avoid exploiting his/her power against the company and the other shareholders, inter alia, while voting at the company's shareholders' meetings and class meetings on the following matters: (i) changes in the articles of association; (ii) an increase in the company's registered capital; (iii) mergers; and (iv) the confirmation of transactions tainted with a conflict of interest or transactions with a controlling shareholder.[433]

A shareholder may not deprive other shareholders of their rights.[434] A controlling shareholder who possesses decisive voting power and a shareholder who, according to the company's articles of association, enjoys the power to appoint an officer, must be fair to the company in exercising his/her power.[435] A breach of this duty is tantamount to a breach of the fiduciary duty by a company's director.[436] For this purpose, a controlling shareholder may be one who belongs to the controlling group, although alone the shareholder would not be regarded as a controlling shareholder.

Section 194 of the Companies Law grants shareholders (and directors) the right to pursue derivative actions in the name of the company and on its behalf, provided the conditions laid down for the derivative action in the Law are met.[437] A derivative action is distinguished by the fact that the cause of action is not that of the shareholder or director but rather that of the company itself. The plaintiff, by bringing the action, does so on behalf of the company where the latter refuses to do so. The Supreme Court has held[438] that in those cases where the

[428] Companies Law, 1999, ss. 114, 115.
[429] Companies Law, 1999, s. 118.
[430] Companies Law, 1999, s. 280.
[431] Companies Law, 1999, ss. 146, 151.
[432] Companies Law, 1999, s. 183.
[433] Companies Law, 1999, s. 192(a).
[434] Companies Law, 1999, s. 192(b).
[435] Companies Law, 1999, s. 193(a).
[436] Companies Law, 1999, s. 193(b).
[437] C.A. 9014/03 *Avraham Greenfield v. Lasar*, Taagidim D-1, 344 (2007); D.R.C. 5334/03 *Danir Ltd. v. Hazan*, Taagidim D-2, 405 (2007); C.C. 474/04 *Yarden v. Lipshitz*, Taagidim D-4, 252 (2007).
[438] C.A.R. 9646/04 *Chasky Alon Yizum Beniya — Vehashkayot Ltd. v. Arieh Michelson Hevra Leyazamut Ltd.*, 59(3) P.D. 380.

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claim alleges damage caused to the company, and the remedy petitioned for is relief for the company, the derivative action is the course on which the plaintiff should embark. In such circumstances a claim by the shareholders does not provide the proper course of action.

j. Amendment No. 3 to the Companies Law

In addition to the changes mentioned above, the 2005 amendment to the Companies Law[439] enacted the following:

(i) The amendment makes it clear that piercing the corporate veil to sue a shareholder is possible only in cases in which the shareholder was aware of the fact that the use of the corporate veil was made in circumstances where piercing of the corporate veil is permitted.

In addition to the above, the amendment struck out section 54(2) of the Companies Law, 1999, which made it possible to attribute corporate obligations to the individuals acting as its organs, in circumstances allowing for "veil piercing."

(ii) The amendment allows companies with a turnover of less than NIS 615,408 not to appoint an auditor.

(iii) The amendment adds additional forms of relief aimed at increasing civil liabilities by means of a derivative action.

k. The Class Action Law

The Class Action Law came into force in 2006. The main aim of the Law is to establish uniform rules regarding class action suits. Prior to the introduction of this Law, class action suits were governed by a number of laws. The Class Action Law repeals all provisions regarding class action suits established under other laws, including Sections 207 and 208 of the Companies Law.

The local jargon for a class action suit is "a representative action." A person wishing to bring such a class action suit must obtain the approval of the district court, which is granted only if the suit complies with all of the following: (i) the cause of action is entirely founded; (ii) substantive questions affecting all the members of the class have been determined by the court; (iii) a class action suit is the proper course of action, taking into consideration the size of the group (for example, the plaintiffs will otherwise not have their day in court); and (iv) the interests of the class will be appropriately represented by the person bringing the class action suit.[440]

l. Public Purpose Company

An amendment to the Companies Law in 2007 established the public purpose company. A public purpose company is a nonprofit company with public goals listed in the Addendum to the law. Such a company may not distribute its profits to its shareholders. The purpose of a public purpose company may concern: (i) the quality of the environment; (ii) health; (iii) religion, legacy and commemoration; (iv) animal rights; (v) human rights; (vii) education, culture and the arts; (viii) science, research and higher education; (ix) sports; (xi) the encouragement of immigration and settlement; (xii) charity; (xiii) the welfare of the community or community, social and national activities; (xiv) the rule of law, the regime or the public administration; or (xv) the establishment of funds or organizations to encourage or support the attainment of such purposes.

2. Partnerships

Under the Partnership Ordinance, which is based on English law, a partnership may be formed as either a general partnership or a limited partnership. Membership in both kinds of partnership is limited to 20 persons,[441] except that lawyers' and accountants' partnerships may include more than 20 partners.[442]

In a general partnership, each partner is responsible and liable for all the debts of the partnership.[443] By contrast, a limited partnership offers protection to a limited partner to the extent of his/her contribution (promised or made) to the partnership.[444] A limited partner may not participate in the management of the partnership. Violation of this prohibition by a limited partner may render the partner liable for all the debts of the partnership, as if the partner were a general partner.[445] A limited partnership must have at least one general partner with unlimited responsibilities for the debts of the partnership.[446] However, it is common to institute a company as the general partner and thereby indirectly limit liability.

A partnership is formed by a partnership agreement and must be registered with the Registrar of Partnerships.[447] The same registration fee is charged for a general partnership and a foreign limited partnership. In addition, a capital fee is levied on limited partnerships.[448] Foreign partnerships, whether general or limited, must register with the Registrar of Partnerships to be able to conduct business in Israel.[449] Foreign limited partnerships may register only with the approval of the Minister of Justice.[450]

3. Sole Proprietorships

A sole proprietorship is usually a small enterprise maintained by an individual trading for his/her own account. Sole proprietorships are most commonly found in the retail and wholesale sectors. A sole proprietorship does not enjoy a separate legal status and its owner is responsible for all its liabilities. A sole proprietorship may register a business name with the Registrar of Business Names in Jerusalem.[451]

[439] Companies Law (Amendment No. 3), 2005.

[440] C.A.R. 9480/02 *Sabo v. Israel Air Fields Authority*, Taagidim F-1, 225 (2009); C.A. 10262/05 *ABIR v. Bank Hapoalim*, Taagidim F-1, 234 (2009); C.A. *Boker v. Cellcom*, Taagidim F-1, 242 (2009).

[441] Partnerships Ordinance (New Version), 1975, s. 3.

[442] Partnerships Ordinance (New Version), 1975, s. 3A.

[443] Partnerships Ordinance (New Version), 1975, s. 20; C.A. 592/88 *Sagi v. Ninio* 46(2) P.D. 254; C.A. 2026/92 *The Assessing Officer v. Sadot* 55(4) P.D. 89.

[444] Partnerships Ordinance (New Version), 1975, s. 57.

[445] Partnerships Ordinance (New Version), 1975, s. 63.

[446] Partnerships Ordinance (New Version), 1975, s. 57(a).

[447] Partnerships Ordinance (New Version), 1975, s. 4.

[448] Partnerships Regulations (Registration and fees), Schedule 1, s. 1, as amended in 1981.

[449] Partnerships Ordinance (New Version), 1975, s. 75(a).

[450] Partnerships Ordinance (New Version), 1975, s. 75(a).

[451] Registration of Business Names Ordinance, 1935, s. 3.

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4. Foreign Companies

Foreign companies wishing to establish a place of business in Israel must register with the Registrar of Companies.[452] In support of the registration application, a foreign company must file a certified copy of its documents of incorporation accompanied by a certified translation (unless the documents are in Hebrew or Arabic), a statement indicating the names of the directors of the company, a statement giving notice of an Israeli resident authorized to accept service on behalf of the company, and a power of attorney authorizing a resident of Israel to act for the company in Israel.[453] Notice of any change in the documents or facts supporting the registration application must be filed with the Registrar of Companies within 14 days after the change.[454] The filing fee is a nominal sum and additional charges incurred for publication in the official gazette are charged. Foreign companies do not pay an annual fee.

Generally, a foreign company must file an annual statement in the form determined by the Minister of Justice;[455] however, the Minister has not yet made use of this authority. As a result, foreign companies are currently not obligated to file an annual statement with the Registrar of Companies.

5. Insolvency and Financial Rehabilitation Law

The Insolvency and Financial Rehabilitation Law, 2018 entered into force on September 15, 2019, and replaced the Bankruptcy Ordinance and section 350 of the Companies Law, 1999. The laws' objective is to achieve, to the extent possible the financial rehabilitation of the debtor, to increase the percentage of the debt received by the creditors and to promote the debtor's reintegration into financial life.[456]

Insolvency proceedings for an individual whose debt is less than NIS 161,236 are conducted at the Execution Office by the Execution Office Registrars appointed by the Law. A debtor who wishes to file an application for an order to commence proceedings with the Execution Registrar may do so provided: (i) the total amount of his or her debt exceeds NIS 53,745; or (ii) he or she submitted a notice stating that he or she cannot pay the debt pursuant to section 7a2 of the Execution Law and the notice is deemed to be an application for an order to commence proceedings.[457] If the Registrar finds that the conditions for initiating the insolvency proceedings are fulfilled, he will order that a hearing be summoned between the debtor and the creditors to discuss a payment arrangement.[458] If the creditors that are party to the proposed arrangement did not agree on the arrangement and the Representative of the Registrar believes it is reasonably possible that the arrangement will be approved, the Representative will deliver the arrangement he has formulated to the Execution Registrar, on the condition that the debtor agreed to the payment arrangement and the arrangement does not apply to secured debts.[459] A payment arrangement approved by the creditors requires the approval of the Execution Registrar.[460]

Insolvency proceedings for an individual whose debt exceeds NIS 161,236 may file an application to commence proceedings with the Superintendent and must meet a number of requirements.[461] If the requirements are met, the Superintendent will issue an order to commence proceedings within 30 days of the date on which the application was filed.[462] A notice on the issuance of an order to commence proceedings will be announced to the public and the Superintendent will send a copy to the creditors.[463] Whoever considers that he or she has a grievance as a result of the issuance of an order to commence proceedings may file an application for revocation with the court within 45 days of the publication date.[464] The court will decide whether to stipulate the coming into force of the order or its effects, in whole or in part, until a decision on the application is made.[465]

A corporation may file an application to commence proceedings if: (i) it is insolvent or the order will help to prevent it from becoming insolvent; and (ii) the total amount of debt exceeds NIS 26,872.[466] The corporation, a creditor or the Attorney General may file an application to commence proceedings with respect to a corporation.[467] A person who might have a grievance as a result of the issuance of an order to commence proceedings may file an objection to the application in court.[468] In an order to commence proceedings, the court will order either:[469]

> (i) The operation of the corporation for its financial rehabilitation if the court is convinced that there: (i) is a reasonable chance of financial rehabilitation; (ii) is no reasonable concern that the operation will harm the creditors; and (iii) there are means to finance the expenses associated with the operation of the corporation; or
>
> (ii) The winding-up of the corporation.

After the issuance of an order to commence proceedings, the assets of the insolvent estate are made available for the payment of the past debts of the corporation and the insolvency proceeding expenses only, the proceedings against the corporation are stayed, and the court appoints a trustee to implement the insolvency proceedings.[470] Once the trustee is appointed, all the powers granted to the bodies and office holders of the corporation are granted to the trustee.[471]

To enable him or her to formulate a financial rehabilitation plan, the trustee may conduct negotiations with the creditors and any other interested parties.[472] When formulating the financial rehabilitation plan, the trustee must consider the claims ex-

[452] Companies Law, 1999, s. 346.
[453] Companies Law, 1999, s. 346(b).
[454] Companies Law, 1999, s. 346(c).
[455] Companies Law, 1999, s. 348.
[456] Insolvency and Financial Rehabilitation Law, 2018, s. 1.
[457] Insolvency and Financial Rehabilitation Law, 2018, s. 187.
[458] Insolvency and Financial Rehabilitation Law, 2018, s. 191.
[459] Insolvency and Financial Rehabilitation Law, 2018, s. 193.
[460] Insolvency and Financial Rehabilitation Law, 2018, s. 196.
[461] Insolvency and Financial Rehabilitation Law, 2018, s. 104.
[462] Insolvency and Financial Rehabilitation Law, 2018, s. 105.
[463] Insolvency and Financial Rehabilitation Law, 2018, s. 106.
[464] Insolvency and Financial Rehabilitation Law, 2018, s. 108(a).
[465] Insolvency and Financial Rehabilitation Law, 2018, s. 108(b).
[466] Insolvency and Financial Rehabilitation Law, 2018, s. 7.
[467] Insolvency and Financial Rehabilitation Law, 2018, s. 6.
[468] Insolvency and Financial Rehabilitation Law, 2018, s. 14.
[469] Insolvency and Financial Rehabilitation Law, 2018, s. 23.
[470] Insolvency and Financial Rehabilitation Law, 2018, s. 25.
[471] Insolvency and Financial Rehabilitation Law, 2018, s. 43.
[472] Insolvency and Financial Rehabilitation Law, 2018, s. 81.

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pected from the National Insurance Institute. The trustee will submit to the court one or more proposals.[473] Once the financial rehabilitation plan has been submitted to the court, the court will present the proposal to the creditors.[474] The approval of a proposal for a financial rehabilitation plan will be granted in a meeting convened for each class of creditors.[475] For the financial rehabilitation plan to obtain approval, it must have the support of the majority of the voters in the class of creditors concerned, and the voters who supported the proposal must hold at least ¾ of the voting powers of all voters at the meeting.[476] If the plan is approved by the creditors, the trustee will present the proposal for the approval of the court.[477] If a financial rehabilitation plan is approved, the powers conferred on the trustee will be returned to the bodies of the corporation and its office holders.[478]

B. Capital Market

The Israeli capital market[479] was formerly tightly controlled by the government, which embarked on a successful liberalization plan several years ago. The government is still active in the capital market because, to a great extent, its budget is financed by the issuance of bonds, the principal of which is sometimes linked to the cost-of-living index. These bonds, as well as the shares of companies that have made public offerings, are traded on the Tel-Aviv Stock Exchange (TASE). Securities trading in Israel dates back to 1935, when the Anglo-Palestine Bank Ltd., together with pre-state Israel's leading banks and brokerage firms, founded the Exchange Bureau for Securities, which acted as an unofficial stock exchange. Trading and listings increased over the next decade, and when Israel was founded in 1948, the authorities made an effort to establish an official bourse. The Tel-Aviv Stock Exchange was incorporated and began operations in 1953. A decade later, a group of bourse members established the TASE Clearing House Ltd. In 1968, the Knesset enacted the Securities Law, which created a solid regulatory framework for the TASE operations. The TASE derivatives market opened in 1993, improving the investment community's risk management ability. In 1997, the fully automated Tel Aviv Continuous Trading System was introduced, and since the end of 1999, all listed securities as well as derivative products have been traded on the new integrated trading system. By the end of 2013, 508 companies listed their stocks on the TASE and 101 companies listed their bonds for trade on the TASE. Around 25 TASE-listed companies are also listed on bourses in other countries, mostly on the Nasdaq and the New York Stock Exchange. Dual listing raised the international profile of Israeli companies, helping to widen their investor bases and boost trading volumes.[480]

The commercial banks have played a central role in the securities market. Banks or their affiliates issued a significant proportion of the shares registered on the Exchange. The shares of the major banks are still among the most liquid on the market. They lead the market as institutional investors, controlled the major investment companies, and managed many mutual funds. Moreover, the banks managed many of the provident and pension funds. Finally, most of the individual investors trade securities on the Stock Exchange through their banks, which *de facto* act as their counselors and advisors. These multiple roles created a potential conflict of interests. On occasion, the banks have used their resources to stabilize the market during periods of increased selling and lack of demand. As previously mentioned, the banks regulated the prices of their own shares until October 1983, thus according their shareholders hefty returns. In 1983, this practice was stopped as a result of the heavy selling of bank shares forcing the government to introduce special measures to guarantee the shareholders a certain return, at a cost of US$7.5 billion to the Israeli economy. A law implementing the recommendations of a special committee was enacted in 2004 to provide for a disposition by the banks of their holdings in mutual and provident funds and allowing them to sell insurance policies in the capacity of agents (see II.E.1., above). The role of the banks in the capital market has now significantly decreased as lenders have turned to the issue of debentures as an alternative to bank financing.

1. Tel-Aviv Stock Exchange

The TASE is a limited liability company that does not distribute profits to its shareholders. The accumulated profits are used to develop the Exchange. Membership of the TASE is open to candidates who can prove their personal qualifications, professional knowledge and financial ability. TASE members are comprised of six groups: (i) an Israeli banks; (ii) a foreign bank; (iii) an Israeli investment house that is not a bank; (iv) an investment house that operates only for its own account; (v) a company incorporated outside of Israel that operates as a member of a stock exchange in the country in which it was incorporated and does not have a permanent representation in Israel; and (vi) a custodial member.[481] The Bank of Israel is also an Exchange member. The Stock Exchange supervises and governs its own membership. Exchange memberships may not be sold or transferred. The Board of Directors of the Exchange, which governs the Exchange's activities, is composed of 16 members, a third of whom represent the public.

2. Foreign Investors

Nonresidents are not subject to any foreign currency restrictions on investments in the TASE when these are effected in foreign currency (see II.B.1., above). The Israeli fiscal climate also favors such investments (see XVII.E., below). Brokerage fees may not exceed 1% of the value of a transaction with respect to shares or 0.7% with respect to bonds. As a rule, many banks charge less than the maximum commission

[473] Insolvency and Financial Rehabilitation Law, 2018, s. 82.
[474] Insolvency and Financial Rehabilitation Law, 2018, s. 83.
[475] Insolvency and Financial Rehabilitation Law, 2018, s. 84.
[476] Insolvency and Financial Rehabilitation Law, 2018, s. 85.
[477] Insolvency and Financial Rehabilitation Law, 2018, s. 86.
[478] Insolvency and Financial Rehabilitation Law, 2018, s. 91.
[479] *See* http://www.tase.co.il.
[480] In June 2000, Israel's capital markets achieved a breakthrough. The Knesset passed Amendment 21 to the Securities Law, 1968, which is also known as the Dual Listing Law. The Law entitles companies traded on U.S. markets to list on the Tel-Aviv Stock Exchange (TASE) with no additional regulatory requirements. The process saves these companies the cost of reporting to two different regulatory bodies. At the same time, the TASE decided to exempt such companies from its listing rules, periodic reporting and listing fees.
[481] https://info.tase.co.il/Eng/about_tase/tase_members/Pages/membership.aspx.

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and large investors may negotiate low rates. No commission is payable on subscriptions for new securities.

3. Dual Listing

Dual listing enables Israeli companies traded on foreign exchanges to dual list on the TASE. The law facilitates their listing. Companies that have traded on the NASDAQ, the New York Stock Exchange or the American Stock Exchange for at least a year since their IPOs, or less than a year, provided they maintain a market value exceeding US$ 150 million, are entitled to be dual listed.

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IV. Principal Taxes

A. Sources of Authority in Tax

1. Legislative

a. Organization of the Tax Law

The Israeli Income Tax Ordinance (New Version) 1961 and its regulations are the primary domestic statutory tax law.[482] The Ordinance is divided into 16 primary chapters. The most commonly used chapters are the first four chapters covering income taxation with respect to corporations and individuals, the fifth chapter which covers capital gains, and the seventh chapter which covers tax-free reorganizations.

Additional primary tax legislation which covers specific taxes can be found in the Value Added Tax Law, 1975, and the Taxation of Land (Appreciation and Purchase) Law, 1963. Apart from that, there are tax-specific provisions embedded in laws regarding various fields in order to implement certain policies, such as to encourage foreign investment, and laws designed to address specific arrangements.

b. Other Legislative Documents to Interpret the Law

The primary source that may be used to interpret a certain law are the "explanatory notes" published along with the law's bill. In addition, the Knesset committees' protocols may also be used to determine the intention of the legislator and to review the discussions that took place during the legislative process. Professional literature published by law professionals and the Israeli Courts' rulings may also be used to interpret Israeli tax laws.[483]

2. Administrative

The Israel Tax Authority (ITA) was re-established on September 1, 2004, following a government decision to unite the governmental tax departments with the goal of consolidating the management of tax collection under one chief executive who is authorized to apply the relevant tax laws. The establishment of the ITA was an important move in terms of improving service to citizens, as well as streamlining the tax system and integrating it into the law enforcement system in Israel. The main function of the ITA is to collect taxes, both direct (income tax, capital gains tax and real estate appreciation tax) and indirect (customs, purchase tax, VAT and excise tax on fuel). As of September 2023, Shai Aharonovitch serves as the Director of the ITA.

B. Income Tax

Income tax is imposed on corporations and individuals under the Income Tax Ordinance (ITO) and regulations issued thereunder. Resident companies are taxed on their worldwide income (see V., below); nonresident companies are taxed only on Israeli-source income (see VI., below).

The following chart summarizes the rates applicable under the Company Tax:

Taxes	Rates
Company tax	23% (a)
Capital gains tax	23% (b)
Withholding tax:	
Dividends	0%, 25%, 30% (c)
Interest	23% (d)
Royalties	23% (d)
Net Operating Losses:	**Period (years)**
Carry back	n/a
Carry forward	Unlimited

(a) This is the tax rate for the tax year 2023.

(b) The "real gain" is taxed at the company tax rate. The "Inflationary Amount" accrued before December 31, 1993, is taxed at the rate of 10%, while the "Inflationary Amount" accrued thereafter is taxed at the rate of 0%. A "real capital gain" accrued before 2005 on the sale of foreign securities is taxed at a special tax rate of 35% (see V.C.4.b.(10), below).

(c) Dividends received from another resident company are free of tax in the hands of the recipient company if the income from which the dividend is distributed is sourced in Israel. The 25% withholding rate applies to distributions to individuals and non-treaty country resident companies. The 30% withholding tax rate applies to individuals or non-treaty resident companies holding at least 10% in one of the means of control of the distributing company (and therefore, constitute a "significant shareholder" as defined in section 88 of the Israeli Income Tax Ordinance). This rate is subject to applicable tax treaties (see V.C.4.c., below).

(d) This tax rate is applicable to nonresident companies and to individuals and is subject to the terms of applicable tax treaties.

Israeli resident individuals, like all other Israeli taxpayers, are subject to tax on their worldwide income, including capital gains. There are two tax brackets: (i) a bracket for tax on personal exertion income (which applies provided that books of account were kept where so required); and (ii) a bracket for tax on other ordinary income. Certain passive income enjoys reduced rates. See further under X., below. In general, nonresidents are subject to tax only on Israeli source income. See further under XI., below.

[482] *See also* http://www.main.knesset.gov.il and http://www.elyon1.court.gov.il.

[483] *See* Aharon Barak, Interpertation in Law (Nevo Publishing); C.A. 165/82 *Kibutz Hatzor v. the Assessing Officer of Rehovot* (May 6, 1985); HCJ 693/91 *Dr. Michael Efrat v. Director of Population and Immigration in the Ministry of the Interior* (Mar. 29, 1993).

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C. Taxation of Land (Appreciation and Purchase) Law

1. Appreciation Tax

The Taxation of Land (Appreciation and Purchase) Law, 1963, essentially taxes capital gains derived from transactions in real estate located in Israel and in the Area on the same basis as gains are taxed under Part E of the Income Tax Ordinance. Until 2001, the Law also taxed a transfer of rights within a "real estate association"[484] (i.e., a company, cooperative or registered partnership that mainly holds Israeli real estate) as if the "real estate association" was transparent,[485] i.e., the tax was levied as if the real estate had been sold without regard to the fact that, in reality, what took place was a share transfer. The objective of such taxation was to prevent these share transfers, which were in their economic essence transfers of the underlying real estate, from escaping the land appreciation tax and purchase tax. In 2001, the Law was amended and the tax is no longer imposed by deeming the real estate to have been sold.[486] Hence, the regime is in essence identical to that under the Income Tax Ordinance. Under the amended Law, the gain is still divided into the "real gain" and the "inflationary amount."[487]

The Law provides for a deferral of tax on the incorporation of a "real estate association" and, unlike the Income Tax Ordinance, includes special provisions to allow for the tax-free liquidation of such associations.[488]

The Treasury had promised to incorporate the complex provisions of the Taxation of Land (Appreciation, Sale and Purchase) Law, 1963, within the provisions of Part E of the Income Tax Ordinance, thus doing away with the anomaly of a special law regulating the taxation of capital gains derived from real estate. But a committee that studied the matter finally recommended that the two tax collecting agencies remain distinct and that the laws remain unintegrated.

2. Purchase Tax

Purchase tax is levied on every acquisition of real property in Israel and the charge is borne by the buyer, be it an individual or a company. The purchase tax rate can vary depending on the legal and residential status of the buyer and the category of the property, but it is generally fixed at 6% of the purchase price.[489] The Taxation of Land (Appreciation, Sale and Purchase) (Purchase Tax) Regulations of 1974 provide a purchase tax relief in the form of exemptions or a reduced rate in certain cases.

However, the purchase of residential apartments is subject to progressive purchase tax rates. The table below shows the tax rates for first-time buyers or those buying their only residential property that are in effect between January 16, 2024, and January 15, 2025.[490]

Single Apartment (NIS)	Tax Rate	Other (NIS)	Tax Rate
0 – 1,978,745	0%		
1,978,745>2,347,040	3.5%		
2,347,240>6,055,070	5%		
6,055,070>20,183,565	8%	1 – 6,055,070	8%
Above 20,183,565	10%	Above 6,055,070	10%

In August 2024, Real Estate Taxation Regulations were published that included an amendment to Regulation 12, limiting its application to the purchase of business properties, including agricultural holdings, intended for use by the immigrant or his or her relatives.

Additionally, Regulation 12A was introduced, which provides new immigrants with a purchase tax reduction when they acquire single residential apartments within the designated period.

3. Purchase Group

Purchase groups usually acquired real estate from a private individual and then entered into a contract with a constructor to build the residential dwelling. They thus saved the VAT on the land which they would have paid had they purchased a finished apartment from a contractor. An amendment, in effect as of January 1, 2011, includes in an "adventure in the nature of trade" a sale to a "Purchase Group" (as defined in the Taxation of Land (Appreciation and Purchase) Law, 1963, by a person who does not deal in land. The seller is the taxpayer in such a case.

VAT is now charged on the seller of the land pursuant to the amendment of the definition of an "adventure in the nature of trade." Amendment 69 of the Taxation of Land (Appreciation and Purchase) Law, 1963, was aimed at regarding Purchase Groups as the purchasers of the finished apartment, thereby rendering them liable for Purchase Tax on the construction costs as well as on the land. The amendment deems a purchase by a Purchase Group as the acquisition of the finished apartment pro rata to each member's share. Thus, the construction costs will be liable to Purchase Tax. The tax will be gradual as applicable to apartments and not flat as applicable to land. Thus, while the construction costs fall to be taxed, the land component will be taxed at a lower rate than before because the Purchase Tax does not differentiate between land and construction in applying its gradual rates to apartments.

The amendment also requires certification of the VAT Director that VAT was paid by the seller of the land (or appropriate collateral was received therefor) as a condition for the issuing of the Land Tax's approval for the registration of title to the apartments.

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[484] *See, inter alia*, A.C. 54436-11-10 *Melisron v. Land Tax Authorities*, Missim KH/6 (Dec. 2014), E-332; A.C. 1429/08 + 1454/08 *Gazit Globe Israel (Pituah) Ltd. v. Land Tax Authorities*, KH/6 (Dec. 2014), E-323.

[485] Taxation of Land (Appreciation and Purchase) Law, 1963, ss. 1 and 7.

[486] As part of the November 2024 draft bill to amend the Income Tax Ordinance, it was proposed to eliminate the condition requiring that, during a corporate restructuring in which an empty lot is transferred to a company classified as a real estate association under the Real Estate Taxation Law, the recipient company must complete construction on the property within five years from the date of the restructuring.

[487] Taxation of Land (Appreciation and Purchase) Law, 1963, s. 47.

[488] Taxation of Land (Appreciation and Purchase) Law, 1963, s. 71, as amended to prevent accordance of tax on undistributed cash dividends.

[489] Taxation of Land (Appreciation and Purchase) Law, 1963, s. 9.

[490] Taxation of Land (Appreciation and Purchase) Law, 1963.

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A "Purchase Group" is defined as a group of purchasers which is organized for purposes of acquiring a "Land Right" (ownership or long-term lease) and construction thereupon of a building employing an organizer for such purpose, provided all purchasers are liable under a contractual arrangement.

The "organizer" is a person who acts for remuneration in organizing the group for purposes of the acquisition and construction, including the preparation of the contractual framework.

The "contractual framework" is defined as "a set of intertwined contracts by virtue of which the group will act to receive the constructed building."

4. Withholding Tax

The purchaser of real estate must register the property in his/her name. To do so, the purchaser must provide the registrar with a tax certification, which will only be issued by the tax authorities once the taxes are paid. This created a problem because the appreciation tax must be paid by the seller, who does not have much interest in the tax certification.

To resolve this problem, an amendment to the Taxation of Land (Appreciation and Purchase) Law, 1963, requires the purchaser to withhold 15% of the land appreciation tax whereupon he/she will be entitled to a tax certification to register the real estate in his/her name. The rate is 7.5% for real estate purchased after November 7, 2011.

D. Sales Tax

In 1999, the Taxation of Land (Appreciation, Sale and Purchase) Law, was amended by the enactment of section 72C, which provided for a sales tax on the sale of real estate or on the disposition of a right in a real estate association. The sales tax was abolished as of August 2007.

E. Value Added Tax

1. General overview

Israel's Value Added Tax (VAT) was introduced by the Value Added Tax Law, 1975 (the "VAT Law"). Under the VAT Law, taxpayers are divided into three separate classes:

(i) "Authorized dealer:" a taxpayer that sells assets or renders services (as these terms are defined by section 1 of the VAT Law), and whose turnover exceeds the minimum amount set by the law, which is NIS 120,000 from January 1, 2024.[491] A dealer whose turnover is lower is considered an "Exempt Dealer" who is not required to charge VAT on its transactions. Nevertheless, the following taxpayers are required to be registered as "authorized dealers" regardless of their annual turnover:[492] any taxpayer who is a member of the liberal professions; physicians, including psychologists, physiotherapists, veterinarians and dentists; owners of various enterprises (for example, driving school owners, real estate traders or brokers and used car dealers); registered companies; and registered cooperative societies.[493]

(ii) "Financial institution": a company or cooperative society carrying on the business of receiving moneys on current account to make payments therefrom, on demand or by check; a company lawfully using the word "bank" as part of its name; any financial institution within the meaning of this phrase in the Bank of Israel Law, 1954, to which the liquidity directions under this Law apply; an insurer; and any class of persons designated by the Minister of Finance.

(iii) "Nonprofit organization": the state, a local authority or an association of towns; a body of persons that does not carry on its business for profit and that is not a financial institution; a corporation established by law and not registered as a company, cooperative society or partnership; and a public fund exempt from income tax under section 9(2) of the Income Tax Ordinance.[494]

For further research on Israel's VAT system, see also the VAT Navigator.

2. Rates

Authorized dealers pay VAT at the rate of 18%[495] on the turnover from all transactions effected by them. A taxpayer is entitled to set off "input tax" (i.e., the VAT paid by the taxpayer during the relevant period) against any VAT for which the taxpayer is liable,[496] provided the item with respect to which the "input tax" was paid is used in a taxable transaction and the deduction is taken within six months from the date on which the VAT invoice was issued.

A financial institution pays tax at the rate of 17%[497] on payroll and the profits arising from operations in Israel.[498] It is not entitled to offset the VAT levied on it with the input tax incurred by it, and therefore a deposit with such an institution or a loan granted by it qualifies as an exempt transaction, so as to avoid "double taxation." Moreover, a loss sustained by a financial institution in any year may be set off against wages paid by it in that year. The Tel Aviv District Court, held that not only is the set-off limited to the current year's losses, but that currently

[491] Value Added Tax Law, 1975, s.1.

[492] Value Added Tax (Registration) Regulations, s. 13 (1976). A 1998 amendment added a provision regarding the registration conditions of an "authorized dealer": the owner of a school or of a kindergarten, in which the pupils are educated on a regular basis, that is not a nonprofit organization, and a school for professional theoretical and practical tutoring, including arts and sports, for groups comprising not less than five pupils, excluding exceptional tutoring of not more than 30 days for all the groups instructed in the same tax year must register as an authorized dealer.

[493] Value Added Tax Law, 1975, s. 1; O.S. 1183/91 *Kolmotrade Ltd. v. VAT and Customs Department*, Missim G-3 (June 1993), E-186.

[494] Value Added Tax Law, 1975, s. 1; C.A. 767/87 *"Besha´arich Jerusalem" Fellowship v. VAT Director*, Missim D-6 (Dec. 1990), E-60; D.A. 23/85 *Hamoa'za Haezorit Emek Israel v. VAT Director*, Missim E-2 (Apr. 1991), E-126; D.A. 75/90 *Amutat Yedidey Beit-Haholim Nahariya v. V.A.T. Director*, Missim E-4 (Aug. 1991), E-150; C.A. 3840/98 *Norwich Union Ltd. v. V.A.T. Director*, Missim N-6 (Dec. 2000), E-64; D.A. 1/96 *MACABI Sherutei Briut v. V.A.T. Director*, Missim Q-4 (Aug. 2003), E-33; D.A. 509/03 *A.S. Nahariya Sport Ltd. v. Director of V.A.T.*, Missim S-1 (Feb. 2005), E-262.

[495] According to a Minister of Treasury Decree, approved by the Finance committee on February 20, 2024, the VAT rate will increase to 18%, effective January 1, 2025.

[496] C.A. 711/89 *Beit Assia Ltd. v. Customs and VAT Director*, Missim F-5 (Oct. 1992), E-119; C.A. 125/83 *Danot Hevra Lehashkaot Ltd. v. VAT Director*, Missim A-2 (Mar. 1987), E-32.

[497] See fn. 493, above.

[498] Value Added Tax Law, 1975, s. 4(b).

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accrued linkage differentials on past losses may not be used to set off wages.[499]

In addition, a temporary order regarding a special surcharge on bank profits entered into force on April 1, 2024.[500] According to the order, until December 31, 2025, unless the position is changed by the Minister of Treasury, large scale banks will pay a further 6% surcharge on their profits (excluding wages). This surcharge will be imposed in conformity with the provisions of the VAT Law. Large scale banks are defined as banks holding at least 5% of all Israeli banks' total assets.

Certain non-profit organizations[501] do not pay VAT; however, such organizations are charged 7.5% on the payroll with respect to their operations in Israel and are not entitled to set off input tax against their VAT liability.[502]

An importer of goods is liable for VAT at the rate of 18%[503] on the value of the goods for customs purposes, including customs duty and other taxes chargeable on the importation of the goods.[504]

3. Deductions

"Authorized dealers" may deduct input tax from VAT they are liable to pay. Where an excess of input tax over VAT has been paid, or where VAT was paid with respect to a transaction later canceled,[505] the tax is generally refundable within 30 days of the date of receipt of the tax return.[506]

Input tax may not be deducted:

(i) When incurred by a financial institution or a nonprofit organization, or where included in an invoice or an import entry issued before registration of the dealer in accordance with the prescriptions of the law, except where the inputs were acquired in the process of the establishment of the business and were in fact used for that purpose.[507]

(ii) When levied on the acquisition of a private motor vehicle, except where the vehicle is acquired by a car dealer,[508] a driving school, a dealer engaged in the renting of vehicles (not including hire purchase), or a dealer whose business is driving passengers (taxi driver, etc.) or arranging tours (travel agency, etc.).[509]

An amendment to the VAT regulations included almost all types of cars in the definition of "private motor vehicle." Thus, input tax on the purchase of almost all types of vehicles cannot be deducted.

(iii) When levied on the purchase (or building) of residential apartments where the dealer runs his/her business from his/her residence.[510]

(iv) When incurred with respect to entertainment expenses, except where the persons entertained are nonresidents.[511]

(v) When incurred with respect to a transaction that is exempt from tax (tax-exempt transactions do not have the same tax consequences as zero-rated transactions, as the input tax on zero-rated transactions is deductible, as discussed in 4., below).[512]

Where input tax is levied on the acquisition of goods or the receipt of services and these are used for both business and nonbusiness purposes, the deduction is made on a pro rata basis. Where the ratio cannot be established, two-thirds of the input tax is deducted if the principal use was for business purposes and one-fourth where the principal use was not for business purposes.[513] This same technique applies when a dealer derives partially exempt turnover during the relevant period, so as to make an apportionment between the taxable and nontaxable part of this turnover.

4. Zero-rate Transactions

Zero-rate VAT allows the taxpayer to claim a refund for input tax levied on him, even though the transaction made by the taxpayer is not liable for VAT. In effect, the net result is that the taxpayer does not owe any VAT, but is entitled to a refund of the input tax charged to the taxpayer.

In essence, this is a measure designed primarily to encourage the export of goods and services from the country and to avoid double taxation (on import into the country and export from Israel). Foremost among the zero-rated transactions are:[514]

(i) The export of goods abroad, with the exception of the export of unset diamonds (not including synthetic diamonds), precious stones and semi-precious stones that are exempt from customs duties;

(ii) The sale of an intangible asset to a nonresident;

(iii) The disposition of goods to a bonded warehouse;

(iv) The rendering of services to a nonresident, unless the services were rendered with respect to an asset located in

[499] I.T.A. 78/95 *Bank Eurotrade Ltd. v. Assessing Officer for Large Enterprises*, Missim J-6 (Dec. 1996), E-181. I.T.A. 82/94 *Be Good Michal Ltd. v. Assessing Officer for Large Enterprises*, Missim K-6 (Dec. 1997), E-105.

[500] Special Payment to Achieve Budget Objectives (Swords of Iron — Temporary Order), 2024. s. 2

[501] Non-profit organizations whose total annual wage payment exceeds the sum published in a Minster of Treasury Decree.

[502] Value Added Tax (Rate of Tax on Nonprofit Organizations and on Financial Institutions) Order, 1992.

[503] See fn. 493, above.

[504] Value Added Tax (Rate of Tax on a Transaction and on the Import of Goods) Order, 1992, s. 1; Value Added Tax Law, 1975, s. 11(a).

[505] D.A. 9/90 *Kupelic Moshe Ltd. v. VAT Director*, Missim E-3 (June 1991), E-27; C.A. 738/86 *Customs and V.A.T. Director v. Asa Pladot Ltd.*, Missim D-1 (Feb. 1990), E-74.

[506] Value Added Tax Law, 1975, s. 39.

[507] Value Added Tax Law, 1975, s. 40A.

[508] Value Added Tax Law, 1975, s. 38 entitles a "dealer" to deduct input tax, and the institutions are not included in the definition of a "dealer" in Value Added Tax Law, 1975, s. 1.

[509] Value Added Tax Regulations, 1976, s. 14(b).

[510] Value Added Tax Regulations, 1976, s. 15.

[511] Value Added Tax Regulations, 1976, s. 16.

[512] Value Added Tax Law, 1975, s. 41.

[513] Value Added Tax Regulations, 1976, s. 18; D.A. 877/83 *Landeko Rubinstein Hashkao't Ltd. v. VAT Director*, Missim A-1 (Jan. 1987), E-159.

[514] Value Added Tax Law, 1975 ("VAT Law 1975"), s. 30; Value Added Tax Regulations, 1976, s. 12(a). See H.C.J. 4140/95 *Super Pharm (Israel) Ltd. v. V.A.T Director*, 54(1) P.D. 49; C.A. 41/96 *Kassuto Sochnuyot Bituach Ltd. v. V.A.T Director*, Missim M-2 (April 1999). E-60. C.A. 7142/10 *A. Gamish Sherutey Koach Adam Ltd. v. V.A.T. Director*, Missim KF/6 (December 2012); E-89. I.T.A. 54886-09-11 *Ofakin Ehud Oskim v. V.A.T. Director* (October 21, 2013).

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Israel, or an Israeli resident was a beneficiary of the services;[515]

(v) The rendering of services outside Israel by a dealer whose principal place of business is in Israel;

(vi) Various services rendered to tourists or the sale of goods to tourists, such as: the accommodation and entertainment of tourists at a hotel or the hospitalization of tourists; the rental of private non-chauffeured vehicles to tourists; and the provision of services to tourists by a travel agency;

(vii) The sale of goods to a person entitled to an exemption from purchase tax;

(viii) The sale of various fruits and vegetables;

(ix) The sale of aircraft and vessels;

(x) Some transactions with regard to business reorganizations (the transfer of assets for shares in a company controlled by the transferor); and

(xi) Transactions with a foreign resident by an Israeli Film Producing Company for purposes of the production of a film in Israel.

It should be noted that the zero rate for a transaction with a nonresident under this section requires that the nonresident is outside Israel at the time of the transaction, and that the nonresident has no business or activity in Israel.[516]

Sections 31A and 31B of the VAT Law provide for a zero rate VAT with respect to services provided by construction enterprises to current homeowners for housing improvements performed as part of building strengthening projects and demolition and building projects. As such services are currently exempt from VAT, the amendment expands the VAT benefit provided to construction enterprises by enabling the deduction of input VAT incurred with respect to the provision of such services.

5. Exempt Transactions

Some transactions are exempt from VAT,[517] most importantly:

(i) The rental of residential apartments for a period not exceeding 25 years;[518]

(ii) The sale of a building approved under the Law for the Encouragement of Capital Investments, 1959, with effect from the tax year 1979, provided the building was leased for a period of at least five years;[519]

(iii) The rental of real estate in consideration for "key money" and the creation of a statutory tenancy or the sale of such real estate (i.e., the sale of real estate with respect to which a statutory tenancy has been created);[520]

(iv) Transactions made by an exempt dealer, excluding the sale of real estate or the sale of equipment in cases where input tax was deducted at the time of purchase;

(v) The sale of assets when the input tax at the time of purchase was denied by law;

(vi) The deposit of monies with a financial institution or the granting of a loan by a dealer to a financial institution;[521]

(vii) The sale of an alternative residence unit, or the value of construction services, in sites declared by the authorities to be "evacuation-for-construction" sites;[522]

(viii) The importation of certain goods into Israel (by persons entitled to exemptions on their entry into Israel), exported goods re-imported to Israel, gift parcels and original works of art;[523]

(ix) Unset diamonds except for synthetic diamonds, precious stones and semi-precious stones;[524]

(x) Goods (except motor vehicles) imported from the areas under the control of the Palestinian Authority;[525] and

(xi) Certain transactions in the Eilat Free Trade Zone (see XVII.P., below).

A memorandum published on November 2024, includes a proposal to add subsection 20 to Section 30(a) of the VAT Law. The subsection would apply zero rate VAT for management services provided to partnerships, as determined by the Minister of Finance, based on the proportion of profit rights held by foreign residents relative to the total profit rights in the partnership, even if the services are rendered to an Israeli resident in Israel.

6. Reporting

A 2009 amendment to the VAT Law, 1975 requires periodical returns, temporary returns, and the returns of non-profit organizations and financial institutions to be filed online as of January 1, 2012.

For this purpose, a return must include a Secure Electronic Signature, defined as an electronic signature that: (i) is unique to its owner; (ii) allows for the identification of its owner; (iii) is produced by a signature device that is under the exclusive control of its owner; and (iv) allows any change in the content of the text after its execution to be identified.[526]

Dealers whose transaction turnover during the 12-month period ending on August 31 of the previous tax year is NIS

[515] A draft bill published in October 2024 proposes to amend the VAT Law; it suggests that VAT Law 1975, s. 30(a)(8), which grants a zero-rate of VAT for services provided to tourists, should be repealed. Additionally, the bill proposes to repeal the arrangement provided for in VAT Law 1975, s. 56 regarding the consolidation of businesses.

[516] Value Added Tax Law, 1975, s. 30(c).

[517] C.A. 6585/97 *Pam Bin Ltd. v. V.A.T Director Jerusalem*, Missim 1998, E-1; C.A. 1340/90 *Ramdo Ltd. v. V.A.T Director*, Missim G-4 (Aug. 1993), E-54.

[518] Value Added Tax Law, 1975, s. 31(1).

[519] Value Added Tax Law, 1975, s. 31 (1A).

[520] Value Added Tax Law, 1975, s. 31(2).

[521] Value Added Tax Law, 1975, s. 31(5).

[522] The exempt amount is limited by the Law. *See* Value Added Tax Law, 1975, s. 31A.

[523] Value Added Tax Law, 1975, s. 32.

[524] Value Added Tax Law, 1975, s. 33.

[525] Value Added Tax Law, 1975, s. 1A(a)(1) and Value Added Tax Regulations, 1976, s. 11.

[526] Electronic Signature Law, 2001, s. 1.

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1,670,000[527] or less may report every other month, while Dealers with transaction turnovers of more than that amount are required to report on a monthly basis.[528]

Dealers are entitled to request a tax refund if their Periodic reports show an excess of aggregate input tax over the total amount of output tax.

7. Tax Invoices

Buyers subject to VAT purchasing assets or services for the purpose of their business must require invoices from covered sellers, or pay by bank transfer, credit card or check, if the value of the assets or services concerned is between NIS 338 and NIS 27,183. If the value of the assets or services is higher than NIS 27,183, the buyer must ask the seller to issue a tax invoice, and may not pay in banknotes or cash.

The "Israeli Invoice Model," implemented under the Economic Efficiency Law for 2023–4, is designed to combat fictitious invoices and mitigate financial losses to the state, which are estimated at billions of shekels annually. From January 1, 2024, tax invoices for transactions exceeding 20,000 ILS must include allocation numbers issued by the Tax Authority via an online system as a prerequisite for deducting VAT input tax.[529]

8. The Palestinian Territories

The main principle regarding VAT and customs is the free movement of goods between Israel and the Palestinian Authority (PA) and, therefore, the PA and Israel are regarded as a single entity for purposes of indirect tax. VAT is, thus, imposed in this context on transactions carried out by an Israeli citizen, a partnership in which the majority of interests is held by Israeli citizens, or by a company deemed to be resident in Israel for income tax purposes.

The PA levies its indirect taxes independently, and special arrangements were entered into to allow for deductions by Israeli VAT taxpayers of input VAT paid to the PA. Under a clearing procedure, Israel and the PA determine the balance of deducted VAT and payments are made accordingly. The PA's VAT rate is 15%, or 1.5% lower than the Israeli rate.[530] Israel has agreed to refund all VAT paid by nonprofit Palestinian institutes acquiring Israeli services and products.[531]

F. Payroll Taxes

An employer's tax was imposed until April 1992 at the rate of 4% on employment income, in accordance with regulations issued under the Employers' Tax Law, 1975, but it was abolished as of January 2008.

G. Stamp Duties

Under the Stamp Duty on Documents Law, 1961, many legal documents were subject to a special stamp duty; however, the rates were usually insignificant. As of 2006, the stamp duty tax was abolished in its entirety.

H. Property Taxes

With effect from April 1981, property tax is levied only on vacant real estate that could be used for the erection of urban buildings, since one of the prime purposes of the Property Tax and Compensation Fund Law, 1961 was to serve as a catalyst for the construction of buildings and to curtail real estate speculation.[532] All other property is exempt from the tax. Land that is deemed to be "property" for property tax purposes is:

(i) Vacant land, including land to which an asset other than a building is affixed.

(ii) Land with a building thereon, if the total building area does not exceed 30% (in the case of residential buildings, 20%) of the total area available for construction according to the planning and construction regulations, and provided the fair market price that could be received for the building as such on October 1 preceding the tax year, was less than the value of the land. As noted above, property tax is levied only on vacant land. However, the law may even tax land with a building thereon, in the event that the exemption is not justified.[533]

(iii) Land that, on January 1, 1990, was planted with orchards but that is not considered to be agricultural land. Land is considered to be appropriate for agriculture if it is suitable for the purpose of growing crops, provided the economic expenditure required for this purpose is reasonable under prevailing market conditions.[534]

The Supreme Court has held that several tests may be used to establish the "taxable unit" for purposes of the Property Tax and Compensation Fund Law, 1961, and that the primary test should be the registration of the land in question at the Land Registry. The secondary test should be the "economic purpose test," which is based on the possible utilization of the land under the applicable landing and zoning legislation. The actual economic use to which the taxpayer puts the land is only a residual test, and the burden of proof that this third test should be applied lies with the taxpayer.[535]

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[527] Value Added Tax Law, 1975, s.67(a2)(1). The sum is determined by the Minister of Treasury.

[528] In the draft bill to amend the VAT Law, it is proposed to lower the turnover threshold required for submitting detailed reports for VAT purposes.

[529] Considering the state of the war, an extension was granted allowing VAT deductions without allocation numbers until May 5, 2024, to give businesses additional time to implement the necessary technological adaptations. Businesses that adopted the model early in the year were granted benefits, such as expedited VAT refunds.

[530] Value Added Tax Law, 1975, s. 1A. Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip, 1995, Protocol on Economic Relations, Article VI(3).

[531] Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip, 1995, Protocol on Economic Relations, Article VI(9).

[532] C.A. 48/85 *Commissioner of Property Tax and Compensation Fund v. Hahevra Hahabashit Lemisschar*, 14 P.D.A. 163.

[533] C.A. 147/90 *The Estate of the deceased Gnizadowich v. The Commissioner of Property Tax and Compensation Fund*, Missim E-2 (Apr. 1991), E-120.

[534] 891 P.C.A. 1221/94 *Tarshish Ltd. v. Commissioner of Property Tax Netanya*, Missim I-2 (Apr. 1995), E-116. *See also* P.C.A. 7970/95 *Moravi and Weiss v. Commissioner of Property Tax Haifa*, Missim K-2 (Apr. 1997), E-22; Assessing Appeal 1104/95 *Commissioner of Property Tax and Compensation Fund Rehovot v. Tshuva*, Missim K-4 (Aug. 1997), E-325. P.C.A. 4539/96 *Arad v. Property Tax Director of Hadera*, Missim L-6 (Dec. 1998), E-61; D.A. 3419/98 *Property Tax Director of Rehovot v. Hashkaot VeNeemanut S.S. Zarfaty Ltd.*, Missim O-2 (Apr. 2001), E-285.

[535] D.A. 737/86 *Elshtein v. The Commissioner of Property Tax*, 14 P.D.A. 247.

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On January 1, 2000, the tax rates, which stood at 2.5% of the value of the land, and 1.2% if the land was classified as business inventory for income tax purposes, were reduced to 0% but the Law was not abolished.

I. Estate Duty

With effect from April 1981, estate taxes were abolished in Israel. However, heirs take the assets with the basis and dates of acquisition of the deceased ("roll over"). Therefore, on the sale of the inherited assets, the heirs are taxed on the capital gains realized from the date of acquisition by the deceased.[536]

Generally, Israel does not levy inheritance or gift taxes. However, non-cash gifts made to non-Israeli residents are subject to capital gains tax, which is normally imposed within 30 days. Gifts made to Israeli residents are generally exempt from capital gains tax and the recipient has a carryover basis in the gift. Gifts of real property (and rights in a real property association) may be exempt from the land appreciation tax at the level of the transferor to the extent made to certain family members. In addition, gifts of real property (or rights in a real estate association) are subject to purchase tax at the level of the transferee, and may be eligible for a beneficial purchase tax rate to the extent made to certain family members.

J. Purchase Tax and Customs Tax

Any investor planning to sell his/her products in the Israeli market will be vitally interested in two factors: (1) Israeli customs rates imposed on the articles, components or materials to be imported into Israel; and (2) customs rates imposed on competitive products, for example, those imported from Germany, Italy, Japan, etc. An experienced Israeli customs broker should be consulted on these matters. Most Israeli tariff rates are *ad valorem*, although there are also specific and compound rates. Specific duties are assessed on net weight, unless otherwise specified in the Customs Regulations. *Ad valorem* duties are assessed based on the cost, insurance and freight (CIF) value, including Israeli port charges.

The value of goods for customs purposes is based on the actual price set by the parties to the transaction concerned, unless special circumstances (such as special relations between the parties) require the use of the "objective," market value-based, method.[537] This change, introduced in 1997, is in accordance with the General Agreement on Tariffs and Trade (GATT) Tokyo-round resolutions adopted by Israel as a member of the organization.

The Brussels nomenclature classification is used for the classification of imported and exported goods. Most basic food commodities, raw materials, and machinery for agricultural and industrial purposes are exempt. Nonessential foodstuffs, luxury consumer goods and products directly competing with goods manufactured in Israel incur the highest rates. Nevertheless, a gradual "exposure program" has been implemented since 1991, resulting in significant reductions in such "protective" tariffs. The customs tax on materials imported for the production of goods to be exported is waived, subject to a guarantee that the export will in fact take place.

Israeli purchase tax is levied on most goods produced in Israel, as well as on many imported goods. Items subject to tax, generally at rates ranging from 2% to 60% of wholesale value but sometimes at much higher rates, include building materials, household furnishings, utensils and appliances, textiles, clothing, office supplies, luxury goods and motor vehicles.[538]

Purchase tax on imported goods is levied based on the value for customs purposes, accompanied by an "added percentage quota" representing the estimated wholesalers' profit.[539] Importers who comply with certain criteria set forth by the Purchase Tax Law (Goods and Services), 1952 may choose to be classified as "Importers under Arrangement."[540] Importers under Arrangement pay the tax based on their actual wholesale prices.

[536] Income Tax Ordinance (New Version), 1961, s. 88 (definition of "Purchase Date").

[537] The Customs Ordinance (New Version), 1957, ss. 130 and 132.

[538] Until 1994, purchase tax was also levied on some services, including the insurance of electrical appliances, receipts from sporting events and nightclubs, driving schools, computer services, and car rental services.

[539] Purchase Tax (Goods and Services) Law, 1952, s. 4B.

[540] Purchase Tax (Goods and Services) Law, 1952, s. 6A. The criteria include mainly a minimum annual import turnover (about US$100,000) and compliance with the income tax and value added tax (VAT) regulations.

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V. Taxation of Domestic Corporations

A. Corporate Income Tax

1. Corporate Residence

Companies incorporated in Israel and companies that exercise the control and management of their business from Israel are considered resident in Israel. Resident corporations are taxed on their worldwide income; nonresident corporations are taxed only on their Israeli-source income.

2. Income Determination

Taxable income is based on financial statements, which are prepared according to generally accepted accounting principles.

Under the Israeli Income Tax Ordinance, corporate income tax is levied on: (i) income from a business, trade, vocation or any transaction or "adventure in the nature of trade"; (ii) dividends, interest, linkage differentials, rents, franchise payments, premiums, lease premiums and other profits derived from real estate; (iii) income from the sale of patents or designs; (iv) income from employment, pensions and annuities; (v) income from agriculture; (vi) profits and gains from betting and lotteries; and (vii) gains or profits derived from any source not enumerated above (see V.C.4., below).

Expenses are deductible if they are wholly and exclusively incurred in the production of taxable income, and incurred with respect to income generated in the same year that the expenditure was incurred. However, as a practical matter, where an expense is of a mixed nature, the Assessing Officer will allow an allocation, so that the part allocable to the production of income is indeed recognized as a business expense. The deduction of some expenses is limited or forbidden (see V.C.5. and 6., below).

Rates of depreciation are determined by statute. Higher rates of depreciation are allowed for some assets and industrial enterprises. Depreciation for tax purposes is generally calculated on a straight-line basis (see V.C.5.g., below).

Inventories are valued at the lower of cost or market value. A first in first out (FIFO) or weighted average basis of valuation is acceptable.

3. Capital Gains

A capital gains tax is imposed on capital gains accrued on the disposal of fixed assets other than real estate. The general rule is that the basis of the asset concerned is stepped up to compensate for the inflation since acquisition. The capital gain is therefore divided into a "real gain" and an "inflationary amount":

(i) The "inflationary amount," which represents the inflationary gain in nominal terms, is taxed at the flat rate of 10% on that part accrued until December 31, 1993, and at 0% on the part accrued after that date; and

(ii) The "real gain" of a corporation is generally taxed at the rate of the corporate tax.

A capital gains (appreciation) tax on gains accrued on the sale of real estate is imposed at the following rates:

(i) The "inflationary amount" is taxed at the flat rate of 10% on that part of the gain accrued until December 31, 1993, and at 0% on the part accrued after that date; and

(ii) The "real gain" of a company is generally taxed at the rate of the corporate tax.

4. Group Taxation and Intercompany Dividends

Consolidated tax returns for corporate groups are allowed only in case of an industrial company controlling another company in the same line of business, or a parent company controlling an industrial company and having at least 80% of its assets invested in industrial companies.[541]

Dividend income received from another resident company is free of tax in the hands of the recipient company if the income out of which the dividend is distributed is sourced in Israel.

Dividends distributed from income sourced outside Israel are taxed, at the company's choice:

(i) At the rate of 25% of the gross dividends paid, with a credit for the tax withheld at source; or

(ii) At the regular company tax rate on the income out of which the dividend was paid, with a credit for the applicable ratable underlying tax paid by the paying company and for the tax withheld at source on the dividend itself (see V.C.4.c., below).

5. Losses

Business losses may be offset against income from any source in the same year. Loss carrybacks are not allowed. Unrelieved business losses may be carried forward for an unlimited number of years to offset business income and capital gains derived from business activities. There are limitations regarding the offset of losses accrued abroad against income that accrued in Israel (see V.C.7., below).

Unrelieved capital losses may be carried forward for an unlimited number of years to offset capital gains. However, a capital loss derived from the sale of securities may be offset in the year of the sale against interest or dividend income derived from that security, or against interest or dividend income derived from other securities, provided the income from dividends or interest is subject to tax at a rate that does not exceed 25%. As a result of the fact that the Income Tax Law (Inflationary Adjustments), 1985 is not in effect as of January 2008, losses are no longer adjusted to the cost of living index.

6. International Aspects

The non-treaty withholding tax rate for payments of a dividend to companies or individuals is 25%/30% (depending on whether the company or individual is a substantial shareholder). Payment of interest and royalties is taxed at a rate of 23%.

Resident companies that derive or receive income accrued outside Israel are entitled to double taxation relief in the form of a foreign tax credit, provided the foreign tax concerned was imposed as a percentage of the income and is not a municipal tax.

[541] Industry Encouragement Law (Taxes), 1969, s.23.

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The taxable income of a "controlled foreign corporation," as specifically defined by the Income Tax Ordinance, is ascribed to its Israeli resident shareholders as if it were a dividend distributed to them.

The income of a foreign vocation company, i.e., the income of a foreign company controlled by Israeli professionals that derives income from the profession of its shareholders, is taxed as if the company were an Israeli resident.

Israeli banks must withhold tax, generally at a rate of 25%, from most overseas remittances unless the remittances relate to imported goods, or when a lower rate applies under an applicable tax treaty.

7. Other Significant Taxes

There are no local taxes other than annual municipal taxes on property.

Value added tax (VAT) is generally levied at the rate of 18%. Exports of goods and certain services are zero-rated and certain transactions are exempt; see IV.E., above.

Any purchase of real property is subject to purchase tax at the rates of 0.5% to 10%.

8. Tax Incentives

To attract foreign investment, Israel has devised an elaborate system of incentives. The incentives are designed to encourage investments in manufacturing facilities, tourism, housing projects, industrial rental buildings, rental dwelling units and agriculture, as well as to attract foreign specialists. The incentives include, inter alia, beneficial tax rates; cash grants (for investments in fixed assets); accelerated depreciation; and a zero rate of value added tax (VAT) on goods and services exported from the country. For further discussion, see XIV., below.

9. Administration

The Israeli tax year is normally the calendar year.

Companies are generally required to file audited annual tax returns and financial statements within five months of the end of the tax year.

Companies must file monthly or bi-monthly returns regarding corporate income tax advances and report withheld taxes, tax advances with respect to nondeductible expenses, etc. (see XII., below).

10. Reportable Opinions and Positions

Rules for reporting the existence of tax opinions and a "reportable position" have been adopted pursuant to the Tax Benefits and Tax Advice, legislative amendments, 2015, published December 9, 2015. The law applies to income tax, VAT, customs, purchase tax and excise tax. The reporting taxpayer, for income tax purposes, is either an individual or a corporation (excluding an exempt public body), which derived income in excess of NIS 3 million during the tax year; or the consideration received by the taxpayer upon the sale of a capital asset, in the tax year exceeded NIS 1,5 million (the tax opinion rendered being in respect of said consideration).

An "opinion" is defined as a written opinion executed by the person rendering it, directly or indirectly, provided: the fee (being at least NIS 100,000) is contingent in whole or in part, upon the achievement of a "tax advantage" or the opinion is an "off the shelf opinion." A "tax advantage" is defined to include (a) a reduction of tax, tax relief, decrease of the tax liability or an advance payment or tax avoidance; (b) the abstaining from the performance of a duty or obligation to withhold tax at source, expenses or taking into account a loss; and (c) the deferral of a tax.

An "off the shelf tax opinion" is defined as: (a) a tax opinion of a standard content concerning the same subject matter rendered, directly or indirectly, to at least three persons (except those excluded therefrom) within a period of two years and which is not dependent mainly on the particular circumstances of the recipient; and (b) a tax opinion which the author initiated and the recipient agreed to keep confidential in whole or in part.

A person in receipt of an opinion as defined above will report its existence in his annual return by submitting a form to be published by the Director of the Israel Tax Authority (ITA). The form will report the existence of the opinion, the act or asset constituting the subject matter of the opinion and the issues raised in the opinion. The opinion itself need not be filed. A person rendering an "off the shelf opinion" must notify the third recipient and every other recipient of its nature. If the opinion was tendered after the filing of the annual return, the taxpayer must file a special return with the aforesaid particulars of the opinion.

A reportable position relates to a position which is contrary to a published position of the Tax Authority and the tax advantage exceeds:

- Income tax: NIS 5 million or NIS 10 million in no more than four tax years;
- VAT/Customs: NIS 2 million or NIS 5 million in no more than four tax years.

The Tax Authority is permitted to publish 50 positions each year except that in 2016 and 2017 it was entitled to publish 100 positions each year. In 2019, the Tax Authority published 23 positions (income tax and international taxation — 22; motor fuel excise — 1) bringing the total published positions to 112 (income tax and international taxation — 80; VAT — 12; customs — 19; motor fuel excise — 1).

Failure to comply with the new rules will be deemed a failure to file a return. Fines may also be levied for a deficit in payment resulting from the failure to file.

B. What Is a Domestic Corporation?

Section 1 of the Israeli Income Tax Ordinance defines "a resident in Israel" or "a resident," when applied to a "body of persons," as:

"(1) A body incorporated in Israel;

(2) Any body of persons the control and management of whose business are exercised in Israel."

Pursuant to the Reform of 2008, foreign companies managed and controlled by new immigrants or Veteran Returning Residents will not be considered residents of Israel for 10 years from their assumption of residence if, but for being managed and controlled by the new immigrants or the Veteran Returning residents, they would not have been classified as corporate residents of Israel.

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The first part of the definition was introduced into the Ordinance in 2003. The "place of incorporation" criterion substituted the former "place of registration of the company" criterion coupled with the "location of its main place of activities" criterion. The substitution of the former criteria (place of registration and principal activities) will draw greater attention to the second part of the definition, i.e., the "control and management" criterion.

The Israeli Supreme Court has not handed down any decisions or laid down any binding precedents with respect to the location of corporate residence. The question came before the District Court of Haifa,[542] which held that each of the terms "control" and "management" is a separate and independent term and, therefore, if either is exercised outside the country, the company will not be regarded as an Israeli resident. The court viewed the term "control" as applicable to the shareholdings in the company under consideration. The case was not appealed.

Comment: In the author's opinion as well as that of the tax authorities, the court wrongly held that "control" and "management" are distinguishable and failed to see that the subject matter of the exercise of the "control and management" under consideration is the "business" of the corporate entity.

The source of the second part of the definition is U.K. case law, and although the case law test there has since been supplemented by the introduction of a statutory "place of incorporation" test in 1988, it is more than likely that the precedents of the U.K. courts will have a persuasive effect in the construing of that part of the definition for purposes of the Israeli Income Tax Ordinance, once the question arises again.

The U.K. courts adopted the principle that a company maintains its residence where it conducts its business. Furthermore, a company is considered to conduct its business where its central management and control is located.[543] Clearly, the Income Tax Ordinance codified the final result of this formula. The central management and control are located where the body charged with the responsibility for the formulation and direction of the company's policies exercises its functions.[544] This body is normally the board of directors. Therefore, the rule of thumb for purposes of the second part of the definition of corporate residence is that the geographic site where the board of directors continually performs its duties determines the location of corporate residence. In the context of the definition of corporate residence, management and control under U.K. tax law are not to be confused with the powers of the shareholders nor are they to be confused with the powers inherent in running the day-to-day operations and business of the company. It is between these two extremes that central management and control lie.

The residence of a subsidiary company is determined in the same manner as that of any other company. Where its central control and management are exercised by the parent company and the latter has no affiliation with the state, the subsidiary is nonresident.[545] However, because of the first part of the definition, if the subsidiary is Israeli incorporated, the location of the central management and control is disregarded.

Under the U.K. decisions, a company may enjoy a dual status.[546] However, this is a rare phenomenon and the Israeli courts have not yet handed down a decision as to whether such dual status is recognized under Israeli law.

In 2002, the Israel Tax Authority (ITA) stated its position with respect to the location of the control and management of a company's business. It is worth noting that the position taken by the ITA does not, of necessity, reflect the position adhered to by the courts in interpreting the provisions of Israeli tax law, but solely the position of the income tax authorities. The tax authorities take the position that "control and management" are one criterion and not two separate criteria of "control" and "management" and that locating the place at which control and management are exercised involves a multi-phase examination. First, according to the tax authorities, the place at which it is necessary to adopt material resolutions governing the business activities of the company must be identified. Second, the controlling and managing organ of the company should be examined and identified. The criteria used to make this identification should not be technical, i.e., the board of directors should not always be assumed to be the organ exercising control and management over the business of the company. Where, for example, the board of directors authorizes another organ to adopt resolutions governing the business affairs of the company and entrusts it with wide authority, the latter will be the organ in possession of the control and management of the business of the company. The circular goes on to stress that the criterion of the place at which the board of directors convenes has lost its predominance and importance in modern times and that criteria of substance should replace technical criteria in locating the place at which control and management of the business of the company is exercised.[547]

In one case, the District Court held that, in the case of a foreign company whose business was operated by its Israeli shareholders, the control and management of the company was in Israel because its foreign directors were not involved in its daily affairs.[548]

C. Taxation of Worldwide Income

1. In General

Israel taxes individuals and corporations on their worldwide income, irrespective of whether the income is ordinary income or capital gains, and irrespective of whether the tax is income tax or the company tax imposed on corporations. Section 2 of the Income Tax Ordinance provides that Israeli company

[542] I.T.A 175/90 *Solel Boneh v. Assessing Officer (Haifa)*, Missim H-2 (Apr. 1994), E-74.

[543] *De Beers Consolidated Mines Ltd. v. Howe* (1906) A.C. 455. *See* Rafael & Efrati, *The Residence of a Company for Tax Purposes*, 29 Hapraklit 573, in Hebrew.

[544] *American Thread Co. v. Joyce*, (1912) 6 T.C. 627; *Calcutta Jute Mills Co. Ltd. v. Nicholson*, (1876) 1 Ex. D. 428; *New Zealand Shipping Co. Ltd. v. Stephens*, (1907) 5 T.C. 553.

[545] *Unit Construction Co. Ltd. v. Bullock*, (1960) A.C. 351; *Gramophone and Typewriter Ltd. v. Stanley*, (1908) 2 K.B. 89.

[546] *Swedish Central Rail Co. v. Thompson*, (1925) A.C. 495.

[547] Income Tax Circular 4/2002, *Guidelines for the location of control and management*, Missim P-2, C-6.

[548] I.T.A 1029/00 *Niego v. Assessing Officer Kfar Sava*, Missim 26/1 E-90. See also I.T.A 1090/06 *Yanko Weiss Ahzakot 1996 Ltd. v. Assessing Officer Holon* (Dec. 18, 2013).

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tax be levied on the worldwide income of Israeli resident corporations and on the Israeli-source income of nonresident corporations. Until 2003, the year in which Israel moved to a full personal basis of taxation, Israel's basis of taxation was quasi-territorial; in theory, the basis was territorial, but as a practical matter, due to statutory fictions introduced into the Israeli Income Tax Ordinance with respect to the location of the source of income, the tax system was, to a large extent, based on the personal ties of the taxpayer to Israel.

With the adoption of the personal basis of taxation in 2003, source rules were enacted through the introduction of section 4A into the Income Tax Ordinance. These provide that:

(i) Business income will be sourced at the place at which the income-producing activities take place;

(ii) Income from "an adventure in the nature of trade" or from a transaction partaking of the nature of a business transaction will be sourced at the place of execution of the transaction;

(iii) Vocational income will be sourced at the place where the service is rendered;

(iv) Employment income will be sourced at the place where the services are performed;

(v) Interest, discount and linkage differentials will be sourced at the place of residence of the payor;

(vi) Rental income will be sourced at the situs of the use of the property;

(vii) Profits, including royalties, from intangible assets will be sourced at the place of residence of the payor;

(viii) Pensions, annuities and maintenance payments will be sourced at the place of residence of the payor;

(ix) Agricultural income will be deemed to arise where the asset giving rise to the income is located; and

(x) Dividends will be sourced at the residence of the corporation paying the dividend.

Notwithstanding these rules, income will be treated as arising from an Israeli source if:

(i) The income is of a passive nature (excluding dividends) and is deducted as an expense by a permanent establishment (PE) of the payor in Israel; or

(ii) The income is employment income and the employer is the State of Israel, a subdivision thereof or a national body specifically mentioned in the Ordinance.

Conversely, passive income (not including dividends) is deemed to be from a source outside Israel when it is taken as a deduction in computing the profits of a PE of an Israeli resident maintained outside Israel.

See Section VI.A., below for further discussion on PE matters.

2. Meaning of Israeli Citizen

Section 3A of the Income Tax Ordinance broadens the scope of Israeli taxation even further. Under section 3A(a), an "Israeli citizen" is defined to include a company controlled by an Israeli citizen. "Control" for this purpose is the direct or indirect ownership of at least 10% of the issued shares of the company or of the voting rights, or the right to hold at least 10% of the issued shares or the voting rights, or a right to receive at least 10% of the profits, or a right to nominate a director.[549] Under section 3A(b) of the Ordinance, the income of an Israeli citizen that accrued in, or was derived from Judea or Samaria ("the Area"), is considered to be income accrued in Israel.[550]

Income of an Israeli citizen residing in the Area that did not accrue or was not derived from Israel or the Area is considered to be foreign-source income.[551] Where an Israeli company paid tax under the provisions of section 3A of the Income Tax Ordinance referred to above to authorities in the Area, Israel credits the amount of the tax paid in the Area against the Israeli tax levied on the income.[552] If an Israeli citizen owns less than 10% of the various rights in the company, although the company is not regarded as an Israeli citizen, the Israeli citizen's proportionate right to the company's income is deemed to be his/her income and is considered to be income accrued in Israel if the income of the company accrued in Israel or the Area. The income is considered to have accrued abroad in all other circumstances. Dividends received by an Israeli citizen out of such income are not subject to any further Israeli taxation.[553] The definition of "the Area" was amended[554] to reflect the establishment of the Palestinian Authority. The definition now specifically states that the Area includes, for purposes of section 3A of the Income Tax Ordinance, all areas under the control of the Palestinian administration. This might result in non-relievable double taxation in certain cases (where there is Palestinian Authority taxation of Israeli-source income), as the agreements between Israel and the Palestinian Authority do not yet contain provisions for the prevention of such double taxation.

Section 89(b)(1) of the Income Tax Ordinance bases capital gains taxation on the Israeli residence of the seller — defined to include an Israeli citizen resident in the Area — irrespective of the location of the sale or the asset. If the seller is a nonresident, section 89(b)(3) provides that the gain will have an Israeli source if: (i) the asset sold is located in Israel; or (ii) the asset is located outside Israel and constitutes a direct or indirect right to an asset, stock-in-trade or an indirect right to real estate or an asset of a real estate association located in Israel; (iii) the asset is a share or a right to a share in an Israeli resident corporation; or (iv) the asset is a right to a share in a foreign corporation most of the assets of which are located in Israel or are rights, directly or indirectly, to assets located in Israel.

3. Accounting

The accounting profession developed with the enactment, by the British Mandatory Authorities, of the Companies Or-

[549] Amendment No. 81, 1990. The Court held that several Israeli shareholders, each holding less than 10%, but holding jointly more than 10%, are to be considered as controlling the company in question: I.T.A. 101/97 *Maa'le Hever v. Assessing Officer Jerusalem*, Missim K-4 (Aug. 1997), E-19.

[550] Income Tax Ordinance, s. 3A(b).

[551] Income Tax Ordinance, s. 3A(b1).

[552] Income Tax Ordinance, s. 3A(e), with no additional credit under Income Tax Ordinance, s. 199.

[553] Income Tax Ordinance, s. 3A(c).

[554] Law for the Amendment of the Income Tax Ordinance (Amendment No. 101), 1994.

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dinance and the Cooperative Societies Ordinance in 1929 and 1920, respectively. These Ordinances provided for an annual audit of the accounts of companies and cooperative societies. In 1941, the Income Tax Ordinance was enacted, instituting reporting requirements and the requirement to maintain books of account. The profession further developed as a result of the need for tax planning, filing tax returns and contesting assessments of the tax authorities. With the establishment of the State, foreign currency investments grew substantially and the capital market developed significantly. Businesses grew and many small companies became medium-sized publicly held companies by issuing shares to the public or by becoming affiliated with investment companies the shares of which were held by the public.

Gradually the tax code became more complex and greater sophistication was required to deal with its various provisions. These developments served as an additional catalyst to the greater reliance placed on accountants. Moreover, laws such as the Law for the Encouragement of Capital Investments, 1959 (see II.A.2.c., above), placed great emphasis on certified accountants for purposes of obtaining the benefits of the Law, while other laws, such as the Securities Law, 1968, set standards for financial reporting and proper disclosure.

Accounting in Israel has reached a proficient level mainly as a result of the readiness of the profession to adopt and apply the concepts and practices of foreign countries in which accountancy has reached high standards. While the profession was guided during its infancy to a great extent by developments in the United Kingdom, in later years it has been greatly influenced by U.S. accounting concepts; however, neither the U.K. nor the U.S. concepts are applied as such.[555]

Under the Companies Law, 1999, an auditor is appointed by a company at the annual general meeting of the shareholders, although the general meeting is entitled, if so specified in the company's articles of association, to appoint the auditor for a longer period, which may not exceed three years.[556] The auditor may be removed only by a general meeting of the shareholders.[557] The Companies Law, 1999 grants the auditor the right of access to the company's books and vouchers, as well as the right to attend any general meeting of the company and board meeting in which the audited books and reports are to be discussed.[558]

The auditing standards prescribed by the Institute of Certified Accountants and incorporated in the Auditors' (Mode of Performance) Regulations, 1973 are almost identical to those adopted by the American Institute of Certified Public Accountants.

In 1997, an Israeli Accountancy Standards Board was established. This institute is intended to fulfill a role similar to that of the Financial Accounting Standards Board in the United States. The Israel Accounting Standards issued by the Israeli Accounting Standards Board are often based on and may include parts of the International Accounting Standards published by the International Accounting Standards Committee (London). Once published, they are binding on members of the profession. In November 2005, the Israeli Accountancy Standards Board published a resolution adopting the International Financial Reporting Standards (IFRS), applicable to financial statements of public companies effective as of January 2008, for periods commencing thereafter. It reads as follows:

> Where the opinion of an auditor is unqualified, it is couched in the following terms: We have audited the accompanying balance sheets of ABC Company ("the Company") as of December 31, 200_ and 200_, and the related statements of operations, changes in shareholders' equity and cash flows, for the years then ended. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audit in accordance with generally accepted auditing standards, including those prescribed under the Auditors' Regulations (Auditor's Mode of Performance), 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> The aforementioned financial statements have been prepared on the basis of historical cost, adjusted to reflect changes in the general purchasing power of the Israeli currency in accordance with pronouncements of the Institute of Certified Public Accountants in Israel. Condensed nominal Israeli currency data, on the basis of which the adjusted financial statements of the Company were prepared, is presented in Note XYZ.

[555] Public Auditors Law, 1955, s. 2. The profession is regulated by the Auditors' Council, which was created under the Public Auditors' Law, 1955, and the Institute of Certified Public Accountants in Israel. The Auditors' Council comes under the jurisdiction of the Ministry of Justice and implements the Public Auditors Law referred to above. The Council is composed of 14 members, including a Chairman, appointed by the Minister of Justice, five members who represent various government departments or agencies, six auditors, appointed by the Minister of Justice who represent the Institute of Certified Public Accountants, a senior member of the accountancy academic staff and a jurist. It grants licenses to practice, conducts qualifying examinations and supervises the upholding of ethical and professional standards. The Institute of Certified Public Accountants is a voluntary institute; however, most accountants in Israel belong to it. The Institute contributes to the standards of the profession and voices its views on accounting matters, taxation, and similar issues. The rules and standards adopted by the Institute usually serve as a basis for formal regulations promulgated by the Minister of Justice (in accordance with Public Auditors Law, s. 11). To practice as an accountant, the applicant must be at least 23 years of age, and must have passed or been exempted from the qualifying examinations. In addition, a two-year period of apprenticeship is required, either in Israel or abroad (Public Auditors Laws, s. 4). Most new candidates hold academic degrees, although this is not a prerequisite.

[556] Companies Law, 1999, s. 154.

[557] Companies Law, 1999, s. 162.

[558] Companies Law, 1999, s. 168.

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> In our opinion, the financial statements, present fairly, in all material respects, the financial position of the Company as of December 31, 200_ and 200_, and of the results of its operations, changes in shareholders' equity and cash flows for the years then ended, in accordance with generally accepted accounting principles.
>
> Pursuant to section 168 of the Companies Law, 1999, we hereby state that we received all of the information and explanations which we requested and that our opinion on the financial statements is given on the best of the information and explanations which we received and as reflected in the books of the Company.[559]

If the company being audited is a public company, the last paragraph will refer to the requirements of the Securities (Preparation of Financial Statements) Regulations, 1993.[560]

The form of the auditor's report, therefore, differs from the U.S. form in two respects. First, the auditor does not certify that the accounting principles were applied on a consistent basis. The auditor addresses the issue of consistency only where he/she is of the opinion that an accounting change was improper or where an accounting change has occurred and the auditor concurs, but believes that no adequate disclosure of the change and its effect was made in the financial statements. Second, while the Statement on Auditing Standard Number 2, section 49 provides that, when financial statements of the previous year are presented as a measure of comparison with those of the current year, the auditor should report on the comparative statements if he/she has examined them, the Institute has issued an opinion that where the audited reports present comparative figures, such comparative figures will be deemed to have been audited regardless of any reference to that effect.

Another Opinion of the Institute describes the circumstances in which the auditor must render a qualified opinion or must refrain from the expression of an opinion as to a specific action or must express a negative opinion. The Opinion follows the recommendations adopted in the United States; however, a piecemeal opinion is permitted and has received statutory confirmation through the Mode of Performance Regulations, 1973.

The Israeli Accounting Standards Board has issued standards on the following issues:

(i) Holdings of Venture Capital Funds: the Standard sets the measurement rules and disclosure requirements for venture capital funds regarding their venture capital investments.

(ii) Construction of Buildings for Sale: the Standard determines the manner in which builders should report their income and expense, assets and liabilities.

(iii) Capitalization of Borrowing Costs: the Standard requires the capitalization of borrowing costs on qualifying assets, which are assets under construction whose preparation for their ultimate use consumes a considerable time and that fall under either of the following groups: assets designated for self-use; or assets designated for sale whose construction period is either abnormally long, expected to last over three years or entails an unusually large investment relative to the business.

(iv) Construction-Type Contracts: the Standard sets the income measurement rules for construction-type contracts. According to the Standard, revenues should be recognized on a percentage-of-completion basis once certain revenue recognition criteria are met.

(v) Corrections and Clarifications Concerning Accounting and Reporting Principles of Not-For-Profit Organizations: the Standard makes some corrections to the previous Opinion 69 (issued by the Israel Institute of Certified Public Accountants) and introduces certain changes to that Opinion.

(vi) Disclosure about New Accounting Standards in Periods Prior to Their Adoption.

(vii) Post Balance Sheet Events: the Standard is based on International Accounting Standard (IAS) No. 10.

(viii) Discontinuing Operations: the Standard is based on IAS No. 35. The purpose of the Standard is to prescribe the presentation of information regarding major discontinuing operations separately from continuing operations.

(ix) Contingent Liabilities and Contingent Assets: the Standard is based on IAS No. 37. The Standard prescribes the accounting and disclosures for all provisions and contingent assets and liabilities. The Standard was approved but has not yet entered into force.

(x) Segment Reporting: the Standard is based on IAS No. 14. The objective of the Standard is to establish principles for reporting financial information by segments. The disclosure requirements in the Standard do not differ from those included in IAS No. 14 in any material way.

(xi) Discontinuance of Adjusting Financial Statements for Inflation: the purpose of the Standard is to abolish the Opinions (mainly Opinion No. 36) issued by the Institute of Certified Public Accountants in Israel related to inflation reporting due to the current low inflation rates (0% in year 2000, 1.4% in year 2001 and 6.5% in year 2002). The starting point for nominal reporting was set for the year ended December 31, 2003.

(xii) The Effects of Changes in Foreign Exchange Rates: the Standard is based on IAS No. 21 and deals with the translation of foreign currency transactions and the translation of financial statements of foreign entities for incorporation into the financial statements of the reporting enterprise. The Standard became operative for financial statements covering periods beginning after December 31, 2003, for enterprises with December 31 fiscal year-ends. For enterprises with other fiscal year-ends, the Standard became operative for financial statements covering periods beginning on or after September 29, 2003.

(xiii) Interim Financial Reporting: the Standard, which is based on IAS No. 34, supersedes Opinion 43 and Opinion 60 issued by the Institute of Certified Public Accountants in Israel. This Standard became operative for finan-

[559] In accordance with Opinion Nos. 61 and 63 published by the Israeli Institute of Public Certified Accountants.

[560] Securities Law, 1968, s. 36.

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cial statements covering periods beginning on or after January 1, 2003.

(xiv) Impairment of Assets: the objective of the Standard, which is based on IAS No. 36, is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through the use or sale of the asset. If this is the case, the asset is described as impaired and the standard requires the enterprise to recognize an impairment loss. The standard also specifies when an enterprise should reverse an impairment loss and prescribes certain disclosures for impaired assets. It does not cover impairment of inventories, deferred tax assets, assets arising from construction contracts, assets arising from employee benefits or most financial assets. The effective date for implementing the Standard was for accounting periods beginning on or after January 1, 2003, but it was recommended as a standard for 2002.

Since January 2008, public companies have had to implement the IFRS. The Israeli Generally Accepted Accounting Principles (GAAP) apply to nonpublic companies that have chosen not to apply the IFRS.

The governing principle in financial reporting is that of fair presentation so that the financial statements present fairly the financial position of the audited company at the balance sheet date and the operating results and cash flow statement for the period indicated. Therefore, hidden reserves are not permitted in financial statements. The statements are prepared based on historical cost but, under Opinions No. 36 and 50 (which were abolished according to Standard 12 as of 2003), were adjusted to reflect changes in the general purchasing power of Israeli currency during the relevant year. In some cases "dollar financial statements" are allowed. Cost of inventories is computed using the FIFO method or the average method basis with items such as tools, implements, and spare parts generally taken in using the base stock method. The last in first out (LIFO) method for the valuation of inventory is not used. The cost of goods includes raw materials, labor and overhead; however, in some cases, periodic overhead costs are not included. Inventory is valued at the lower of its book value or fair market value. In comparing the fair market price to the historical cost, the fair market price is taken as the net realizable value. The comparison between the market price and the historical cost is made for each item or for each group of similar items.

Depreciation is generally computed using the straight-line method; however, the residual value is not taken into account. Interest incurred during periods of construction is capitalized and depreciation is computed accordingly.

Investments in associated companies (i.e., companies controlled to the extent of 20% or more) are usually presented by applying the equity method. Bonus shares are not independently recognized and all other investments in shares of nontraded companies that are not subsidiaries or associated with the audited company are stated at cost unless their value has declined below cost. Special rules apply to the presentation of both marketable and unquoted linked bonds. All outstanding balances in foreign currency or in accounts linked to an index are presented in accordance with the exchange rate or the index prevailing at the date of the balance sheet.

Goodwill is regarded as an asset if it has been acquired for consideration and is amortized in the case of a decrease in its value. Goodwill usually arises from an excess of the costs of an investment in subsidiary companies over the equity in net assets at acquisition, after appropriate values have been assigned to all assets acquired. Research and development (R&D) costs are generally regarded as an expense when incurred; however, in some instances these costs are amortized over a period of three to five years. Patents are amortized in the case of a decrease in their value. Organizational expenses are amortized over a period of three to five years.

Reserves are set up for contingent liabilities as well as for taxes, where timing differences occur between tax accounting and general accounting rules. For income tax purposes, reserves are regarded as an expense only where the liability is indeed contingent. However, the taxpayer may dispute the liability and nevertheless demand that a reserve be set aside to meet it. A reserve may not exceed the total amount of the claimed liability.[561]

The nominal financial statements must further be adjusted for tax purposes.[562] The adjustment concerns mainly the timing of the recognition of expenses or income, the disregarding of the revaluation of assets, and such matters as the investment grant, on which no depreciation is allowed. As of 1982, special adjustments had to be made pursuant to special laws, discussed in XIX., below, designed to prevent the taxation of inflationary gains but, as of January 2008, the inflationary adjustment legislation was abolished due to the decrease in the rate of inflation.

Income is reported for each tax year separately. The tax year begins on January 1 and ends on December 31. However, under section 7 of the Income Tax Ordinance, the Commissioner may allow the use of a different 12-month period in very limited cases, including in the case of a company whose share capital and voting rights are held to the extent of 51% by a nonresident company whose shares are traded on a foreign stock exchange or in the case of a company where the rights to 51% of its profits are invested in such a company.

4. Calculation of Gross Income

a. In General

The Israeli notion of income is derived from the U.K. tax system and is similar to that employed by the Internal Revenue Code of the United States. There is no single determinative test indicating whether a receipt partakes of the nature of income. The features most relied on in characterizing a receipt as income include its periodicity, the nature of the asset involved in its derivation, the structure of the receiving enterprise and the consideration given for the receipt.[563]

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[561] For tax purposes, see C.A. 190/58 *The Assessing Officer (Large Enterprises) v. Nakid*, 14 P. 2237; I.T.A. 392/82 *Hahevra HaAmerikait Yisraelit LeGas v. Assessing Officer (Large Enterprises)*, 16 P.D.A. 50; C.A. 600/75 *Tel-Ronen Kablanim Ubonim v. Assessing Officer Tel-Aviv*, (1977) 31(2) P.D. 763. I.T.A. 43/95 *Hahevra HaAmerikait Yisraelit LeGas v. Assessing Officer (Large Enterprises)*, Missim O-2 (Apr. 2001), E-69.

[562] Income Tax Ordinance, s. 131(c).

[563] For example, the Court held that the consideration given to a retiring manager for a covenant not to compete stems from the knowledge and expertise

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Under the Income Tax Ordinance, income tax is levied only on income from the sources enumerated in the Ordinance in the following order:

(i) Business, trade and vocation or any transaction or adventure in the nature of trade;

(ii) Employment;

(iii) Dividends, interest, linkage differentials and discounts;

(iv) Pensions, annuities and payments in the nature of maintenance;

(v) Rents, franchise payments, premiums on leases, premiums and other profits derived from real estate;

(vi) Profits derived from property other than real estate;

(vii) Agriculture;

(viii) The sale of patents or designs (to which the Patents and Designs Ordinance, 1924, or the Designs Law, 2017, are applied) by their inventors or the sale of copyrights by their creators, where the invention or creation concerned does not result from the ordinary business of the inventor or creator;

(ix) Profits and gains from betting and lotteries; and

(x) Gains or profits derived from any source not enumerated above.

It is evident that the importance of ascribing income to a statutorily designated source has decreased since the addition of the last subsection — the "catch all" clause.

It has been held that the sources enumerated above are descriptive rather than conclusive and that the classification of income must be made on a functional basis. Income that can be classified under two of the sources will be classified under one source since the different sources exclude each other.[564]

Regarding the first source of income, a distinction must be drawn between "business" and "any transaction or adventure in the nature of trade," since the classification of income as belonging to one of these sources bears significant different consequences. For example, the right to separate filing and tax computation is accorded to spouses mostly with respect to income derived by a spouse from personal exertion in a business, vocation or employment and not with respect to a transaction or adventure in the nature of trade.

One of the most important features of a "business" is its continuous and recurring organized activity[565] in contrast to other commercial activities that lack institutionalization;[566] however, in one case,[567] the Supreme Court ruled that, for purposes of the loss carryforward provisions, there was no need to distinguish between a "business" and an "adventure in the nature of trade." There is no conclusive test, and each case must be determined on its merits and with regard to its special circumstances.[568]

b. Capital Gains

(1) In General

Capital gains are taxed under two separate laws. Capital gains derived from the sale of real property located in Israel and the Area, including shares in real estate associations, are taxed in accordance with the provisions of the Land Taxation Law (Appreciation, Sale and Purchase), 1963.[569] All other capital gains come under the aegis of Part E of the Israeli Income Tax Ordinance. In both cases, the method of taxation is quite complex. The general rule is that the basis of the asset is stepped up to compensate for the inflation since its acquisition. The capital gain is therefore divided into the "real gain" and the "inflationary amount." The "inflationary amount," which represents the inflationary gain in nominal terms, is taxed at the flat rate of 10% on that part accrued up until December 31, 1993, and at 0% with respect to the inflationary amount accrued thereafter.[570] The "real gain" was formerly taxed as if it were ordinary income and was considered to be at the "highest slice" of the taxpayer's taxable income.

Within the framework of the tax reform introduced in 2003, as amended in a 2011 amendment, the "real gain" is taxed as follows:

"Real Gain" Accrued:	Tax Rate — Individuals	Tax Rate — Companies
Before Jan. 1, 2003 (determining date)	Marginal rate (up to 48%)	25%
Jan. 1, 2003 – Dec. 31, 2011	20%/25%	25%
As of Jan. 1, 2012	25%/30%	25%

Real estate is generally taxed as follows:

gained throughout his employment, and therefore should be classified as employment income or income from a vocation: I.T.A. 353/91 *Holtzman v. Assessing Officer Tel-Aviv 4*, Missim I-6 (Dec. 1995), E-71. *See also* I.T.A. 7/94 *Beit Horim Ronit 1988 Ltd. v. Assessing Officer Acre*, Missim J-3 (June 1996), E-100; I.T.A. 110/95 *Gez v. Assessing Officer Hadera*, Missim K-1 (Feb. 1997), E-179.

[564] I.T.A. 62/85 *Kiryat Yehudit v. The Assessing Officer (Large Enterprises)*, 14 P.D.A. 24, settled by the parties during the course of an appeal before the Supreme Court, with the Tax Authorities conceding the principle of the exclusivity of sources. *See also* I.T.A 143/91 *Mordechai v. Assessing Officer Haifa*, Missim I-3 (June 1995), E-80; I.T.A 134/92 *Mahagna Josef v. Assessing Officer Hadera*, Missim I-3 (June 1995), E-125.

[565] C.A. 111/83 *Elmor v. The Commissioner of Value Added Tax*, 39(4) P.D. 1; I.T.A. 35/82 *Mizrahi v. Assessing Officer Jerusalem*, 1984 (2) P.M. 338; I.T.A. 286/91 *Eliezer v. Assessing Officer Netania*, Missim I-3 (June 1995), E-106; I.T.A. 155/97 *Brener v. Assessing Officer Gush Dan*, Missim M-2 (Apr. 1999), E-201; I.T.A. 120/98 *Fares Vahabi v. Assessing Officer Zafad*, Missim M-4 (Aug. 1999), E-252; I.T.A. 1093/98, 1094/98, *Hazan v. Assessing Officer Netania*, Missim Q/5 E-189.

[566] C.A. 597/75 *Bernstein v. The Assessing Officer*, 9 P.D.A. 157; I.T.A. 17/92 *Harel v. Assessing Officer Acre*, Missim G-6 (Dec. 1993), E-196.

[567] I.T.A 92/84 *A.H.A. Goldstein Ltd. v. The Assessing Officer*, 13 P.D.A. 211.

[568] C.A. 504/65 *Esel v. The Assessing Officer*, 29(3) P.D. 365; I.T.A. 195/90, 31/93 *Azam v. Assessing Officer Haifa*, Missim H-5 (Oct. 1994), E-104; C.A. 9412/03 *Hazan v. Assessing Officer of Netanya*, Missim S-2 (Apr. 2005), E-104.

[569] In 1999, the Land Appreciation Tax Law, 1963, was radically amended, and was given a new name: The Taxation of Land Law (Appreciation and Purchase), 1963. One of the most important changes in the 1999 amendment was the introduction of the sales tax (enforced with effect from Jan. 1, 2000).

[570] Income Tax Ordinance, s. 91(c); Taxation of Land Law (Appreciation and Purchase), 1963, s. 48A.

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"Real Gain" Accrued:	Tax Rate — Individuals	Tax Rate — Companies
Before Nov. 7, 2001 (determining date)	Marginal rate (up to 48%)	25%
Nov. 7, 2001 – Dec. 31, 2011	20%/25%	25%
As of Jan. 1, 2012	25%/30%	25%

The "real gain" accrued during the period between January 1, 2003, and December 31, 2011, is taxed at the rate of 20% for an individual and at the company tax rate for companies (not including shares sold by a substantial shareholder (holding at least 10%) that are taxed at 25%). A "real gain" accrued as of January 1, 2012, is taxed at the rate of 25% (while shares sold by a substantial shareholder are taxed at 30%). The same rule applies for "real appreciation" ("real gain" accrued on real property), except for the determining date.

With respect to the disposition of assets purchased prior to the determining date, the tax rate will be a weighted average between the three tax rates (48%, 20%/25% and 25%/30%) in accordance with the ratio of the holding periods of the asset in each period.

However, a provisional provision in effect from November 15, 2010, until December 31, 2012, provided that an individual would be taxed at the rate of 20% on the "real gain" on the following conditions: (i) the real property was purchased between April 1, 1961, and November 6, 2001, and sold between November 15, 2010, and December 31, 2011; (ii) there is a plan (according to the Planning and Building Law, 1965) to build at least eight apartments on the land; and (iii) within 36 months from the date of the sale, the building of eight apartments or 80% of the apartments designated for residence were completed.[571] With respect to these assets, the tax rate was a weighted average between the former tax rate and the newer tax rate in accordance with the ratio of the holding periods of the asset prior to and after December 31, 2002. However, where the asset disposed of was real estate, and the sale took place between November 7, 2001, and December 31, 2002, a 20% reduction of the tax was granted, and where the sale took place in 2003 a reduction of 10% was granted. These reductions were also granted on the disposition of real estate purchased between November 7, 2001, and December 31, 2002 (a reduction of 20%, i.e., a tax rate of 20%), and on a disposition of real estate purchased during 2003 (a reduction of 10%, i.e., a tax rate of 22.5%).

The real gain derived by an individual from the sale of shares and securities on the Tel-Aviv Stock Exchange is subject to a 25% tax, provided the seller is not a substantial shareholder (i.e., a shareholder who holds at least 10% of the stock and is consequently subject to a 30% tax). However, corporations are subject to the company tax rate on the realized gain.

Under a special Order of the Minister of Finance, nonresidents are exempt from tax on the "inflationary amount" where the "inflationary amount" is calculated based on the foreign currency used to purchase shares of a company.[572]

(2) Transfers of Shares and Liquidations

Before 2003, special provisions of the Income Tax Ordinance provided that, on the sale of the shares of a company, the undistributed profits, as defined by the Ordinance, were to be taxable at the 10% rate, as part of the "inflationary amount."[573] This provision was designed to equalize the treatment of current dividends and liquidation dividends, and the use of the term "inflationary amount" was of a technical nature, due to the former 10% tax rate levied on the "inflationary amount" (now zero), and had nothing to do with inflation. In most instances, taxpayers found it worthwhile to realize the gain before a liquidation process was initiated and thereby create a surplus that constituted part of the "inflationary amount." These provisions also applied in the case of the liquidation of a company.[574] The Ordinance also provided that tax on the sale of capital assets during the process of liquidation was to be credited against the tax due from the shareholder on the net liquidation dividend, thus granting undue double relief for the underlying company tax.

Nevertheless, the Supreme Court nullified this double relief in a ruling. In *Mano*,[575] the Supreme Court ruled that one of the important principles of tax law is the assessment of taxes on the real income of the taxpayer. Double tax relief infringes this principle, and was consequently held inapplicable by means of purposive construction of the Ordinance.

With the introduction of the reform of 2003, the part of the real gain equal to the earnings surplus was no longer regarded as an inflationary amount. In accordance with the new provisions, that part of the real gain equal to the surplus will usually be taxable at the rate of 25%/30%. The two exceptions to this rule are that: (i) where the shares sold were purchased prior to December 31, 2002, that part of the surplus attributable to the period ending on December 31, 2002, will be liable to a tax levied at the rate of 10%; and (ii) where the distribution of the dividend to the selling corporate shareholder would not have been liable to tax, the amount of the real gain equal to the surplus will be exempt from tax to equalize its treatment with that of the exemption accorded to intercompany dividends (see c., below, regarding intercompany dividends).

As of January 1, 2006, shareholders are no longer able to claim the tax credit for the tax paid by the company on liquidation; and all gains accrued by the company during the liquidation process are considered regular profits, so that corporate shareholders pay no additional tax on them ("earnings surplus"). As for individual shareholders, the "earnings surplus" provision was cancelled regarding shares purchased after January 1, 2003; in any event the rate of tax on dividends and capital gains is identical.

[571] Taxation of Land (Increasing the Supply of Residential Apartments — Provisional Provision) Law, 2011, s. 5.

[572] Order — Re Exemption from Capital Gains Tax on Inflationary Excess upon the Sale of Shares of Nonresident, 1978, s. 1.

[573] Income Tax Ordinance, s. 94B.

[574] Income Tax Ordinance, s. 94B(b).

[575] C.A. 1194/03 *The Assessing Officer of Haifa v. Esther Mano*, Missim KD/3 (June 2010), E-257.

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(3) Bonus Shares

Bonus shares are treated in the same way as "the principal shares" on which they are issued.[576] A bonus share is deemed to have been acquired on the day on which the principal share was acquired,[577] so that the cost of an individual bonus share or principal share is always the amount bearing to the cost price of the aggregate of the bonus shares and principal shares the same proportion as the nominal value of the individual share bears to the nominal value of the aggregate of those shares.[578]

(4) Incorporation Rollover

Under section 104 of the Income Tax Ordinance, a deferral of tax in the form of a "rollover" is granted for assets transferred to a new company in return for at least 90% of its shares, provided certain requirements regarding continuity of interest for a two-year period are met.[579] The court has held that section 95(a) (the predecessor of section 104) was enacted to prevent the taxation of a transfer of property to a company for most of its shares because such a transfer does not economically affect the ownership of the property. The wording of section 95(a) required that "immediately after the sale" the transferor held 90% of the share capital of the transferee. The Court held that this wording should be construed narrowly, i.e., the transferor did not have to hold 90% of the voting power for any specific period of time, provided the transferor held it immediately after the sale.[580] These rules have been modified by the criteria enacted by the legislation referred to above, in force since 1994.

On the sale of any property acquired by a company in the above circumstance, or on the sale of the shares received for any such property, the basis of the property in the hands of the seller is the basis of the property transferred. The same holds true for the date of acquisition of the assets exchanged in the tax-free exchange. Thus, the exempting provisions are in essence tax-deferral provisions. Special rules permit the preservation of the deferral even where there is a transaction involving a decrease in the holdings of the transferor during the two year period, for example, a public issue of shares or a private placement of no more than 25% of the company's shares.

(5) Corporate Reorganizations

Since 1994, the tax treatment of corporate reorganizations has been consolidated in part E2 of the Income Tax Ordinance. Part E2 was amended in 2000 to achieve greater uniformity of the Ordinance with the Companies Law, 1999. In addition to the provisions of section 104 regarding the incorporation rollover, discussed in (4), above, sections 103 and 105 of the Ordinance allow for tax-free mergers, consolidations and spin-offs, provided certain conditions are met. Such reorganizations are exempted from tax under the Income Tax Ordinance, the Income Tax (Adjustments for Inflation) Law, 1985, and the Taxation of Land (Appreciation and Purchase) Law, 1963,[581] as well as from VAT and stamp duties on the transactions and documents related to the reorganization process. The assets transferred under these provisions preserve their basis and date of original acquisition, and hence the "exemption" is actually a deferral of tax until the assets are realized by the transferee.

Most of the conditions that must be satisfied to qualify for a tax-exempt merger[582] or spin-off are similar:

(i) The reorganization plan requires the prior consent of the Income Tax Commissioner.[583]

(ii) The participating companies may be Israeli resident companies or cooperative societies, or "foreign companies" under the Companies Ordinance or the Companies Law, 1999 (see III.A.4., above). The participation of foreign companies is subject to the approval of the Commissioner.[584]

(iii) The reorganization must be based on valid economic and business reasons, with tax avoidance not being the predominant aim.[585] To that effect, the corporations resulting from the reorganization are required to continue the "main economic activity" of the original companies for a specified period (the "required period").[586] In the case of a spin-off, only one of the new companies is required to continue the original activities, but the others are all required to conduct independent business activities.

(iv) The majority of the assets transferred as part of the reorganization may not be disposed of during the required period and should be used in the transferee's business. For that purpose, "the majority of the assets" means assets with a value of at least 50% of the market value of the company prior to the merger or spin-off.[587]

(v) The ownership structure after the reorganization should reflect the preservation of economic interests. In a merger, the transferor's shareholders should be allotted shares in the transferee reflecting the ratio of the market value of the transferred assets to the market value of the total assets involved in the merger.

The shares allotted should constitute the sole consideration (directly or indirectly), i.e., no "boot" is allowed.[588]

[576] I.T.A. 935/70 *Kenes v. The Assessing Officer (Large Enterprises)*, 6 P.D.A. 8.

[577] Income Tax Ordinance, s. 94(a)(1).

[578] Income Tax Ordinance, s. 94(a)(2).

[579] The rollover relief does not cover the transfer of assets by a partnership or by individual partners (Income Tax Ordinance, s. 104A(b)), unless the requirements of s. 104B(d) are met.

[580] C.A. 83/81 T.M.B. *Tachzukat Mifalim Ltd. v. The Assessing Officer*, 40 P.D. 402.

[581] In some cases, the sale of real estate on a corporate reorganization will be subject to a reduced purchase tax rate of 0.5%.

[582] The 2000 amendment enables the merging companies to merge again within a short time (a chain of mergers) without jeopardizing the tax rights under this section.

[583] Income Tax Ordinance, s. 103I(a).

[584] Income Tax Ordinance, s. 103C(7) (mergers), and s. 105C(5) (splits).

[585] Income Tax Ordinance, ss. 103C(1) and 105 C(1).

[586] Income Tax Ordinance, s. 105 C(3); the required period is the longer of the following periods: (i) the period up to two years after the reorganization; or (ii) the period up to the end of one year following the end of the tax year in which the court reorganization decree was rendered, or in which the reorganization was approved by the court. Income Tax Ordinance, s. 103C(3).

[587] Income Tax Ordinance, s. 105 C(2).

[588] Cash consideration is allowed only if there is a court order for the acquisition of the shares of any minority shareholders dissenting to the merger: Income Tax Ordinance, s. 103D.

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Furthermore, after the merger, the shareholders participating in the merger must together hold at least 25%[589] of the rights in the merged company.[590] To alleviate the strictness of the requirements under the Ordinance, under a 2000 amendment, the shareholders may dispose of the shares received on a merger after one year, provided they dispose of all the shares and receive cash in return, and the purchaser is deemed to be a shareholder as of the date of the merger.[591]

(vi) Certain market value limitations are imposed prior to a merger. Thus, the market value of any party may not exceed nine times the market value of any other party.[592] Moreover, the value of the rights received by the transferor's shareholders must equal at least 10% of the total market value of the rights in the transferee during the required period.[593] This requirement is relaxed for companies among which "special relations" exist, i.e., a parent and subsidiaries, or companies under common control.[594] In a spin-off, the market value of any company after the spin-off may not exceed four times the market value of any other company involved in the spin-off. Furthermore, the market value of the assets transferred to each transferee and the assets remaining in the ownership of the transferor (if any) must be no less than 10% of the total market value of the assets prior to the spin-off.

(vii) Net operating losses accrued before the reorganization may be transferred and set-off against future profits; however, for a period of five years after the reorganization, the amount set off may not exceed 20% of the total amount of losses transferred or 50% of any transferee's taxable income, whichever is lower.

(viii) In a spin-off, the liabilities of the transferor are split between the transferees proportionally to the market value of the assets transferred to them, whereas accrued losses are split proportionally to each transferee's equity.

(ix) Benefits granted under the Law for the Encouragement of Capital Investments, 1959 (see XVII.A., below) may be carried over to the transferees after the reorganization. Such a carryover of benefits requires the approval of the Investment Center.[595]

(6) Unlinked Loans Transferred with Shares

Where an unlinked non-interest bearing loan is made to a company by a shareholder and is transferred three years after its making, together with shares or other rights in the company, the consideration for the loan is deemed to be part of the consideration for the shares, to the extent of the adjusted basis of the loan. Where, on the sale of the shares, a capital loss arises as a result of this calculation, it is set off, shekel for shekel, against the capital gain from the loan.[596] In essence, the Income Tax Ordinance recognizes that the financing of small companies is usually effected by shareholders' loans that in effect are similar to share capital invested in the company. Therefore, the Ordinance requires that the provisions applicable to the treatment of a loan as share capital apply only where the loan is unlinked and bears no interest. In the event that a loan is linked, the linkage differentials are allowed as a deduction to the company and constitute taxable income in the hands of the shareholder,[597] unless they are exempt under special regulations.[598]

(7) Exchanges of Depreciable Assets

Section 96 of the Income Tax Ordinance provides for a deferral of tax on the exchange of a depreciable asset used for the production of income for another, similar asset.[599] Where a capital gain arises from the sale of depreciable property and, within 12 months after or four months before the day of the sale, the taxpayer acquired other property to replace the sold property at a price exceeding the balance of the adjusted basis of the property sold, the taxpayer may require that only the amount by which the consideration received for the sold property exceeds the price of the acquired property be regarded as a capital gain. The taxpayer may do so with respect to the whole capital gain or only with respect to the "real gain." Pursuant to such an election of the taxpayer, the tax deferred on the sale of the property sold will be collected on the sale of the new property unless the taxpayer again chooses the section 96 route. Depreciation will be calculated on the basis of the cost of the new asset reduced by the amount of the capital gain on which the tax was deferred. It should be noted that the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for The Years 2013 and 2014), 2013 stipulated that section 96 does not apply with respect to rights in real property located outside of Israel, certain private vehicles, and property sold in a notional sale under section 100A1 of the Income Tax Ordinance.[600]

[589] A draft bill published in November 2024 suggests amending the Income Tax Ordinance proposed to abolish the 25% holding requirement following corporate restructuring under various sections of the Ordinance.

[590] Income Tax Ordinance, s. 103C(8).

[591] Income Tax Ordinance, s. 103C(9A).

[592] Income Tax Ordinance, s. 103C(6)(b).

[593] Income Tax Ordinance, s. 103C(6)(a).

[594] Income Tax Regulations (Merger of Companies Among Which Special Relations Exist), 1995.

[595] Law for the Encouragement of Capital Investments, 1959 s. 74B.

[596] Income Tax Ordinance, s. 94A.

[597] Income Tax Ordinance, s. 17(1), as regards the company; Income Tax Ordinance, s. 2(4), as regards the shareholder.

[598] Income Tax (Exemption from Tax of Linkage Differentials on a Loan Advanced by a Controlling Shareholder) Regulations, 1986; and as of Jan. 1, 1998, Income Tax (Exemption from Tax of Linkage Differentials Resulting From a Positive Balance of a Controlling Shareholder) Regulations, 1998.

[599] Income Tax Ordinance, s. 96 applies only if the exchanged asset is a depreciable asset: C.A. 130/81 *The Assessing Officer v. Ashkenazi*, 12 P.D.A. 229; I.T.A. 8/84 *Aharon Joseph v. The Assessing Officer*, 14 P.D.A. 3. The similar asset that was acquired does not have to be a depreciable asset, although it must be an "asset": *The Assessing Officer v. Ashkenazi*, 12 P.D.A. 229. It was held that the exchanged asset must replace the sold asset: I.T.A. 6, 7/77 *Baumel v. The Assessing Officer*, 9 P.D.A. 149, but, in more recent years, cases have taken a more liberal approach from the taxpayer's point of view and the deferral of tax will be allowed if the exchanged asset may serve to perform an alternative to one of the functions of the asset disposed of. *See* I.T.A. 193/89 *Cherni v. Assessing Officer Acre*, Missim E-3 (June 1991), E-85; C.A. 499/87 *Einhorn v. Assessing Officer Jerusalem*, Missim D-1 (Feb. 1990), E-106; and I.T.A. 185/90 *Moaza Mekomit Yahud v. Assessing Officer Petach Tikva*, Missim G-1 (Feb. 1993), E-127.

[600] *See also* I.T.A *Amot Hashkaot Ltd. v. The Assessing Officer for Large Enterprises*, Missim KG/6 (Dec. 2013), E-227.

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(8) Conversions to Inventory

Special provisions apply to the conversion of property into inventory. Where the Assessing Officer is satisfied that a person has converted any property owned by that person into inventory or has converted any fixed asset in his/her business into inventory in his/her business, the tax levied depends on the time that has elapsed from the date on which the taxpayer acquired the property. Where four years have elapsed from the date on which the taxpayer acquired the property to the date of the transfer, the transfer is regarded as a sale, but the taxpayer is not required to pay the tax on it except where the inventory is sold in whole or in part. If the taxpayer sells a part of it, the taxpayer is not required to pay tax in excess of the consideration received by him on that sale.[601] Where four years have not elapsed, the transfer is not regarded as a sale and the original basis of the property is the cost of the inventory.[602]

(9) Publicly Traded Securities

Until the tax reform introduced in 2003, capital gains derived from the sale of securities traded on the Tel-Aviv Stock Exchange (TASE) were free of capital gains tax. This exemption served as an incentive to induce companies to register their shares for trade on the TASE and thereby grant their shareholders an opportunity to derive tax-free income.

As of 2003 and until the end of 2005, real capital gains derived from the disposition of shares traded on the TASE were taxed at a reduced rate of 15%. A 10% tax was levied on the nominal gain derived from the sale of unlinked notes, bonds and similar securities traded on the TASE.

With effect from January 1, 2006, these rates have changed to 20% and 15%, respectively, regarding individual shareholders who are not substantial shareholders (who are subject to tax at the rate of 20% or 25%), whereas the applicable tax rate for companies is 23%. Regarding the tax regime prior to January 1, 2006, a taxpayer wishing to enjoy the reduced rates was not entitled to deduct interest and linkage differentials incurred in the production of the income derived from the securities sold and had to be outside the scope of the law regulating taxation under inflationary conditions. It is worthwhile noting that the tax on capital gains derived from the sale of securities traded on the TASE applies only to gains derived after January 1, 2003, and that the computation is done on a linear basis (see b.(1), above).

To induce foreign investors to invest in securities traded on the TASE, section 97(B2) of the Income Tax Ordinance grants a tax exemption to nonresidents on capital gains derived from the sale of securities traded on the TASE.[603] In addition, section 97(B3) of the Ordinance, enacted as part of Amendment No. 147, provided for a tax exemption for residents of Israel's treaty partner countries on the sale of securities otherwise taxed by Israel, provided the securities were purchased between July 1, 2005, and December 31, 2008.

Amendment No. 169,[604] effective as of January 1, 2009, aims to encourage foreign investors to continue investing in Israel. The Amendment elaborates and simplifies the tax exemptions for foreign residents. The main benefits include: (i) an exemption for foreign residents on interest income, discount fees and exchange differentials derived from corporate bonds on the TASE (the exemption applies to any foreign resident on the day of payment even if the bonds were acquired prior to January 2009); and (ii) a capital gains exemption on the sale of Israeli securities acquired after January 1, 2009 (as noted above, prior to the amendment only treaty country residents who met certain conditions were exempt from capital gains on the sale of non-traded Israeli securities).

In the past, capital gains derived from the sale of securities traded on the TASE (and in some cases on a stock market abroad) were accorded preferential tax treatment. To counter tax avoidance by means of registering shares for trade on the stock market, the provisions of section 101 of the Income Tax Ordinance were enacted. Under these provisions, the registration of shares on the stock exchange was regarded as the sale of the shares on the date of their registration. However, when filing a first return after the registration, the holder of the shares had the right to request that the registration not be regarded as a sale.[605] If the holder made such a request, the exemption from capital gains tax on the sale of the shares did not apply on the sale of the shares and the holder was taxed accordingly. Moreover, the holder of the shares has the right to withdraw the request at the time of the actual sale and pay the tax that would have been due had the registration been regarded as a sale, together with linkage differentials and such interest as is imposed by the Income Tax Ordinance on all late payments.[606]

Section 101 of the Income Tax Ordinance dealt with a notional sale, and did not provide for the computation of the consideration, which is essential for the computation of the capital gain. The Court held that the notional consideration was the amount that would have been paid by a voluntary buyer had there been an actual sale.[607] Such consideration is a matter of assessment. Where it was determined in trading on the stock exchange on the day of the registration of the shares, such a determination governed. Otherwise an assessment based on the closest transaction to the registration, whether prior to or immediately after it, was made.

In 1984, the Minister of Finance issued a special order designed primarily to prevent the avoidance of the tax imposed by section 101 of the Income Tax Ordinance by the use of options and warrants.[608] With the amendment of section 101 in 2002, this order was annulled and section 101 then covered the entire spectrum of the taxation of notional income on the registration of securities for trading on a stock exchange.

A District Court decision held that section 101 applied only to registration on the TASE,[609] since the definition of a "stock

[601] Income Tax Ordinance, s. 100(1).

[602] Income Tax Ordinance, s. 100(2); C.A. 358/87 *VAT Director v. Akala*, Missim D-1 (Feb. 1990), E-98.

[603] Income Tax Ordinance, s. 105L(c).

[604] Income Tax Ordinance (Amendment 169), 2008.

[605] *See also* I.T.A. 178/97 *Rosenboim v. The Assessing Officer Tel-Aviv 4*, Missim N-3 (June 2000), E-98.

[606] Income Tax Ordinance, s. 159A.

[607] C.A. 111/87 *Rubinstein Ltd. v. The Assessing Officer (Large Enterprises)*, Missim I-3 (June 1995), E-56.

[608] Income Tax (Exemption from Tax on Capital Gain from the Sale of Shares) Order, 1981, as amended in 1984, which was designed to close the loophole left by Income Tax Ordinance, s. 101.

[609] I.T.A. 48/94 *Levin v. Assessing Officer Tel-Aviv*, Missim J-6 (Dec. 1996), E-122.

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exchange" in section 1 of the Income Tax Ordinance referred to stock-exchanges of only two sorts: those that received a permit under the Securities Law, 1968 (currently only the TASE), and those designated by the Minister of Finance for that purpose, who had not at that time made such a designation. As explained hereinafter this decision was upset by the reform of 2003.

Within the framework of the reform introduced in 2003, the provisions of section 101 of the Income Tax Ordinance required amendment so as to reflect the fact that the reform introduced a reduced tax on capital gains derived from the sale of securities traded on the TASE. Therefore, the Ordinance differentiates between securities registered for trade prior to 2003, and those registered thereafter. With respect to securities registered for trade prior to 2003, on which the tax was paid on their registration for trade, the capital gain on their sale will go untaxed until January 1, 2003, and the remainder of the real gain will be liable to the reduced tax rate. Securities registered for trade after January 1, 2003, with respect to which the taxpayer requested the deferral of tax until their actual sale and did not withdraw his/her request, will on their sale be taxed at the regular company tax rate and the remainder of the gain will be taxed according to the applicable tax rates depending on the shareholder and on the date of sale. Where the taxpayer withdrew his/her request to defer the tax, the real gain up to the registration will be subject to tax at the regular company tax rate with interest and linkage differentials, the inflationary amount will be subject to tax at a rate of 10% up to December 31, 1993, and the remainder of the gain up to January 1, 2003, will be exempt from tax; however, with effect from 2003 and thereafter, any gain will be taxed at the applicable rate for the real capital gain depending on the shareholder and on the date of sale. Securities registered for trade after 2003, with respect to which no request for a deferral of tax was made, will be liable to tax until 2003, at the regular company tax rate on the real gain (10% on the inflationary amount until December 31, 1993) and the remainder of the gain from 2003 and until the registration will be liable to tax on the real gain according to the applicable tax rates depending on the shareholder and on the date of sale. The gain derived after registration will be liable to a reduced tax on the real capital gain. Should the taxpayer request the deferral of the tax until the actual sale and not withdraw his/her request, the gain up to January 1, 2003, will be taxed at the regular company tax rate on the real gain (10% of the inflationary amount until December 31, 1993) and the remainder, until the date of the sale, will be liable to tax on the real gain according to the applicable tax rates depending on the shareholder and on the date of sale. Should the taxpayer decide to withdraw his/her request to defer the tax event, that part of the capital gain derived up to 2003, will be liable to the regular company tax rate on the real gain and 10% on the inflationary amount up to December 31, 1993, to which will be added interest and linkage differentials. The remainder of the gain arising from 2003 up to the date of registration will be liable to tax according to the applicable tax rates depending on the shareholder and on the date of sale, to which will be added interest and linkage differentials. The last part of the gain derived after 2003 up to the actual sale will be liable to the reduced tax rate on the real gain.

To bring its provisions into line with the tax reform introduced in 2003, section 101 of the Income Tax Ordinance now provides that it will also apply to stock exchanges outside Israel insofar as its provisions pertain to companies that are residents of Israel for tax purposes. The debate as to whether section 101 of the Income Tax Ordinance applied only to the TASE or to other stock exchanges as well has therefore been brought to an end. It will also apply to shareholders of nonresident companies registering their shares on the TASE.

As implied above, with the abolition of the preferred tax regime governing capital gains derived from the sale of securities traded on the stock exchange (with effect from January 1, 2006), section 101 of the Income Tax Ordinance no longer applies, except as described above.

(10) Sales of Foreign Securities

An Israeli resident corporation is liable to tax on its worldwide income, including capital gains derived from the sale of assets outside Israel (see (1), above). To encourage investment in Israeli securities, the 2003 tax reform safeguarded a special tax of 35% on the real capital gain levied on transactions in foreign securities. This rate was in effect until 2004. A "real capital gain" accrued after 2004 was taxed at the rate of 15% in the case of sales that took place before January 1, 2006, and is taxed at 20%, in the case of sales taking place after that date, provided the seller is not a substantial shareholder subject to a 25% tax. Capital gains derived from the sale of foreign securities purchased prior to 2005 but sold thereafter, are taxed in accordance with the ratio of the holding period ending on December 31, 2004, to the period commencing on that date and ending on the date of sale, so that on a linear basis the tax on the gain derived from the first holding period will be 35% while the tax on the remaining period will be levied at the prevailing rate. The tax is computed in all cases on the gain expressed in the currency used to purchase and sell the foreign security. A foreign security includes any foreign security that is traded on a stock exchange or on a regulated market outside Israel, other than those of Israeli resident corporations and securities publicly traded both in Israel and abroad. Capital gains derived from the sale of foreign securities of non-traded corporations will be liable to tax at the ordinary rates, i.e., the standard corporate tax rate on the real gain up until 2003 and thereafter 25%, with the inflationary amount up to the close of 1993 being taxed at 10%.

(11) "Departure" Tax

Section 100A of the Income Tax Ordinance provides that an asset (not including Israeli real estate) owned by an Israeli resident (be it a company or an individual) that ceased to be an Israeli resident, is deemed to be sold on the day preceding the day on which the taxpayer lost his or her tax residence status. However, such a taxpayer may choose to defer the payment of the tax until the actual disposal of the asset.

In a decision handed down in November 2019, the Supreme Court of Israel[610] upheld a district court ruling that an exit tax applicable to the assets of a resident of Israel who moves to another country applies to assets situated both inside Israel and outside Israel. The tax calculation will be based on the increase in value of the assets up to one day before the end

[610] C.A 5694/18, *David Koenig. v. Assessing Officer Tel Aviv 3*, Missim (Nov. 2019).

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of the taxpayer's residency. Should the taxpayer refrain from paying the tax on that date, he or she will be deemed to have requested deferral of the tax payment to the date on which the asset is realized and, if there is a tax treaty between Israel and the country to which the taxpayer moves, its provisions will not apply to deny Israel taxing rights.

However, in cases where the exit tax results in double taxation (i.e., in Israel and the country to which the taxpayer moves), the tax authorities of both countries will resolve the question of dual taxation by mutual consent procedures. ("Mutual Agreement Procedures").

Example: The original price of a property is NIS 100; the property was held for three years and sold for NIS 700 (assuming inflation is zero). The seller became a foreign resident two years before he sold the property and did not pay the tax in Israel on that date. In this example, "the portion of the taxable profit" is NIS 200: the real capital gain is multiplied by one-third (i.e., the holding period from the date of purchase until the date the seller became a foreign resident, divided by the period from the date of purchase to the date of realization).

(12) Capital Losses

Capital losses are set off against capital gains under section 92 of the Income Tax Ordinance.[611] Since a capital gain is divided into the "real gain" and the "inflationary amount," a special method had to be found to allow for an equitable set-off of capital losses. The Ordinance therefore provides that a capital loss is first set off against the "real gain" and each shekel of the balance is set off against three and a half shekels of the "inflationary amount." For purposes of the set-off, a gain or a loss within the meaning of the Taxation of Land (Appreciation and Purchase) Law, 1963 is deemed to be included in the capital gain or capital loss, as the case may be. Where an amount is not set off in whole or in part as provided above, the procedure outlined above is followed for the next succeeding tax years; however, the taxpayer is obliged to set off the loss in the first year in which such set-off is possible. Furthermore, a capital loss derived from the sale of a security may be set off in the year of the sale against interest or dividends derived from that security, or against interest or dividend income from other securities, provided the income from dividends or interest is subject to a tax rate that does not exceed 25%. Since the Income Tax (Inflationary Adjustments) Law is no longer in effect as of January 1, 2008, losses are no longer adjusted to the cost-of-living index. Capital losses sourced outside Israel must be first set off against capital gains sourced outside Israel; only thereafter may they be applied against capital gains derived from Israel.

(13) Land Appreciation and Purchases

For a discussion of the Taxation of Land (Appreciation and Purchase) Law, 1963, see IV.C., above.

(14) Cryptocurrencies and Other Digital Assets

Cryptocurrencies are digital assets that rely on a consensus mechanism for validation. The mechanism involves a network of individual computers working together to verify and record transactions, creating a shared and verifiable ledger known as the Blockchain. The participants responsible for validating transactions are referred to as "miners."

Crypto miners play a crucial role in maintaining the integrity of cryptocurrency network. They use their computational power to solve complex mathematical problems and validate transactions. When a transaction is initiated, it is broadcasted to the network, and miners compete to validate and add the transaction to a new block on the blockchain. This process ensures the validity of a transactional, prevents double-spending, i.e., spending a digital token more than once, and secures the integrity of the ledger.

In cryptocurrency exchanges, the transferer and transferee rely on the blockchain to verify availability of funds before and during a transaction. This design makes it highly unlikely for manipulation and fraud to occur. There is a small fee that is bestowed upon the transferer to compensate the miners.

What sets different cryptocurrencies apart is their distinct organizational structures and underlying blockchain technologies. Each cryptocurrency operates on its own blockchain, which determines how transactions are verified and recorded. Today there are thousands of currencies with only a few specifically popular ones.

The Israeli Tax Authority (ITA) classified cryptocurrency as a tradeable asset and not as a currency.[612] Accordingly, all profits and losses associated with cryptocurrencies are regarded as of capital nature. The District Court in *Noam Kopel v. Assessing Officer* Rehovot,[613] stated that cryptocurrencies are capital assets that give rise to capital gains, and not foreign currencies that are exempt from tax according to section 9(13) of the Income Tax Ordinance. As stated in the definitions in the Bank of Israel Law,[614] in order for a currency to be considered as "banknotes or coins" it must have a physical-tangible expression. Cryptocurrencies do not have a physical aspect, and therefore do not meet the definition prescribed by law. As the court stated, cryptocurrencies are not considered a real substitute for coins or banknotes in any country.

Capital gains are taxed at 25%[615] and taxpayers are required to provide records when filling their tax returns in order to support their claims of gains or losses.

Income from cryptocurrency can also be classified as business income. For example, if the income of an individual taxpayer that is derived from cryptocurrency is the main income, and the taxpayer is intensively involved in mining or trading cryptocurrencies. In this case, the income from digital assets will be considered as business income, and the tax will be calculated according to the personal income tax brackets, which can get up to a 50% tax rate. If a corporation is using cryp-

[611] A capital loss may not be set off against current income: I.T.A. 258/72 *Rotberg v. The Assessing Officer*, 6 P.D.A. 159. Furthermore, the Income Tax Ordinance allows the set off only of losses that, had they been profits, would have been subject to capital gains tax. Therefore, a loss incurred on the sale of personal assets that were exempt from tax, may not be set off against capital gains: C.A. 14/85 *The Assessing Officer v. Goldstein*, 15 P.D.A. 59.

[612] Income Tax Circular 05/2018.

[613] T.A. (Merkaz) 11503-05-16 *Kopel v. Assessing Officer Rehovot* (Published on Nevo, 2019).

[614] Bank of Israel Law, 2010.

[615] Income Tax Ordinance, s. 91(b)(1).

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tocurrencies for business purpose, the applicable tax rate will be 23%, and in addition, VAT will apply at the rate of 18%.

On November 2024, a memorandum was published proposing amendments to the Income Tax Ordinance that focus on the taxation of digital currencies and assets. The proposed amendment introduces new definitions of "Foreign Currency," "Distributed Ledger Technology" (DLT) and "Digital Asset." The proposed changes make it clear that profits from the sale of digital currencies will no longer be considered tax-exempt income under Section 9(13), even if the currency is legal tender in a foreign country if it was not issued by an official monetary authority. Additionally, the amendment proposes that the geographic source of capital gains from the sale of Digital Assets will be considered to be in Israel in certain circumstances, for example, when the seller is an Israeli resident or when the Digital Asset reflects rights related to assets in Israel. The purpose of the amendment is to ensure the effective taxation of profits from Digital Assets with a connection to Israel.

In addition, on November 2024 the Minister of Finance informed the OECD of Israel's commitment to implementing the Crypto Asset Reporting Framework (CARF), which establishes a regulatory framework for information exchange in the digital currency sector.

The CARF project was introduced following a request from G20 leaders in October 2022 to develop a comprehensive, transparent and effective information exchange system for the digital currency sector. The project is spearheaded by the Global Forum under the OECD, with the aim of enhancing transparency and facilitating tax-related information exchanges.

c. Dividend Income

The ordinary income tax was imposed in addition to the corporate tax, but it was abolished as of tax year 1992 and only the corporate tax is now in effect.[616]

Dividends received from another corporation are free of tax in the hands of the recipient if the income out of which the dividend was distributed is sourced in Israel. Thus, if the distributing corporation distributes its entire Israeli-sourced income, consisting of dividends received from another company, the dividends received by the distributing corporation are not subject to tax in its hands.[617] It is taxed (corporate tax) when derived as income by the payor and is taxed again (income tax) when received by the ultimate, non-corporate shareholder.[618] The Income Tax Ordinance takes into consideration the fact that the income out of which the dividend was paid has already been subject to corporate tax. It therefore sets the rate of tax on dividends received by individuals at 30% for substantial shareholders and at 25% for other shareholders.[619] In *Oz Technologies (1972) Ltd. v. Large Enterprises Tax Assessor,* the Tel Aviv District Court held that the provisions of Section 126(b) of the Income Tax Ordinance may be applied to dividends distributed out of funds that represent depreciation amounts claimed by the company solely for tax purposes and that were not recorded as an expense in the company's financial statements as a result of the adoption of the fair value model.[620]

Until the 2003 tax reform, any dividend distributed by an Israeli resident corporation to another Israeli resident corporation was exempt from company tax. Within the framework of the 2003 tax reform, the exemption was curtailed in that it now applies only to dividends distributed out of income sourced in Israel. Dividends distributed from income sourced outside Israel, irrespective of whether the distributing corporation is a resident of Israel, are taxed, at the taxpayer's choice either: (i) at the rate of 25% of the gross dividends paid with a credit for the tax withheld at source; or (ii) at the regular corporate tax rate on the income out of which the dividends were paid with a credit for the applicable ratable tax paid by the paying corporation and for the tax withheld at source on the dividends themselves.

The 2003 amendment of the Income Tax Ordinance attempts to neutralize the beneficial effect of a number of tax treaties entered into by Israel, especially the 1973 Israel-Netherlands tax treaty. Thus, Article 26(4)(b) of that treaty provides that dividends distributed by a company resident in The Netherlands to an Israeli company owning at least 25% of its share capital, will be liable to tax in Israel as if the distributing corporation was an Israeli resident corporation. In the past, when all dividends distributed between Israeli resident corporations were free of tax, this article of the treaty accorded, as a practical matter, an exemption from the tax on dividends distributed by corporations resident in The Netherlands to Israeli resident corporation owning at least 25% of their share capital. After the amendment, since dividends attributable to income from sources outside Israel no longer qualify for the statutory dividend exemption, the treaty article has lost its tax appeal.

Under Article 20(3) of the (old) 1971 Israel-Singapore tax treaty, a dividend paid by a corporation resident in Singapore to a corporation resident in Israel owning at least 25% of its share capital was free of Israeli tax. The Treasury entered into negotiations with Singapore to amend this specific article, and it was indeed amended in the (new) 2005 Israel-Singapore tax treaty. Although the effective date of the treaty is generally January 1, 2006, this provision (Article 22(3)(ii)) entered into force on January 1, 2008. The provision applies only to companies that were residents of Singapore prior to the effective date of the new treaty. Negotiations with other countries to block other escape routes will most likely follow.

Nonresident corporations are also subject to a 25% income tax on dividends (see V.C.8.a., below).

Dividends paid on foreign securities, i.e., securities traded on stock exchanges outside Israel (shares of Israeli resident corporations traded outside Israel are not included in this definition), were liable, through the close of 2004, to tax at the rate of 35% and since then, the tax on such dividends has been equal to that paid by regular Israeli companies (the choice between 25% or the regular corporate tax rate on the income from which the dividends were paid with a suitable foreign tax credit, including a credit for the underlying tax).

d. Controlled Foreign Corporations

The reform of 2003 introduced provisions regarding the taxation of controlled foreign corporations (CFCs). In accor-

[616] Income Tax Ordinance, s. 126(a).
[617] Income Tax Ordinance, s. 126(b).
[618] Income Tax Ordinance, s. 2(4).
[619] Income Tax Ordinance, s. 125B.

[620] Tax Appeal 26652-02-222 *Oz Technologies (1972) Ltd. v. Large Enterprises Tax Assessor,* Tel Aviv District Court, Income 26.9.24.

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dance with these provisions, the taxable income of a CFC, as specifically defined by the Income Tax Ordinance, is ascribed to its Israeli resident shareholders as if it were a dividend distributed to them. The Ordinance lays down a set of conditions that have to be met for tax to be levied on the Israeli resident shareholders of a CFC: (i) that the foreign corporation's income must consist mainly of passive income, and that the tax rate it suffers may not exceed 15% of its taxable income (20% prior to Amendment No. 198 of the Israeli Income Tax Ordinance); that more than 50% of its "means of control" (i.e., the right to participate in a distribution of profits; the right to appoint a director; the right to liquidation proceeds; and the right to instruct another person with respect to exercising an aforesaid right, whether such rights are accorded by shares or any other means, including a trust) must be held by Israeli residents; and that its shares must be unregistered; and (ii) that the shareholder must be a controlling shareholder, i.e., a resident of Israel holding directly or indirectly, at least 10% of the means of control of the corporation. Where these two conditions are met, the controlling shareholders are deemed to have received a dividend in the amount that they would have received had such a dividend been declared and distributed by the company.

The Reform of 2008 prescribes that, for purpose of the definition of a CFC, the rights of new immigrants and Veteran Returning Residents will not be taken into account as rights of residents for a period of 10 years from their assumption of residence.

The CFC provisions were necessitated by the introduction of the personal basis of taxation within the framework of the tax reform of 2003. They are designed to prevent the avoidance of tax on financial income by the erection of an artificial tax barrier between the ultimate Israeli resident beneficiary of the income and the income itself, in the form of a tax haven corporation.

Section 75(B)(c) of the Income Tax Ordinance provided that, in computing the tax liability of the controlling shareholder, a foreign tax credit would be granted for the tax that would have been withheld at source by the country of residence of the CFC on the actual distribution of the dividend. This notional credit could have been used to avoid tax by the "screen saver" technique, i.e., the use of a CFC registered and resident in a country that withholds tax at the rate of 30% on its dividends, thereby annulling any Israeli tax that could be levied on the notional dividend.

The Bill with respect to the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), 2013 included certain amendments with respect to the CFC regime which were enacted later in the Law for the Amendment of the Israeli Income Tax Ordinance (No. 198), 2013 and are effective as of January 1, 2014.

Amendment No. 198 includes, inter alia, revision of the requirements for the exclusion of publicly traded companies from the CFC regime; exclusion of certain dividend income from the CFC allocable to its shareholders (i.e., certain dividends received will not be considered as passive income to the extent that the profits that produced such dividends were taxed at a rate higher than 15% and to the extent that certain minimum holding requirements are met); expansion of the definition of "passive income" to include certain securities sold by the CFC; provisions with respect to sale of CFC shares by a controlling shareholder to enable the shareholder to deduct from the consideration received certain deemed dividends that were included in his/her income; and provisions with respect to the calculation of the CFC income and profits. One of the most significant provisions promulgated in Amendment No. 198 with respect to the CFC regime is the abolishment of the "notional credit" provision. Under the pre-Amendment No. 198 CFC regime, Israeli shareholders in CFCs were able to utilize the "notional credit" to avoid tax by using the "screen saver" technique as detailed above. However, under the amended CFC provisions, the foreign tax credit will be available to shareholders in CFCs only to the extent that such tax was actually paid by the shareholder (i.e., in the year the CFC's profits were actually distributed or in the year that such tax was withheld at source).

e. Foreign Vocation Companies

The introduction of the personal basis of taxation within the framework of the tax reform of 2003 was accompanied by another anti-avoidance measure with respect to foreign income — the foreign vocation company (FVC) provisions of section 5(5) of the Income Tax Ordinance, now repealed.

These provisions were designed to prevent the avoidance of tax on foreign vocational income by the erection of an artificial tax barrier between the ultimate Israeli resident beneficiary of the income and the income itself, in the form of a foreign corporation.

Section 5(5) of the Income Tax Ordinance deemed part of the income of an FVC, to the extent of the Israeli shareholder's rights in the FVC, to be Israeli-sourced income. An FVC is defined as a closely held company within the meaning of that term in section 76(a) of the Ordinance, where: (i) 75% or more of its means of control is owned by Israeli residents; (ii) the Israeli residents holding at least 10% of the rights, who hold together at least 50% of the rights in the company, serve the company in a special vocation;[621] and (iii) most of the company's income is derived from a special vocation.

The Reform of 2008 prescribed that, for purpose of the definition of a Foreign Vocation Company, the rights of new immigrants and Veteran Returning Residents would not be taken into account as rights of residents for a period of 10 years from their assumption of residence.

It should be noted that prior to Amendment No. 198 (as detailed below), although leading to a quite similar tax result, the FVC provisions taxed the foreign company's income as Israeli-source income, whereas the CFC provisions tax a deemed dividend distributed by the foreign company to the Israeli shareholder. This difference had led a number of practitioners to contend that the FVC provisions were invalid as they were in conflict with the provisions of Israel's tax treaties.

As a result, and due to the ineffectiveness of the FVC regime, the Bill with respect to the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), 2013 provided a few amendments with respect to the FVC regime which were later enacted in the Law for the Amendment of the Israeli In-

[621] A "special vocation" is defined in Income Tax (Determining of Special Vocation) Decree, 2003.

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come Tax Ordinance (No. 198), 2013 and are in force as of January 1, 2014. The Amendment abolished the provisions of section 5(5) and promulgated section 75B1 of the Income Tax Ordinance which sets forth the provisions with respect to FVCs. The Amendment provides comprehensive modifications to the FVC regime in order to match the FVC regime with the CFC regime. According to the revised FVC regime, the foreign company's income will no longer be considered as Israeli-source income, however, section 75B1 provides that the FVC's income (generated from special vocation) attributable to its Israeli controlling shareholders shall be included in their income for Israeli tax purposes as a notional dividend subject to a tax equal to the company tax set forth in section 126(a) of the Israeli Income Tax Ordinance.

f. Stock Options

Stock options are a common form of employee remuneration in Israel. Section 102 of the Income Tax Ordinance was amended within the framework of the 2003 tax reform and provides three alternative rules on the taxation of stock options as follows:

(i) When an option is granted without the involvement of a trustee, the grant itself is not a taxable event so long as the option is not negotiable on a stock exchange; where the option is so negotiable, the employee is taxed at the ordinary rates on the value of the option at the time of its grant, the amount treated as income is allowed as a deduction to the employer, and the employee is liable for capital gains tax on exercising the option;

(ii) When an option is granted to a trustee on behalf of an employee, the employee is liable to income tax at ordinary rates applicable to employment income upon receipt of the option from the trustee, or upon its exercise, in accordance with its value, and the relevant amount may be deducted by the employer as an expense;

(iii) When an option is granted to a trustee on behalf of an employee but the employee is liable only for capital gains tax upon the receipt of the option or upon its exercise, the employer is not entitled to take any deduction on the capital gain attributed to the employee.

Employers must provide notice of plans involving trustees to the Assessing Officer.

g. Notional Income

Under section 3(i) of the Income Tax Ordinance, where a person exercises a right that the person previously received to acquire any property or service and at the time of exercise there is a difference between the price normally payable for such property or service and the price paid by that person, the difference is regarded as employment income, if the right was accorded in conjunction with an employee-employer relationship. This difference is regarded as business income under section 2(1) of the Ordinance if the right is given to a supplier, and as income under section 2(4) of the Ordinance if the right is given by a company to a controlling shareholder or a relative of a controlling shareholder. At the application of the taxpayer, the tax on the difference on the exercise of the right is calculated as if the difference were income received in equal installments over a period extending from the time of the conferring of the right until its exercise, but not exceeding six years ending within the year of exercise. In practice, the Income Tax Authorities reserve taxation under section 3(i) to options that are not dealt with by section 102 of the Ordinance (for example, options to purchase assets other than shares), such as options granted to controlling shareholders.[622]

Under section 3(i) of the Income Tax Ordinance, where a person is given, directly or indirectly, an interest-free or a low interest loan, the difference between the interest (and linkage differentials) payable on the loan and the interest rate set for this purpose by the Minister of Finance is regarded as employment income if the loan is given in conjunction with an employer-employee relationship, as business income under section 2(1) of the Ordinance, if it is given to a supplier,[623] or as income under section 2(4) of the Ordinance, if it is given to a controlling shareholder or a relative of a controlling shareholder. Case law provides that a "loan" for purposes of section 3(i) does not necessarily involve a transfer of money from a creditor to a debtor. When a person retains money due to another, with the latter's consent, such retention is tantamount to a loan.[624] Case law further provides that a loan is considered interest-free if in the same tax year no interest was charged or paid with respect to it.[625]

The regulations provide that the taxable interest difference is the difference between the interest accumulated on the balance of the principal (during a certain period) according to the specific terms of the loan and the interest that would have accumulated had its rate conformed to the increase in the consumer price index together with interest charged at 3.87%.[626]

Amendments (No. 67 and 68) to the Income Tax Ordinance added section 3(j), which provides that where a person grants an interest-free or a low-rate interest loan, the person granting the loan will incur income tax on the difference between the interest payable under the interest rate set for this purpose by the Minister of Finance and the interest (and linkage differentials) payable on the loan. With the repeal of the Income Tax (Inflationary Adjustments) Law as of January 2008, section 3(j) was amended to make the difference between the interest payable and the interest rate determined by the Minister of Finance subject to companies tax and deductible or usable to offset a loss. Section 3(j) applies only to loans that are recorded in double entry account books and to the extent provided to a related party. Section 3(j) does not apply to certain loans, debts and deposits that are specified in the definition of a "loan" and in section 3(i). Furthermore, the section does not apply to international loans, which are treated as "international transactions"

[622] In C.A. 7034/99 *Assessing Officer Kfar Sava v. Yair Dar*, Missim R-3, (June 2004), E-5, the Supreme Court held that pre-reform options for nontraded securities were taxed on exercise and that no tax liability attached to their grant.

[623] C.A. 32/86 *Rimon Bituach Vefinansim v. The Assessing Officer Tel-Aviv 20*, P.D.A. 103; C.A. 533/89 *The Assessing Officer (Large Enterprises) v. Zilberstein and Mintz*, Missim G-5 (Oct. 1993), E-62.

[624] I.T.A. 97, 98/85 *Etinger Ltd. v. The Assessing Officer*, 16 P.D.A. 227; I.T.A. 56, 57/82 *Malts Ltd. v. The Assessing Officer*, 12 P.D.A. 115; C.A. 32/86 *Rimon Bituach Vefinansim Ltd. v. The Assessing Officer*, 20 P.D.A. 103; I.T.A. 44/85 *Etsion v. The Assessing Officer*, 13 P.D.A. 313.

[625] I.T.A. 88/86 *Sharon Ltd. v. The Assessing Officer*, 16 P.D.A. 259 *as approved in* C.A. 758/88 *Sharon Ltd. v. The Assessing Officer*, Missim F-3 (June 1992), E-66.

[626] Income Tax (Setting of Interest Rate) Regulations, 1985.

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as defined in section 85A, and therefore subject to the transfer pricing regulations.

h. Other Inclusions in Gross Income

Generally, the accounting methods described above are used to measure the gross income of a corporation. Linkage differentials arising as a result of foreign exchange deposits deserve special attention. The Income Tax Authorities have interpreted the statute to require the inclusion of these differentials in gross income even when the foreign currency was not realized and case law supports this interpretation.[627] Section 8C of the Income Tax Ordinance provides that even taxpayers on a cash basis method of reporting income must include exchange rate differentials in income whether or not a realization (conversion) of the foreign currency took place. In the case of a revaluation of the Israeli currency, the linkage differentials are taxable except where specifically exempt.

i. Exclusions from Gross Income

Excluded from gross income are those items of income that are specifically exempted by statute, namely: (i) certain linkage differentials;[628] (ii) dividends (as described in c., above); (iii) exchange rate differences on a company's foreign currency deposit accruing from payments made by a foreign resident on account of its shares;[629] and (iv) exchange rate differences in the hands of a resident company accruing from the deposit of proceeds from an issue of shares until use is made of the proceeds and provided the exemption period does not exceed two years from the issue date.[630]

5. Business Expenses

a. In General

Section 17 of the Income Tax Ordinance provides that "for the purpose of ascertaining the chargeable income of any person there shall be deducted, save insofar as the deduction is limited or disallowed under section 31, all outgoings and expenses "wholly and exclusively" incurred during the tax year by such person in the production of the income… ." Section 17 adopts an approach, similar to the U.K. approach, whereby an expense is deductible only if it is incurred "wholly and exclusively" in the production of income. However, as a practical matter, where the expense was of a mixed nature, the Assessing Officer would allow an allocation so that the part allocable to the production of income would indeed be recognized as a business expense.

After the Supreme Court ruled that childcare expenses were compatible with the rule of section 17 and hence deductible,[631] the Court held that, in case of a mixed expense, the income-producing portion is deductible.

Amendment No. 170 to the Ordinance amended section 32(1) to deny the deduction of expenses that are not "bound and integrated" in the production of income. The section defines an "expense bound and integrated in the production of income" as an expense that is integrated with the natural process of deriving income and with the natural structure of the source of the income, so as to constitute an inseparable part of the income-producing process.

While section 17 enumerates a number of important expenses, this enumeration does not preclude the deduction of other expenses.[632] The enumerated expenses include interest and linkage differentials,[633] rent, repairs,[634] bad debts,[635] a portion of sums paid by an employer to a provident fund, and expenses incurred to prevent soil erosion and other disasters, as well as expenditures incurred with respect to air raid precautions,[636] depreciation, and expenses incurred in connection with the preparation of returns and the handling of tax matters in any assessment or appeal proceedings.

The statutory scheme relevant to the deduction of business expenses is embodied in a number of provisions of the Income Tax Ordinance. While section 17 allows for the deduction of all expenses and costs incurred "wholly and exclusively" in the production of income, its rule is subject to the provisions of section 31, which empowers the Minister of Finance, with the

[627] C.A. 510/80 *Assessing Officer Jerusalem v. Dfus Mercaz Ltd.*, 36(4) P.D. 589.

[628] Income Tax Ordinance, s. 9(13A).

[629] Income Tax Ordinance, s. 9(14B).

[630] Income Tax (Exemption from Tax of Exchange rate differences of an Israeli company which sells shares on a Foreign Stock Exchange) Regulations, 1981.

[631] C.A. 4243/08 *Vered Peri v. The Assessing Officer (Gush Dan)*, Missim X-3, E-90.

[632] C.A. 475/68 *Rehov Pinsker 42 Ltd. v. The Assessing Officer*, 2 P.D.A. 98; I.T.A. 234/88 *Merkaz Ramir Ltd. v. Assessing Officer (Large Enterprises)*, 19 P.D.A. 156; C.A. 735/86 *Ben-Shachar Zraim Ltd. v. Assessing Officer Tel-Aviv 3*, 18, P.D.A. 10.

[633] Linkage differentials were traditionally recognized only when paid on a business loan and not on credit extended to buyers: C.A. 408/82 *Mifalei Tnua Le'Israel v. Assessing Officer (Large Enterprises)*, (1986) 40(2) P.D. 693. A Tel-Aviv District Court decision departs from this tradition by determining that suppliers credit constitutes a business loan for income tax purposes: I.T.A. 181/84 *Bernstein v. Assessing Officer Tel-Aviv*, (1987) 15 P.D.A. 179. See I.T.A. 138/87 *Tambour Ltd. v. Assessing Officer Haifa*, (1988) 16 P.D.A. 163, for the deduction of exchange rate differentials; *see also* I.T.A. 638/85 *Malon Plaza Ltd. v. Assessing Officer (Large Enterprises)*, Missim D-5 (Oct. 1990), E-49; C.A. 3515/97 *Assessing Officer Beer Sheva v. Beit Merkahat Ilan*, Missim P-4 (Aug. 2002), E-1.

[634] The tests for determining whether an expense is of a capital or ordinary income nature are applicable in determining whether expenses paid for repairs or renewals of capital assets are deductible: C.A. 43/61 *Mercaz Ha´Hamzan Ltd. v. Assessing Officer (Large Enterprises)* (1961) 15(3) P.D. 2512; I.T.A. 54/87 *Tslivi v. Assessing Officer Jerusalem*, (1989) 17 P.D.A. 349, a controversial decision permitting the deduction of the expenses of overhauling a car engine; I.T.A. 16, 87, 88, 93/92 *Artan v. Assessing Officer Haifa*, Missim G-1 (Feb. 1993), E-168, dealing with expenditures on real estate repairs; I.T.A. 54/87 *Blue Zliby v. Assessing Officer Jerusalem*, Misssim C-4 (July 1989), E-24; I.T.A. 138/00 *Mano v. Assessing Officer Haifa*, Missim Q-2 (Apr. 2003), E-18.

[635] Bad debts are recognized only in the same tax year as that in which they became bad, and only if incurred or suffered in connection with the taxpayer's business: I.T.A. 168/79 *Sochnut Hasharon Le Haspakat Delek v. Assessing Officer Petach Tikva* (1971) 4 P.D.A. 172; I.T.A. 43/95 *Hahevra HaAmerikait Yisraelit Le Gas Ltd. v. Assessing Officer (Large Enterprises)*, Missim O-5 (Oct. 2001), E-96; and I.T.A. 334/85 *Ugda Hashkaot Ltd. v. Assessing Officer Tel-Aviv 4* (1989) 17. P.D.A., 459; I.T.A. 1146/99 *D.N.G. v. Assessing Officer Rehovot*, Missim R-6 (Dec. 2004), E-16.

[636] According to C.A. 406/72 *Kolnoa "Rina" BeHolon Ltd. v. Assessing Officer Tel-Aviv 3*, 27(2) P.D. 630, the purpose of this provision is to encourage taxpayers to take certain security measures encouraged by the legislator, thus including purely nonrevenue expenses in Income Tax Ordinance, s. 17; *see* I.T.A. 316/88 *Ef-Shar Ltd. v. Assessing Officer Tel-Aviv* (1991) 19 P.D.A. 304; I.T.A. 149/92 *Fischer v. Assessing Officer Haifa*, Missim H-2 (Apr. 1994), E-19, and I.T.A. 296/91 *Goldberg v. Assessing Officer Tel-Aviv*, Missim G-1 (Feb. 1993), E-163, in which it was held that the deduction could not be taken by an individual against income with no relation to the deduction.

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approval of the Knesset Finance Committee, to promulgate regulations curtailing or prohibiting the deduction of certain otherwise allowable business expenses.

While section 17 of the Income Tax Ordinance provides a list of examples of deductible expenses, section 32 lists specific nondeductible expenses. Section 30 restricts the deduction of expenses in excess of those necessary, in the opinion of the Commissioner, for the production of the taxpayer's income.[637] Finally, section 33 of the Ordinance authorizes the disallowance of deductible expenses where proper books and records were not maintained.

b. Organizational Expenses

In general, organizational expenses, such as the expenses incurred on the registration of a company or the fees paid with respect to the preparation of the business vehicle, are not considered to be expenses "wholly and exclusively" incurred in the production of income and are therefore disallowed as a deduction.[638] In one case,[639] the court ruled that expenses incurred in developing a market were allowable as a deduction, even though the company did not produce any income as a result of incurring them. The company attempted to act as an intermediary between producers and consumers; therefore, the expenses were deemed to be business expenses. However, a salary paid to a physician, while the physician specialized at another hospital, by a hospital not yet opened to the public was not allowed as a deduction.[640]

c. Travel and Entertainment Expenses

Under special regulations issued by the Minister of Finance,[641] the deduction of travel and entertainment expenses is severely restricted.[642]

The regulations do not allow any entertainment expenses to be deducted unless the person being entertained is a nonresident.[643] Expenses incurred for travel abroad are further restricted; the deduction must not only be "wholly and exclusively" incurred in the production of income but also "necessary"[644] and may not exceed the specific *per diem* amounts as well as air fare rates set forth in the regulations.

Under a complex formula governing the deduction of expenses for company cars, the deduction is restricted so that not all such expenses are allowed.[645] The formula employed attempts to neutralize expenses for the private use of a vehicle (the test is mathematical). Moreover, the notional value of a company car put at the disposal of an employee constitutes income in the hands of that employee[646] in the amounts designated from time to time by the Minister of Finance with the approval of the Finance Committee of the Knesset.[647]

d. Interest

Section 17(1)(a) of the Income Tax Ordinance provides that sums payable as interest or linkage differentials on money borrowed by the taxpayer may be allowed as a deduction if they are payable on capital used in deriving the taxpayer's income. It has been held that a taxpayer in the financing business who takes out interest-bearing loans to re-lend the money to others may deduct the interest as an expense even though the money that the lender lends bears no interest in the same tax year.[648] However, a person deriving income in the form of interest or dividends (i.e., passive income) is not allowed to deduct interest paid as an expense if the person did not derive interest or dividend income during the same tax year, since the expense was not incurred in the production of that income.[649] In *Pazgas*,[650] it was held that interest incurred on a loan taken out to allow for a distribution of dividends was not deductible. However, in *PiGlilot*,[651] it was held that even if only an indirect nexus exists between the loan taken out for the distribution of the dividends and the production of income such interest is deductible. Such an indirect nexus exists where, from an economic point of view, financing by loans or equity leads to the same result. The following cumulative conditions must be met to attain that result:

> (i) The distribution of the dividend must meet the criteria in the Companies Law, i.e., the company may distribute a dividend only out of its profits[652] ("the profit test") and subject to the company's ability to pay off its current and prospective debts ("the payment test"). If met, this two-tiered test qualifies the company to make a "permitted distribution." The court may grant its approval to a distribution that fails to meet the conditions of the profit test, provided it is not doubtful that despite the distribution, the company will meet its current and future obligations.[653] A company may purchase its own shares without the court's sanction only out of funds from which it could make a "permitted distribution."

[637] I.T.A. 319–321/82 *Pirchey Bickel Ltd. v. Assessing Officer Kfar-Sava*, Missim D-5 (Oct. 1990), E-71; I.T.A. 306/88 *Zinometal Ltd. v. Assessing Officer Netanya*, Missim E-2 (Apr. 1991), E-65; I.T.A. 198/89 *Laor v. Assessing Officer Tel-Aviv 4*, Missim E-4 (Aug. 1991), E-125; I.T.A. 20/95 *P.H. Hachzakot v. Assessing Officer Tel-Aviv 3*, Missim K-3 (June 1997), E-148.

[638] I.T.A. 132/00, *Chevrat Nihul Kenyonim D.H.P Ltd. v. Assessing Officer Haifa*, Missim P-6 (Dec. 2002), E-144.

[639] C.A. 316/67 *Sides v. The Assessing Officer (Large Enterprises)*, 21(2) P.D. 291, later cited in C.A. 338/78 *Elco v. The Assessing Officer (Large Enterprises)*, 10 P.D.A. 215.

[640] I.T.A. (T.A.) 809/67 *Ne´ot Margalit Inc. v. The Assessing Officer*, 1 P.D.A. 234.

[641] Income Tax (Deduction of Certain Expenses) Regulations, 1972.

[642] Income Tax (Deduction of Certain Expenses) Regulations, 1972, s. 2.

[643] Income Tax (Deduction of Certain Expenses) Regulations, 1972, s. 3.

[644] Income Tax (Deduction of Certain Expenses) Regulations, 1972, s. 2(2).

[645] Income Tax (Deduction of Vehicle Expenses) Regulations, 1995.

[646] Income Tax Ordinance, s. 2(2).

[647] Income Tax (Value of the Use of Vehicles) Regulations, 1987.

[648] C.A. 191/61 *Hevra Lepituach T'veria v. the Assessing Officer*, 15 P.D. 2455; I.T.A. 108/91 *Shacheviz v. Assessing Officer (Large Enterprises)*, Missim N-2 (Apr. 2000), E-112.

[649] C.A. 314/67 *The Assessing Officer Tel-Aviv 4 v. Nichsey Coha'nim Ltd.*, 21(2) P.D. 748; I.T.A. 52/91 *Burlington Israel Ltd. v. The Assessing Officer (Large Enterprises)*, Missim H-5 (Oct. 1994), E-71. In a more recent case, the Court refused to apply accounting principles to fix the amount of the debt, and allowed the full amount of interest paid as an expense, given the fact that the loan was actually used to derive taxable income: I.T.A. 150/92 *Hevrat Israeli Dov Hashkaot Ltd. v. Assessing Officer Tel-Aviv 1*, Missim J-5 (Oct. 1996), E-99.

[650] C.A. 6557/01 *Pazgas v. the Assessing Officer (Large Enterprises)*, Missim W-6 (2006), E-51; I.T.A. CA.

[651] 8301/04 *PiGlilot v. the Assessing Officer (Large Enterprises)*, Missim X-3 (2007), E-98.

[652] Companies Law, 1999 s. 302(a), (b).

[653] Companies Law, 1999 s. 303(a).

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(ii) The undistributed profits were used to produce income and substituted for the taking out of a loan.

(iii) The cost of financing the distribution of the dividend with equity was more expensive than the cost of financing it with loan capital.[654]

Furthermore, a company suffering from financial difficulties arising from the use of its resources for purposes other than the production of income may not deduct interest on loans that were obtained for use in the production of income,[655] if at the time the non-income-producing investment was made, the need for investment in an income-producing source (for which the loan was taken out) was foreseen.[656]

As stated above, only financial expenses incurred in the production of income are allowed as a deduction. However, section 11 of the Income Tax (Inflationary Adjustments) Law, 1985, provided that interest on capital used for the acquisition of a fixed asset before the asset was used for the production of income was deductible, provided the amount of the deduction did not exceed the cost of the fixed asset, less interest charged to the asset cost, multiplied by the index increase from the later of the beginning of the tax year or the month in which an amount paid for the asset's acquisition constituted a "negative change," until the earlier of the month in which the asset began to serve in the production of income or until the end of the tax year. The amount of the deduction was not added to the original price of the asset in calculating depreciation for purposes of determining the capital gain or the land appreciation tax due on the sale of the asset. Section 11 is no longer in force as of 2008, following the repeal of the Income Tax (Inflationary Adjustments) Law effective January 2008.

Income Tax Circular No. 88/20 provides that fees paid to a bank or insurance company in an effort to "hedge" future transactions, as well as rate differentials payable on such transactions, must be treated in the same manner as the "hedged" transaction itself. When the taxpayer engages in futures transactions to protect his/her current operations' exposure, such as raw materials purchased for export sales, the cost of hedging is a current expense and is therefore allowed as a deduction. When the hedge is entered into to protect a capital transaction, such as the purchase of new machinery, the cost of hedging is a capital expenditure.

e. Royalties

Royalties are deductible in full if incurred "wholly and exclusively" in the production of income. The tax authorities verify the nature of royalties to disallow a deduction when tangible or intangible property is acquired and to differentiate them from payments for services (for example, the installation of machinery, training, etc.).

f. Taxes

Generally speaking, taxes incurred in the production of income are allowed as a deduction, except for income taxes, which are not considered to have been incurred in the production of income but rather to have been incurred after the production of income.[657] The Supreme Court has denied the deduction of foreign income taxes for the same reason.[658] Local taxes (business taxes, etc.) are allowed as a deduction.[659] Fees in the nature of taxes, incurred in the production of income, are also allowed as a deduction in determining the taxable income of a taxpayer. Linkage differentials and interest accrued on a tax debt resulting from the failure to transfer withholding tax are allowed as a deduction.[660]

g. Depreciation and Amortization

Section 21 of the Income Tax Ordinance provides that "there shall be allowed a deduction in respect of depreciation of any building, machinery, plant or furniture, or other assets including live and agricultural stock, and plantations, owned by the taxpayer and used for the purpose of producing his/her income." No depreciation is granted with respect to land. Depreciation is computed in accordance with the straight-line method as a percentage of the original cost and in accordance with regulations of the Minister of Finance, except in the case of certain taxpayers who may use the declining balance method. For purposes of depreciation, the tenancy of immovable property for a period of 49 years or more is treated as ownership.[661]

Depreciation is allowed only with respect to assets that are used for the production of income. Therefore, depreciation is not allowed with respect to assets that were not used at all for this purpose, or were not so used in their natural function or in the ordinary course of business.[662] However, depreciation is allowed with respect to assets that constitute part of the manufacturing apparatus of the taxpayer even though they were temporarily out of service for a reasonable period of time.[663] Where a grant in aid was received with respect to an asset used in the production of income, or where a debt originating from a loan for the acquisition of such an asset is forgiven or written off within five years from the year of its receipt, or where VAT was paid with respect to the acquisition of the asset and deducted as "input tax," the original cost of the asset may not include the grant in aid, the debt, or the input tax, as the case may be.[664] A 1981 amendment to the Income Tax Ordinance, embodied in

[654] I.T.A. (T.A.) 284/79 *Friction Materials Corp. v. The Assessing Officer (Large Enterprises)*, 1981 (2) P.M. 51; C.A. 638/85 *The Assessing Officer (Large Enterprises) v. Malon Plaza Ltd.*, Missim D-5 (Oct. 1990), E-55. If such an allocation is not possible, the entire expense is disallowed: I.T.A. 163/88 *Shaham v. Assessing Officer Tel-Aviv*, Missim I-3 (June 1995), E-93.

[655] C.A. 425/79 *Angel v. The Assessing Officer*, 36(3) P.D. 829 and C.A. 787/86 *Moran v. The Assessing Officer Tel Aviv 3*, Missim E-5 (Oct. 1991), E-53; C.A. 3515/97 *Assessing Officer Beer Sheva v. Beit Merkahat Ilan*, Missim P-4 (Aug. 2002), E-1.

[656] C.A. 787/86 *Moran v. Assessing Officer Tel-Aviv*; 19 P.D.A, 426; I.T.A. 149/72 *Chior Ltd. v. Assessing Officer Haifa*, 6 P.D.A. 254.

[657] Income Tax Ordinance, s. 32(7).

[658] C.A. 212/69 *Moller Textile (Israel) 1961 Ltd. v. The Assessing Officer Haifa*, 24(1) P.D. 73.

[659] I.T.A. 13/93 *Herman Itzhak v. Assessing Officer Haifa*, Missim H-2 (Apr. 1994), E-152; I.T.A. 72/92 *Hof Galia Ltd. v. Assessing Officer Haifa*, Missim H-2 (Apr. 1994), E-128.

[660] C.A 10691/06 *Sarig Electric Ltd. v. Assessing Officer Jerusalem 1*, Missim 25/1 E-70. *But see* C.A 438/90 *Assessing Officer Haifa v. Hed Hakrayot*, Missim O-1, E-1.

[661] Income Tax Ordinance, s. 21(a).

[662] C.A. 158/57 *Tsemer Plada Tsoor Ltd. v. The Assessing Officer*, 12 P.D. 177; I.T.A. 99/95 *Fried & Fried Ltd. v. Assessing Officer Haifa*, Missim K-1 (Feb. 1997), E-171.

[663] C.A. 158/57; I.T.A. 135/64 *Mori v. The Assessing Officer*, 47 P.M. 135.

[664] Income Tax Ordinance s. 21(b).

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section 21(c), allows a 16.5% rate of depreciation for special facilities constructed for invalids in public buildings where such facilities were required by the planning authorities. In 2003, with the abolition of the favorable tax treatment on a sale of goodwill, special regulations were issued to allow for the amortization of goodwill over 10 years.[665] Special provisions restrict the increase of the basis of an asset for purposes of depreciation by means of a transfer in which the taxpayer does not relinquish his/her control over the asset.[666]

In no event may the aggregate depreciation allowance exceed the cost of the asset. The cost of the asset for this purpose is the purchase cost and not the market price.[667] The cost of the asset includes not only the amount paid for its purchase but also the incidental expenses that were incurred for this purpose (i.e., legal expenses, registration fees, transportation and assembly expenses, customs, etc.).[668] Where the whole or part of the depreciation cannot be deducted in a particular tax year because the source with respect to which depreciation is claimed did not yield sufficient income in that year, the amount not deducted is regarded as a loss within the meaning of section 28 of the Income Tax Ordinance, which deals with the carrying over of net operating losses.[669]

It is worth noting that the original cost of the asset (i.e., the basis) is expressed in shekels. Therefore, in times of inflation, depreciation in accordance with the regulations issued by the Minister of Finance becomes rather meaningless.

Special provisions were enacted in the Law for the Encouragement of Capital Investments, 1959,[670] and the Law for the Encouragement of Industry (Taxes), 1969 (see XVII.C., below), to grant favored enterprises accelerated depreciation. In accordance with these provisions, the depreciation rates are much higher than those accorded under the regulations of 1941. Under the 1941 regulations, the depreciation rate for equipment and machinery is 7% with some exceptions, which attain a rate of 9% or 10%. According to special regulations, the depreciation rate for personal computers is 33%.[671]

A company owning an "approved enterprise" or "beneficial enterprise" may elect for accelerated depreciation under the Law for the Encouragement of Capital Investments, 1959, or depreciation in accordance with the regulations. Accelerated depreciation calls for 200% of the ordinary rate for equipment, 400% of the ordinary rate for buildings, provided that no more than 20% be allowed in any one year, and 250% for equipment used in shifts.

One of the salient features of the laws regarding the taxation of inflationary profits is the indexing of the depreciation deduction in accordance with the Israeli rate of inflation. However, due to the repeal of the Income Tax Law (Inflationary Adjustments) Law as of January 2008, the indexing of depreciation deduction is no longer available. These laws provide that, notwithstanding the provisions of any other law, depreciation rates with regard to fixed assets are to be computed under their special provisions. The Income Tax (Inflationary Adjustments) (Depreciation Rates) Regulations, 1986, provide for depreciation rates with regard to specific fixed assets. The regulations are valid despite the repeal of the Income Tax (Inflationary Adjustments) Law.

Under the regulations, an "industrial company" that owns equipment used in its "industrial enterprise" may use the declining balance method. A taxpayer electing to use the declining balance method for a specific depreciable asset is bound by the election for the entire period during which the asset is in use. The rates of depreciation are augmented and are conditional on the first usage of the asset in Israel.

The regulations further provide that certain fixed assets, if qualifying under the Law for the Encouragement of Capital Investments or the Law for the Encouragement of Capital Investments in Agriculture for a special rate of depreciation, enjoy the accelerated rates accorded by these laws.

Fixed assets that are subject both to "Encouragement Laws" and the regulations may enjoy one of the different rates provided by them, at the owners' choice.

To encourage economic activity in Israel during the Coronavirus crisis, on November 10, 2020, the Israeli Minister of Finance approved the Income Tax Regulations (Accelerated Depreciation During the Coronavirus Period) (Temporary Provision), 2020 (the "Accelerated Depreciation Regulations").

The Accelerated Depreciation Regulations provide for a depreciation rate double the rate otherwise allowed under any applicable law for equipment purchased by taxpayers, subject to certain conditions.

Specifically, it appears that taxpayers are even entitled to double accelerated depreciation rates to which they are entitled, and of which they have availed themselves, under the Law for the Encouragement of Capital Investments, 1959 or the Income Tax Regulations (Adjustments for Inflation) (Depreciation Rates), 1986. As a result, in certain cases, the Accelerated Depreciation Regulations may effectively make it possible for a taxpayer to deduct the entire, or almost the entire, cost of acquiring equipment in the tax year of acquisition.

Since the application of the Accelerated Depreciation Regulations is not limited to taxpayers operating in particular economic fields, any taxpayer, regardless of the field in which it operates, is entitled to accelerated depreciation for eligible equipment.

The main conditions set out in the Accelerated Depreciation Regulations concern the equipment that is eligible for the benefit, though it should be noted in this context that the Regulations do not explicitly define what is meant by "equipment." They provide only that the term includes machinery and certain "work vehicles" other than trucks (intangible property is excluded), where all the following criteria are satisfied:

(i) The equipment was acquired during the period beginning on September 1, 2020 and ending on June 30, 2021;

(ii) The equipment was put into use in the production of income in Israel within three months from the date on which it was acquired or by June 30, 2021, whichever is later. This period is extended to nine months in the case of equipment that cannot be put into use within three months

[665] Income Tax (Rate of Depreciation for Goodwill) Regulations, 2003.

[666] Income Tax (Rate of Depreciation for Goodwill) Regulations, 2003, s. 24.

[667] I.T.A. 218/70 *Bahar v. the Assessing Officer*, 3 P.D.A. 279.

[668] 508 C.A. 233/55 *Mekorot Ltd. v. Municipal Tax (Arnona) Director*, 10 P.D. 261; C.A. 487/79 *Chimovile Ltd. v. The Assessing Officer*, 12 P.D.A. 96.

[669] Income Tax Ordinance, s. 22.

[670] Law for the Encouragement of Capital Investments, 1959, ss. 42, 43, and 43A.

[671] Income Tax Regulations (Depreciation) (Amendment), 1996.

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and equipment that was used by an Industrial Enterprise, as defined in the Encouragement Law; and

(iii) The equipment is used in Israel.

h. Obsolete Equipment

Section 27 of the Income Tax Ordinance provides a special deduction with respect to the replacement of machinery or equipment, but not of any other asset. The deduction is granted only to taxpayers engaged in a business or vocation that, during a particular tax year, spent a specific amount on the replacement of machinery and equipment that is or has been used for the purpose of that business or vocation. The deduction is equal to the amount of the expenditure incurred by the taxpayer on the acquisition of the old machinery and equipment, less the aggregate of the amount of the depreciation deducted by the taxpayer with respect to that machinery and equipment, and the amount received by him on its sale, or is equal to the amount expended by the taxpayer on the new machinery and equipment, whichever is less.

Where an amount has been deducted pursuant to these provisions, any loss that could have been set off under the provisions of Part E of the Income Tax Ordinance with respect to the sale of the old machinery and equipment, is reduced by that amount.

These provisions do not apply to private motor vehicles within the meaning of the Traffic Ordinance.

i. Charitable Contributions

Section 46 of the Income Tax Ordinance provides that a taxpayer making a contribution in excess of a statutory minimum (NIS 180 in 2023) to a National Fund[672] or to a "Public Institution,"[673] is entitled to a tax credit at the rate of 35%, in the case of an individual, or the company tax rate, in the case of a corporation, on the amount contributed, provided that no credit is allowed in a given tax year in excess of 30% of the taxable income for that tax year or a statutory ceiling (NIS 9,000,000 in 2023), whichever is lower. These amounts are adjusted yearly in accordance with the rise in the cost-of-living index.

Moreover, section 46A of the Ordinance provides that the aggregate amount of the credit in accordance with section 46, together with deductions claimed for expenses incurred in R&D activity under provisions of the Income Tax Ordinance that are of particular interest to a foreign investor, may not exceed 50% of the taxpayer's taxable income. A public institution failing to meet the requirements set forth in the Ordinance, or with an essential part of its activity not aimed at achieving a public cause, runs the risk of losing its tax-exempt status.[674]

j. Capital Losses

Capital losses are not allowed as a deduction in determining ordinary chargeable income. Such losses may only be offset against capital gains as discussed in V.C.4.b.(12), above. As will be noted in 7., below, a net operating loss may be used to offset a capital gain.

k. Casualty Losses and Thefts

The Income Tax Ordinance does not contain any provisions with respect to casualty losses, but the courts have held that damages caused by fire may be deducted.[675] In a number of cases, the courts have held that thefts give rise to a deduction, provided they do not result from an embezzlement of funds or goods by senior executives within the enterprise concerned.[676]

l. Reserve Accounts

Generally, amounts set aside to reserve accounts are not allowed as a deduction.

There is an exception to this rule in the case of reserves for contingent liabilities. Under the decided cases, a taxpayer may set aside a reserve and claim a deduction with respect to a contingent liability that the taxpayer contests, provided the contingent liability meets three conditions:

(i) In accordance with generally accepted accounting principles the taxpayer must set aside a reserve or else be deemed to have misstated his/her income;

(ii) The facts of the case and the accounting techniques allow for the accurate ascertainment of the amount of the liability; and

(iii) The contingent liability will most probably become final in the near future.

By setting aside the reserve, the taxpayer is not barred from contesting the liability and, should the taxpayer succeed in his/her efforts, taxable income will be increased accordingly.[677] It is common practice to set aside a reserve for contested indirect tax liabilities. No contingent liabilities may be reserved for and deducted, if specifically prohibited by the Income Tax Ordinance, for example, where there is a requirement that actual payment be made.[678] The Supreme Court has held that, in certain circumstances, a taxpayer may set aside and deduct a reserve for future liabilities and that the taxpayer may adjust the reserve in accordance with the rate of inflation and thereby

[672] The Jewish Agency, the World Zionist Organization, the United Jewish Appeal and the Keren Kayement Le-Israel.

[673] A corporate body of at least seven members, most of which are not affiliated with one another or a religious trust whose trustees are not affiliated with one another, that exists and acts for a public cause, whose assets and revenues are used solely for achieving the public cause, and that has filed an annual return with respect to its assets, revenues and expenses to the satisfaction of the Assessing Officer.

[674] Income Tax Ordinance, s. 46(A1); for "public objective," see H.C.J. 637/89 *Huka LeMedinat Israel v. The Minister of Finance*, 21 P.D.A. 19.

[675] C.A. 735/86 *Ben-Shachar Zra´im Ltd. v. Assessing Officer Tel-Aviv*, Missim D-1 (Feb. 1990), E-71.

[676] C.A. 475/68 *Rehov Pinsker 42 Ltd. v. The Assessing Officer*, 2 P.D.A. 89; I.T.A. (T.A.) 170/71 *Express Tours Ltd. v. The Assessing Officer*, 5 P.D.A. 27; I.T.A. 101/97 *Zoher v. Assessing Officer Nazareth*, Missim L-6 (Dec. 1998), E-25; C.A. 735/86 *Ben-Shachar Zra´im Ltd. v. Assessing Officer Tel-Aviv*, Missim D-1 (Feb. 1990), E-71.

[677] C.A. 190/58 *The Assessing Officer (Large Enterprises) v. Nakid*, 13 P.D.A. 1453; C.A. 600/75 *Tel-Ronen Kablanim Ubonim v. The Assessing Officer*, 3 P.D.A. 86; I.T.A. 85/83 *Aharon v. The Assessing Officer*, 14 P.D.A. 307; C.A. 860/75 *Isranil Ltd. v. The Assessing Officer (Large Enterprises)*, 9 P.D.A. 138; I.T.A. 157/89 *Ramado Ltd. v. Assessing Officer Haifa*, Missim E-2 (Apr. 1991), E-68; I.T.A. 5082/97 *Yang Ltd. v. Assessing Officer Haifa*, Missim N-3 (June 2000) E-127; C.A. 1124/03 *Ganey Ofer v. Assessing Officer Tel-Aviv 1*, Missim V-2 (Apr. 2005), E-3.

[678] Income Tax Ordinance, s. 18(b).

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decrease his/her taxable income.[679] In one case it was held that a gas supplier was not entitled to deduct linkage differentials accruing on deposits, received as collateral for equipment (gas tanks), despite their linked refundability on termination of the contract pursuant to which they were made.[680]

m. Bad Debts

Section 17(4) of the Income Tax Ordinance provides for the deduction of "bad debts incurred in any business or vocation, proven to the satisfaction of the assessing officer to have become bad during the tax year and doubtful debts to the extent that they are reasonably estimated to the satisfaction of the assessing officer to have become doubtful during the said year, notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said year." For a debt to be recognized as a "bad debt," it is insufficient for the debtor to declare insolvency. Only with the commencement of liquidation or bankruptcy proceedings does it become so recognized.[681] Section 17(4) further provides that all sums recovered during a tax year on account of amounts previously written off or allowed with respect to bad and doubtful debts, for purposes of the Ordinance, are to be treated as receipts of the business or vocation for that year.

n. Inventory Write-Downs

Inventory is valued at cost or market value, whichever is lower, in accordance with generally accepted accounting principles. Thus, an unrealized loss is allowed as a deduction where the value of the inventory drops below its cost.

In times of inflation, the carrying of inventory became a major source of concern for many taxpayers. The concern is the taxation of inflationary profits. The burden was alleviated in the past, to a great extent with respect to industrial enterprises, by means of a special deduction based on the adjustment of the price of the inventory. A special committee formed by the government to determine a method of taxation during times of inflation concluded that the entire fiscal regime should be revised to avoid the taxation of inflationary profits.[682] Its recommendations brought about the enactment of the Income Tax (Taxation under Inflationary Conditions) Law, 1982, superseded by the Income Tax (Inflationary Adjustments) Law, 1985 (see XVI., below), which is now no longer in force due to low inflation. The tax authorities have agreed to allow a write down for real estate held as inventory by developers.[683]

o. Rents

Section 17(2) of the Income Tax Ordinance provides that "rent paid by any tenant of land or buildings occupied by him for the purpose of acquiring income" is allowed as a deduction. As already mentioned (see a., above), the list of deductions contained in section 17 is not a closed, exclusive list and rental payments incurred with respect to movable assets are also allowed as a deduction.[684] Rent paid for premises before their occupation by a business must be capitalized.

A lease transaction is treated as either a genuine lease or an installment purchase contract. The basic guidelines for the classification of a lease as either a sale or a "true" lease have been laid down by the Israeli courts in several key precedents on the matter[685] that tend to focus on the economic substance of the transaction in question, i.e., whether the terms of the agreement imply an intention of the parties thereto to affect a sale or a lease. Based on this principle, in 1989, the Israeli income tax authorities issued criteria regarding the taxation of leasing transactions.[686] The provisions set forth four criteria, the existence of which will entail the classification of a lease as a financial lease. A lease will be classified as a financial lease if:

(i) Under the terms of the agreement, the lessee gains title to the leased equipment at the end of the lease term;

(ii) The lessee is granted an option to purchase the equipment at the end of the lease term at a price that is — as of the date of the agreement — significantly below the expected market value of the equipment at the end of the lease term;

(iii) The lease term is 75% or more of the economic useful lifetime of the leased equipment; and

(iv) The present value of the rent amounts to 90% or more of the present market value of the equipment.

The provisions do not specify whether all four criteria must be met for a lease to be classified as a financial lease.

In addition to these criteria, regulations have been promulgated entitling lessees to elect, subject to certain conditions, that their lease be regarded as an operating lease even if the terms of the lease meet the criteria set out above.[687] The regulations apply to a leasing contract if the contract meets the following conditions:

(i) It calls for rental payments to be made on fixed dates;

(ii) Intervals between payments are no more than three months and the last payment is made less than three months before the end of the lease;

(iii) Each rental payment is calculated based on a fixed percentage of the cost of the equipment, to which are

[679] C.A. 159/79 *K.B.A. Kvutsat Boney Arim v. The Assessing Officer (Large Enterprises)*, 35(3) P.D. 572; I.T.A. 392/82 *Hahevra HaAmericait Yisraelit LeGas Ltd. v. The Assessing Officer (Large Enterprises)*, 16 P.D.A. 50; I.T.A. 135/88 *Balalis v. Assessing Officer Afulla*, 18 P.D.A. 220.

[680] I.T.A. 43/95, 31/96 *Hahevra HaAmerikait Yisraelit Le Gas Ltd. v. The Assessing Officer (Large Enterprises)*, Missim O-2 (Apr. 2001), E-69.

[681] I.T.A. (T.A.) 239/83 *Elia´hu Baranes v. The Assessing Officer*, 14 P.D.A. 203, I.T.A 43/95 *Hahevra HaAmerikait Yisraelit LeGas v. The Assessing Officer (Large Enterprises)*, Missim O-5 (Oct. 2001), E-96.

[682] Report of the Committee Established to Examine Taxation During Inflationary Times, Jerusalem, Mar. 1980, p. l.

[683] Income Tax Circular 12/2004, *The Taxation Treatment of the Decline in Inventory Value of Building Contractors and Real Estate Dealers*, Missim R/3 C-1.

[684] C.A. 431/69 *The Assessing Officer Tel-Aviv 5 v. Derby Chimicalim Ltd.*, 24(2) P.D. 24; I.T.A. 48/78 *Golombe v. Assessing Officer Tel-Aviv*, 10 P.D.A. 68.

[685] I.T.A. (T.A.) 376/80 *Klitit Rechev Ltd. v. The Assessing Officer (Large Enterprises)*, 12 P.D.A. 341; I.T.A. (T.A.) 181/84 *Bernstein Gil v. The Assessing Officer*, 15 P.D.A. 179; I.T.A. 7/94 *Beit Horim Ronit 1988 Ltd. v. Assessing Officer Acre*, Missim J-3 (Aug. 1996), E-100.

[686] Income Tax Authorities' Operational Provision No. 40/89.

[687] Income Tax Regulations (Special Deductions of a Leased Equipment User), 1989.

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added reasonable interest rate and exchange differentials; and

(iv) The lease period covers at least 75% of the depreciation period allowed for tax purposes, and in the case of certain taxpayers, the entire period.

An important prerequisite contained in the regulations is that the lease contract must be approved in advance by the Director of the Israel Tax Authority for the regulations to apply to it and classify it as an operating lease.[688]

A lessee electing to apply the regulations may deduct the rental payments. Nonetheless, the consideration from the sale of the leased equipment by the lessee is treated as a real capital gain. In sum, in the case of a lease for a period of less than 25 years, the lessee may deduct the lease payments under the provisions of section 17(2), provided the economic substance of the lease is not a purchase agreement.

Under 1977 special regulations, a lessee of real estate for a term of less than 49 years may deduct rental payments and, if they are paid in a lump sum, may amortize them over the term of the lease.[689] Special provisions apply to the amortization of investments in such premises. Other, 1998 regulations[690] provide for the amortization of improvements made by a lessee in leased premises at the rate of 10% annually, with the balance being deducted at the end of the lease term.

In *PiGlilot*,[691] the taxpayer claimed that rental payments on the lease of real estate for a period of 49 years, which included an option to extend the term for an additional 49 years, were deductible because the lease was an "operational lease" (the 1977 regulations were not relevant because the lease term exceeded 49 years). The Supreme Court determined that when the term of a lease exceeds 25 years, deductibility under section 17 is conditional on the lease being an "operational lease" and not a "financial lease." The court determined that the rights given to the lessee in this case were similar to ownership rights and, therefore, the lease could not be classified as an "operational lease."

p. Salaries and Wages

Under section 18(a) of the Income Tax Ordinance, a retirement grant, leave pay, convalescence pay, holiday pay, sick pay and other similar expenses may be deducted under section 17 only in the tax year in which they were actually paid to the person entitled to them or to a provident fund within the meaning of section 47. Payments made to a provident fund with respect to the last month of the tax year are deemed to have been made during the tax year, if they were made within one month after the end of the tax year. "Similar expenses" are the subject of the *Dikla* case in which the Supreme Court held this provision applicable to gold watches presented as a gift on retirement and hence denied a deductible reserve therefor.[692]

Salaries and wages are deductible on a current basis. It is important to note that section 18(b) of the Income Tax Ordinance provides that any salaries, wages, management fees, interest or linkage differentials and other payments paid by a company controlled by not more than five persons, within the meaning of section 76 of the Ordinance, to any of its controlling members are to be allowed as a deduction only: (i) if they are paid during the tax year in which the deduction is claimed; (ii) if the person credited with such amounts includes them in their annual return for the same year; or (iii) if the tax to be withheld at source under the provisions relating to withholding taxes on wages was in fact withheld within three months after the closing of the tax year and transferred to the Assessing Officer within seven days of its withholding, together with interest and linkage differentials from the end of the tax year or the special accounting period until the date of withholding.

Under section 17(5) of the Income Tax Ordinance, a special deduction is allowed for sums paid by an employer (up to a ceiling set by the Ordinance), subject to the conditions and at the rates prescribed by regulations, for the purpose of section 47 of the Ordinance, by way of ordinary annual contributions to a provident fund (for various objectives such as pension, severance pay, etc.), approved by the Commissioner for purposes of section 17(5). The amount allowed as a contribution of the employer is limited to 7.5% of the employee's wages (subject to certain conditions) up to a maximum amount adjusted according to the rate of inflation, with any contribution in excess thereof constituting taxable income in the hands of the employee.

q. Life Insurance

According to Income Tax Circular 20/88, a company is allowed to deduct premiums paid to insure the lives of key personnel (but not, for example, of inactive "partners"), provided the insurance policy is meant to protect the company against the loss of their services. The expenses are not deductible when other persons, such as family members, are the beneficiaries.

With respect to controlling members, deductibility is restricted under the terms of section 32(9) and (10) of the Income Tax Ordinance.

r. Economic Counseling and Management Fees

Economic counseling expenses that are related to the current management of the business and management fees are allowed as a deduction if sufficient proof of their nature as such is provided.[693] However, such expenses, if related to the acquisition of a capital asset or to the establishment of a new business, are not deductible.[694]

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[688] Income Tax Regulations (Special Deductions of a Leased Equipment User), 1989, s. 7(a).

[689] Income Tax Regulations (Deductions of Leasing Fees), 1977.

[690] Income Tax Regulations (Deductions for the Adjustments of Rented Premises), 1998.

[691] 8301/04 *PiGlilot v. the Assessing Officer (Large Enterprises)*, Missim U-3 (2007), E-98.

[692] C.A. 3348/97 *Assessing Officer (Large Enterprises) v. Dikla Hevra LeNihul Kranot Neemanut Ltd.*, Missim O-5 (Oct. 2001), E-64.

[693] I.T.A. 234/88 *Mercaz Ramir Ltd. v. Assessing Officer (Large Enterprises)*, 19 P.D.A. 156.

[694] I.T.A. 1003/69 *Hevrat M.D.M. Ltd. v. The Assessing Officer*, 4 P.D.A. 82; C.A. 263/70 *Mifaley Musika Israelim v. The Assessing Officer*, 4 P.D.A. 169; C.A. 414/78 *Rechev Israeli Ltd. v. The Assessing Officer*, 10 P.D.A. 207; C.A. 761/77 *Avna'al Ltd. v. Assessing Officer (Large Enterprises)* (1978) 32(2) P.D. 494; C.A. 495/88 *Greenberg Ltd. v. The Assessing Officer Tel Aviv*, Missim F-3 (June 1992), E-53.

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s. Treatment of Child Care

Under section 17 of the Income Tax Ordinance, an expense is deductible only if it is incurred "wholly and exclusively" in the production of income. A decision of the Supreme Court[695] held that certain childcare expenses are necessary for the production of income by their parents and, therefore, deductible under section 17. However, an amendment to section 32 of the Ordinance overturned the ruling by providing that childcare expenses are not deductible.

t. Academic Studies

The Supreme Court held in *Bank Yahav*[696] that an employer's payment for academic studies should be treated as employment income since, generally, academic studies are more beneficial to the employee than the employer. In this context, the Supreme Court held that academic study expenses of an employee or a self-employed individual are usually not deductible, as they create a persistent advantage to the taxpayer. Furthermore, the courts held that even specific M.B.A. studies create such a persistent advantage.[697] It is worth noting that, as of 2005, a resident holding an academic degree is entitled to 1 or 1/2 credit point depending on the circumstances.

u. Meals

In Amendment 179 of the Ordinance expenses for meals while at work whether at the work location or elsewhere were barred from deduction. However, section 17 of the Ordinance allows the deduction of expenses for a breakfast included in deductible lodging expenses.

6. Capital Expenditure

Capital expenditure is not allowed as a deduction from current and ordinary income. Section 32(3) of the Income Tax Ordinance specifically denies the deduction of "any capital withdrawn or any sum employed or intended to be employed as capital." Section 32(4) denies a deduction for "the cost of any improvements." Capital expenditure must therefore be capitalized and written off in accordance with the depreciation allowed with respect to the asset for which the expenses were incurred.[698]

It is worth noting that the income tax authorities regard expenses incurred in the prevention of competition on the acquisition of a business or when an employee retires as aimed at gaining a long-term business advantage and thus as capital expenses. The only exception to this may be expenses incurred because of a probable economic need to prevent competition during a very short term.[699]

7. Loss Carryovers

Under section 28 of the Income Tax Ordinance, the amount of a loss incurred by any person during the tax year in any business or vocation that, had it been a profit, would have been taxable under the Ordinance, may be set off against that person's total chargeable income from other sources in that year.

It should be emphasized that: (i) although losses incurred in any business or vocation may be set off against income from other sources during the same year, losses incurred from any other source of income may not be set off against income from a business or vocation;[700] (ii) a loss incurred outside Israel (a "foreign loss") may be set off against foreign income in accordance with the "basket system" as explained in XVII.A.2., below);[701] and (iii) a loss must be incurred by the same taxpayer as the taxpayer against whose income it is set off, so that losses incurred by a company may not be set off against its owner's income or vice versa.[702] Furthermore, the purchase of a loss company for purposes of setting off its losses against its future income may be deemed to be an artificial transaction for purposes of section 86 of the Income Tax Ordinance.[703] A 2007 amendment to the Income Tax Ordinance[704] allows an individual to set off their business loss against their employment income upon termination of the business and assumption of new employment.

Under section 28(b) of the Income Tax Ordinance, the balance of a business or vocational loss from an Israeli source that could not be used during the year in which it was incurred may be carried forward indefinitely. However, such a balance may be set off only against Israeli or foreign-sourced income from a business or a vocation and it must be set off during the first year in which such a set-off is possible. The Ordinance does not require that the set-off be against income from the same business or vocation as that in which the loss was incurred. When a loss is carried forward, it may also be used to offset a capital gain incurred in any business or vocation. However, section 28(c) grants the taxpayer an option: the taxpayer may opt not to set off a business loss against the "inflationary amount" of a capital gain or against a capital gain, dividend or interest liable to a 25% maximum tax. The reason for this is clear. The tax on the "inflationary amount" is limited to 10% on the inflationary amount accrued until 1994 and exempt thereafter, while the maximum ordinary rates of tax on business and vocation income reach 48% for individuals and the regular company tax rate for companies. Curiously enough, in the past it might have

[695] C.A. 4243/08 *Vered Peri v. The Assessing Officer (Gush Dan)*, Missim X-3, E-90 (2009).

[696] C.A 3501/05 *Assessing Officer (Jerusalem) v. Bank Yahav*, Missim U-6, E-113 (2007).

[697] I.T.A 807/06 *Yair Zorea v. Assessing Officer (Hadera)*, Missim X-6, E-148 (2008).

[698] As a rule, expenses incurred for raising capital are not deductible; however, under section 5B of The Law for the Encouragement of Industry (Taxes), 1969, such expenses when incurred in raising equity capital on the stock exchange are amortized and deducted over three years. The same holds true for options, I.T.A. 1059/98 *Cementcal v. Assessing Officer (Large Enterprises)*, Missim R-2 (Apr. 2005), E-132.

[699] Income Tax Circular No. 20/88; I.T.A. 346/70 *Assessing Officer Haifa v. Off Haifa Ltd.*, 4 P.D.A. 107.

[700] I.T.A. 83/77 *Pegasus Ltd. v. The Assessing Officer*, 10 P.D.A. 12; C.A. 615/85 *The Assessing Officer v. A.H.A. Goldstein Ltd.*, Missim D-6 (Dec. 1990), E-36; C.A. 128+375/75 *The Assessing Officer v. Haachim Mark*, 8 P.D.A. 121.

[701] Income Tax Ordinance, s. 29.

[702] C.A. 404/65 *Pardes Syndicate Ltd. v. The Assessing Officer*, 20(3) P.D.; C.A. 210/67 *Paz-Gas Ltd. v. The Assessing Officer*, 22(1) P.D. 64.

[703] C.A. 3415/97 *Assessing Officer for Large Enterprises v. Rubinstein*; C.A. 265/67 *Mephi Ltd. v. The Assessing Officer (Large Enterprises)*, 21 P.D. 503; C.A. 414/78 *Rechev Israeli Ltd v. The Assessing Officer*, 10 P.D.A. 207; C.A. 495/88 *Baruch Grinberg Ltd. v. Assessing Officer Tel-Aviv*, 20 P.D.A. 171.

[704] Income Tax Ordinance (Amendment 154), 2007.

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been worthwhile for the taxpayer to set off the loss against a capital gain that was an "inflationary amount" despite the difference in the tax rate. For, in an inflationary economy, it must always be remembered that the "value" of the loss diminishes in accordance with the rate of the inflation. Indeed, the laws regulating the taxation of inflationary profits linked the loss to the cost-of-living index and thereby maintained its "value" in real terms. Thus, the loss remained a loss and did not become a hidden profit subject to tax, as before the enactment of these laws. Nevertheless, due to the repeal of the inflationary adjustments law, as of January 2008 losses are no longer linked to the cost-of-living index. The reason for granting a taxpayer the option not to set off a loss against a capital gain or favorably taxed dividend or interest is similar: to allow the taxpayer not to offset favorably taxed income with a loss that can be used to offset higher taxed income. A foreign loss incurred in a business or vocation that could not be set off against income in the year in which it was incurred, may be carried forward to subsequent tax years and set off against the foreign income of the taxpayer derived from a business or vocation including capital gains, provided that the set-off is made in the first year during which income is available for the set-off. However, the taxpayer does have an option to set off a foreign business loss that was carried forward against Israeli business or vocational income, provided the foreign business loss was derived from a business controlled and managed in Israel. In such a case, the amounts so set off will not be available for a set-off against foreign-sourced business or vocational income and capital gains.

In a landmark case in 2003,[705] the Supreme Court ruled that where the sole motive for the acquisition of the shares of a company was the enjoyment of its losses by the infusion of income from a new activity into the company, the carryover of the loss would be denied despite the fact that under a literal interpretation of the statute, the set-off should have been allowed. The court ruled that the purchase of a "loss" solely for the purposes of enjoying its income tax advantages was an "artificial transaction" within the meaning of section 86 of the Income Tax Ordinance. However, in 2008, the Supreme Court held in *Ben Ari*[706] that even where a "loss" was acquired solely for the purposes of enjoying its income tax advantages, in some cases, such a loss may be set off against future income. Ben Ari was the owner of 32% of the rights in a garage. The garage had substantial losses and ceased its activities. Ben Ari purchased 68% of the shares of the garage company and transferred to it a profitable activity of insurance. The Supreme Court held that 32% of the loss was deductible at the company level since it reflected Ben Ari's ownership prior to the purchase of the remaining 68% of the shares from the other shareholders.[707]

According to the language of section 28 of the Income Tax Ordinance and considering the purpose and the legislative intent of the provision, losses cannot be set off against income generated in tax years preceding the year in which the losses were generated. In *Hirschzon*, the court held that section 28 constitutes a complete, comprehensive, and orderly provision, and that its failure to address losses arising in certain circumstances does not amount to a legislative lacuna.[708]

Notwithstanding these provisions regarding the set-off of losses, section 29 of the Income Tax Ordinance contains special provisions with respect to the set-off of losses incurred outside Israel.

A loss incurred by a resident of Israel that, had it been income, would have been foreign passive income[709] may be set off against any passive income derived from outside Israel. A loss incurred from the renting of real estate attributable to depreciation may be set off against a capital gain derived from the sale of the rented real estate.

Where the loss cannot be set off in the tax year in which it was incurred, it may be carried over to succeeding years, provided it is set off during the first year in which the taxpayer is allowed to do so, and that the set-off is made against passive income derived from outside Israel during those years. It should be stressed that where the loss could have been set off in any one year and the set-off was not made, the taxpayer will not be able to carry over the set-off to succeeding years (see section 29(1)(B) of the Income Tax Ordinance).

Where the taxpayer incurred a loss in a business or vocation carried on outside Israel that, had it been a profit, would have been taxable in Israel, the relevant set-off rules are contained in section 29(2) of the Income Tax Ordinance and are as follows:

(i) A current loss will first be set off against the taxable income, including capital gains, derived from a business or vocation outside Israel;

(ii) Any excess loss will be allowed as a set-off against foreign passive income available for such a set-off after the set-off of a foreign passive loss against it;

(iii) Any excess loss, not set off pursuant to the above, derived from a business "controlled and managed" from Israel may be set off against income derived in Israel during the same taxable year;

(iv) Should there still remain any loss not set off after the above set-off, it will be carried over to succeeding years and will be available for set off against the taxable income of the taxpayer derived from foreign sources constituting a business or vocation including capital gains; and

(v) At the request of the taxpayer, the latter may set off any excess loss from a business outside Israel that is "controlled and managed" from Israel against taxable income, including capital gains, and the tax levied on real estate located in Israel.

Finally, no set-off will be allowed for a loss incurred outside Israel that, had it been a profit, would not have been tax-

[705] C.A. 3415/97, *Assessing Officer for Large Enterprises v. Yoav Rubinstein*, Missim Q-4 (Aug. 2003), E-3.

[706] C.A. 738706 *Ben Ari v. The Assessing Officer (Jerusalem)*, Missim V-3, E-71 (2008).

[707] In *Signon Sherutey Tikshuv Ltd. v. The Assessing Officer of Petah-Tikva*, Missim KE/4 (Aug. 2011), E-182, the Israeli Supreme Court ruled that a capital loss incurred on the sale of shares by an Israeli corporation subsequently after a dividend was distributed constituted an "artificial transaction" according to section 86 of the Israeli Income Tax Ordinance as it lacked "economic substance." Such a method used by the taxpayer is known as "dividend stripping."

[708] Further Civil Hearing 2308/15 *Rehovoth Tax Assessor v. Damari*, [Nevo Publishing] (12/09/17).

[709] I.e., interest, linkage differentials, dividends, rent, royalties; *see* Income Tax Ordinance, s. 29(1)(a).

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able in Israel, and no such set-off will be allowed where a taxpayer did not file a return with respect to such a loss for the year in which it was incurred.

8. Tax Rates and Calculation of Taxable Income

a. In General

Under section 126 of the Income Tax Ordinance, the chargeable income of a company is subject to companies' tax at the rate of 23%.

The maximum rate of tax on dividends distributed to individuals and nonresident companies is 30%.[710] As indicated in V.C.4.c., above, in calculating taxable income for purposes of applying the company tax, "income from dividends or from the distribution of profits received directly or indirectly from another body of persons liable to Israeli company tax derived from a source located in Israel shall not be included, nor will any income enjoying a special tax rate be so included." Thus intercompany dividends are free from company tax in Israel, provided the company tax was borne by the dividend-paying company and the source of the income from which the dividend is distributed is Israeli.[711]

Dividends distributed out of the profits of an approved or beneficial enterprise[712] are subject to a 20% income tax and the same applies to dividends paid by a company out of such dividends.[713] In the latter case, the company is entitled to deduct from its taxable dividend income, dividends it distributed in the same year, or in preceding years.

"Real" capital gains are subject to company tax. The inflationary amount is taxed at the rate of 10% (with respect to the inflationary amount accrued until 1993) and 0% (with respect to the inflationary amount accrued thereafter).[714]

Taxation under the Taxation of Land (Appreciation and Purchase) Law, 1963 is similar to the taxation of capital gains described in the previous paragraph.

b. Family Companies and Transparent Companies

In 1978, a special amendment was introduced into the Income Tax Ordinance to allow for the "pass through" of income and losses of "family companies."[715] The main objective of the legislation was to allow shareholders of such closely held companies to be taxed directly on their profits and thereby reduce the income tax liability they would have suffered had they received dividends from their companies. However, a "family company" was not taxed as a partnership. Instead, the shareholder entitled to the greater amount of the profits of the company or, in the case of two or more such equal shareholders, the consenting shareholder nominated by the company, had to be appointed the sole taxpayer for all the income of the "family company."

The income of a "family company" was computed at the company level, and then attributed to the taxpaying member. The income was then subject to the taxpayer's (individual) tax rates and special concessions,[716] and the taxpayer could offset his/her personal income with losses incurred by the company.[717]

Losses incurred by the taxpaying member prior to the period in which the company became a "family company" may not be used to offset "family company income."[718] Losses incurred by the company prior to its becoming a "family company" may not be set off against the taxpaying member's current income.[719] In addition, the Israeli courts ruled that dividends received from income generated during the period in which the company was considered a "family company" and were offset at the level of the company against losses generated during the period in which the company was not considered a "family company" — are subject to tax despite the provisions of s. 64A(a)(1). That section provides that distribution of profits generated during the period in which the company was considered a "family company" shall be disregarded.[720]

The Ordinance does not require the taxpaying member of the "family company" to be a resident of Israel; however, the member must be a "relative" of the other shareholders within the meaning of section 76(d)(1) of the Income Tax Ordinance.[721] The Income Tax Authorities used to contend that all members of the family had to be directly related to each other and that relations through an intermediary did not suffice.[722] This interpretation of the Ordinance was challenged, and the Supreme Court held that the criteria of the Ordinance are met where all shareholders are related to each other through a "chain," even if some members are not directly related to each other.[723] Moreover, the Income Tax Authorities contended that, where a spouse was chosen as the taxpayer, the income of the "family company" was to be added to his/her spouse's income, an absurd result but one that the language of the statute certainly supports.

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[710] Income Tax Ordinance, s. 125B.

[711] Income Tax Ordinance, s. 126(b).

[712] Subject to the conditions set forth in Law for the Encouragement of Capital Investments, 1959, s. 47(a)(3) or (4), s. 47 (a1), s. 51(b) or s. 53c(b).

[713] Law for the Encouragement of Capital Investments, 1959 s. 47(b)(2).

[714] Income Tax Ordinance, s. 91(a).

[715] Income Tax Ordinance, s. 64A.

[716] I.T.A. 93, 114/87 *Feldenstein and Others v. The Assessing Officer*, 19 P.D.A. 329: the Court held that the elected taxpayer is subject to a special levy imposed only on individuals, even though the income was derived by a company. I.T.A. 58/90 *Hevrat Alef Zara Ltd. v. Assessing Officer Tel-Aviv 4*, Missim F-6 (Dec. 1992), E-175; C.A. 896/90 *Assessing Officer Haifa v. Halevi*, Missim I-4 (Aug. 1995), E-56: the Supreme Court held that the exemption from tax granted to an invalid applies to "family company" income attributed to him. I.T.A. 12/94 *Atzmon v. Assessing Officer Jerusalem*, Missim J-2 (Apr. 1996), E-81: the exemption granted for rental income earned by an individual applies to rental income derived by a "family company" and taxed at the individual's level.

[717] C.A. 3574/92 *Assessing Officer Gush Dan v. Pereg*, Missim K-1 (Feb. 1997), E-55.

[718] Income Tax Ordinance, s. 64A(a)(6).

[719] I.T.A. 1222/02 *Shkalarsh v. Assessing Officer Ramla*, Missim U-2 (Apr. 2004), E-27; I.T.A. 82/94 *Bi-Gud Michal Ltd. v. Assessing Officer (Large Enterprises)*, Missim K-6 (Dec. 1997), E-105. In a recent decision, the Supreme Court changed this ruling by giving effect to a compromise agreement entered into between the parties. (*See* C.A. 6742/97 *Assessing Officer (Large Enterprises) v. Bi-Gud Michal Ltd.*, Missim S-3 (June 2002), E-1.)

[720] I.T.A. 39456-01-12 *Mauric Herchko v. The Assessing Officer of Rehovot* (June 10, 2014); I.T.A. 1130-06 *Beges Carlos v. The Assessing Officer of Tel Aviv 4* (July 15, 2013).

[721] "Relative," for this purpose, means "spouse, brother, sister, parent, grandparent, descendant and descendant of spouse and spouse of those enumerated."

[722] Income Tax Circular No. 78/16 Appendix 1, s. 1.

[723] H.C.J. 61/81 *Mahtesh Ltd. v. The Assessing Officer (Large Enterprises)*, 35(1) P.D. 1. The Income Tax Authorities consequently apply this ruling. *See* Income Tax Implementation Instruction 84/42.

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The advantages of a "family company" were significantly eroded by the reduction in company tax and the elimination of income tax on companies, when the rate of tax applicable to companies on undistributed income (67%) was set significantly lower than the highest rate imposed on individuals. The "family company" became advantageous when the choice was between an individual's own business and a dividend distributing company.

With the 2003 tax reform came the introduction of section 64A1 of the Income Tax Ordinance. As a result of its enactment, "family companies" no longer exist. Instead, taxpayers have a choice between ordinary companies and "transparent companies." A "transparent company" is a private company resident in Israel whose shareholders are all individuals resident in Israel that elected to be classified for income tax purposes as a "transparent company." These companies may have up to a maximum of 50 shareholders. The taxation of the profits of a "transparent company" is similar to that of the profits of a partnership, i.e., the taxable income of the "transparent company" is ascribed to the shareholders in accordance with their ratable share of the profits and is deemed their income whether distributed or not. In short, a "transparent company" is not a tax paying entity, and therefore, any dividend from a "transparent company" does not create a taxable event. Until the reform of 2003, transparency taxation was limited to "family companies" and to "real estate companies" (i.e., companies whose sole business was the holding of real estate and the deriving of income therefrom). On the issuance of special regulations, which will render these provisions effective, the transparent entities known as the "real estate company" and the "family company" will vanish, with all "family companies" becoming "transparent companies," unless an election to the contrary is made. Transparent companies will only be available to taxpayers after the issuance of regulations relating to their taxation. It is worth mentioning that due to the amendments concerning the "family company" regime as detailed below (which concept is very similar to the provisions of the "transparent company" regime), it appears that such prospective regulations with respect to the "transparent company" regime are not expected to be promulgated in the near future.

To prevent certain tax planning opportunities that were available under the "family company" regime, the Israeli legislature stipulated certain amendments to the "family company" regime as part of the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014) 2013. The amendments are primarily designated to deal with tax planning opportunities that were available with respect to the representative shareholder in a "family company," under which such shareholder was able to elect the "family company" status in certain taxable years in which the company incurred losses and would offset such losses against his/her taxable income. Furthermore, under the previous "family company" regime, the representative shareholder was able to revoke the "family company" status in subsequent years to the extent that the company generated taxable income (or *vice versa*) and no longer generated losses that were deductible against the representative shareholder's income.

Under the new "family company" regime, with effect as of January 1, 2014, a company may elect to be treated as a "family company" for tax purposes only in the three months subsequent to its incorporation. Furthermore, a "family company" which does not meet the conditions in section 64A will lose its "family company" status as of the beginning of the taxable year in which the conditions were not met. However, dividends received by the company in such a taxable year will be included in the representative shareholder's income and will be subject to a 25% tax (30% in the case of a substantial shareholder). The latter provision shall not apply to the extent that the company lost its "family company" status as a result of the death of one of its shareholders or the acquisition of at least 25% of its shares.

Another significant amendment to the "family company" regime provides that a company which lost its "family company" status or elected not to be treated as a "family company" may not elect to be treated as a "family company" in the future. This provision is applicable to current "family companies" and to new "family companies" incorporated after January 1, 2014. Additional amendments to the "family company" regime include: certain provisions with respect to tax-free reorganizations will not apply with respect to "family companies"; a new method of calculation of the distribution of the "family company's" profits and with respect to the allocation of the consideration from the sale of shares in a "family company"; certain tax benefits (e.g., tax exemption available with respect to foreign residents on the sale of shares in an Israeli company) will apply with respect to income generated by the "family company" only to the extent that such tax benefits are applicable to the representative shareholder, and will apply pro rate according to the income allocable to such shareholder; and additional reporting requirements in the case of failure to meet with the conditions provided under section 64A.

It is worth mentioning, that a "family company" that is interested in terminating its "family company" status is required to submit such a notification with the Israeli Tax Authorities no later than a month before the beginning of the taxable year it is interested in terminating its status. As detailed above, such a company may not elect to be treated as a "family company" in the future.

c. Closely Held Companies

Closely held companies controlled by five or fewer people, in which the public has no substantial interest, are subject to certain provisions concerning a deemed distribution of dividends.[724]

The Director of the Israeli Tax Authority may order the relevant assessing officer to act as if part of the closely held company's undistributed profits were actually distributed. The notional distribution is limited to 50% of those undistributed profits, minus the amount of the profits that were actually distributed as dividends.

The issuance of such an order is subject to the following conditions:

> 1. The company did not distribute to its shareholders at least 50% of its profits for the relevant tax year, during a five-year period after the end of the relevant tax year;

[724] Income Tax Ordinance, ss. 76–77.

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2. The company's accumulated profits exceed 5 million NIS;

3. The company is able to distribute its profits — fully or partially — without damage to the existence and development of its business activity;

4. The non-distribution of profits results in tax avoidance or tax reduction;

5. The order of the Director was rendered after consultation with a special advisory committee;

6. The company was given an adequate opportunity to present its arguments before issuance of the order; and

7. Following the notional distribution, the accumulated profits did not fall below 3 million NIS.

d. Personal Service Companies

A personal service company, also known as a "wallet company," is a company used by its individual shareholder for providing certain services. Those services usually should be provided directly by the individual shareholder — as an employee or as a self-employed, but are provided indirectly by the company in order to reduce the income tax rate and the national insurance payments. Therefore, in certain cases, and to prevent abuse of the "two tier taxation method," the Wallet Company's income is considered as the income of the individual shareholder.

The taxable income of a wallet company, which is a closely-held corporation (and not a foreign vocation company), which derives from the business activity of its individual significant shareholder (i.e., a shareholder who holds at least 10% in one or more of the company's means of control), will be considered as the income of the individual shareholder, in one of the following cases:[725]

1. The closely-held corporation's income derives from the services provided by its individual shareholder to another company (including a party related to it), such as officer services, management services, etc. In addition, it is a prerequisite that the individual shareholder or the closely-held corporation are officers in the company that receives the services, and that the individual shareholder is not a significant shareholder, directly or indirectly, in that company. In this case, the income will be classified as business income, as personal exertion income or as income from other sources.

2. The closely-held corporation's income derives from the services provided by its individual shareholder to another party, and these services are of a type usually performed by an employee for his employer. The term "another party" includes a party related to it but does not include a party for which the individual is a significant shareholder, directly or indirectly, or a partner. In this case, the income will be classified as personal exertion income.

In this regard, the services will be considered as usually performed by an employee for his employer if all the following conditions are met:

(i) During the relevant tax year, the source of 70% or more of the closely-held corporation's income or its taxable income — excluding special income and special gains — derives from the services;

(ii) The services are provided by the individual shareholder or his/her relative, including the closely-held corporation's employees, directly or indirectly, including a related closely-held corporation;

(iii) The services are provided for one party or its relative, during a period of 30 months at least, within a period of four years. A service which is provided to a partnership by one of its partners will not be considered as a service of one party; and

(iv) The closely-held corporation employs three or fewer employees, and the individual shareholder and his or her relative are considered to be one employee.

A law for the taxation of undistributed profits in closely held companies was passed in November 2024. The law imposes an additional 2% tax on accumulated profits that are not distributed as dividends. The law outlines the conditions for imposing this tax, which specifically targets profits that were invested in passive assets. A temporary provision for 2025 exempts from taxes the transfer of assets and funds from a dissolving company to its individual shareholders (taxes on surplus distributions). Transfers of real estate to an individual shareholder will be exempt from purchase tax. The law also includes provisions for calculating the additional tax, determining accumulated profits and accounting for various factors that may affect the calculation. Additional measures are introduced to prevent tax evasion, ensure proper coordination across tax years and establish the law's effective commencement date. Overall, the law aims to tighten tax obligations with respect to the undistributed profits of privately-held companies and ensure these profits are not shielded from tax through manipulations such as deferred dividend distributions or asset transfers.

9. Special Cases: Shareholder Withdrawals of Company Funds and Use of Company Assets

An amendment to the Income Tax Ordinance of 2017[726] prevents the withdrawal of funds from a company or the use of its assets for a long period from being classified by the shareholder as a temporary use (i.e., loan, lease, etc.) of the company's assets, to avoid payment of dividend tax at the rate of 30% for the full amount of the funds or the asset and, instead, to pay taxes only for the use of the funds or the assets (i.e., income tax on the interest/rent).

According to the amendment, the withdrawal of funds from a company or the use of its assets by a substantial shareholder or related party is considered as income in the hands of the shareholder, unless the funds or the use thereof were fully taxed. The income will be classified as a dividend to the extent of the share of the shareholder in the company's profits, and the balance as income from other sources, depending on the circumstances.

These provisions are subject to the following transitory measures:

[725] Income Tax Ordinance, Sec. 62A.

[726] Income Tax Ordinance, Sec. 3(i1).

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1. Withdrawal of funds:

• The term "withdrawal of funds" includes providing a guarantee for a substantial shareholder, but it does not include the amount of cumulative withdrawals that did not exceed NIS 100,000 on any day in the relevant tax year and the preceding tax year.

• The date of the taxable event is at the end of the tax year following the tax year in which the funds were drawn.

• The income is equal to the amount of the withdrawal of funds less: (a) the credit balance of the shareholder which is recorded in the financial statements of the company and; (b) a loan from a bank for a period exceeding two years, which was transferred within 60 days to the shareholder, on the condition that he bears the loan costs and that the company did not provide any guarantee against that loan.

• Until the date of the taxable event, the shareholder will be liable to tax for the imputed interest income (the rate of the interest is determined on a yearly basis by the Minister of Finance).

2. Provision of company's assets for use of its shareholders

• The term "asset" includes only the following assets: (a) an apartment, including its contents, whose use is for personal use of a substantial shareholder; (b) works of art or jewelry; (c) aircraft and vessels whose main use is for personal use of a significant shareholder; and (d) other assets determined by the Minister of Finance in this regard.

• The date of the taxable event is at the end of the tax year in which the asset was provided, and at the end of each year thereafter until the asset is returned to the company.

• The income is equal to the cost of the asset less: (a) the credit balance of the shareholder which is recorded in the financial statements of the company and; (b) if the property is an apartment, the loan on which a fixed charge was registered, and the fixed charge is for a period of at least three years.

During the period of the use of the asset until its restoration to the company, income is attributed to the shareholder, at the market value of the use or at the rate prescribed in the Income Tax Ordinance, whichever is higher, less payments made by the shareholder for the use of the asset.

3. Intercompany loans:

A loan given to another company for a financial purpose will not be considered as a withdrawal of funds or use of an asset on the condition that the recipient is not a fiscally transparent corporation, provided all its shareholders are not companies liable to corporate tax in Israel.

10. Pillars One and Two

As the number of MNEs has increased significantly in the last decade, it is in the interest of countries around the world to agree global taxation arrangements. The Two Pillar Solution, developed by the OECD, aims to prevent profit shifting to tax shelters, and at the same time, reduce unnecessary tax burdens on taxpayers. Israel is committed to applying the model, and for the last couple of years, the Israeli legislature has been developing the infrastructure on which the Two Pillar Solution will be implemented.

As of April 2024, the model has not been implemented in the Israeli taxation system and it is too soon to determine its impact on taxpayers. However, according to the Bank of Israel review, this model should have relatively little effect regarding tax benefits for foreign investors whose investment in Israel is not their sole enterprise. Also, since Pillar One relates to the largest MNEs in all the countries that they operate in, investments in Israel will probably be affected by it no differently as from investments elsewhere. The impact of Pillar Two, however, will depend on both an investment's geographical criteria and the nature of the investment, as noted in the chapters on the Encouragement Laws (see II.A.2.c., above).

In August, 2024, the Israel Tax Authority published an announcement regarding the implementation of the Subject to Tax Rule (STTR) as part of the OECD's Pillar Two initiative (STTR rules have not yet been incorporated into any tax treaty signed by Israel).

In addition, the Minister of Finance announced plans to adopt a Qualifying Domestic Minimum Top-Up Tax (QDMTT) starting from the 2026 tax year, which would be applicable to multinational groups based in Israel with an annual turnover of 750 million euros or more. At this stage, no additional tax collection mechanisms (i.e., the Income Inclusion Rule (IIR) and the Under-taxed Payments Rule (UTPR)) will be implemented with respect to income of group companies that are not resident in Israel, with this issue to be revisited following the implementation of the QDMTT. The adoption of these rules will require appropriate legislation.

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VI. Taxation of Foreign Corporations

A. What Is a Foreign Company?

In Israel, the term "foreign company," refers to a "nonresident company," i.e., a corporation registered outside Israel that does not meet the definitions of a "resident company." In short, a foreign corporation is a company the business of which is not controlled and managed from Israel and that was not incorporated in Israel. A foreign corporation may be a tax resident of Israel without being registered as a foreign corporation.

Registration is required under section 346 of the Companies Law, 1999 and failure to register in the case of a foreign corporation with a place of business in Israel constitutes a violation of the law. The Income Tax Ordinance does not regard the mere registration of a company under the Companies Law, 1999 to engage in business in Israel as tantamount to that company becoming a resident of Israel for tax purposes. Once the status of a "resident company" is attained, registration with the tax authorities is required.

The Reform of 2008 prescribed that a foreign company whose business is managed and controlled in Israel by new immigrants or veteran returning residents is not considered a resident of Israel for 10 years from the date the founder assumed Israeli residence if, but for being so managed and controlled, it would not have been classified as a resident of Israel.

To clarify the distinction between Israel's domestic nexus rules and the typical permanent establishment (PE) approach followed under tax treaties, the table below compares Israeli domestic law with the provisions found in various treaties regarding the determination of the source of income from different types of earnings. This comparison should help highlight the key differences in how income is sourced and taxed under domestic law and treaty-based rules.

	Section 4A of the Ordinance	Tax treaties
Business income	The geographic source of business income is the location where the business activity generating the income is carried out.	The right to tax business profits is granted to the country of residence, unless the business operates through a PE in the other Contracting State.[727]
Employment income	The geographic source of employment income is the location where the work was performed.	Income from employment is generally taxed in the employee's country of residence. However, if the work is performed in another country (the source country), that country may also tax the income. Exceptions apply if the employee stays less than 183 days in the source country, the salary payer is not a resident of that country, and the payment is not linked to a PE in that country.[728]
Passive income — dividends, interest and royalties	The geographic source of the income is the place of residence of the payer.	Interest paid by a Contracting State, a resident of a Contracting State or a local authority of a Contracting State is considered sourced in that State, with an exception for interest related to a PE, where the source is the location of the PE.[729]

B. Determination of Taxable Income

1. General Rules

Under the applicable domestic rules, a nonresident foreign corporation is liable for Israeli tax on income "accruing in or derived from Israel."[730] The source rules applicable to income of nonresident corporations are identical to those applicable to resident taxpayers (see IV.C.1., above). Hence, a nonresident corporation will be liable for Israeli taxes on income derived from the conduct of a business in Israel, and on passive income in the form of dividends, interest and royalties where the payor is an Israeli resident.

As regards the carrying on of a business in Israel, there is no domestic Israeli law requirement that the taxable activities be carried on through a PE for them to be taxed in Israel. Therefore, in the case of a foreign company that is resident in a jurisdiction with which Israel has no tax treaty, the fact that its business income accrues in or is derived from Israel will be sufficient to make such income taxable in Israel. For the position where a treaty with a PE provision applies, see discussion at VI.B.2., below regarding the ITA's approach to PE issues.

The nature of Israel's domestic nexus rule may lead to uncertainty for foreign corporates that conduct Israeli operations where no treaty applies and corporates that make digital sales, render services, make supplies or conduct other operations in Israel from outside Israel. The ITA addressed the issue of dig-

[727] OECD Model Convention, Art. 7.

[728] OECD Model Convention, Art. 15.

[729] Israel-United States tax treaty, Art. 4(2).

[730] Income Tax Ordinance, s. 2.

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ital establishments in Circular 4/2016, in which it outlines a more aggressive approach to finding that a company has a substantial economic presence and therefore derives income from Israeli.

Generally, a "significant economic presence" of a service provider may give rise to a PE in Israel. Specifically, a "significant economic presence" may be established where:

(i) The services concerned are used by a large number of Israeli customers;

(ii) There are a "substantial" number of transactions with Israeli customers (it should be noted that "substantial" is not further defined);

(iii) The services are provided via the Internet and consumed by a large number of Israeli consumers; or

(iv) The online services concerned are tailored for Israeli consumers or users, i.e., in terms of their design and the language used.

In this regard, it should be noted that the ITA continues to make adaptations to its approach to taxing transactions undertaken on developing financial and digital transaction platforms. In an interpretive notice made available to the public, the ITA maintained that the wording "accruing in or derived from" encompasses digital financial activity, especially on the internet. Any foreign entity that derives its income from digital transactions in the course of its business with Israeli clients or customers, via local facilities or intermediaries, will bear Israeli tax liability on that income[731] (subject to a PE analysis where relevant for treaty purposes — see VI.B.2., below).

A nonresident corporation will be liable for Israeli capital gains tax on the sale of assets located in Israel, or on the sale of shares in Israeli companies. However, nonresident corporations are exempted from Israeli capital gains tax where the shares are sold on the Israeli stock exchange. It should be stressed, however, that section 68A of the Income Tax Ordinance denies these tax benefits to a nonresident company that is controlled by Israeli residents or if Israeli residents are entitled (directly or indirectly) to 25% or more of the company's income or profits.

2. Permanent Establishments

a. General

As noted above, there is no definition of "permanent establishment" in domestic Israeli law. As such, in the absence of an applicable tax treaty, a nonresident does not have to carry on activity that rises to the level of a PE for the nonresident to create a taxable presence in Israel: from a domestic perspective, Israel may still be able to tax all Israeli-source income of a nonresident in accordance with the rules set out at VI.B.1., above.

Conversely, where a nonresident of Israel is resident in a jurisdiction with which Israel has a tax treaty and is entitled to benefits under the treaty, typically the treaty will provide that Israel is only able to tax the nonresident on its business profits if its activities amount to a PE in Israel within the meaning of the treaty concerned. Israel's tax treaties typically follow the OECD Model Convention and MLI definition of a PE, that being either:

(i) A fixed place of business, through which business of an enterprise is wholly or partly carried on, other than if that activity is of a wholly preparatory or auxiliary nature; or

(ii) The business is carried on with the use of a dependent agent that regularly concludes contracts or otherwise plays a principal role in the conclusion of contracts without notable modification by the company.

b. Fixed Place of Business

For a fixed place of business of a foreign corporation to qualify as an Israeli PE, all three of the following conditions must be fulfilled:

(i) There must be a physical place of business (for example, an office, factory or store);

(ii) The physical place of business must be in Israel; and

(iii) The business of the foreign corporation must be carried on through the fixed place of business.

c. Dependent Agent

A foreign corporation may be deemed to have an Israeli PE where it has a "dependent agent" in Israel. For these purposes, a dependent agent is defined as a person (including an incorporated entity) that has the authority to bind the foreign corporation to contracts, where the person exercises that authority habitually and regularly and the contracts the person has the authority to relate to the business activities of the foreign corporation.

d. Virtual PE via Digital Services

Online activity conducted via the internet with clients, customers or consumers in Israel may give rise to an Israeli PE.

In the past, the permanent place of business in relation to sales activity conducted online was regarded as the place where the relevant server was physically located. Currently, in the age of the digital economy where the server can be physically located almost anywhere in the world, the physical location of the server will be given little weight in determining whether and where a PE exists. The activities of a foreign corporation operating via the internet are sometimes carried on through a permanent physical location in Israel, but where a foreign corporation has no such physical presence, it may still be regarded as having a taxable presence in Israel as a "virtual" PE.

In determining the existence of a virtual PE, the ITA considers the same factors that lead to a digital service provider having a substantial economic presence in Israel (see VI.B.1., above), with the additional requirement that the services be provided via a fixed place or a dependent agent in Israel as in the case of a non-virtual PE. In this context, however, Circular 4/2016 makes the additional point that activities that may otherwise be considered wholly preparatory or auxiliary — and therefore as not giving rise to a PE — may take on greater significance alongside the substantial economic presence of a digital service provider, thus creating a greater risk of the service provider being found to have a PE.

[731] ITA Circular 4/2016.

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See VII., below for the method of taxation where it is determined that a foreign corporation resident in a tax treaty jurisdiction has an Israeli PE or, where the foreign corporation is resident in a non-treaty jurisdiction, that its income otherwise has a taxable source in Israel.

C. Method of Taxation

A few provisions of the Income Tax Ordinance require special mention in discussing the tax regime applicable to foreign companies. These are discussed in 1. to 3., below.

1. Special Relief for Israeli Taxed Shareholders of Foreign Corporations

Section 163 of the Income Tax Ordinance, entitled "Relief from Tax on Dividends from Israeli Income of Companies Resident Abroad," provides that, where it is proven to the satisfaction of the Assessing Officer that an ordinary dividend paid to an Israeli taxpayer with respect to which the taxpayer is chargeable to tax under the Israeli Income Tax Ordinance was paid by a foreign corporation and the income of that company out of which the dividend was paid (referred to in the section as "the relevant income") includes income on which the dividend-paying company paid income tax in Israel, the recipient of the dividend is entitled to relief from tax with respect to "such part of the dividend as bears to the whole of the dividend the same ratio as the Israeli income bears to the whole of the relevant income."

Note: This provision is now of limited importance since no income tax is imposed on companies. It applies only to foreign corporations distributing dividends out of dividends paid to them by Israeli resident corporations that withheld at source Israeli tax at the rate of 25% and 30% pursuant to section 125B of the Ordinance.

2. Withholding

Section 170 of the Income Tax Ordinance is of great importance in the context of the taxation of foreign corporations. It provides that a person paying chargeable income to a nonresident corporation or individual must withhold tax in accordance with the corporation and income tax rates applicable to retained earnings at source ("or tax at such other rate as the Assessing Officer may … prescribe by notice in writing") unless a special rate for such withholding was determined under the Income Tax Regulations (Deduction from Interest Dividend and Other Gains) (see XII.F., below).

The regulations set the withholding rate at 30% for dividends paid to substantial nonresident shareholders and at 25% for dividends paid to other nonresident shareholders of a company registered on the stock exchange.

Withholding tax on interest paid to a nonresident is to the same as the withholding tax on interest paid to a resident (20% or 15%).

For the rates of source country taxation applying to investment income, services income and capital gains under Israel's domestic law and tax treaties and the context for the application of those rates, see the Withholding Tax Chart.

3. Special Instructions

In 1981, the Treasury issued instructions with respect to the expenses of foreign companies incurred by their local subsidiaries that eliminate Israeli taxable income. Pursuant to the instructions, Israeli taxable income is computed based on the ratio of Israeli income to worldwide income as applied against the profits of the foreign corporation, or after deduction of a flat 35% for the expenses incurred in Israel.[732] It is doubtful whether these instructions are still being implemented.

[732] Income Tax Implementation Instruction No. 81/84.

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VII. Taxation of a Branch

A. Determination of Taxable Income

The Income Tax Ordinance does not provide special rules for the taxation of branch operations. The taxation of branch operations, therefore, falls under the general aegis of the applicable provisions of the Income Tax Ordinance unless otherwise subject to a tax treaty that requires a PE to be present for such operations to be taxable, in which case the existence of a PE must first be established as outlined at VI.B.2., above. Once established, the determination of taxable income follows similar principles.

A branch is liable to tax on all income "accruing in or derived from Israel." In certain cases, a special allocation is required between Israeli-source income and foreign-source income. Moreover, the Income Tax Ordinance allows for the deduction of expenses incurred outside Israel in the production of Israeli-source income. In the case of a branch, an allocation must be made to take into account expenses incurred by the headquarters on behalf of the branch. The Ordinance is silent with respect to the rule for the allocation of expenses to a geographic source. The general practice is that, where an expense is directly attributable to the production of Israeli-source income, it is allowed as a deduction against that income, provided it meets the criteria of section 17 of the Ordinance and is not barred under other special provisions of the Ordinance or regulations promulgated by the Minister of Finance. Where an expense is not directly attributable to the Israeli activity, administrative practice allows for an apportionment or allocation of the expense; however, no firm guidelines have been set. Occasionally, the Treasury reaches an agreement with a nonresident taxpayer pursuant to which the entire income from the activities carried out in Israel is calculated based on a certain percentage of the turnover of the taxpayer. In such cases, the question of the allocation of expenses does not arise. In other instances, a formula is agreed on for the allocation of expenses to Israeli-source income.

In general, it is best to treat a branch as a "separate accounting entity" and to record its income separately, as if it were a subsidiary.

Finally, it is worth noting that no loss incurred outside Israel is to be allowed as a deduction or carryover for purposes of determining the Israeli tax liability of a nonresident. In sum, the general pattern of allocating expenses or income is built on a two-tier system. First, an attempt is made to specify and trace expenses to the Israeli-source income. Second, where this is unfruitful, or where the expense cannot be traced specifically to an Israeli source, an apportionment is made based on a formula agreed on between the Treasury and the taxpayer.

B. Method of Taxation

The method of taxing branch profits closely follows the method of taxing foreign companies discussed in VI.C., above. Where the foreign company is not a resident, the branch profits are subject to a 25% flat tax. Under section 170 of the Income Tax Ordinance, payments of chargeable income to a branch require withholding. It is customary to request an exemption from the withholding duty, which the Assessing Officer readily grants if he/she is convinced that the tax will be paid directly by the branch. In practice, however, few business operations use a branch to conduct a trade or business in Israel. Perhaps branch operations play their greatest role during the first year of business activities in Israel. In the event that a branch incurs losses, these may be set off against the profits of the foreign company if it is taxed on worldwide income and the pertinent provisions of the income tax statutes in its home country allow for the setting off of losses incurred abroad. Where a subsidiary is used and losses are incurred, they may only be set off against future business income of the subsidiary.[733] When losses are envisaged during the initial years of operation, it is best to commence operations in the form of a branch and thereafter to incorporate the branch into a subsidiary, a feat that may be accomplished with the deferral of the capital gains tax that would otherwise be levied on the transfer of the fixed assets.[734]

A U.S. investor should note that, since an Israeli private limited company is not listed as a "per se" corporation under the U.S. check-the-box regulations, it is possible to elect for partnership treatment of an Israeli subsidiary. The branch structure will hence be of relatively limited use to U.S. companies operating in Israel.

No branch profits tax is levied except under section 52 of the Law for the Encouragement of Capital Investments, 1959, pursuant to which a branch of a "Foreign Investors Company" is liable for a 15% tax on remittances as if they were a dividend.

C. Subsidiary vs. Branch

When a subsidiary is used, it is in most cases regarded as a "resident company." In the case of undistributed profits, the tax on similar income of a branch and that of a subsidiary is the same. Under the Income Tax Regulations (Deduction from Interest and Dividend and Specific Gains), the withholding rate on dividends payable to nonresidents is 30% for significant shareholders and 25% for non-significant shareholders and no further tax is levied due to the provisions of section 125B. Thus, the total tax burden comes to 43.75% (25% company tax and 25% income tax) as opposed to 25% in the case of a branch.

Moreover, as noted in B., above, a branch is preferable where first year losses are expected. A subsidiary is preferable where it enjoys Israeli tax incentives and retains its earnings, thereby avoiding their taxable distribution to the parent company. Thus, the tax on the retained earnings is deferred (or never paid where the shares are sold and the alternative benefits (see II.A.2.i., above) were elected) until a dividend is distributed or until the shares are sold (which sale may be tax exempt where a

[733] Income Tax Ordinance, s. 28(b).

[734] If the assets transferred are real estate rights, The Taxation of Land (Appreciation, Sale and Purchase) Law, 1963, s. 70, provides that the sale of such rights to an association, by the holder of a right in the transferee, in consideration of an "allocation" in the transferee, "shall be exempt from tax if: (1) that association is a real estate association, or became a real estate association immediately after acquiring the land; (2) the association right vested in the person who sold the real estate right to the association is coextensive with the real estate right sold by him; or (3) the ratio which the value of the allocated shares bears to the value of the association is equal to the ratio of the value of the real estate right transferred to the total value of the association. "When the assets are personal property, Income Tax Ordinance, s. 104 provides for a nontaxable transfer of such assets to the company, provided certain conditions are met.

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tax treaty reserves the right of taxation to the state of residence of the alienator of the shares, i.e., the parent company). In other words, the cash flow of the parent company may be impaired, but the net result is the enhancement of its equity position in the subsidiary.

Comment: As a practical matter, it is generally easier to deal with the relations between a parent company and its subsidiary than with the relations between a branch and its headquarters. The participation of the two entities in the process of deriving the income allows for cross-invoicing, contracts and the establishment of "arm's-length" relations. Naturally, such relations cannot be established in a legal sense where a branch is used, and therefore, the requirement is for allocations based on various formulae, which in the final result might be detrimental to the foreign company.

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VIII. Taxation of Partnerships

Section 63 of the Income Tax Ordinance designates the method of taxing partnerships. It provides that, where the assessing officer is convinced that a business or vocation is carried on by two or more persons jointly, the income of any partner from the partnership is deemed to be the share of the income of the partnership to which the partner was entitled during the tax year and this income is included in the partner's return. Thus, a partnership is not in itself a tax-paying entity. Rather, the partners are regarded as ratably earning the income of the partnership.[735]

The income of the partnership itself is calculated and determined at the partnership level and only thereafter attributed to the partners, but where a partner is denied a particular deduction, the restriction applies only to that partner in computing their taxable income derived from the partnership.[736] The assessing officer may require a partnership return and, in fact, this is the practice in Israel. Such a return includes the names and addresses of the partners together with their respective shares of the partnership's income. Where the assessing officer is not satisfied that a business or vocation is carried on by two or more persons jointly, section 63(b) of the Income Tax Ordinance provides that "the gains or profits from such business or vocation shall be deemed to have accrued to such person entitled to a share of such gains or profits as the assessing officer may elect, and assessment of tax shall be made accordingly."

In 2001, the Supreme Court finally settled the long-standing argument over whether a partnership interest as such could be the subject of a taxable capital transaction in deciding that the sale of an interest in a partnership is much like the sale of a share in a company and should be treated in the same way.[737]

A partnership, especially a limited partnership, is a useful vehicle for conducting business in Israel where losses are anticipated during the initial years of operation and may be used to offset income in some other tax jurisdiction. Indeed, a partnership is most effective where the foreign investor is a limited partner and may offset such losses without extending his/her liability beyond a prescribed amount (see III.A.2., above).

Limited partnerships are used as tax shelters for foreign investments. Thus, for example, where a loan may be received for research and development (R&D) expenses (in lieu of a grant, which is not deductible), it is common to establish a limited partnership and thereby gain the advantage of a deduction on both the outlay of the taxpayer and the additional loan, where the taxpayer's country of residence allows such a deduction. Moreover, Israeli tax law, as yet, has not developed any "at risk" rules, hence a set-off is allowed regardless of the amount of liability assumed by the limited partners.

The Minister of Finance is empowered to deem certain types of partnerships, the units of which are registered on the Tel-Aviv Stock Exchange (TASE) or elsewhere, to be companies for purposes of the Income Tax Ordinance, thus causing distributions made by them to their members to be deemed dividends.[738]

The draft bill to amend the Income Tax Ordinance proposes replacing Section 63(e), which grants the authority to set specific provisions for certain partnerships. It seeks to empower the Minister of Finance, with the approval of the Knesset's Finance Committee, to establish regulations stating that a partner's share of income from securities or other financial assets, subject to conditions yet to be set, will be considered passive income or capital gains, all subject to conditions defined by the Minister with the approval of the Finance Committee.

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[735] C.A. 536/88 *Etz Lavud Tassiot VeHashkaot Ltd. v. The Assessing Officer (Large Enterprises)*, Missim F-6 (Dec. 1992), E-60; I.T.A. 149/88 *Gadaban Afif v. Assessing Officer*, 19 P.D.A. 152.

[736] I.T.A. 83/77 *Pegasus Ltd. v. The Assessing Officer*, 10 P.D.A. 12; I.T.A 92/84 *A.H.A. Goldstein (1975) Ltd. v. The Assessing Officer*, 13 P.D.A. 211; C.A. 128+375/75 *The Assessing Officer v. Haachim Mark*, 8 P.D.A. 121; C.A. 536/88 *Etz Lavud Taasiot VeHashkaot Ltd. v. The Assessing Officer (Large Enterprises)*, Missim F-6 (Dec. 1992), E-60.

[737] C.A. 2026/92 *Assessing Officer Petach-Tikva v. Sadot Hevra LeHovala (1982) Ltd.*, Missim O-3 (June 2001), E-53.

[738] Income Tax Ordinance, s. 63(d).

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IX. Taxation of Israel Holding Companies

A. Profits of Israel Holding Companies

In 2005, a new tax regime was introduced with respect to Israel holding companies, as defined in the Income Tax Ordinance. Within this framework, a tax exemption is granted with respect to the following income of an Israel holding company:

(i) Capital gains derived from the sale of shares constituting part of a "block of shares" entitling the seller to at least 10% of the rights to profits in the company whose shares are being sold, provided the shares were held by the holding company for at least 12 consecutive months (an "entitling share");

(ii) Dividends received on an Entitling Share if distributed during a period of 12 consecutive months during which the recipient company held at least 10% of the controlling interests in the distributing company;

(iii) Interest, dividends and capital gains derived from securities traded on the Tel-Aviv Stock Exchange (TASE); and

(iv) Interest and linkage differentials received from financial institutions.

No foreign tax credit is allowed with respect to exempt income. The conditions relevant to the tax exemption of interest received from an affiliated company will be regulated in special Regulations yet to be enacted.

An Israel holding company will not be subject to the tax regime applicable to controlled foreign companies (CFCs) with respect to its holdings in foreign companies controlled by it.

B. Dividends Distributions by Israel Holding Companies

Dividends distributed by an Israel holding company to its shareholders are taxed as follows:

(i) Dividends distributed to nonresident shareholders are subject to a 5% tax withheld at source; and

(ii) Dividends distributed to Israeli resident shareholders:

(a) Where the recipient is an individual, the general tax regime applies (25% with respect to an individual who is not a controlling shareholder and 30% in case of a controlling shareholder);

(b) where the dividends are distributed to a corporation: when the source of the dividends is interest, dividends or capital gains from shares traded on the TASE, the rate of tax is the corporate tax rate; when the source of the dividends is capital gains from the sale of an Entitling Share, the rate of taxation will be 23%; and

(iii) In all other cases, the dividends will be subject to the general tax regime applicable to dividends.

C. Tax Regime Eligibility

To avail of the preferential tax regime, an Israel holding company must meet several preconditions that were introduced into the definition of a holding company. Similarly, special conditions were laid down with respect to the holdings of the entity entitling it to the preferential tax treatment with respect to income derived therefrom.

The definition of a holding company is a company (but not a "body of persons") incorporated in Israel[739]:

(i) Whose business is controlled and managed solely from Israel;

(ii) That is not a public company within the meaning of the Companies Law, 1999, and is not a financial institution within the meaning ascribed thereto in the Value Added Tax Law, 1975;

(iii) That is not a family company or a transparent company (companies whose income is ascribed to a major shareholder or to the shareholders pro rata respectively);

(iv) That did not enjoy, on the acquisition of assets, exemptions under Chapter E-2 of the Income Tax Ordinance dealing with structural changes and incorporation or under section 70 of the Taxation of Land (Appreciation, Sale and Purchase) Law, 1963 granting an exemption from tax to shareholders transferring real estate to a company for no consideration;

(v) That, during the course of 300 days or more during each tax year commencing with the tax year after its incorporation, met the following two conditions:

- the basis of shareholdings in affiliated companies, together with the balance of loans made to such companies, did not fall below NIS 50 million; and
- the basis of its shares in affiliated companies, together with the balance of loans it made to such companies, equals 75% or more of the basis of all its assets;

(vi) That did not have any income taxable under section 2(1) of the Ordinance (business income), except for income derived from services rendered to affiliated companies and except for an inflationary increment that is regarded as income from a business; and

(vii) That notified the assessing officer by a notice signed by all its shareholders that it elected to be taxed under the tax regime applicable to Holding Companies within 90 days of its incorporation.

A corporation that failed to meet the conditions of the definition of an Israel holding company during the year of its incorporation and during the following year will be regarded as having never met these conditions. A holding company that fails to meet these conditions after that period will cease to be regarded as an Israel holding company as of the beginning of the tax year in which it failed to meet the conditions.

An Israel holding company may, by a notice signed by all its shareholders to the Director of the Israel Tax Authority, elect to cease to enjoy the tax regime applicable to holding companies, whereupon it will no longer enjoy the preferential tax treatment as of the tax year following the tax year during which notice was given.

[739] Income Tax Ordinance, s. 67C.

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An "affiliated company" must be a "body of persons" (as opposed to a "company" for purposes of the holding company regime):

(i) That is a nonresident with residence in a reciprocating state and that files in that state a return with respect to its income or a nonresident with residence in a country with a tax rate of at least 15% on business income at the time the Holding Company first acquired the shares;

(ii) At least 75% of the income of which derived or accrued from outside Israel is business income, i.e., income that would be liable for Israeli tax had it been Israeli source, under section 2(1) of the Income Tax Ordinance, during the tax year (in computing the income, there will be added to it the pro rata share of the income of affiliated companies (a holding of at least 10% whether directly or indirectly), while management fees from a related taxpayer, consideration from the sale of an asset (except for the sale of a security traded on the stock exchange issued by a company in which the holding company is not a controlling shareholder), and a dividend from affiliated companies will not be taken into account);

(iii) The basis of whose Israeli assets including rights in a foreign company whose principal assets are located in Israel, does not exceed 20% of the basis of all its assets; and

(iv) Whose income during the tax year, including income from the sale of real estate or a right in a real estate association derived or accrued from Israel, does not exceed 20% of its entire income during the tax year.

D. Notional Taxation of Israeli Resident Shareholders

An Israeli resident holding shares in an Israel holding company at the end of the tax year will be deemed to have received a dividend from the holding company whether or not the dividend was in fact distributed. The tax payable with respect to such a notional dividend will be computed in accordance with the tax regime that would have been applicable, had the dividend actually been distributed.

Where the holding is an indirect holding by means of a chain of Israeli resident shareholders, the tax will be paid by the first Israeli resident shareholder in the chain.

On the actual distribution of the dividend, no further Israeli tax will be levied and no such tax will be levied if the dividend was used to set off a loss.

On the sale of a share in a holding company by a resident of Israel, a tax credit with respect to the capital gains chargeable thereon will be granted with respect to the tax paid on the notional dividend, provided the dividend was not actually distributed prior to the sale. The amount of the credit will be adjusted in accordance with the Consumer Price Index as of the closing of the tax year in which the tax was levied on the notional dividend, and it is limited to the amount of tax payable on the sale of the share. Profits with respect to which a notional tax was paid will not be deemed to be retained profits with respect to which a tax will be due on the sale of the shares.

E. New Immigrants

New immigrants and returning residents who held shares in an Israel holding company prior to arriving in Israel can obtain a tax rate of 5% on dividends received from the holding company for 10 years after becoming Israeli residents. The rules regarding the notional taxation of dividends do not apply with respect to shares held in Israel holding companies during the time they were nonresidents, subject to certain conditions.

F. Change in Status

Gains derived from sales of assets by an Israel holding company that lost its tax exempt status are dissected on a linear basis in accordance with the periods during which the assets were held by the entity. The real capital gain attributable in the period during which the company was an Israel holding company are tax-exempt while the remainder of the real gain is subject tax. Dividends distributed by a holding company that lost its preferential tax status out of profits derived during the period during which it maintained its preferential status, or out of the exempt portion of a capital gain derived from an asset sale after it lost preferential status, are subject to a 5% tax.

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X. Taxation of Investment Funds

A. Venture Capital Funds

1. In General

The Israel Tax Authority (ITA) published Income Tax Circular No. 9/2018, which sets forth the tax regime applicable to venture capital funds.[740] The preferred tax regime is aimed at encouraging foreign investments in venture capital investments in Israel.

A venture capital investment is a qualifying investment in the Israeli know-how and high-tech industry, with at least 75% of it being made in consideration of the issuance of shares, option stocks or convertible bonds of the target company.

A qualifying investment is an investment which is made in a target company, i.e., an Israeli resident company or a foreign company whose main assets or activities, indirectly and directly or indirectly, are located in Israel ("Israeli related company"). A qualifying investment does not include an investment in marketable securities, unless they are held by the fund for at least one year.

The main activity of a target company must be a qualifying activity, i.e., the establishment or expansion of plants in Israel in the following sectors: Industry, manufacture, agriculture, tourism, transportation, construction (except real estate), water, energy, technology, communications, computing, security, medicine, software, biotechnology, and nanotechnology. A qualifying activity does not include an activity in the sectors of services, commerce, and finance (except for certain activities that were approved in advance and explicitly by the Director of the ITA) and the real estate sector.

2. Eligibility Criteria

The tax regime applies to a venture capital fund that meets all the following conditions:

(i) There are at least 10 unrelated (directly or indirectly) investors in the fund and who are not partners in the general partner;

(ii) The investors in the Fund do not hold more than 20% of the total rights in the Fund, with the exception of one investor only who may hold up to 35% of the Fund's rights;

(iii) The foreign shareholding rate in the Fund is at least 30%;

(iv) The total investments of the Fund are not less than US$ 10 million, of which at least US$ 5 million must have been provided by foreign investors;

(v) The fund does not invest more than 25% of the capital it raised in one company;

(vi) The fund invests in qualifying investments in Israel according to one of the following two alternatives, whichever the lower:

At least US$ 10 million is invested in qualifying investments, provided that at least US$ six million is invested in Israeli companies with the developed knowledge owned by them or in foreign companies that hold an Israeli subsidiary whose developed knowledge is owned by this subsidiary.

At least 50% of the investments of the fund are in qualifying investments, provided that at least 30% of the investments of the Fund are invested in Israeli companies that own the developed knowledge or in foreign companies that hold Israeli subsidiaries that own the developed knowledge.

(vii) The fund does not invest an amount exceeding 20% of the total amount of its investments in Israel in companies the securities of which are traded on the Stock Exchange on the date of the investment;

(viii) The fund does not hold short-term cash deposits or marketable securities, unless they originate from funds transferred by the investors according to their obligations or from the fund's revenues for the investments of the Fund or until their distribution; and

(ix) The fund management is carried out by the general partner. Limited partners who hold more than 4% of the fund's rights may not participate in any form in the aforementioned management.

Circular No. 9/2018 also discusses, based on prior rulings of the ITA, the tax regimes that apply to venture capital funds that do not meet the eligibility conditions described above, including funds held by less than 10 investors, funds without a permanent establishment in Israel, co-investor funds, and annex funds.

3. Taxation of Venture Capital Funds, Foreign Investors, and General Partners

The tax regime applies only to venture capital investments attributed to foreign investors.[741] The tax rules which apply to the fund (in respect of the shareholding rate attributed to foreign investors), foreign investors, and general partners (in respect of the shareholding rate attributed to foreign investors), are as follows:

(i) Income derived from qualifying investments (capital gain, dividend and interest) are exempt from tax;

(ii) Other income (including a management fee received from the target company) is liable to tax (if any) in accordance with the Income Tax Ordinance or the provisions of the relevant tax treaty;

(iii) The fund (in respect of the shareholding rate attributed to foreign investors) and foreign investors are not liable to tax in Israel on any income derived from investments in foreign companies or companies that are not Israeli related companies.

[740] Income Tax Circular No. 9/2018, Taxation of Venture Capital Funds (March 14, 2018).

[741] Under certain conditions, the tax regime also applies to Israeli investors.

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4. Taxation of Venture Capital Fund Managers, General Partners, and Shareholders

The tax regime applies only to venture capital investments attributed to foreign investors.[742]

The fund manager and the general partner must carry out the business activity, in respect of investments to be made in Israel, through a permanent establishment in Israel.

The tax rules which apply to the fund manager, general partner and its shareholders, for their share in the fund's profits, including management fee and success fee, are as follows:

(i) The fund manager is liable to tax at the marginal tax rates or corporate tax rate, as the case may be, on income received from the Fund.

(ii) The general partner and its shareholders are liable to tax at the marginal tax rates or corporate tax rate, as the case may be, on income received from the Fund, including a success fee, which is considered as business income. However, the foreign shareholders are liable to tax at a rate of 15% only for their share in the success fee derived from investments made in an Israeli resident corporation or an Israeli-related company (unless the shareholder is a foreign company in which 25% or more of its controlling interest is held by Israeli residents).

B. Private Equity Funds

1. In General

The Israel Tax Authority (ITA) published a circular which details the tax regime that applies to private equity funds.[743] The preferred tax regime is aimed at encouraging foreign investments in qualifying investments.

A qualifying investment is an investment that is made in a target company, i.e., an Israeli resident company or a foreign company whose main assets or activities, directly or indirectly, are located in Israel ("Israeli related company"). A qualifying investment does not include an investment in marketable securities, unless they are held by the fund for at least one year.

The main activity of a target company must be a qualifying activity, i.e., establishment or expansion of factories in Israel in the following sectors: industry, manufacture, agriculture, tourism, transportation, construction (except real estate), water, energy, technology, communications, computing, security, medicine, software, biotechnology, and nanotechnology. A qualifying activity does not include an activity in the sectors of services, commerce and finance (except for certain activities that were approved in advance and explicitly by the Director of the ITA) and the sector of real estate.

2. Eligibility Criteria

The tax regime will apply to a private equity fund that meets all the following conditions:

(i) The number of investors in the fund is not less than 10 and who are not related to each other, directly or indirectly, and are not partners in the general partner.

(ii) The investors in the fund do not hold more than 20% of the total rights in the fund, with the exception of one investor only who may hold up to 35% of the fund's rights.

(iii) The foreign shareholding rate in the fund is at least 30%.

(iv) The total investments of the Fund are not less than US$ 10 million, of which at least US$ 5 million has been provided by foreign investors.

(v) The fund does not invest more than 25% of the capital it raised in one company.

(vi) The fund invests in qualifying investments in Israel according to one of the following two alternatives, whichever is the lower:

At least US$ 10 million is invested in qualifying investments, provided that at least US$ 6 million is invested in Israeli companies with the developed knowledge owned by them or in foreign companies that hold an Israeli subsidiary whose developed knowledge is owned by this subsidiary.

At least 50% of the investments of the fund are invested in qualifying investments, provided that at least 30% of the investments of the fund are invested in Israeli companies that own the developed knowledge or in foreign companies that hold Israeli subsidiaries that own the developed knowledge.

(vii) The fund does not invest an amount exceeding 20% of the total amount of its investments in Israel in companies the securities of which are traded on the stock exchange on the date of the investment.

(viii) The fund does not hold short-term cash deposits or marketable securities, unless they originate from funds transferred by the investors according to their obligations or from the fund's revenues for the investments of the Fund or until their distribution.

(ix) The management of the fund is carried out by the general partner. Limited partners who hold more than 4% of the fund's rights do not participate in any form in the aforementioned management.

Circular No. 9/2018 also discusses, based on prior rulings of the ITA, the tax regimes that apply to venture capital funds that do not meet the eligibility conditions described above, including funds held by less than 10 investors, funds without a permanent establishment in Israel, co-investor funds, and annex funds.

3. Taxation of Private Equity Funds, Foreign Investors, and General Partners

The tax regime applies only to qualifying investments (including income derived from them) attributed to foreign investors.[744]

[742] Under certain conditions, the tax regime also applies to Israeli investors.

[743] Income Tax Circular No. 10/2018, Taxation of Private Investment Funds (Private Equity) (March 14, 2018).

[744] Under certain conditions, the tax regime also applies to Israeli investors.

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(i) The taxation rules which apply to the fund (in respect of the shareholding rate attributed to foreign investors), foreign investors, and the general partner (in respect of the shareholding rate attributed to foreign investors), are as follows: Income derived from realization of qualifying investments is exempt from tax.

(ii) The dividend tax is at the rate of 15% for individual investors and at the rate of the corporate tax for non-individual investors. However, foreign investors from a contracting state with a lower dividend tax are taxed in accordance with the provisions of the relevant tax treaty. Moreover, a tax-exempt foreign investor is exempted from the dividend tax. A tax-exempt foreign investor is a public institution, a manager of a long-term savings plan or a pension fund which is a resident of a contracting state, provided that the dividend is exempt from tax in the contracting state for the reason they are considered as profits on retirement savings.

(iii) Interest income is liable to tax in accordance with the Income Tax Ordinance provisions. However, foreign investors from a Contracting State with a lower tax are taxed in accordance with the provisions of the relevant tax treaty. Moreover, a tax-exempt foreign investor is exempted from the tax. However, if the target company deducts or capitalizes as the cost of an asset, interest expenses paid on a loan received from the fund, the interest income is liable to tax at the rate of 5% or at a lower tax rate in accordance with the provisions of the relevant tax treaty.

(iv) Other income (including a management fee received from the target company) is liable to tax (if any) in accordance to the Income Tax Ordinance or the provisions of the relevant tax treaty.

(v) The fund (in respect of the shareholding rate attributed to foreign investors) and foreign investors are not liable to tax in Israel for any income derived from investments in foreign companies or companies which are not Israeli related companies.

4. Taxation of the Private Equity Fund Managers, General Partner, and Shareholders

The tax regime applies only to qualifying investments attributed to foreign investors.[745]

The fund manager and the general partner must carry out the business activity, in respect of investments to be made in Israel, through a permanent establishment in Israel.

The taxation rules which apply to the manager of the fund, general partner, and its shareholders, for their share in the fund's profits, including management fee and success fee, are as follows:

(i) The fund manager is liable to tax at the marginal tax rates or corporate tax rate, as the case may be, for income received from the fund.

(ii) The general partner and its shareholders are liable to tax at the marginal tax rates or corporate tax rate, as the case may be, on income received from the fund, including a success fee, which is considered business income.[746] However, the foreign shareholders are liable to tax at a rate of 15% only on their share in the success fee derived from investments made in an Israeli resident company or Israeli related company (unless the shareholder is a foreign company in which 25% or more of the controlling interest is held by Israeli residents).

[745] Under certain conditions, the tax regime also applies to Israeli investors.

[746] As a part of the November 2024 draft bill to amend the Income Tax Ordinance, it is proposed to add Section 125B2, which imposes a 32% tax on success fees received by an Israeli resident managing partner, derived from fund profits generated by investments in securities or other financial assets, under conditions to be determined by the Minister of Finance and approved by the Finance Committee. Additionally, it is proposed to add subsection (6) to Section 31 of the VAT Law (which specifies cases eligible for VAT exemption), stating that success fees received by a managing partner in an investment fund, derived from an investment in a financial asset of a type to be defined in the regulations, will be exempt from VAT.

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XI. Taxation of Real Estate Investment Trusts

The real estate investment trust (REIT) enables the public to purchase shares in a company that invests in income-producing real estate. The trust distributes its profits to the shareholders on an ongoing basis. Thus, by purchasing the shares of the fund, the public can invest, indirectly, in large projects of income-producing real estate, and at the same time enjoy the benefits of a direct investment in those projects.

The shareholders are deemed to own, directly, the income-producing real estate owned by the fund. Thus, as a rule, the profits of the fund are taxed only once — at the level of the shareholders, i.e., the profits are not taxed at the level of the fund.

A company must meet certain criteria to be qualified as a REIT. It must be incorporated in Israel, exercise the control and management of its business from Israel, and be traded on the Israeli stock exchange. In addition, the company must meet additional requirements regarding the distribution of its shares to the public, the composition of its real estate assets, leveraging, and distribution of profits to its shareholders.

The fund is entitled to special tax benefits with respect to long term residential leases and is allowed to invest in such projects from their initial stage.

The fund is obliged to distribute at least 90% of its taxable income to its shareholders. The distribution must be made within four months from the end of the year in which the taxable income was derived (i.e., until April 30). Moreover, the fund is obliged to distribute its capital gains and land appreciation gains derived from sale of income-producing real estate. The distribution must be made within a year from the date of the sale.

The taxable income distributed to the shareholders is liable to tax on the date of the distribution. The income is considered as the income of the shareholders, for the purpose of the calculation of the tax liability, tax rates and offsetting losses, with the exception of the following income:

(i) Irregular income is liable to tax at a rate of 70% without entitlement to an exemption, deduction, tax allowance or set off. Irregular income includes: (I) income derived from the sale of business inventory; (II) income exceeding 5% of the total income of the fund and not derived from income-producing real estate, negotiable securities, bonds of the State of Israel, and deposits; (III) income derived from the sale of real estate for projects of long term residential leases (supervised by the government), if they were sold less than 20 years from the date of their purchase by the fund;

(ii) Taxable income derived from the sale of income-producing real estate held by the fund as a current asset is liable to marginal tax if the shareholder is an individual and to corporate tax if the shareholder is a company;

(iii) Taxable income derived from income-producing real estate which is not held by the fund as a current asset or real appreciation derived from the aforementioned real estate is liable to tax at a rate of 20%.

The distributed income in the hands of the shareholders is classified according to the classification of the income in the hands of the fund. However, the distributed income in the hands of the shareholders will not be considered as personal exertion income, and therefore will not be entitled to tax benefits or reliefs which apply to such income.

The taxable income which the fund is not obliged to distribute to its shareholders (up to 10% of its taxable income) is liable to corporate tax at the level of the fund, and also to dividend tax at the level of the shareholders. However, irregular income is liable to tax at a rate of 60% at the level of the fund.

Net losses of the fund cannot be distributed or attributed to the shareholders but rather will be carried forward and offset against the fund's income in the subsequent years.

Upon the sale of the fund's shares, the regular tax regime will apply. However, the seller may offset a loss incurred upon the sale of the shares against taxable income (except for irregular income) distributed to him during the year of the sale.

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XII. Taxation of Trusts

A. Prior Rules

Unlike the tax regimes of other countries, the Israeli statutory tax regime did not contain any explicit arrangement for the taxation of trusts until 2006. Thus, trusts were not specifically recognized as separate taxable entities and no "pass through" rules existed for them. Evidently, the various types of trusts that are common in the west, for example, discretionary trusts, were unknown to the Income Tax Ordinance.

Before the enactment of Amendment no. 147 to the Income Tax Ordinance, Israeli common tax wisdom maintained that tax could be avoided by means of an irrevocable discretionary trust that had a number of beneficiaries. In such a case, where it was not clear how the income would be distributed, the beneficiary, it was believed, could not be taxed because it was uncertain as to what income, if any, the beneficiary would receive. The trustee could not be taxed because the income would eventually leave their possession in favor of the beneficiaries,[747] and the settlor could not be taxed on the income of the trust if the trustee was free to deal with the assets of the trust, after their settlement, in their sole discretion and provided further that the trust was an irrevocable trust. As often stated in the court's precedents, the owner of an asset is entitled to its fruits and once an asset was transferred to the trust it was transferred to it with the right to its fruits.[748]

As a result of the well-established source doctrine, the prior tax regime governing trusts in Israel provided for tax exemption on distribution of the trust's assets as well. In *Minz & Silberstein*,[749] the Supreme Court decided that for a receipt to be taxable it must have a source and that where a source is lacking no income can be attributed to the taxpayer. Where the trustee had total and absolute discretion in dealing with the assets of the trust, and the beneficiary had no specific entitlement to receive any assets from the trust, a beneficiary in receipt of a distribution might be acquiring wealth but would not receive "income" within the meaning attributed to this notion under the Income Tax Ordinance.[750]

In September 2002, a special committee was established for the purpose of defining and laying down rules regulating the taxation of trusts. The committee submitted its recommendations, but these did not form the basis for the new taxation rules regarding trusts.[751]

[747] Moreover, it was unclear as to whether any tax paid by the trustee would be credited against the tax ultimately paid by the beneficiary and at what rates the tax should be imposed on the trustee (progressive for individual or corporate for company). Where the trustee was a nonresident and the income was derived from outside Israel, in the absence of transparency, Israel could not levy any taxes. Tax experts believed that to avoid taxation based on residence, the trust had to be administered from outside Israel.

[748] ITA 77/74 *Ginzburg et al v. Assessing Officer of Haifa*, Missim J/6, E-138; C.A. 3914/91 *Laham v. Assessing Officer of Nazareth*, Missim J/5, E-70; I.T.A. 363/02 *Grill v. Assessing Officer Haifa*, Missim S/1 E-24 (2004).

[749] D.N. 3962/93 *Mintz and Silberstein v. Assessing Officer for Large Enterprises*, Missim 11/1, E-94.

[750] Under prior law, accumulated funds distributed by a trust after the process of generating the income was completed might have constituted not a source of income but rather an accumulation of funds that bore the manifestation and attributes of a private capital asset. It could have been contended that such an accumulation was not a "source" of income, which is a sine qua non for the imposition of income tax. Despite arguments to the contrary by virtue of which the source rules were abandoned, conventional wisdom still held that a mere increase in wealth, as of itself, and without the existence of a source of income, was not taxable. *See* Y. Edrey, *The Theoretical Basis of New Trends in Court Rulings*, Eiuney Mishpat, 20, p. 283; A. Alter, *Taxation of Receivables and Definition of "Income" According to the Income Tax Ordinance*, Missim A/3 p. A-41; A. Yoran, *Forty Years of Tax Laws*, Mishpatim 19, pp. 762–763.

[751] The committee's recommendations differentiated between a trust of which the settlor and the beneficiaries were residents of Israel, and a trust of which the settlor or the beneficiaries were nonresidents. The residence of the trustee was regarded as void of any tax implications for purposes of categorizing the trust under these recommendations. An "Israeli resident trust" was to be defined as an irrevocable trust of which at least one of the settlors and one of the beneficiaries were individuals resident in Israel. Such a trust was to be taxed as follows: first, the transfer of an asset to the trust was to be regarded as a "disposition" and therefore liable to capital gains tax or to any other tax imposed on such a disposition. The committee did suggest that in cases where the direct transfer of the asset to the beneficiary of the trust would have been free of tax, such as in the case of a "relative," then a special provision should be made for a "rollover" of the original purchase price and original date of purchase so that the trust would "step into the shoes" of the settlor. It was proposed that current profits of the trust were to be taxed at the regular rates applicable to Israeli residents whether or not distributed, however, tax should be levied at the special rates on income of individuals ordinarily subject to those rates (10%, 15% and 35% with respect to interest, and 25% with respect to capital gains). Of course, as a consequence of the taxation of the current profits, distributions would go untaxed. The distribution of assets on the dissolution of the trust would not create taxable income and special provisions would apply to losses incurred by the trust. The recommendations of the committee divided "mixed trusts" into five categories: (i) A trust with a "non-resident beneficiary" was defined as a trust settled by a resident of Israel where all the beneficiaries were nonresidents. In the case of such a trust, a transfer of assets in the course of the settling of the trust would create a taxable event. The current income of the trust sourced outside Israel would not be liable to Israeli taxation and the distribution of assets, whether during the life of the trust or in the course of its liquidation, would not be liable to tax. (ii) A "non-resident settlor trust" was defined as a trust for the benefit of Israeli resident beneficiaries settled by an individual nonresident, or by a former resident of Israel with respect to whom 15 years had elapsed since he/she lost his residence in Israel. In the case of such a trust, the transfer of assets in the course of the settlement of the trust would not create an Israeli taxable event, no Israeli tax would be levied on the non-Israeli source income of the trust and distributions, whether during the life of the trust or in the course of its liquidation, would not be liable to Israeli tax. (iii) A "limited non-resident settled trust" was defined in the recommendations as a trust, the beneficiaries of which were Israeli residents, settled by nonresidents one of which was a corporate member or an individual who was a resident of Israel at any time during the 15 years preceding the settlement of the trust. In the case of such a trust, no taxable event would occur on the transfer of assets during the course of the settlement of the trust, no tax would be levied on the non-Israeli source income of the trust, and 15% tax would be levied on a beneficiary on the entire distribution received whether in liquidation or during the life of the trust. (iv) A "non-resident beneficiary trust" was a trust settled by an Israeli resident where the beneficiaries were all nonresidents. Consequently the dispositions inherent in the settlement were to be taxed, while non-Israeli source current income and distributions would be tax-free. (v) Finally, a "non-resident settled and non-resident beneficiary trust" was defined as a trust settled by nonresidents, the beneficiaries of which were nonresidents. Such a trust would not be subject to any Israeli taxation on its non-Israeli sourced in-

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As of 2003, a person who settled a trust was under a duty to file an annual return with the Income Tax Authorities. Likewise, a person who received from a trust an amount in excess of NIS 100,000, as well as any person who was a beneficiary of such a trust and who was entitled to its funds, directly or indirectly, whether or not liable for tax in Israel was under an obligation to file such an annual return. The committee suggested that these reporting requirements be enhanced.

B. Current Rules

Within the framework of Amendment no. 147 of the Income Tax Ordinance, the Israeli legislature finally addressed a loophole in relation to the taxation of trusts that had not been dealt with in the comprehensive reform of 2003 (Amendment No. 132). The main aspects of the post-amendment No. 147 tax regime are discussed below.[752]

A "trust" is defined in section 75C of the Income Tax Ordinance, which provides quite a number of definitions relevant to the chapter dealing with the taxation of trusts, as an arrangement pursuant to which a trustee holds the "trustee's assets" (as defined below) for the benefit of a beneficiary, entered into in Israel or outside Israel, whether defined under the law applicable thereto as a trust or otherwise.

"Trustee's assets" are defined in the same section as assets that were accorded[753] to the trustee, or purchased or received by him, including assets held by a corporate trustee for the purposes of holding trustee's assets, whether registered as a corporation or not. "Trustee's income" is defined as the income accrued or derived from the trustee's assets. These two terms of art are frequently used throughout the legislation containing the tax regime applicable to trusts. The regime depends on how a trust is classified, as explained below, the guiding principle being the attribution of the trustee's income and the trustee's assets to the settlor or beneficiary in accordance with the classification of the trust, with the trustee being regarded as the assessee and the person liable for the tax on the trustee's income, which is taxed, in the year during which it is derived or accrued, at the maximum marginal rate applicable to individuals, without any personal deductions, credits or allowance, and with no set-off of losses between the trust and the beneficiaries or the settlors and vice versa.

A "settlor" is defined in section 75D of the Income Tax Ordinance as a person who accorded, whether directly or indirectly, an asset to the trustee. In addition, there is, a long list of acts or events that are deemed to constitute a settlement.[754] Moreover, where a trustee accords another trustee an asset, the settlor who first accorded the asset to the first mentioned trustee, is regarded as the person who accorded the asset to the other trustee.

A "beneficiary" is defined as a person who may enjoy the trustee's assets or the trustee's income, whether directly or indirectly, including: a person who will be entitled to such enjoyment on the fulfillment of a condition, except a person whose rights are conditioned on the passing away of the settlor or another beneficiary, as long as they are alive; an unborn beneficiary; an indirect beneficiary in a chain of trusts; and a person who holds controlling interests in a corporate body that is a beneficiary and that is not a public institution.

C. Classification of Trusts and Applicable Tax Treatment

Prior to Amendment No. 197, the tax regime covered four categories of trusts, as discussed in 1. to 4., below.

1. Israeli Resident Trust

a. Definition

An Israeli resident trust is defined as a trust where, at the time of its settlement, at least one settlor and one beneficiary were residents of Israel, and during the tax year under consideration either one settlor or one beneficiary was a resident of Israel.

Any trust that is not a nonresident settlor trust, a nonresident beneficiary trust or a testamentary trust will also be regarded as an Israeli resident trust.

b. Tax Treatment

The Income Tax Ordinance provides with respect to an Israeli resident trust that the trustee income and trustee assets will be attributed to the settlor. The disposition of an asset in favor of the trustee by an individual will not be deemed a disposi-

come. The following table sets forth the recommendations of the committee:

	Settlement	Current Income	Distribution	Liquidation
Israeli Resident Trust	Full tax (0–45% or 25%)	Full tax (45%) or special rates (10%, 15%, 25%)	0	0
Non-Resident Settlor Trust	0	0	0	0
Limited Non-Resident Settled Trust	0	0	15%	15%
Non-Resident Beneficiary Trust	Full tax (0–45% or 25%)	0	0	0
Non-Resident Settled and Non-Resident Beneficiary Trust	0	0	0	0

[752] The legislation concerning the taxation of trusts is technical and complex and includes many anti-avoidance provisions. This chapter concentrates only on the main provisions and attempts to avoid as much as possible the highly technical provisions, which, in the opinion of the author, blur the overall picture.

[753] "According" is defined as transferring an asset to a Trustee of a Trust for no consideration.

[754] Among others, where a person was: a substantial shareholder in a corporate body at the time the body accorded that asset to the Trustee; a person who held controlling interests in a corporate body at the time that body accorded an asset to the Trustee, where the person or his relatives are Beneficiaries in the same Trust; a person who was a Beneficiary of the Trust at the time the Trustee accorded an asset or income to another Trustee after the last Settlor passed away or at the time that the Beneficiaries of the Trust were changed without a direction for such a change in the deed of the Trust, unless proved to the satisfaction of the Assessing Officer that such a person had no influence on the decision; a Beneficiary who can influence the affairs of the Trust; a resident of Israel who accords an asset to a Trustee in a Nonresident Settlor's Trust wherein he/she or his/her relatives are Beneficiaries.

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tion thereof and a distribution by the trustee to the beneficiary will be taxed just like a disposition made directly by the settlor to the trustee, thus allowing certain dispositions to go tax-free where relations between the settlor and the beneficiary merit such tax treatment. For these purposes, the settlor is regarded as a resident of Israel, even if, at the time of the distribution, the Settlor was a nonresident. The Ordinance also provides that with a trust with several settlors, where a disposition by one of them to the beneficiary would have been liable to tax had it been made directly by that settlor to the beneficiary, such a disposition will render the entire distribution liable to tax.

An Israeli resident trust is deemed for Israeli fiscal purposes to be a resident of Israel even if the settlor has ceased to be a resident of Israel. In these circumstances, the trustee income and assets are attributed to an individual resident in Israel. These rules were apparently promulgated to overcome difficulties in the application of tax treaties to which Israel is a party, but few practitioners believe that they will prove effective.

In certain circumstances, the Ordinance allows for a deviation from the tax regime described above and for the attribution of the trustee income to the beneficiary or the settlor. The Ordinance provides further that, in these circumstances, the person to whom the trustee income is attributed will be deemed the assessee and liable for the tax.

c. Change in Trust Classification Under Prior Rules

The following table sets forth the possible changes in status and their effect on an Israeli resident trust and the classification of the trust according to the tax regime prior to Amendment No. 197 (see XII.J., below):

	Settlors	Beneficiaries	Outcome
Point of Origin	One Israeli	One Israeli	Israeli resident trust
Change 1	One Israeli	All non-residents	The trust remains an Israeli resident trust even though it practically has no ties to Israel (during the tax year, one settlor or one beneficiary was resident in Israel).
Change 2	All non-residents	One Israeli	Israeli resident trust
Change 3	All non-residents	All non-residents	The trust becomes a non-resident beneficiary trust
Change 4	One Israeli	All non-residents; one beneficiary becomes a major	Upon the last minor beneficiary becoming a major, the trust becomes revocable and therefore a non-resident beneficiary trust and the trustee assets are deemed disposed of on the relevant day.

2. Non-Resident Settlor Trust

a. Definition

Prior to Amendment No. 197, two alternative definitions were supplied for a non-resident settlor trust:

(i) Alternative 1: at the time of the settlement and during the tax year all the settlors were nonresidents.

(ii) Alternative 2: during the tax year, all the settlors and all the beneficiaries are nonresidents.

b. Tax Treatment

The Income Tax Ordinance provided with respect to a non-resident settlor trust that the trustee income and assets would be attributed to the non-resident settlor. The transfer of an asset from the settlor to the trustee without consideration was not deemed a disposition and a distribution from the trustee to the beneficiary was not taxed as if the asset were transferred directly from the settlor to the beneficiary.

The trust was regarded for Israeli fiscal purposes as non-resident and, where the settlors were non-residents from different countries, the trustee assets and income was attributed to the individuals resident in those countries, on a pro rata basis in accordance with the market value of the assets at the time of their transfer to the trustee.

3. Non-Resident Beneficiary Trust

a. Definition

A non-resident beneficiary trust is defined as an irrevocable[755] trust if: (i) all the beneficiaries are non-residents, whose identity is known[756] and (ii) at least one settlor of which is a resident of Israel. Moreover, the trust deed must provide specifically that no Israeli resident may become a beneficiary of the trust[757] and the settlor's tax return for the year of the settlement must include a declaration that the trust has no Israeli resident beneficiary[758] and that no Israeli resident may become a beneficiary.

The definition is applied every tax year. The definition also excludes from this category of trusts a testamentary trust.

b. Tax Treatment

The Income Tax Ordinance provides that with respect to a non-resident beneficiary trust, the trustee income and assets will be attributed to the non-resident beneficiary. The transfer of an asset from the settlor to the trustee will be liable to tax as if it were a direct disposition from the settlor to the beneficiary

[755] Income Tax Ordinance, s. 75C defines an Irrevocable Trust as a Trust that is not a Revocable Trust (see definition below) provided the Assessing Officer received a certified affidavit of the Settlor and of the Trustee that the Trust was an Irrevocable Trust at the time and on the form fixed therefor by the Director of the Taxes Authority. A Revocable Trust is defined in the same section as falling under the aegis of one of 10 cases specified therein, which are characterized by the lack of complete alienation of the assets transferred to the Trust from the Settlor. For specific instances, see Income Tax Ordinance, s. 75C.

[756] For purposes thereof, an unborn Beneficiary will be deemed a Beneficiary whose identity is known.

[757] For existing Trusts, see the transitional rules discussed at XII.F.

[758] Or a Beneficiary resident of Israel whose entitlement to Trust benefits is conditioned on the termination of his Israeli residence.

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and the distribution by the Trustee to the beneficiary will not be deemed a disposition.

The trust is deemed for Israeli fiscal purposes to be a non-resident and where the beneficiaries are non-residents from various countries, the trustee assets and income are attributed to the nonresident individuals from those countries in accordance with their appropriate shares.

c. Change in Trust Classification Under Prior Rules

The table below illustrates the outcomes to the classification of non-resident beneficiary trust where there is of a change in the residence of either the settlor or the beneficiaries, according to the tax regime prior to Amendment No. 197:

	Settlors	Beneficiaries	Outcome
Point of Origin	One Israeli	All non-residents	Non-resident beneficiary trust.
Change 1	One Israeli	All non-residents but no return filed by Trustee	The trust is deemed to have during the tax year an Israeli resident beneficiary.
Change 2	All non-residents	All non-residents	A non-resident settlor trust without a tax event occurring.
Change 3	One Israeli	One Israeli	The trust becomes an Israeli resident trust entitled to relief under sections 14(a) and (c) (business income and passive income); sections 16, 97(b) and 97(B3) of the Ordinance.
Change 4	One Israeli	All non-residents; but the trust is revocable, there exists an unknown beneficiary and a condition of the settlement was breached.	The trust is regarded as never having been a Non-resident beneficiary trust.

4. Testamentary Trust

a. Definition

A testamentary trust is defined as a trust settled under a testament with all of its settlors being the testators who at the time of their death were Israeli residents.

b. Tax Treatment

In a testamentary trust, the trustee income and assets are attributed to the beneficiary.

Where the trust has at least one Israeli resident beneficiary, the trust is deemed to be resident in Israel, the trustee income is deemed to be the income of an Israeli resident and the trustee assets are deemed to be held by an Israeli resident.

Where the trust does not have any Israeli resident beneficiaries, the tax regime applicable to the trust will be similar to that applicable to a non-resident beneficiary trust and the trust will be deemed for Israeli fiscal purposes to be non-resident. Where the beneficiaries reside in different countries, the trustee income and assets will be appropriated among the individuals of those countries in accordance with each individual's share as a beneficiary.

In any event, the bequeathing of an asset to a trustee under a testamentary trust and a distribution to a beneficiary will not be deemed a disposition.

Where the trust has one or more returning residents or new immigrants to Israel as a beneficiary and the trust does not have any other Israeli resident beneficiaries, the trustee income will qualify for most of the tax benefits accorded to returning residents and new immigrants.

When there is a change in the residence of the settlor or a beneficiary, a non-resident settlor trust and a non-resident beneficiary trust will not be regarded as having changed their classification for 10 years from their assumption of Israeli residence, provided the trust's assets are located outside Israel and its income is derived from assets located outside Israel.

The Income Tax Ordinance provides for a deviation from these rules, in certain circumstances, and the attribution of the trustee income in such circumstances to the beneficiary.

c. Summary

The following table summarizes the tax rules regarding the various kinds of trusts prior to Amendment no. 197:

Trust	Settlement	Current Income	Distribution
Israeli Resident	No disposition	Israeli resident	As if transferred from settlor to beneficiary
Non-resident settlor	No disposition	Non-resident	As if transferred from settlor to beneficiary
Non-resident beneficiary	Disposition	Non-resident	No disposition
Testamentary	No disposition	According to the beneficiaries' identity	No disposition

D. Reporting Requirements

In accordance with the statutory language, a resident settlor must file a return with the assessing officer in the year of settlement and in every year in which an asset or income was transferred to the trustee. The return should include the identity of the trustee, the identity of any protector, the identity of the beneficiaries and their place of residence and other particulars with respect to the transferred assets. Where the settlor is a non-resident and has no ties with Israel, it is far from clear whether there exists an authority to require the settlor to file such a return.

A resident beneficiary must file with the assessing officer a return with respect to any non-cash distribution, even when

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the distribution is not liable for tax and report details with respect to the assets or income distributed to the beneficiary.[759]

The trustee is also required to file returns. With respect to trusts settled by Israeli residents, the filing requirement is unqualified, while, where the settlor is a nonresident, the limited cases that give rise to a reporting duty are where the trust has Israeli-source income or assets located in Israel, and only with respect to those assets or that income. The return will include details with respect to the identity of the settlor, the beneficiaries and the date on which distributions were made. In some cases, the settlor or a beneficiary may file the annual returns in lieu of the trustee.

A trustee of a non-resident beneficiary's trust is required to attach a form issued by the Director of the ITA with respect to each distribution made during the tax year and include therein the names of the beneficiaries and the amounts distributed to them. The trustee is also required to include in their tax return a declaration stating that the trust does not include any Israeli resident beneficiaries. This declaration will be filed with the assessing officer even if, during the tax year concerned, the trustee was relieved of their duty to file a tax return.

Amendment no. 272 to the Israeli Income Tax Ordinance, which expands the application of trust reporting obligations to new or returning residents, was published in April 2024. As of January 1, 2026, trustees will be required to notify the ITA in accordance with the relevant provisions of the Ordinance.[760]

A trustee of a trust required to submit annual reports under Section 131 to the Income Tax Ordinance must include information in the report regarding individuals who are substantive shareholders of the trust. This requirement will take effect for annual reports covering 2025 and subsequent tax years.

E. Corporate Transfers

A disposition made by a corporation to a trust is deemed to be a sale of the asset disposed of and a dividend distributed to the individual shareholders. This is a special rule designed to prevent tax avoidance by means of dispositions to trusts through corporate bodies.

F. Transitional Provisions

The transitional provisions provided that the tax regime would apply to trusts that were settled before the effective date (January 1, 2006), but only with respect to the trustee's income accrued or derived as of the effective date.

Israeli residents reported in their annual return for the year 2006 on trusts that they settled prior to the effective date that were still in existence on that date. The return included particulars with respect to the date of settlement of the trust, the trustee, the beneficiaries and any protector, as well as with respect to the assets that were accorded to the trust and the date thereof.

The transitional provisions provided that notices, requests or declarations that should have been filed at the time of settlement of the trust, or at any other date prior to the effective date, had to be filed within 90 days of the date of the publication of Amendment No. 147 (August 10, 2005) or from the date of the issuance of a special form therefor, whichever was later. The forms relating to trusts were issued in June 2008. The Director of the Israel Tax Authority (ITA) allowed the filing of all the forms and returns regarding trusts until June 30, 2009, without penalty.

In addition, the transitional provisions provided that, with respect to a non-resident beneficiary's trust settled prior to the effective date, there was no requirement to include in the deed of trust a provision stating that no Israeli resident may become a Beneficiary of the Trust. The transitional provisions further provided that, with respect to Israeli resident trusts that were irrevocable and that were settled prior to August 10, 2005, no tax would be collected from the trustee or settlor with respect to income derived until that date provided they filed appropriate notices with the assessing officer.

G. Exceptions

Under section 75Q of the Income Tax Ordinance, the provisions regarding the taxation of trusts will not apply in the cases of: a mutual fund, including a mutual fund for investments outside Israel; a provident fund; a trust settled for purposes of insuring the performance of a certain obligation; executors, custodians appointed by the court, a trustee in bankruptcy, a person acting under section 350 of the Companies Law, a liquidator of a company or a trustee under a debenture; a designation that is a Public Institution under section 9(2) of the Ordinance; and a trustee as defined in section 102 of the Ordinance.

H. Regulations

Under section 75R of the Income Tax Ordinance, the Minister of Finance, with the approval of the Finance Committee of the Knesset, has been granted the right to promulgate regulations regarding the following: foreign tax credits; the computation of the taxable income or the capital gain derived by the trustee; the taxation of trustee income on a pro rata basis in accordance with the shares of non-residents from different countries in certain circumstances;[761] and other conditions, limitations, adjustments and instructions with respect to the chapter dealing with the taxation of trusts.

I. Collection of Taxes

While the Ordinance provides that the income will be taxed in the hands of the trustee, it also provides that the settlor will be responsible for any final tax assessment levied on the Trustee in an Israeli resident trust and that in all cases, the beneficiary will be responsible for the tax being the part of a final assessment made on the trustee, but not in excess of any distribution received from the trust by the beneficiary.

J. Amendment No. 197

Amendment no. 197, which was promulgated as part of the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years

[759] Income Tax Ordinance (Amendment 165), 2008.

[760] Income Tax Ordinance, s. 75P2(c)(1)–(2).

[761] Income Tax Regulations (Provisions Regarding Amendment of Foreign Trustee's Assessment and Determination of a Capital Gain upon Distribution to Foreign Beneficiary), 2008; Income Tax Regulations (Designation of Income for Foreign Individual Beneficiary and Determination of a Capital Gain of Designate Trust), 2008.

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2013 and 2014) 2013, significantly revised the taxation of trusts in Israel. Generally, the main idea behind the Amendment is to deal with situations where a foreign settlor establishes a trust in favor of an Israeli beneficiary and contributes a certain asset to the trust (a classic foreign settlor trust, as defined prior to the Amendment). In such a scenario, under the pre-amendment tax rules, the asset transferred to such a trust and the income generated from it was not subject to Israeli tax — assuming the asset was located outside of Israel.

In such a circumstances, the trust could refrain from distributing its assets for a long time and avoid potential Israeli tax liability until the actual distribution. On the other hand, to the extent that the foreign settlor would have gifted such an asset directly to the Israeli resident, a future sale of the asset from the date of the transfer, or any income generated from the asset from that date onwards, would have been subject to Israeli tax. As a result, the foreign settlor trusts became a "tax shelter" for Israeli beneficiaries until the distribution of their assets.

Amendment no. 197 sets forth tax rules with respect to trusts settled by foreign residents and also provides for additional reporting requirements to the ITA.

The Amendment provides, inter alia, two new definitions of trusts subject to Israeli taxation: (i) the Israeli beneficiary trust and the (ii) relatives trust. In addition, the classification of foreign settlor trust was repealed and replaced by the foreign resident trust.

1. Israeli Beneficiary Trust

a. Definition

A trust will be considered an Israeli beneficiary trust (to the extent that all of its settlors are foreign residents (since the date of its settlement) and during the taxable year at least one of its beneficiaries is an Israeli resident.[762]

b. Trust Contributions

Generally, a contribution made by a foreign resident to an Israeli beneficiary trust is treated as a direct transfer from the settlor (the foreign resident) to the beneficiary. Such contributions will be beyond the scope of the Israeli tax regime to the extent that the contributed assets are not located in Israel. However, even with regard to assets located in Israel, to the extent that the contribution of such assets is made without any consideration provided by the beneficiary in exchange, such contribution will also in general not be subject to Israeli tax.

c. Tax Treatment

Such a trust will be taxed as an Israeli resident trust (i.e., settled by Israeli residents), and will be subject to Israeli tax on its worldwide income. The trustee's income will be considered as income generated by an Israeli resident for Israeli tax purposes, and the trustee's assets will be considered as if they were held by an Israeli resident (as a result, for example, any sale or disposition of the trust's assets will be subject to Israeli tax).[763]

d. Trust Distributions

The distribution of an asset by the trustee will not be subject to Israeli tax, to the extent that had the asset been transferred directly from the settlor to the beneficiary, the transfer would not have been subject to Israeli tax.

2. Relatives Trust

a. Definition

A trust will be considered a relatives trust to the extent that it is an Israeli beneficiary trust and all of its settlors and its Israeli beneficiaries are one of the following: (i) the settlor is a parent, grandfather, spouse, child or grandson of the beneficiary; or (ii) the settlor is a second-degree relative of the beneficiary (sibling, spouse's children, spouse of each of the aforementioned, child of sibling, parent's sibling), and the assets were provided to the trust by its settlor in a bona fide contribution made with no consideration provided by the beneficiary in exchange therefore.[764]

In addition, it should be noted that upon the death of one of the settlors of an relatives trust, the trust will be considered as an Israeli resident trust from the settlor's death onwards.[765]

b. Reporting Requirements

The trustee of a relatives trust must report to the ITA at the latest within 180 days (as of August 1, 2013)[766] from the latest of the date the trust was established or the date the trust is considered an relatives trust.[767]

c. Trust Contributions

Generally, a contribution made by a foreign resident to a relatives trust is treated as a direct transfer from the settlor (the foreign resident) to the beneficiary. Such contributions will be beyond the scope of the Israeli tax regime to the extent that the contributed assets are not located in Israel. However, even with regard to assets located in Israel, to the extent that the contribution of such assets is made without any consideration provided by the beneficiary in exchange, such contribution will also generally not be subject to Israeli tax.

d. Trust Distributions

Any distribution made by a relatives trust to an Israeli resident is subject to an Israeli tax at a fixed rate of 30%.[768] Nev-

[762] Income Tax Ordinance, s. 75H1(a).

[763] It should be noted, that according to regulations promulgated with respect to the apportionment of the trust's income to its foreign beneficiary, to the extent that certain conditions are met, income allocated to a foreign beneficiary may not be subject to Israeli tax at the level of the trust, as well as at the level of such beneficiary.

[764] Income Tax Ordinance, s. 75H1(b).

[765] Income Tax Ordinance, s. 75H(g). Such provision shall not apply to the extent that the settlor's spouse is still alive (during the spouse's lifetime) and was his spouse at the time the settlor performed one of the contributions to the trust.

[766] Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), s. 42(f)(1) 2013.

[767] The provision was extended through June 30, 2015, with respect to RTs established prior to Jan. 1, 2014. For additional information with respect to the provisions applicable to trusts provided in Amendment No. 197, see Israeli Tax Authorities publications dated Feb. 3, 2014, Mar. 9, 2014, June 25, 2014, and Mar. 10, 2015.

[768] Income Tax Ordinance, s. 75H1(d)(2).

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ertheless, the trustee may elect[769] to be taxed on an annual basis with respect to the trust's foreign income that is intended to be distributed to an Israeli resident, at a fixed rate of 25%.[770] It should be noted that this election is irrevocable as long as the trust is considered a relatives trust.[771] Distribution of an asset by the trustee would not be subject to Israeli tax, to the extent that had such asset been transferred directly from the settlor to the beneficiary, such transfer would not have been subject to Israeli tax. In a mixed distribution, income is deemed to be distributed before capital.[772]

e. Tax Treatment

Israeli sourced income generated by the trust (or its assets) will be subject to Israeli tax at the marginal tax rate (to the extent that a specific tax rate is not provided, e.g., the capital gain tax rates, etc.).

f. Benefits for Returning Residents

If a foreign settlor trust becomes a relatives trust as a result of one of its beneficiaries migration to Israel,[773] such a trust will be entitled to the benefits provided under the Ordinance (e.g., tax benefits with respect to income generated outside of Israel, etc.) with respect to the trust's income allocated (pro rata) to such beneficiary.

g. Reporting Requirements

In addition to the reporting requirements discussed in XII.D., above, a beneficiary in a trust which is considered a relatives trust, an Israeli beneficiary trust or an Israeli resident trust, who receives a distribution (cash or non-cash) from the trust, is required to file an income tax return (i.e., a standard income tax return as provided for in section 131 of the Income Tax Ordinance) with the ITA for the year in which such distribution was made.[774] A tax return must be filed irrespective of whether the distribution is subject to Israeli tax.[775]

Furthermore, Amendment no. 223 to the Income Tax Ordinance of 2016 stipulates that an Israeli resident who has moved to another country and believes that the rebuttable presumption of the "days tests" of their residency in Israel is no longer valid,[776] and that Israel's right to tax the individual is thus overruled by the tax treaty between Israel and the destination country, must report this claim with a written explanation and supporting documents to the ITA attached to their income tax return.[777]

3. Foreign Residents Trust

Amendment no. 197 replaced the foreign settlor trust with the foreign residents trust, which is defined in section 75I as either:

> (i) A trust in which during the tax year all the settlors and all the beneficiaries are foreign residents; *or* all the settlors are foreign residents and all the beneficiaries are public-purpose beneficiaries (i.e., charities) or foreign residents, *and* it did not include any Israeli-resident beneficiaries since its formation; or
>
> (ii) A trust in which all of its settlors are deceased and during the tax year all the beneficiaries are foreign residents; *or* all the settlors are deceased and all the beneficiaries are public-purpose beneficiaries or foreign residents, *and* it did not include any Israeli-resident beneficiaries since its formation.
>
> A foreign residents trust may be revocable or irrevocable.

The most significant aspect of the amendment is that a foreign residents trust will not be subject to Israeli tax liability, but only to the extent that it has no Israeli resident settlors or resident beneficiaries. Prior to the Amendment, a foreign settlor trust with Israeli beneficiaries was, generally, not subject to Israeli tax.

However, the definition of a foreign residents trust is not clear and raises certain doubts. It is unclear whether the requirement that the trust not have Israeli beneficiaries since its formation applies to all alternatives mentioned in the definition or only to those alternatives that include public purpose beneficiaries.

Stated differently, the question is whether the definition of a foreign residents trust includes two alternatives, with each of them including the requirement to exclude Israeli beneficiaries from the moment the trust is formed; or whether the definition includes four alternatives and only two of these alternatives — those which relate to public purpose beneficiaries, include this requirement.

Under the "four alternatives argument," a trust in which all of its settlors and all of its beneficiaries are foreign residents in the tax year should be considered a foreign residents trust, regardless of whether there were any Israeli-resident beneficiaries in the past. According to such interpretation, the "no Israeli-resident beneficiaries since its formation" requirement applies only to trusts with mixed beneficiaries (i.e., foreign residents and public-purpose beneficiaries). Similarly, under the "four alternatives argument," a trust in which all of its settlors were deceased and all of its beneficiaries in the tax year are foreign residents, should also not be subject to the "no Israeli-resident beneficiaries since its formation" requirement.

[769] Within 30 days from the date the trust was established or considered an RT (at the latest).

[770] Income Tax Ordinance, s. 75H1(d)(3).

[771] Income Tax Ordinance, s. 131(a)(5b)(6), provides that a trustee performed the 25% tax rate election provided under section 75H1(d)(3), will be required to file an annual income tax return with the ITA.

[772] Income Tax Ordinance, s. 75H1(d)(2)(a).

[773] As provided under the "returning veteran resident," "returning resident" or an Israeli resident for the first time provisions in the Ordinance.

[774] Income Tax Ordinance, s. 131(a)(5b)(5).

[775] FSTs, FBTs, or a trust established according to the terms of a will (all as defined under the Ordinance), will not be subject to the reporting requirement set forth under section 131(a)(5b)(5) only to the extent that the distribution does not consist of an Israeli-sourced asset.

[776] Income Tax Ordinance, s. 131(a)(5e).

[777] Law for the Amendment of the Income Tax Ordinance (No. 223), 2016.

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XIII. Taxation of Resident Individuals

A. Scope of Taxation and Residence

As of January 1, 2003, Israeli resident individuals, are subject to tax on their worldwide income, including capital gains.[778]

Section 1 of the Income Tax Ordinance defines an Israeli resident as a person whose "center of life" is in Israel.[779] In determining residence, several indicators are taken into consideration, for example, permanent home, ties to the community, the location of the nuclear family and economic interests, much like under the center of vital interests test found in tax treaties. Although the term is elaborated in the Ordinance, the center of life of a person can be established differently in various circumstances.

Consequently, in the cases in which the courts have been required to decide on questions of residence, various decisions have been reached in application of differing combinations of the above factors. It is therefore not possible to conclude that the presence or absence of any given factor is decisive; instead the various factors need to be considered from all relevant perspectives.[780]

The Supreme Court's ruling in *Sapir*[781] is a significant decision regarding the determination of residency status based on a family's place of residence. The court established that family units can be split for fiscal purposes in appropriate cases, acknowledging that some families choose to live separately, and this should not be a determining factor of residency in the special circumstances of the case. In *Sapir*, although the woman concerned was an Israeli resident, the husband was not regarded as one. Similarly, in *Lederman*,[782] the court determined that a distinction should be made between the taxpayer's center of life in the United States and his partner's center of life in Israel. The district court recognized that there may be various reasons for a nuclear family to have separate centers of life and that it is possible to separate the centers of life of spouses, even if their relationship is good. The court emphasized that while a complete separation might support the taxpayer's claim, this is not always the case, as some couples may maintain a good relationship from a distance, resulting in each spouse having a separate center of life despite their personal closeness.

In the first instance, the following two tests apply for purposes of determining an individual's center of life and thus his or her residence status in Israel. If either is met, this creates a rebuttable presumption that an individual is resident in Israel, subject to further detailed consideration of the "center of life" test and the factors outlined above that may override this determination (or *vice versa* — a person not meeting either of the tests below may still have his or her center of life in Israel if the facts so demonstrate):

(i) Presence in Israel for 183 days or more during the tax year; or

(ii) Presence in Israel for 30 days or more during the tax year and 425 days during the two preceding tax years.

The days test merely shifts the burden of proof and serves as an additional tool for determining a person's center of life. Case law and the tax authorities have agreed that days spent in Israel by taxpayers who were in Israel as a result of exceptional circumstances (such as caring for a sick family member) should not be taken into account.[783] The tax authorities focus on the number of days a taxpayer spends in Israel or another country to determine residency in cases where the place of residence is unclear.[784]

Should an Israeli resident decide to exit the country to reside elsewhere, he or she is taxed on a deemed capital gain on the assets he or she holds on the day before he or she leaves Israel. Section 100A in the Ordinance establishes the rules for determining the value of such assets (see V.C.4.b.(11), above).

B. Determination of Gross Income

The gross income of an individual is determined in the same manner as that of any other taxpayer. An individual is taxable with respect to all nine categories of income enumerated in section 2 of the Income Tax Ordinance,[785] as well as other sections of the Ordinance, such as section 3. However, a number of items of an individual's income are exempt from tax.

Most notable among the items of exempt income are the following:

(i) Severance pay on retirement from employment, up to a maximum amount set by the Ordinance based on the number of years of employment.[786] This amount is a multiple of the last monthly salary and the number of years of employment. In special circumstances, the Director General of the Israel Tax Authority (ITA) is entitled to increase the exemption, but not beyond the statutory limit. Severance pay payable in the event of death is exempt to the extent of a multiple of twice the last monthly salary and the number of years of employment but may not exceed the statutory limit. Again, in special circumstances, the Director General is entitled to increase the exemption, without exceeding the statutory ceiling.

(ii) Compensation paid as a result of death or bodily injury.[787]

(iii) The higher of: any part of a pension paid by a provident fund or a pension fund managed by an insurance company, derived from a net after tax payment; or 35%

[778] Income Tax Ordinance, s. 2. The section further enumerates the 10 sources of taxable income — see V.C.4.a., above, and Income Tax Ordinance, s. 89.

[779] Income Tax Ordinance, s. 1.

[780] See, *inter alia*, C.A. 477/02 *Aryeh Gonen v. Assessing Officer Haifa*, Missim K/9 (February 2006), E-71; I.T.A.7038/03 + I.T.A. 8017/04 + *Soler Giora v. the Assessing Officer of Jerusalem 3*, Missim K/1 (February 2006), E-143; C.A. 4862/13 *The Assessing Officer of Kfar Saba v. Michael Sapir*, Missim KH/3 (June 2014), ("*Sapir*") E-139; I.T.A. *Yael Zur v. The Assessing Officer of Haifa*, Missim KH/6 (December 2014), E-211; I.T.A 517/04 *Zaiger v. Assessing Officer Eilat*, Missim T-3, E-37 (2005).

[781] See *Sapir*.

[782] TA 41182-01-19 *Lederman v. Tel Aviv Tax Assessor 5* (published in Taxes Online, March 24, 2021).

[783] 24557-02-15 *Yehuda Talmi v. Tax Assessor Kfar Saba*, published in Mismim 50/1 (March 2018) p. 20 (21.01.2018) ("*Talmi*"). The decision was affirmed by the Supreme Court (1779/18 *Yehuda Talmi v. Tax Assessor Kfar Saba*, Mismim 50/4) on Civil Appeal (December 2020) p. 10 (02.12.2020).

[784] Tax Ruling 9857/12.

[785] Including the "catch-all" of Income Tax Ordinance, s. 2(10).

[786] Income Tax Ordinance, s. 9(7A)(a).

[787] Income Tax Ordinance, s. 9(7).

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of a pension received on retirement from work up to the statutory ceiling set by the Ordinance.[788] Where the pension is not received as a result of employment or from a pension fund, 35% of the entire pension is exempt from tax regardless of the amount of the pension,[789] provided it is paid on the individual reaching retirement age.[790]

(iv) Certain income derived by disabled persons from their personal exertions or from any other source, if the income is within the limit set by the Ordinance.[791]

(v) Payments made to an employee resulting from his/her employer's contributions to a provident fund that were nontaxable when paid to the fund.[792]

(vi) Profits accruing from contributions of employers or self-employed persons to educational funds,[793] provided certain qualification periods, set out in section 9(16A)(a) of the Ordinance, have elapsed when the deposit matures.

(vii) The value of employees' travel to and from work,[794] provided the travel is necessary due to the location and conditions of work and is organized in a collective fashion for the employees and in accordance with the terms set down by the Commissioner.

(viii) Linkage differentials and interest accruing on compensation paid for a delinquency in the payment of employment income.[795] Where the compensation is paid with respect to employment income exceeding a prescribed ceiling, the part of the compensation awarded for that element of income that would have been paid as income tax, had the income been paid when due, is in fact regarded as and paid as tax.[796]

(ix) Certain allowances paid to taxpayers wounded or disabled as a result of military operations or to dependents of soldiers who died as a result of acts of war.[797]

(x) Maternity grants; widows' allowances and other survivors' allowances; and old age allowances paid by the National Insurance Institute.[798]

(xi) Allowances received by victims of Nazi persecution.[799]

(xii) Allowances paid to invalids under the National Insurance laws of a foreign country.[800]

(xiii) Alimony paid to a person, whether for himself or for his/her children by his/her spouse, or by a former spouse or received from the National Insurance Institute.[801]

(xiv) Passive foreign income of new immigrants, veteran returning residents, and Returning Residents deriving from assets they owned during five to ten years of residence and foreign business income earned during the first four years after immigration (see XVII.B.1., below).

(xv) Interest on a foreign currency deposit accruing to an Israeli resident during the first 20 years after his/her immigration to Israel if the source of the deposit dates to pre-residence days and the deposit was made within 90 days of the transfer of the fund to Israel.[802]

(xvi) Certain rental income derived by a resident employee on a change in his/her place of work (the exemption results from the allowing of rental expenses as a set off against rental income).[803]

(xvii) Rental income (up to a statutory limit) derived by an individual under the Income Tax Law (Exemption from Tax on Income Derived from Rental of Residences) 1990.

(xviii) Non-business linkage differentials on government bonds and on bank deposits.[804]

(xix) Exchange differentials received by a nonresident on a loan made in foreign currency unless made by an Israeli permanent establishment (PE) of the nonresident.[805]

(xx) Life insurance proceeds (only the "risk" proceeds), unless paid to a nonrelative, where the premium was not allowed as a deduction in the computation of the policyholder's taxable income.[806]

(xxi) Proceeds received by a nonresident under a policy insuring the nonresident against changes in the exchange rate of the Israeli Shekel with respect to the principal of a loan made by the nonresident in foreign currency.[807]

(xxii) Linkage differentials accruing: on compensation payable on the expropriation of property; on compensation payable because of a loss in the value of real estate as a result of a building plan; on the consideration received for the sale of property where the sale is taxable, except in the case of property used for business or professional purposes; on account of the cancellation of a transaction to acquire property; and with regard to a loan made to another

[788] Income Tax Ordinance, s. 9B.

[789] In November 2024, a proposal for the Economic Efficiency Law was published in the Official Gazette, which includes a proposed amendment to Income Tax Ordinance, s. 9A extending the 52% tax exemption rate for qualifying pensions, pension buyouts and exempt capital balances for the year 2025 and beyond.

[790] Income Tax Ordinance, s. 9B.

[791] Income Tax Ordinance, s. 9(5). The District Court has held that compensation paid by a company to a disabled shareholder for his services as an employee should be at arm's length, and any excess paid to the shareholder should be viewed as a deemed dividend, which qualifies for less favored tax-exemption. I.T.A. 278/01, 322/01 *Asher Korenbloom v. Assessing Officer Ako*, Missim R-6 (Dec. 2004), E-140.

[792] Income Tax Ordinance, s. 9(17).

[793] Income Tax Ordinance, s. 9(16A).

[794] Income Tax Ordinance, s. 9(20).

[795] Income Tax Ordinance, s. 9(21)(a).

[796] Income Tax Ordinance, s. 9(21)(b).

[797] Income Tax Ordinance, s. 9(6).

[798] Income Tax Ordinance, s. 9(6c).

[799] Income Tax Ordinance, s. 9(6).

[800] Income Tax Ordinance, s. 9(6E).

[801] Income Tax Ordinance, s. 9(22).

[802] Income Tax Ordinance, s. 16; Income Tax Order (Exemption from Tax on Interest on Foreign Currency Deposits), 2002, s. 2.

[803] Income Tax Ordinance, s. 17(2) and (12).

[804] Income Tax Ordinance, s. 9(13).

[805] Income Tax Ordinance, s. 9(15).

[806] Income Tax Ordinance, s. 9(19).

[807] Income Tax Ordinance, s. 9(15A).

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person (on condition that the loan was not made as part of the taxpayer's business or profession).[808]

(xxiii) Capital gains derived from the sale of a "qualifying residential apartment," as defined in the Taxation of Land (Appreciation and Purchase) Law, 1963 (see XVII.M., below).

(xxiv) Capital gains derived: from gifts to the state, a local authority or other public institutions;[809] from the realization of an asset held outside Israel and sold within 10 years of immigration; on the sale of personal belongings; and from the receipt of "key money," but only with respect to premises used for residential purposes.[810]

(xxv) Scholarships for students during their studies at higher educational institutions and for researchers during their studies at research institutions or religious research institutions not in excess of NIS 90,000, as long as no consideration was given for the scholarship.[811]

C. Allowances, Deductions and Credits

In 1975, the Israeli tax system underwent a major reform, as a result of which personal deductions were replaced by a "credit system." In effect, the credit system permits the paying of allowances based on the taxpayer's personal status or circumstances. Many personal deductions were not transformed into credits. Instead, they found their way into pensions, or increased allowances granted by the National Insurance Institute, or other forms of compensation. For example, the deduction for soldiers serving compulsory military service was replaced by an increase in pay accorded directly to the soldiers.

Under the current system, "credit points" are differentiated from "allowance points." A "credit point" is an amount adjusted annually to meet the inflation rate (for 2023, NIS 235 per month or NIS 2,820 annually), and is deducted from the tax owed once calculated on the net taxable income.[812] By contrast, an "allowance point" is an amount actually paid to the taxpayer regardless of whether the taxpayer derived taxable income or the fact that his/her liability to income tax did not reach the amount of the allowance payable to him.[813] In effect, the allowance points were the seeds of a negative income tax system, which was enacted in 2007. The law grants monthly payments for low-salaried employees (NIS 2,060 to NIS 6,750). Currently the law applies only to employees in certain areas of the country.[814] Grants under the law are conditional on the recipient deriving employment income.

The following credits are available:

	Taxpayer	Credit Points
(i)	Resident (also granted to a spouse filing a separate return)[815]	2 ¼
(ii)	Resident individual maintaining his/her spouse, if the taxpayer or his/her spouse has reached "retirement age," or is blind or disabled as defined by the ordinance[816]	1
(iii)	Travel to the place of gainful employment[817]	¼
(iv)	The registered spouse, where his/her income is assessed jointly with the income derived from personal exertion of the other spouse in addition to the first two credits mentioned above:[818]	
	• entitled to credit points with respect to children	1 ¾
	• not entitled to credit points with respect to children	1 ½
	• travel credit	¼
(v)	Spouse assisting in business or vocation or on an agricultural farm (return filed jointly), in addition to (ii) and (iii) above, and provided that, if entitled to credit points with respect to spouse as specified in (iv) above, he/she opted for one of the following two alternatives:[819]	
	• entitled to credit points with respect to children	1 ¾
	• not entitled to credit points with respect to children	1 ½
(vi)	Parent in a single parent family:[820]	
	• for each child during the year of birth	1 ½
	• for each child 1–5 years old	2 ½
	• for each child 6–18 years old[821]	1
	• for each child during the year in which he/she turns 18 years old	½
(vii)	A father in a single parent family that is not entitled to a credit according to item (vi)[822] or father whose wife is entitled to a credit according to item (xi):[823]	
	• for each child during the year of birth	1 ½

[808] Income Tax Ordinance, s. 9(13A); Income Tax (Exemption from Linkage Differentials) Order, 1984.

[809] Income Tax Ordinance, s. 97(a)(4).

[810] Income Tax Ordinance, s. 88.

[811] Income Tax Ordinance, s. 9(29).

[812] Income Tax Ordinance, s. 33A.

[813] Income Tax Ordinance, s. 33A.

[814] The Law for the Increase of Engagement in Employment and for the Reduction of Income Gaps (Negative Income Tax), 2007.

[815] Income Tax Ordinance, s. 34.

[816] Income Tax Ordinance, s. 37.

[817] Income Tax Ordinance, s. 36.

[818] Income Tax Ordinance, s. 38.

[819] Income Tax Ordinance, ss. 67 and 39.

[820] Income Tax Ordinance, s. 40(b)(1). *See also* Israeli Tax Authorities Circular 2/2014 re Credit Points Under Section 40 — Joint Parental Custody.

[821] On May 18, 2022, the Law of Increasing Credit Points for Parents with regards to Income Tax (Temporary Provision) 2022 was published in the Law Book 2972. Based on the Temporary Provision, a parent of a child who is between 6 and 12 years in tax year 2022, will be entitled to an additional credit point for the child. On April 20, 2023, the law was amended and published in Law Book 3039. Based on the amendment, a parent of a child who is between 6 and 12 in the tax year 2023, will be entitled to an additional credit point.

[822] Income Tax Ordinance, s. 40(b)(1a).

[823] Income Tax Ordinance, s. 66(c)(5).

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	• for each child 1–5 years old	2 ½
(viii)	A parent in a single parent family who is a widow or widower and is entitled to a credit according to item (vi) or (vii)	1
(ix)	A separated parent who is entitled to credit according to item (vi) and where separated parents are sharing their children's support, if the parent is not living with the children (and therefore not entitled to credit points with respect thereto)[824]	1
(x)	A woman[825]	½
(xi)	A wife (filing separate return), mother of children under age 18, for each child:[826]	
	• during the year of birth	1 ½
	• ages 1–5	2 ½
	• ages 6–18	1
	• during the year in which he/she turns 18	½
(xii)	• For each child that in 2022 is between the ages of 6 and 12[827]	1
	• For each child that in 2023 is between the ages of 6 and 12[828]	1
(xiii)	New immigrant: where the registered spouse's income includes the income of a new immigrant spouse, the following credit points are granted provided the income of the nonregistered spouse does not exceed a certain amount. If it does exceed that amount, separate computations (returns) are made, and the points are not taken into consideration in the computation of the registered spouse's tax assessment.[829]	
	• during first 12 months	1 (½ per month)
	• during next 18 months	4 ½ (¼ per month)
	• during the next 12 months	2 (1/6 per month)
	• during the next 12 months following above 12 months	1 (1/12 per month)
(xiv)	Resident or spouse having a paralyzed, blind, or retarded child[830]	2
(xv)	Remarried divorced person or his/her current spouse liable for alimony to former spouse[831]	1
(xvi)	Resident holding academic degree: (i) BA — one credit point for the shorter of three years or the period of study, or (ii) MA — ½ credit point for the shorter of two years or the period of study.[832] It should be noted that, according to the provisions of the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), 2013 the aforementioned credit points with respect to academic degrees are limited to a period of one year. This temporary provision is applicable only to students who graduated from January 1, 2014, through December 31, 2022.	1 or ½
(xvii)	Resident entitled to a professional diploma for one year commencing on the year after receiving the diploma or one year later.[833]	1

These credits are available under the Income Tax Ordinance as indicated in the relevant footnotes to the above and are not in lieu of the "allowance points" paid by the National Insurance Institute.

In addition to the above "credit points," the following special personal credits and deductions are available:

(i) An individual is accorded a tax credit for amounts paid for life insurance and/or as payments to a provident fund (unless allowed as a deduction); however, the credit is limited to a specified maximum amount.[834]

Where the provident fund is a comprehensive pension plan (i.e., pension payments for invalids and for survivors), the credit rate is 35% of the amount contributed to the plan, but may not exceed the designated statutory ceiling.[835] Self-employed persons and employees for whom their employer did not make a contribution to a provident fund or pension fund may deduct from their income with respect to payments made to such funds 7% and 5% respectively,[836] but may not take deductions in excess of a statutory designated ceiling.[837] Where payment is made to secure a future pension, an additional deduction is allowable at the rate of 4%, again subject to a statutory ceiling. Of course, in no event may the deduction exceed the amount actually paid to the fund.

(ii) A special credit is granted for charitable contributions.[838] The credit is up to 35% of the amount contributed and is limited to the lower of 30% of taxable income, or a ceiling set by the Income Tax Ordinance (NIS 9 million for 2022) subject to restrictions stated in the Ordinance.[839] Excess credit may be carried over to the three succeeding tax years.

[824] Income Tax Ordinance, s. 40(b)(2).
[825] Income Tax Ordinance, s. 36A.
[826] Income Tax Ordinance, s. 66(c)(3).
[827] Income Tax Ordinance, s. 66(c).
[828] Income Tax Ordinance, s. 40(c)(1).
[829] Income Tax Ordinance, s. 35.
[830] Income Tax Ordinance, s. 45.
[831] Income Tax Ordinance, s. 40A.
[832] Income Tax Ordinance, s. 40C.
[833] Income Tax Ordinance, s. 40D.
[834] Income Tax Ordinance, s. 45A.
[835] Income Tax Ordinance, s. 45A(b).
[836] Income Tax Ordinance, s. 47(b).
[837] Income Tax Ordinance, s. 47(a)(1).
[838] Income Tax Ordinance, s. 46.
[839] Income Tax Ordinance, s. 46A.

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(iii) A credit is allowed for a youth or for his/her spouse that have reached the age 16 but not yet 18.[840]

An individual paying national insurance contributions[841] (and, until 1997, "parallel tax") with respect to income not derived from employment is entitled to a deduction at the rate of 52% of the amount paid by him (excluding penalties paid with respect to the above), provided the deduction does not exceed his/her chargeable income before the deduction.[842] Where an employer is exempt from national insurance contributions on account of his/her employee, the latter is entitled to deduct from his/her income the contributions imposed on him.

D. Tax Rates and Calculation of Taxable Income

There are two income tax brackets: (i) a bracket for tax on personal exertion income, and all income of an individual aged 60 and above (which applies provided that books of account were kept where so required); and (ii) a bracket for tax on other ordinary income. Certain passive income enjoys reduced rates.

The tax brackets are linked periodically to the cost-of-living index[843] to prevent inflation from causing a steeper tax rate to apply to what, in effect, is the same real income.

The tax rates are as follows:[844]

Income Brackets and Tax Rates for 2024			
Any Income Other Than Personal Exertion of Individuals Below Age 60		**Personal Exertion Income or Any Income for Individuals Above 60**	
Annual Income	**Tax Rates**	**Annual Income**	**Tax Rates**
		Up to NIS 84,120	10%
		NIS 84,121 – 120,720	14%
		NIS 120,721 – 193,800	20%
Up to NIS 269,280	31%	NIS 193,801 – 269,280	31%
NIS 269,281 – 560,280	35%	NIS 269,281 – 560,280	35%
NIS 560,281 – 721,560	47%	NIS 560,281 – 721,560	47%
Above NIS 721,560	50%	Above NIS 721,561*	50%
* An additional levy at the rate of 3% + an additional 2% on "capital"-source income is imposed on income exceeding NIS 721,560 (in 2025[845]).			

E. The Tax Unit

The general rule in Israel calls for the joint computation of the income of spouses. Section 65 of the Income Tax Ordinance provides that "For the purposes of this Ordinance, the income of spouses shall be deemed to be the income of the registered spouse and shall be charged in his/her name."

An important exception to this rule is found in section 66 of the Income Tax Ordinance, which allows a spouse to compute his/her income separately if the spouse's income is derived from "personal exertion in any business or vocation or from employment…"[846] Eligibility for separate assessments was conditional on the non-dependence of the source of the income of one spouse on the source of the income of the other spouse.[847] Prior to Amendment no. 199 (as detailed below), the Ordinance contained specific provisions aimed at defining the dependence of one source on another source. For purposes of determining whether income is dependent or independent, the Ordinance provided that the income of one spouse was *not* regarded as generated from an independent source if it was derived from:

(i) Any business or vocation of the other spouse;

(ii) A company in which both spouses or the other spouse directly or indirectly, had the right of management or the right to 10% of the voting rights, unless the recipient of the income had income from the company for a reasonable time, and at least for one year before the marriage, or for five years before his/her spouse, directly or indirectly, had any right in the company; or

(iii) A partnership in which both spouses or the other spouse, directly or indirectly, owned at least 10% of the capital or of the rights to the profits, unless the recipient of the income had income as aforesaid from the partnership for a reasonable time, and at least for one year before the marriage or for five years before his/her spouse, directly or indirectly, had any right in the partnership.[848]

Although the common wisdom was that these presumptions were non-rebuttable, the Supreme Court held in a landmark decision that taxpayers may rebut the presumptions by proving that despite the "dependence" under the presumption, the spouse derives personal exertion income independently.[849] Following that holding, the District Court held that a wife who worked together with her husband in their joint business successfully overcame the presumption that her income had been derived from a source dependent on that of her husband and, therefore, was assessed separately.[850]

Naturally, a separate assessment, in most cases, proved more favorable to a couple because it allowed the progressive

[840] Income Tax Ordinance, s. 40B.

[841] As of 1995, such payments include national health insurance. See II.E.7.

[842] Income Tax Ordinance, s. 47A.

[843] A new law has been passed that freezes tax updates for the years 2025–7, meaning no adjustments will be made according to the Consumer Price Index. The savings resulting from this measure will continue to affect the year 2028 and beyond, including with respect to adjustments to income tax brackets, tax credits, exemptions and social benefits.

[844] Tax rates for 2013 and subsequent years, as provided for under the Reduction of Deficit and Changes in Tax Burden Law, 2012, of August 2012.

[845] The law states that the surtax rate on taxable income from "capital" sources would be increased by an additional 2%. "Capital" source-income includes, among other things: dividends; interest; capital gains; rental income; and capital gains from the sale of real estate rights. It should be noted that the proposal to extend the surtax to all capital gains from the sale of a residential property that are not exempt was not accepted, and the existing provision in the Ordinance, which imposes the surtax only on capital gains exceeding 5,382,285 shekels, remains unchanged.

[846] Including income from personal exertion within the meaning of paras. 1–7 of the definition of that term in Income Tax Ordinance, s. 1.

[847] Income Tax Ordinance, s. 66(d).

[848] Income Tax Ordinance, s. 66(d).

[849] C.A 900/01 *Kelles v. Assessing Officer Tel-Aviv 4*, Missim Q/3 (June 2003), E-9.

[850] I.T.A. 1250/05 *Shkuri v. Assessing Officer Kfar Saba*, Missim W/4, E-151 (2009). In I.T.A 540/08 *Malkiely v. Assessing Officer Ashkelon*, Missim W/4, E-191 (2009), the Be'er-Sheva District Court, in an obiter dictum, criticized the holding in *Shkuri*.

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scales of taxation to be applied separately to the income of each spouse. Nowadays the courts seem to view separate assessments with greater favor.[851] As of 2012, married taxpayers jointly engaged in a business were allowed to opt for a separate computation if they met the stringent requirements of the law and the income of one spouse did not exceed NIS 48,960 per annum. However, in a case where both spouses worked together in a company in which the husband held 96% of its shares, the Supreme Court overturned this rule and held that in the case where income of a spouse is derived from a company in which the other spouse holds at least 50% of its shares, the income of both spouses would be assessed jointly.[852]

A 1998 amendment[853] added section 65A to the Ordinance, which provides that a tax file managed by the Assessing Officer with respect to the income of a couple must carry the names of both the husband and the wife.

Amendment no. 89 to the Income Tax Ordinance, which has been in effect since January 1993, retained most of the substantive provisions with respect to joint assessments but removed the gender distinction between the spouses. The amendment added a provision[854] concerning the prenuptial assets of a spouse and inherited property received during the matrimonial period. With respect to gains from such property, separate assessments are allowed. Other "non-personal exertion gains" were computed jointly by being added to the income of the spouse whose personal exertion income is higher or, if there is no such income, to the income of the "registered spouse."

The "registered spouse" is the spouse having the higher income of the two spouses in the two years *preceding* the tax year under review; however, the spouses may jointly give notice — at least three months before the beginning of the tax year — informing the assessing officer which of them is to be the "registered spouse." Where they have done so, or where the assessing officer determined the registered spouse, the registration is in effect for at least five tax years, unless the individuals concerned are no longer spouses or the Commissioner decides otherwise.[855]

Following the Supreme Court's ruling in the *Malkiely*[856] case, the provisions with respect to the eligibility of separate assessments of couples with dependent sources of income were significantly altered in Amendment no. 199 of the Israeli Income Tax Ordinance effective as of January 1, 2014. Amendment no. 199 abolished the provisions of sections 66(d) and (e) and set forth requirements with respect to couples desiring that their assessment be calculated on a separate basis. These requirements are discussed above.

[851] I.T.A. 510/99 *Itach v. Assessing Officer Ashkelon*, Missim O-1 (Feb. 2001), E-190; I.T.A. 7/95 *Kardi v. Assessing Officer Ashkelon*, Missim L-6 (Dec. 1998), E-116; I.T.A. 542/06 *Les. v. Assessing Officer Eilat*, Missim W/2, E-260 (2009).

[852] C.A. 8114/09 *Malkiely v. Assessing Officer Ashkelon*, Missim 26(1), E-68A.

[853] Law for the Amendment of the Income Tax Ordinance (No. 77), 1988.

[854] Income Tax Ordinance, s. 66(b).

[855] Income Tax Ordinance, s. 64(b).

[856] C.A. 8114/09 *Malkiely v. Assessing Officer Ashkelon*, Missim 26(1), E-68A.

F. Capital Gains

Capital gain refers to the profit from the sale of a capital asset, such as real estate, stock or other investments. Capital gain is calculated as the difference between the selling price of the asset and the original purchase price. If the selling price is higher than the purchase price, it is a capital gain. In other words, capital gain is the nominal profit from the sale, while inflation is taken into account when calculating the capital gain tax. This is done by distinguishing between the real capital gain, and the inflationary amount. Distinguishing between the two is important, since real capital gain is taxable, while the inflationary amount is not taxable.

Capital gains are considered chargeable income, whether it is an Israeli resident who produced capital gain in Israel or abroad by the sale of assets, or a foreign resident who produced capital gains on the sale of the following:[857]

(i) Assets located in Israel;

(ii) Assets located abroad located abroad that are essentially a direct or indirect right to an asset or inventory, or that are an indirect right to a real estate right or to an asset in a real estate association located in Israel. The taxation applies only in respect of the part consideration that stems from the property located in Israel;

(iii) Assets that are a share or the right to a share in an Israeli entity;

(iv) Assets that are a right in a foreign resident entity, which in essence is the owner of a direct or indirect right to property located in Israel. The taxation applies only with respect to the part of the consideration that stems from property located in Israel.

An individual is liable to tax on real capital gains that accrued from January 1, 2012, at a rate that is no greater than 25%;[858] if the real capital gain accrued before January 1, 2012, the tax rate is 20%. In the case of sales of company stocks, this rule applies only where the seller did not hold a substantial amount of the stock within 12 months preceding the sale. A substantial shareholder in this context is one who holds control of at least 10% of the company stock by any means. If this condition is not met, the seller will be subject to a tax rate that does not exceed 30% for capital gains accrued from January 1, 2012; a tax rate of 25% applies for capital gains accrued before January 1, 2012. The tax on the inflationary amount (i.e., the part of the capital gain that equals the amount by which the adjusted balance of the original cost exceeds the balance of the original cost) is 10%.[859]

Once an asset has been sold, the seller must submit a form to the Assessing Officer within 30 days after the sale, specifying the calculations of the capital gains or capital loss, and the tax calculation in respect of the sale. The seller must pay an advance in the amount of the tax that applies to the profit.[860] Cap-

[857] Income Tax Ordinance, s. 89.

[858] Income Tax Ordinance, s. 91.

[859] Income Tax Ordinance, s. 91(c).

[860] Income Tax Ordinance, s. 91(d)(1).

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ital gains shall be exempt from tax if it arises out of one of the following circumstances:[861]

(i) The sale on a non-convertible bond traded in the TASE, provided that the bond was issued before May 8, 2000, and was listed for trading on the TASE before January 1, 2003;

(ii) The sale of a bond or a bond with warrants issued by the state or guaranteed by it, provided that the bond was issued or guaranteed before May 8, 2000;

(iii) A gift to the state, to a local authority, or to a public institution (according to the meaning in section 9(2) to the ordinance);

(iv) A gift to a relative, and a gift to another individual, if the assessing officer was convinced that the gift was given in good faith, and the gift recipient is not a foreign resident; and

(v) An individual's capital gain from the sale or redemption of a unit in a chargeable trust fund.

[861] Income Tax Ordinance, s. 97.

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XIV. Taxation of Nonresident Individuals

The statutory definition of the status of individual nonresidents is found in section 1 of the Income Tax Ordinance. A nonresident taxpayer is defined as a person: "(i) other than a person resident of Israel; or (ii) an individual who resided without Israel for at least 183 days each year, during two consecutive tax years, whose primary residence or 'center of life' was not in Israel for two additional tax years."[862]

Generally speaking, nonresidents are subject to tax only on Israeli source income, i.e.: (i) business income derived from business activities that take place in Israel; (ii) employment income derived from services rendered in Israel; (iii) dividend, interest, discount and linkage differentials paid by an Israeli resident; (iv) rental income from property located in Israel; (v) profits, including royalties, from incorporeal assets paid by an Israeli resident; and (vi) pensions, annuities and maintenance payments paid by an Israeli resident.

Under the Nonresident's Credit Point Regulations, 2007, a nonresident, not being a "foreign expert" or a "foreign teacher," is entitled to 2.25 credit points per month, provided the individual is legally present in Israel.

A "foreign expert" is an individual: (i) who is legally present in Israel; (ii) who was "invited to Israel" by a resident employer[863] to render services in a field the person specializes in; (iii) who is employed in his/her field of occupation during the entire period he/she is in Israel; and (iv) whose remuneration exceeds NIS 13,300 per month. A "foreign teacher" is an individual who was invited by a teaching institution to teach in Israel. Under special regulations promulgated by the Minister of Finance, foreign experts and foreign teachers are entitled to a specific exemption for amounts paid to them for living expenses while in Israel, provided these amounts do not exceed the designated limits (NIS 320 per day for meals, and an unlimited sum for a dwelling).[864] Moreover, the exemptions are available only during the first 12 months of the individual's stay in Israel.[865]

There is no discrimination between residents and nonresidents as to the rates of tax. As stated at XV.C., below, a nonresident must file an annual return reporting his/her income unless specifically exempted.

Special incentives exist with regard to the income of nonresidents, particularly with respect to linkage differentials, certain interest and capital gains. These are discussed more fully in XVII., below.

The draft bill to amend the Income Tax Ordinance proposes adding a new subsection (b4) to Section 97 that would empower the Minister of Finance, with the approval of the Knesset's Finance Committee, to determine that income from the sale of securities by a foreign resident will be exempt from capital gains tax, even if the capital gain is derived from a PE in Israel, subject to conditions that are yet to be set.

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[862] Para. (ii) was added within the framework of Amendment 168 to the Income Tax Ordinance, effective as of Jan. 2007.

[863] That is not a "manpower contractor" or a "manpower broker," as defined in the regulations.

[864] Income Tax (Deduction of Sojourn Expenses of a Nonresident) Regulations, 1979. Implementation Instruction No. 88/32 of the Income Tax Authorities provides, with regard to foreign employees who come to Israel to work as experts for a period of less than 12 months, that the actual expenses of their stay in Israel are deductible. These include hotel or other accommodation and actual meal expenses up to a designated ceiling per day, for which the employee himself paid and with respect to which documentation is provided. Expenses for meals up to a designated ceiling per day are allowed without submission of proof. Air travel from the foreign employee's home to Israel and back are not deductible. If such expenses were paid by the employer, they must be added to the employee's taxable income. *See* I.T.A. 19/87 *Sherman v. Assessing Officer Gush-Dan*, Missim D-5 (Oct. 1990), E-94. *See also* Income Tax (Foreign Athletes) Regulations, 1998. A temporary change was made to these regulations for the tax years 2001–02. The regulations for 2001–02 add definitions for companies providing temporary workers. A "foreign expert" is defined as an expert who meets the following requirements: (i) he/she is an invitee invited to provide services to the host provided that the invitee is solely engaged in his specialty and provided that the host is not a provider of temporary workers; (ii) his stay in Israel is lawful; (iii) he/she provides services in the field of his specialty during his entire stay; and (iv) his income is more than NIS 10,000 multiplied by the number of months of his stay in which taxes were withheld from his income (if the foreign expert spent less than one month in Israel, the above amount will be divided by 30 and multiplied by the number of days of his stay). This amount is to be adjusted under Income Tax Ordinance, s. 120B, as though it were a social allowance, and rounded off to the nearest NIS 100. The temporary change has become permanent, as the language of the regulations was changed in 2005. The provision regarding the deduction of sojourn expenses was not altered. A temporary provision decrees that, in calculating the credit points of a foreign expert, 2 ¼ credit points be credited with respect to income remaining after the deduction of sojourn expenses. The credit will be calculated in relation to the foreign expert's period of stay, excluding the period for which he/she was entitled to deduct sojourn expenses. Nevertheless, as of 2007, the Nonresident's Credit Point Regulations, 2007 provide that the Income Tax (Deduction of Sojourn Expenses of a Nonresident) Regulations, 1979 are relevant only for Foreign Experts or Foreign Teachers.

[865] Income Tax (Deduction of Sojourn Expenses of a Nonresident) Regulations 1979, s. 2.

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XV. Tax Administration

A. Assessment of Nonresidents

Section 108 of the Income Tax Ordinance provides that a nonresident of Israel having an agent in Israel is assessable and chargeable in the name of the agent, whether the agent is a trustee, guardian or committee, or of any attorney, factor, receiver, branch or manager, whether such attorney, factor, receiver, branch or manager was in receipt of the income or not, in like manner and in like amount as the nonresident would be assessed and charged if the nonresident were resident in Israel and in actual receipt of the income. Furthermore, section 109 of the Ordinance provides that a nonresident is assessable and chargeable with respect to any income arising, whether directly or indirectly, through or from any attorney, agency, receivership, branch or management and is so assessable and chargeable in the name of the attorney, factor, agent, receiver, branch or manager. Section 112 provides a procedure for calculating the income of a nonresident chargeable to tax in the name of a resident person where the income cannot be readily ascertained. The procedure calls for the ascertainment of the income "on a fair and reasonable percentage of the turnover of the business done by the nonresident person through or with the resident person." In such a case, those provisions of the Ordinance relating to the filing of returns or other documents by a person acting on behalf of others are applied so as to require returns or other documents of the business to be furnished by the resident person in the same manner as by persons acting for incapacitated or nonresident persons. The exact percentage of the turnover must be determined by the Assessing Officer having regard to the nature of the business, and is subject to appeal.

Most importantly, a nonresident is not chargeable to tax in the name of a broker or a general commission agent or other agent where that broker, general commission agent or other agent is not an authorized person carrying on the regular agency of the nonresident or a person chargeable as if they were an agent in pursuance of section 110 (ship master), section 111 (resident carrying on business with a nonresident) or section 112 (nonresident chargeable to tax in the name of a resident on the basis of turnover), with respect to the gains or profits arising from sales or transactions carried out through the broker or agent.[866]

B. Books of Account

The Income Tax Ordinance empowers the Income Tax Commissioner to issue directions regarding the keeping of books of account by any business, trade, profession or vocation and to lay down rules with regard to methods of recording the income derived from such sources.[867] The Director General of the Israel Tax Authority (ITA) has exercised this power[868] and has imposed the duty of keeping books of account on all taxpayers, except those who do not attain a certain turnover (excluding transactions of selling equipment where the purchaser deducted input tax) if they do not employ a statutory number of employees. The duty is imposed on manufacturers, wholesalers, retailers, building contractors, professionals, owners of various schools, real estate brokers, dealers in motor cars, persons engaged in the rendering of services, farmers, gas station owners, insurance agents, diamond dealers (a special provision allows them to maintain their books in U.S. dollars)[869] and any other person who carries on a trade or business not mentioned above. In addition, a duty is imposed on suppliers of goods and catering services, taxi drivers, barbershops, beauty parlors, automatic laundries and dry-cleaning facilities to maintain cash registers.

The taxpayer may pay a high price as a result of failure to adhere to the Director General's instructions with respect to the maintaining of books of account. The assessing officer is not obliged to accept books presented by a taxpayer who failed to maintain proper books of account.[870] In such cases, the assessing officer is empowered to assess the income in accordance with their best judgment.[871] The burden of proving that the assessment is excessive lies with the taxpayer,[872] whereas, if the taxpayer kept proper books of account, the burden of justification lies with the assessing officer. A taxpayer failing to keep proper books of account is not able to take advantage of the lower tax rates imposed on the first three brackets of income derived from personal exertion or on income of taxpayers over age 60.[873] Such a taxpayer also suffers an additional tax at the rate of 10% for the first year in which the books of account were not maintained and at the rate of 20% for each subsequent year.[874] Of course, such a taxpayer's advance payments are increased to correspond to the additional tax. The assessing officer is empowered to deny the deduction of expenses that are not supported by proper books of account and, again, such expenses may be assessed by the assessing officer using a "best judgment" approach.[875] Where a taxpayer failed to maintain proper books of account in circumstances considered to aggravate the failure, the taxpayer is denied deductions and setoffs for depreciation, interest, bad debts and losses and, of course, any net operating loss for the year concerned.[876] Expenses incidental to the payment of tax that are otherwise allowable as a deduction are denied where books of account have not been maintained, or if the return was not based on proper books of account.[877]

The deduction of legal costs relating to income tax appeals is denied if the court or the committee for determining the acceptability of books of account determines that the proceedings (appeal or objection) were vexatious or lacked any reasonable cause. These expenses are not deductible in connection with income from a business or vocation lacking books of account, or if the return was not based on proper books of account.[878] Ordinarily, the assessing officer may exempt a taxpayer, in whole or in part, from the payment of advances on account of the tax-

[866] Income Tax Ordinance, s. 115.
[867] Income Tax Ordinance, s. 130(a).
[868] Income Tax Provisions (Keeping Books of Account) (No. 2), 1973, s. 2, combined with VAT Regulations (Keeping Books of Account), 1976.
[869] Income Tax Ordinance, s. 130A.
[870] Income Tax Ordinance, s. 130(b).
[871] Income Tax Ordinance, s. 145(b).
[872] Income Tax Ordinance, s. 155.
[873] Income Tax Ordinance, s. 121(b)(2).
[874] Income Tax Ordinance, s. 191B(a).
[875] Income Tax Ordinance, s. 33(a).
[876] Income Tax Ordinance, s. 33(b) and (c).
[877] Income Tax Ordinance, s. 17(11)(b).
[878] Income Tax Ordinance, s. 17(11)(a), (b).

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es due for the current year. However, the Income Tax Ordinance forbids such reductions in the amount of the tax advances where the taxpayer failed to maintain the required books of account.[879] Other provisions deny a refund of tax within the ordinary prescribed 60 days in certain circumstances, while yet others increase the rate of tax to be withheld at source in the case of taxpayers failing to maintain proper books of account. A taxpayer that fails to maintain books of account is not entitled to act as an "authorized supplier" to government departments or public institutions (as long as the anticipated transaction between the supplier and the department or the institution exceeds more than a statutory amount)[880] and is not afforded a state guarantee, grant or support.[881] Finally, failure to keep proper books of account in itself constitutes a criminal offense.[882]

C. Income Tax Returns

Section 131 of the Income Tax Ordinance provides that the following persons must file an annual income tax return:

(i) An individual resident in Israel who was 18 years old or older at the beginning of the tax year. However, an individual whose primary source of income is from employment is exempt from the duty to file a return if their employment income does not reach the amount prescribed by the Minister of Finance and if their income from other sources is insignificant and has already been subject to withholding at source.[883] A registered spouse may refrain from including the income of their spouse if the latter files a separate return or if attaches to the return a declaration of the spouse that they will file separately.

(ii) A spouse who is not a registered spouse and who declared under (i), above, that they will file a separate return.

(iii) A minor resident in Israel with income in excess of a statutory limit or such other amount as may be prescribed for this purpose by the Minister of Finance.

(iv) Any nonresident who derived taxable income during the tax year under consideration. However, by virtue of a special regulation,[884] a nonresident is not required to file a return with respect to the following income if taxes were withheld at source: income from trade or business if the activity did not exceed 180 days during the tax year; employment income; and interest, dividends and royalties.

(v) A "body of persons," as defined in section 1 of the Ordinance, that derived income during the tax year.

(vi) A person who during the tax year sold a taxable real estate right or alienated a right in a "real estate association," as defined in the Taxation of Land (Appreciation and Purchase) Law, 1963, unless the person was assessed prior to the filing at the maximum rate of tax on the gain.

(vii) A trustee. With respect to trusts settled by Israeli residents, the filing requirement is unqualified. If the Settlor is a nonresident, a reporting duty arises only where the trust has Israeli-sourced income or assets located in Israel, and only with respect to that income or those assets. The return must include details with respect to the identity of the Settlor, the Beneficiaries and the date on which distributions were made. In some cases, a Settlor or a Beneficiary may file the annual returns instead of the Trustee.

(viii) A controlling shareholder of a foreign vocation company (FVC) (see V.C.4.e., above) or of a controlled foreign company (CFC) (see V.C.4.d., above).

(ix) Any person who took an action falling in the "aggressive" tax planning strategies list.

(x) With regard to trusts, the following:

- A settlor who settled a trust or transferred an asset to a trust during the tax year;
- A trustee of a trust settled by an Israeli resident, or a trustee who had income or an asset in Israel, whether or not resident in Israel;
- A beneficiary who received a distribution from a trust, including a distribution which is not subject to tax in Israel, excluding distributions of properties sourced outside of Israel to a beneficiary in a foreign residents trust or a foreign beneficiary trust or to a beneficiary in a trust established according to a will of which all its beneficiaries are foreign residents; and
- A trustee in an Israeli beneficiary trust that is subject to the provisions of section 75H1(d)(3).

(xi) Any person required by the assessing officer to submit a return, whether or not falling in one of the categories listed above at (i) through (x).[885]

Section 134B of the Income Tax Ordinance, which was added under the 2008 Reform, exempted new and returning residents from filing with respect to exempt income during their first 10 years of residence. Amendment 272 repealed Section 134B, resulted in the revocation of the exemption from reporting requirements for "New Israeli Residents" and "Veteran Returning Residents." Starting from January 1, 2026, these individuals will continue to be exempted from tax on income generated outside of Israel, but will be required to submit an annual tax return report to the ITA regarding such income. It should be noted that the previous provision will continue to apply to individuals who were classified as "New Israeli Residents" or "Veteran Returning Residents" before January 1, 2026.

Section 131(b) of the Income Tax Ordinance specifies the contents of the return. "The return shall specify the income of the person filing it in the year to which it relates and all the particulars required for the purposes of this Ordinance in respect of that income… ." A return based on a complete set of double entry accounts must be accompanied by a balance sheet and a profit and loss (P&L) account. A return based on a complete set of accounts not based on the double entry method must be accompanied by "particulars of the calculation on which the

[879] Income Tax Ordinance, s. 180(a).

[880] With Public Bodies Transactions (Enforcement of Bookkeeping and Payment of Tax Debts) Law, 1976, s. 2(a)(1), (b).

[881] With Public Bodies Transactions (Enforcement of Bookkeeping and Payment of Tax Debts) Law, 1976, s. 2A.

[882] Income Tax Ordinance, s. 216(5).

[883] Income Tax Ordinance, s. 134A; re regulations *ibid.* note 19.

[884] Income Tax (Exemption from Filing Return) Regulations, 1988, s. 5.

[885] Income Tax (Exemption from Filing Return) Regulations, 1988, s. 6.

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declared income is based." If the return is not based on books of account, it must be accompanied by a detailed estimate of turnover, expenses, and percentage of profits, or by documents or other data on which the declared income is based. With the exception of the return of a partnership, the return of a "body of persons," must be certified by an auditor and "adjusted by him for the purposes of the tax." A special provision allows for the auditing of a cooperative society by an "audit union." Most important to note is section 131(f), which provides that "where a person has not attached documents specified in subsection (b) to the return or where the return submitted by a person has not been certified and adjusted as provided in subsection (c), such person shall, for the purposes of sections 145(b) and 158A(c), be deemed not to have submitted a return unless he has submitted documents as aforesaid on some other date authorized by the assessing officer."[886]

The assessing officer is empowered under the Income Tax Ordinance, where there are reasonable grounds for so doing, to demand in writing that the auditor who certified a balance sheet or an adjustment account provide the assessing officer with a report clarifying the extent and results of the audit.[887]

The return must be submitted not later than April 30 of any tax year; however, a person whose return is based on a complete set of double entry accounts may submit the return by May 31. Where the taxpayer, with the permission of the assessing officer, bases their return on a special period of assessment, the return must be submitted within five months from the date on which the period of assessment ends.[888] In practice, the tax authorities have adopted a strict approach requiring taxpayers to be punctual. Where, for special reasons, a return cannot be submitted by the due date, the taxpayer is required to provide an estimate of their taxable income to the assessing officer and file their return later.[889] In such case, the tax must be paid based on the estimate shown on the return and the taxpayer may not withhold payment until the final return is filed.

Income tax returns must be submitted in Hebrew, which is Israel's official language (together with Arabic). Previously the tax authorities have been willing, in exceptional cases, to accept returns in English, provided appropriate arrangements were made.[890] The Attorney General, however, has issued instructions to all government agencies to accept solely Hebrew and Arabic documents.

D. Mandatory Disclosure of Aggressive Tax Planning

In relation to the OECD Base Erosion and Profit Shifting (BEPS) action 12, Israel adopted a mandatory disclosure regime. Amendment no. 215 of the Income Tax Ordinance established section 131D, which imposes a reporting obligation upon the receipt of a legal opinion that is designed to allow a "tax advantage," on the condition that the fee for the legal opinion is at least NIS 100,000, for the maximal tax savings that would be created for the recipient, or alternatively if the opinion is based on a "shelf-planning" arrangement.

Section 131D describes a "tax advantage" as either:

(i) A tax discount or relief, postponement of the tax event, reduction of the tax amount, or tax avoidance;

(ii) The avoidance of an obligation to deduct taxes or expenses or to consider a loss; or

(iii) The postponement of the date of payment of tax.

The Income Tax Ordinance describes "shelf-planning" as the following:

(i) A legal opinion that included mainly uniform content on the same subject, that was given to three different and unrelated taxpayers, within a two-year period, and there was no control between one over the other; or

(ii) A legal opinion that was given to the client at the initiative of the tax advisor and the recipient was obligated to confidentiality regarding its content.

The purpose of the amendment is to help the ITA to identify tax planning that is inconsistent with the intent of the legislature to conduct effective audits and tax collection in accordance with the law.

The reporting obligation applies to an individual or a "body of persons"[891] whose income during the tax year, excluding proceeds from the sale of property, exceeded NIS 3 million, or if the proceeds from the sale of the property during the tax year exceeded NIS 1.5 million and the legal opinion was given with regards to the sale of the property. Taxpayers are required to report disclosures in their tax returns on covered tax planning opinions obtained as from January 1, 2016.

E. Assessments and Appeals

A return filed under section 131 of the Income Tax Ordinance is deemed to be an income tax self-assessment of the taxpayer and, following its receipt, the assessing officer notifies the taxpayer of their tax liability. Within three years or, with the approval of the Income Tax Commissioner, within four years of the end of the tax year in which the return was filed, the assessing officer is empowered, under section 145(a)(2), to accept the taxpayer's self-assessment or to assess the taxpayer's income based on their best judgment if there are reasonable grounds to believe that the return is incorrect. The decision of the assessing officer is subject to an administrative appeal before another assessing officer, whereon, in the absence of an agreement, an order is issued. The order may be appealed to the District Court and, ultimately, to the Supreme Court.

Under section 135 of the Income Tax Ordinance, the assessing officer has far-reaching powers to investigate the affairs of a taxpayer, including the right to enter premises, seize documents and conduct investigations to gain full knowledge of the taxpayer's income.

[886] Income Tax Ordinance, s. 145(b) empowers the Assessing Officer to assess, according to his best judgment, the amount of the chargeable income of a person who failed to submit a return. Income Tax Ordinance, s. 158A(c) provides that the rights of the taxpayer under Income Tax Ordinance, s. 158A(a) and (b), namely the right to a hearing where the assessment was made according to the best judgment of the Assessing Officer and the right to receive an explanation as to the specific manner in which the assessment was made, are to be denied to a person who did not submit a return.

[887] Income Tax Ordinance, s. 131B.

[888] Income Tax Ordinance, s. 132.

[889] Income Tax Ordinance, s. 133.

[890] Income Tax Circular No. 15/88.

[891] Income Tax Ordinance, s. 131D(g)(2).

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F. Audit Process and Limitations Period

According to the Income Tax Ordinance, the taxpayer's tax return, which is filed on an annual basis, constitutes the initial assessment according to which the tax is due. The statute of limitations period is generally four years, commencing at the end of the year in which the relevant return was filed.[892] The ITA may extend the statute of limitations period for one additional year[893] provided certain conditions are fulfilled.[894]

The ITA may review the tax return filed by the taxpayer and, inter alia, may request to discuss the tax return or provide additional information,[895] after which they may propose an adjustment to the return.[896] The taxpayer may agree with the adjustment or file an objection with the ITA.[897] If an objection is filed by the taxpayer, the case is forwarded to another official in ITA for further review. [898]

If an agreement is not reached, the ITA will issue a decree with respect to the adjusted assessment and the tax due according to its position.[899] The taxpayer may file an appeal with a District Court.[900] The appellant-taxpayer is considered as a plaintiff for purposes of the appeal, and the ITA a defendant.[901]

The taxpayer is required to pay the amount of tax due in advance.

G. Withholding of Tax at Source

1. In General

The collection of taxes in Israel is based, to a great extent, on the withholding of income tax at source. To that end, regulations have been issued requiring the withholding of tax at source on:

(i) Salaries, wages, certain allowances, severance pay, and pensions.[902]

(ii) Dividends, payments from mutual funds, interest and linkage differentials.[903]

(iii) The remuneration of authors, artists, lecturers, examiners of tests, sportsmen, insurance agents, directors, and providers of administrative services.[904]

(iv) Various payments for office services, including translation, typing, bookkeeping, systems analysis and programming for computers and data processing.[905]

(v) Taxable income paid to a nonresident from which no income tax was deducted under (i) to (iv), above.[906]

(vi) Payments to subcontractors made by contractors in the construction and trucking industries.[907]

(vii) Payments made by industrialists engaged in the clothing, metal, electricity and electronics industries, including those engaged in trucking services and the transportation of passengers where the work was performed by subcontractors in these industries.[908]

(viii) Payments for services rendered or goods sold to a governmental or semi-governmental institution or entity.[909]

(ix) Various payments made to suppliers and subcontractors by companies authorized by the government or a local authority to explore for, produce, supply and transport minerals, oil, water or electricity.[910]

(x) Payments of severance pay that are not exempt from tax.[911]

(xi) Payments resulting from: the sale of securities;[912] the lending of securities;[913] dividends paid by the borrower of a security with respect to a "short" transaction;[914] and income derived from futures transactions in foreign currencies.[915]

(xii) Certain payments for services or assets provided or sold to large companies.[916]

(xiii) Payments for agricultural products.[917]

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[892] Income Tax Ordinance, s. 167(a)(2).

[893] Income Tax Ordinance, s. 147(a)(1).

[894] C.A. 976/06 *Dan Marom v. Tax Authorities* (Dec. 6, 2008). *See also* I.T.A. 32858-02-12 *Ran Dvir v. The Assessing Officer of Natanya*, Missim KH/5 (Oct. 2014), E-179; C.A. 3929/13 *The Assessing Officer Tel Aviv 3 v. Yossi Neeman*, Missim KI/1 (Feb. 2015), E-136.

[895] Income Tax Ordinance, ss. 135, 151.

[896] Income Tax Ordinance, s. 145(a)(2)(b).

[897] Income Tax Ordinance, s. 150.

[898] Income Tax Ordinance, s. 150A.

[899] Income Tax Ordinance, s. 152(b).

[900] Income Tax Ordinance, s. 153(a).

[901] Courts of Law (Income Tax Appeals), 1978, s. 9(b).

[902] Income Tax and Employers Tax (Withholding from Salary and Payment of Employers Tax) Regulations, 1993.

[903] Income Tax (Withholding from Interest and Linkage Differentials) Regulations, 1977; Income Tax (Withholding from Interest) Regulations, 2002; Income Tax (Withholding from Payments Paid to an Owner of a Unit in a Mutual Fund) Regulations, 2002.

[904] Income Tax (Withholding on Authors Remuneration) Regulations, 1964; Income Tax (Withholding from Insurance Commission) Regulations, 1964; Income Tax (Withholding from Certain Types of Remuneration) Regulations, 1967.

[905] Income Tax (Withholding from Certain Types of Remuneration) Regulations, 1967, s. 1.

[906] Income Tax Ordinance, s. 170.

[907] Income Tax (Withholding from Payments for Building and Trucking Works) Regulations, 1973.

[908] Income Tax (Withholding from Payments for Clothing, Metal, Electricity Electronics and Trucking Works) Regulations, 1973.

[909] Income Tax (Withholding from Payments for Services or Goods) Regulations, 1977.

[910] Income Tax (Withholding from Payments for Services or Goods) Regulations, 1977.

[911] Income Tax Ordinance, s. 164.

[912] Income Tax (Determination of the Consideration Received from the Sale of a Foreign Security as Income and Withholding from the Consideration) Order, 1992; Income Tax (Determination of the Consideration, Payment or Capital Gain from the Sale of a Security or from Future Transactions as Income) Order, 2002; Income Tax (Withholding from Consideration, Payment or Capital Gain from the Sale of a Security or from Future Transactions) Regulations, 2002.

[913] Income Tax (Withholding from Lending Fee) Regulations, 2002.

[914] Income Tax (Withholding from Dividend Paid by the Borrower) Order, 1992.

[915] Income Tax (Withholding from Income Derived Pursuant to an Agreement in Respect of Foreign Currency Future Rates) Order, 1990.

[916] Income Tax (Withholding from Payments for Services or Goods) Regulations, 1977.

[917] Income Tax (Withholding from Payments for Agricultural Work or Products) Regulations, 1979.

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(xiv) Payments made by the National Insurance Institute as workmen's compensation and for military service.[918]

(xv) Payments for the processing of diamonds.[919]

(xvi) Payments made by a provident fund to an employer.[920]

(xvii) Payments of rental fees.[921]

(xviii) Payments made to a nonresident.[922]

(xix) Lottery and gambling receipts.[923]

(xx) Payments made to employees of a trustee in bankruptcy.[924]

2. Exemption for Payments to Foreign Residents

In many cases, payments to non-Israeli residents to their own foreign bank account, using bank wire-transfers, are subject to withholding tax, unless the payer is granted a tax exemption by the assessing officer.

However, to facilitate overseas investments by Israeli residents, a payment to a foreign resident will be exempted from withholding tax, under the following conditions:[925]

a. The payee is a resident of a tax treaty country (a country with which Israel has a tax treaty) and the transfer of the payment is to a bank account located in such a country;

b. The payment is for one of the following purposes:

(i) Purchase of shares;

(ii) Purchase of real estate or other tangible assets located overseas;

(iii) Granting a loan to a foreign resident; or

(iv) Granting a shareholders' loan; and

c. The payer provides the bank with a statement with all the relevant details of the payment.

H. Advance Rulings

In Israel, advance rulings are referred to as "pre-rulings." The pre-ruling regime was introduced by Amendment no. 147 to the Income Tax Ordinance. A taxpayer may apply for a pre-ruling regarding liability to tax, the tax result or any tax consequences of an act performed, income or profit generated, or expenditure or loss incurred, by the taxpayer. The aim of a pre-ruling is to reduce uncertainty.

Pre-rulings may be obtained from the Israeli Tax Authority on all tax matters. In addition, from time to time the Tax Authority publishes circulars with respect to various tax issues, including administrative procedures. The Tax Authority also publishes its official interpretation of the Israeli tax legislation (referred to as the "Havak"). In addition, the Tax Authority provides its interpretation with respect to the Land Taxation Law (Appreciation, Sale and Purchase), 1963 and the Value Added Tax Law, 1975. The Authority's interpretation of the tax laws is not binding from the taxpayer's point of view and merely represents the Authority's view with respect to the issue concerned.

The ITA is prepared to rule on issues regarding:

(i) Income tax;

(ii) Value added tax (VAT);

(iii) The taxation of land appreciation;

(iv) The Law for the Encouragement of Capital Investments; and

(v) The Law for the Encouragement of Industry (Taxes).

An application for a pre-ruling must be submitted before a tax return is filed regarding the transaction and, with respect to issues related to VAT or the taxation of land appreciation, before the transaction. The ITA publishes annually some of its more important pre-rulings issued during the year. The rulings constitute a persuasive source of non-binding precedents for the tax bar.[926]

In 2010, the ITA also launched a fast track pre-ruling service to provide short and quick response concerning generally applicable and recurring issues that are not considered to overly complex. The topics chosen for fast track treatment include, among others: (i) merges of exempt mutual funds; (ii) taxable mergers of mutual funds; (iii) the calculation of the weighted discount rate; (iv) allocation of units per share; (v) step-up basis when upon the receipt of foreign assets; and (vi) the tax status of new residents and veteran returning residents.

I. Advance Payments of Tax

By providing for withholding at source from employment income, the Income Tax Ordinance adopts a "pay as you earn" system. Similarly, withholding at source on other income is designed to provide for the early collection of the tax due. Self-employed individuals and companies are required to make advance payments, payable in monthly installments throughout the tax year.[927] Some of the advance payments are based on the assessments of past years, appropriately linked to the rise of prices as of the return on which the advance payment is based. Most advances are paid pursuant to section 175(b) of the Ordinance, which was amended to provide for the payment of advances on the basis of the taxpayer's turnover.

Upon a taxpayer's request, the number or amount of the advance payments may be decreased if the assessing officer is

[918] Income Tax (Withholding from Payments Made as Compensation for Employment Accidents, and Remuneration for Military Service) Regulations, 1979.

[919] Income Tax (Withholding from Payments for Processing of or Trading in Diamonds) Regulations, 1992.

[920] Income Tax (Withholding from Payments Paid by Provident Fund to an Employer) Regulations, 1981.

[921] Income Tax (Withholding from Payments of Rental Fees) Regulations, 1998.

[922] Income Tax (Withholding from Payments Paid to Nonresidents) Regulations, 1992.

[923] Income Tax (Withholding from Payments Resulting from Gambling, Lotteries or Prize Awarding Activities) Regulations, 2003.

[924] Income Tax (Determination of Income of Employees of a Trustee in Bankruptcy or a Company in Liquidation as Income) Order, 1971.

[925] Israel Tax Authority — Division of Professional Affairs, "Statement Procedure Regarding Payment to a Foreign Resident" (26.9.2017).

[926] *E.g.*, C.A 1804/05 *Aloni v. Assessing Officer Kfaer Saba*, Missim X-2, E-64 (2008).

[927] Income Tax Ordinance, s. 175.

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of the opinion that the income of the taxpayer will not justify the advance tax required of him. However, if the final return later shows that the reduction was unjustified, the taxpayer will be subject to an interest penalty at the annual rate of 4% (or at a different rate determined by the Minister of Finance in accordance with the prevailing economic conditions), as well as linkage differentials, on the amount by which the advance payments were reduced.[928]

[928] Income Tax Ordinance, s. 190(a); s. 159A(a).

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XVI. Transfer Pricing

A. Scope of Provision

Until the tax reform of 2003, the Income Tax Ordinance did not contain specific provisions relating to transfer pricing between related parties. Within the framework of the 2003 tax reform, section 85A was added to the Ordinance and provides that in an international transaction between parties enjoying a special relationship, where the prices or terms of the transaction are different from those that would have been established absent the special relationship, the transaction must be reported in accordance with prevailing ordinary market conditions.

A "special relationship" is defined as a relationship between related parties as well as a relationship resulting from the control of one party over the other party or the control of a third person over the parties to the transaction. A party to such a transaction may request a pre-ruling from the tax authorities with respect to a specific transaction or a series of similar transactions. The tax authorities are required to respond to the request within 180 days, and if the tax authorities fail to do so, the prices set forth in the request are regarded as the market prices.

Moreover, section 85A(e) of the Income Tax Ordinance empowers the Minister of Finance to prescribe methods for allocating income, expenses, deductions and credits in cases where transfer prices stray from market prices, as well as provisions relating to returns and documents to be filed with the Assessing Officer. In November 2006, the Minister of Finance prescribed rules under section 85A(e) — The Transfer Pricing (Determining Market Price) Regulations. The regulations provide that, to ascertain whether an international transaction was conducted between related parties at fair market prices, market research must be undertaken to compare the international transaction to similar transactions in accordance with specific comparison methods. Once a comparison method has been selected and the market research performed, the international transaction will be considered conducted at the fair market price, insofar as it does not deviate from the specified range of the market price. If the international transaction does deviate from the specified range, as determined by the regulations, the reported price of the transaction will be adjusted for tax purposes in the manner stipulated therein and the taxpayer will accordingly be subject to additional tax.

The Director General of the Israel Tax Authority (ITA) may order that the regulations will not apply to an international transaction if: (i) the transaction is a one-time transaction, or the scope of the transaction is small; and (ii) the concern that prices may be determined that depart from market prices in the above circumstances does not justify the application of the regulations. This type of transaction will be reported as if there is no special relationship between the parties.

With the approval of the Finance Committee of the Knesset, the Minister of Finance may prescribe with respect to all taxpayers or categories of taxpayers provisions regarding registration and documentation, and provisions regarding reports, documents and data that are submitted to the assessing officer, which will apply to taxpayers belonging to a multinational group.[929] A multinational group consists of two or more entities where both the following conditions are fulfilled: (i) at least one entity is a foreign resident; and (ii) one holds the control of the other entity(ies) (i.e., holds directly or indirectly 50% or more of one of the means of control).[930]

Section 4 of the Income Tax Ordinance provides that, where a person carries on in Israel an agricultural, manufacturing or other productive undertaking and sells any product of the undertaking in a wholesale market outside Israel or for delivery outside Israel, the full profits arising from the sale should be deemed to be income of that person accruing in or derived from Israel. These provisions do not apply if it is "shown to the satisfaction of the assessing officer that the profit has been increased through treatment of the product outside Israel other than by way of handling, grading, blending, sorting, packing or disposal," whereon "such increase of profit shall not be deemed income accruing in, or derived from Israel." If the taxpayer otherwise disposes, uses, or deals with any product of the undertaking outside Israel, the profits that might have been obtained if the taxpayer had sold the product in the most advantageous way in a wholesale market outside Israel are deemed to be the profits arising from its disposal, dealing, or use and to be income of the taxpayer accruing in or derived from Israel.

The Income Tax Ordinance does not contain a transfer pricing provision with regard to domestic transactions, but it is important to be aware of four provisions of the Ordinance in this context:

(i) Section 30 of the Ordinance provides that the amount of any deduction usually allowed in computing taxable income with respect to any expenditure must not exceed the amount required by the assessee to produce the income. Moreover, it provides that any question arising with respect to the denial of such a deduction must be decided by the Commissioner and is subject to appeal as if it was an assessment.

(ii) The assessing officer is empowered to allocate expenses incurred in the production of exempt income or partially exempt income in accordance with section 18(c) of the Ordinance. This section provides that, where the income of any person includes income for which a special rate of tax has been fixed or that is exempt from tax (known as "preferred income"), the expenses incurred by that person in producing the preferred income may be allowed as a deduction under section 17 only against that income. Where these expenses cannot be ascertained, there may be deducted from the preferred income such part of the expenses incurred by the taxpayer in producing his/her total income as bears to the total of such expenses the same ratio as the preferred income bears to the total income. Section 18(c) applies only to income from one of the sources enumerated by the Ordinance and does not apply to capital gains.[931]

(iii) Section 85(a) of the Ordinance indirectly accomplishes an allocation of expenses by taxing a transfer of trading stock at less than its market value. Trading stock that

[929] Income Tax Ordinance, s. 85B.

[930] Income Tax Ordinance, s. 85A.

[931] I.T.A. 11/82 *Leumi-Pia Ltd. v. The Assessing Officer*, 13 P.D.A. 130; C.A. 638/85 *Assessing Officer of Large Enterprises v. Malon Plaza Ltd.*, 18 P.D.A. 401.

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belonged to a discontinued business or trading stock removed or transferred from the business other than for consideration or other than for full consideration is regarded as having been sold at its fair market value.[932]

(iv) Under section 86 of the Ordinance, the Assessing Officer may disregard a transaction, act or disposition that reduces or is liable to reduce the amount of tax payable if he or she believes that the transaction, etc., is artificial or fictitious, or that a particular disposition was not in fact carried out or that one of the main goals of the transaction, etc. is improper avoidance or improper reduction of tax. Section 86 of the Ordinance is a broad provision with flexible boundaries on which the Director General of the ITA may probably base an allocation of income. It reads as follows:

> Where the assessing officer is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, or that one of the principal objects of a particular transaction is improper avoidance or improper reduction of tax, the assessing officer may disregard any such transaction or disposition and the person concerned shall be assessable accordingly. Avoidance or reduction of tax may be regarded as improper even if it is not contrary to law. For the present purpose, "transaction" includes an act. It has been held that, in order not to fall under section 86, a transaction must have a commercial basis apart from the desire to avoid or mitigate tax.[933]

The Israeli District Court has clarified a ruling on artificial transactions in *Spector v. Large Enterprises Assessing Officer*.[934] The court stated that tax planning is subject to a two-step test. The first test examines whether the tax planning was "positive." Tax planning is positive when the taxpayer acts in accordance with the intended policy of the legislator concerning the granting of a tax exemption or tax relief. The second test examines whether the transaction concerned is artificial. An artificial transaction is a transaction that lacks fundamental commercial rationale. The objective burden proof (i.e., to prove that a transaction is artificial) lies with the ITA; the subjective burden proof (i.e., to prove that a transaction is based on a fundamental commercial reason) lies with the taxpayer.

These provisions are designed primarily to mitigate the consequences of tax avoidance and to allow for a true reflection of income. There is no requirement that the tax avoidance motivation be proven for the sections referred to above to apply. The provisions do not refer specifically to related companies, nor do they differentiate between foreign and Israeli taxpayers.

There are no provisions in the Ordinance to prevent double taxation as a result of the allocation of income or expenses. Hence, the allocation of income or expenses may result in double taxation in an international context. The special provisions enacted in the tax treaties to which Israel is a party, discussed in XVIII.B., below, offer some refuge to taxpayers.

Section 111 of the Income Tax Ordinance provides as follows:

> Where a nonresident person carries on business with a resident person, and it appears to the assessing officer that owing to the close connection between the resident person and the nonresident person and to the substantial control exercised by the nonresident person over the resident person, the course of business between those persons can be so arranged, and is so arranged, that the business done by the resident person in pursuance of the connection with the nonresident person produces to the resident person either no profits or less than the ordinary profits which might be expected to arise from that business, the nonresident person shall be assessable and chargeable to tax in the name of the resident person.

Section 114 of the Income Tax Ordinance provides that an attorney, factor, agent, receiver, branch or manager in whose name a nonresident person is chargeable to tax on profits arising from the sale of products manufactured or produced by the nonresident outside Israel, may apply to the assessing officer to have the assessment to tax on those profits made or amended based on the profits that might reasonably be expected to have been earned by a merchant. Where the goods are retailed by or on behalf of the manufacturer or producer directly, and proof to the satisfaction of the assessing officer of the amount of the profits is provided, the assessment may be made or amended accordingly.

B. Determination of Arm's Length Price

The determination of arm's length prices for inter-company transactions in Israel follows the Organization for Economic CO-operation and Development (OECD) Transfer Pricing Guidelines.

Section 2 of the Income Tax Regulations (Determination of Market Conditions), 2006, provides for the following transfer pricing methods:

(i) Comparable Uncontrolled Price Method (CUP) — The CUP compares the price of the controlled transaction to the price of an uncontrolled transaction that has similar characteristics and risks;

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[932] C.A. 59/87 *Hashkaot VeTamlugim Ltd. v. Assessing Officer Tel-Aviv 1*, Missim D-1 (Feb. 1990), E-22; I.T.A. 157/89 *Ramdo Ltd. v. Assessing Officer Haifa*, Missim E-2 (Apr. 1991), E-71; I.T.A. 2/91 *Kol v. Assessing Officer Jerusalem*, Missim G-6 (Dec. 1993), E-23; I.T.A 5025/96 *Plazenshtein Uri v. Assessing Officer Haifa*, Missim N-1 (Feb. 2000), E-124.

[933] C.A. 83/81 *T.M.B. v. The Assessing Officer*, 13 P.D.A. 253; C.A. 495/88 *Greenberg Ltd. v. The Assessing Officer*, 20 P.D.A. 171; C.A. 672/88, 2546/90 *Rami Lev v. Assessing Officer Haifa*, Missim G-1 (Feb. 1993), E-61; C.A. 823/75 *Hertsikowich v. The Assessing Officer for Large Enterprises*, 8 P.D.A. 299; C.A. 761/77 *Av-Na'al Ltd. v. The Assessing Officer for Large Enterprises*, 32 P.D. 494; C.A. 252/87 *Gachelet Hevra LeHashkaot Ltd. v. The Customs and V.A.T. Director*, 45(1) P.D. 245; I.T.A. 126/91 *Poplin v. Assessing Officer Haifa*, Missim I-1 (Feb. 1995), E-80; I.T.A. 110/95 *Gez v. Assessing Officer Hadera*, Missim K-1 (Feb. 1997), E-23; I.T.A. 1125/00 *Silban v. Assessing Officer Tel-Aviv 4*, Missim Q-4 (Aug. 2003), E-12; C.A. 3415/97 *Assessing Officer for Large Enterprises v. Rubinstein*, Missim Q-4 (Aug. 2003), E-3. The burden of proof lies, however, with the Assessing Officer, who has to persuade the Court that the transaction under consideration should be disregarded: C.A. 614/82 *Land Appreciation Tax Officer v. S. A. P. Ltd.*, Missim A-1 (Sept. 1987), E-24; P.C.A. 8522/96 *Rochvarger v. Assessing Officer Tel-Aviv 1*, Missim K-3 (June 1997), E-70; I.T.A. 1231/01, *Dobrovsky v. Assessing Officer for Large Enterprises*, Missim R-4 (Aug. 2004), E-14.

[934] Tax Appeal 5366-05-20 *Spector v. Large Enterprises Assessing Officer* (December 7, 2022).

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(ii) Resale Price Method (RPM) — The RPM examines the gross margin earned by a reseller in a controlled transaction and deducts an appropriate resale margin from the resale price of the product;

(iii) Cost Plus Method (CPM) — The CPM is used when there is no market price available to serve as a basis for pricing. The CPM sets a price by calculating the standard cost of delivering the relevant goods and adding a standard profit margin;

(iv) Transactional Net Margin Method (TNMM) — The TNMM compares the net profit margin of a controlled transaction to the net profit margin of an uncontrolled transaction that is engaged in a similar transaction;

(v) Profit Split Method (PSM) — The PSM combines the profitability or potential profitability of the related parties in the transaction and split the profits in a way that is fair to both parties.

In *Broadcm Semiconductor Ltd. v. Assessing Officer Kfar Sava*,[935] the court upheld the arm's length principal and emphasized the importance of conducting a detailed functional analysis and a comparability analysis to determine the arm's length prices for inter-company transactions, and held that the inter-company agreements should be respected. *Medingo Ltd. v. Assessing Officer Afula*[936] is another significant transfer pricing case. This case involved a dispute over the transfer pricing of intangible assets. The court emphasized the importance of the preparation and signing of transfer pricing documentation, in order to reflect the transactions and the responsibilities, rights and obligations of the parties involved accurately. The case also highlighted the arm's length principle, and whether a transaction complies with the principle should be examined in two stages. At the first stage, the nature of the transaction should be examined. At the second stage, the price of the transaction should be examined, whether it is consistent with market conditions.

C. Reporting and Documentation

In July 2017, the OECD updated the guidelines on transfer pricing, aligning the recommendations from Action Plan 13 of the BEPS.

The Israeli transfer pricing documentation requirements usually includes the following components:[937]

(i) A Master File, which provides an overview of the global operations, organizational structure, and transfer pricing policies regarding the multinational enterprise group;

(ii) A Local File, which provides specific information about the company's transactions, including the nature of the transactions, the transfer pricing method applied, and the analysis supporting the arm's length pricing;

(iii) A Country-by-Country report, which is submitted in Israel by the ultimate parent entity resident in Israel, and provides detailed information on all entities within the multinational group; and

(iv) Other transfer pricing documentation, including a market conditions study.[938]

According to section 85A of the Income Tax Ordinance, the annual tax return requires a statement on whether international transactions were conducted. If so, ITA Form 1585 (see Worksheet 5) must be filed together with the annual tax return, and the filing must describe the international transaction at issue.

The market conditions study should be submitted to the assessing officer at the assessing officer's request within 30 days.[939]

Taxpayers are required to submit a Master File only if the multinational entities have a group revenue of the previous year of over NIS 150 million.[940]

Israel's Country-by-Country reporting requirements are consistent with BEPS Action 13 and apply to multinational enterprise (MNE) groups with consolidated revenue that exceeds NIS 3.4 billion and whose ultimate parent entity is a resident of Israel. The ultimate parent entity must electronically submit an annual country-by-country report to the ITA. The report will consist of financial and business data for each tax jurisdiction where the MNE operates, including details of the business activities undertaken by each group entity, along with their revenue, profit before income tax, and income tax paid and accrued. The report will be transmitted as part of automatic information exchange to other countries where there are entities of the multinational enterprise that are parties to an agreement signed by Israel.

An ultimate Israeli parent entity within a MNE group that is obligated to report to the ITA may choose to report in another country where a group entity exists, provided that a report regarding the choice is submitted to the ITA by the end of the applicable tax year.

Additionally, Israeli entities that are part of a MNE group that are not the ultimate parent entity, are also required to report to the ITA, indicating the country where the MNE group submits its reports. This report is included in the annual report that is submitted to the ITA, in addition to reporting through email.

In August 2023, the Israel-US Competent Authority Arrangement (CAA) on the exchange of Country-by-Country (CbC) reports was signed with a view to increasing international tax transparency. The CAA will improve access to information regarding the global distribution of income, taxes paid and indicators of the location of economic activity across the tax jurisdictions in which MNE groups operate. The US and Israeli Competent Authorities will exchange the CbC reports they receive from each Reporting Entity that is a tax resident in their respective jurisdiction annually, provided one or more Consti-

[935] T.A. (Merkaz) 26342-01-16 *Broadcm Semiconductor Ltd. v. Assessing Officer Kfar Sava* (2019).

[936] T.A. (Tel Aviv-Jafa) 53528-01-16 *Medingo Ltd. v. Assessing Officer Afula* (2022).

[937] Income Tax Ordinance, s. 85A(c), Income Tax Regulations (Determination of Market Conditions), 2006, s. 5.

[938] Income Tax Regulations (Determination of Market Conditions), 2006, s. 5(b).

[939] Income Tax Regulations (Determination of Market Conditions), 2006, s. 5(a).

[940] Income Tax Regulations (Determination of Market Conditions), 2006, s. 5(a)(10).

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tute Entities of the Reporting Entity's MNE group is/are tax resident in the other Competent Authority's jurisdiction or is/are subject to tax on profits from business conducted through a PE located in that jurisdiction.[941]

D. Advanced Pricing Agreements

Advanced Pricing Agreements (APAs) are used to provide clarity regarding transfer pricing agreements. By entering an APA, taxpayers can engage with the tax authorities in order to agree on an accepted transfer pricing method. APAs aim to reduce the risk of transfer pricing disputes and provide a cooperative framework for resolving potential disagreements.

There are three types of APAs available in Israel:

(i) Unilateral APAs involve discussions and agreements between the taxpayer and the ITA. The APA is only valid for the tax year and the taxpayer discussed in the agreement;

(ii) Bilateral APAs are based on a single mutual agreement between the competent authorities of two tax administrations under the relevant tax treaty;

(iii) Multilateral APAs refers to a situation where there is more than one bilateral mutual agreement.

In order to file for an APA in Israel, taxpayers can engage with the ITA before formally submitting an application for an APA. The pre-filing consultation can help identify the potential issues. Once the taxpayer wants to formally apply for an APA, the taxpayer must submit an application to the ITA, providing detailed information on the intercompany transaction, transfer pricing methos, economic analysis, and any other relevant information. After the taxpayer submits the application, the ITA reviews the application and engages in negotiations with the taxpayer. Once an agreement has been reached, the APA if formalized in a written agreement.

E. Competent Authority

The competent authority that is responsible for handling transfer pricing matters in Israel is the Israeli Tax Authority (ITA). The ITA transfer pricing unit oversees transfer pricing issues and works to ensure compliance with Israeli transfer pricing rules and regulations. The transfer pricing unit is responsible for reviewing the different documentation and for providing taxpayers with the guidance they may need to address transfer pricing issues.

When there are cross-border transfer pricing issues involving an Israeli tax treaty, as the competent authority, the transfer pricing unit may engage in negotiations with the other tax authority.

[941] For more details see https://www.irs.gov/pub/irs-lbi/israel-exchange-arrangement-of-country-by-country-reports.pdf.

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XVII. Tax Incentives

Israeli tax incentives are plentiful and cover a wide spectrum of economic activities. Only a brief synopsis is afforded within the framework of this Portfolio. Specifically dealt with are the Law for the Encouragement of Capital Investments, 1959, and the Law for the Encouragement of Industry (Taxes), 1969, while more general coverage is afforded to the various provisions of the Income Tax Ordinance that are of particular interest to foreign investors, the Law for the Encouragement of Capital Investments in Agriculture, 1980, the film industry and oil exploration.

A. The Law for the Encouragement of Capital Investments

1. In General

The Law for the Encouragement of Capital Investments of 1959 is aimed at encouraging capital investment and economic entrepreneurship, while giving priority to technological innovation as well as to business activity in national priority zones, to achieve the following aims: (i) increase the manufacturing capacity of the Israeli economy; (ii) enhance the competitiveness of the Israeli business sector in global markets; and (iii) create an infrastructure for new and lasting employment. The incentives are provided primarily to industry, high-tech, renewable energy, tourism, research and development (R&D) services for foreign residents, foreign investments, and residential rentals.

The Law for the Encouragement of Capital Investments specifically denies benefits to companies engaged in mining natural resources and to government corporations, based on the rationale that they cannot in any case relocate their operations outside Israel. The underlying rationale for the denial of benefits to government corporations apparently lies in the fact that they cannot relocate their activities abroad without government authorization and therefore do not require encouragement.

The incentives available under the Law for the Encouragement of Capital Investments may be divided into two main programs administering the conditional tax benefits and grants:

(i) Tax benefits are administered by the Israel Tax Authority (ITA). In general, prior approval for tax benefits is not required from any authority. Accordingly, a companies complying with the criteria stipulated in the law can claim tax benefits in their tax returns. However, to obtain greater certainty, companies may apply to the ITA for a pre-ruling to ascertain that it meets the criteria necessary for the tax benefits.

(ii) Grants are administered by the Authority for Investments and Development of the Industry and Economy as well as the Administration of Tourism Investments. Eligible entities must be approved by the relevant government authority as an Approved Entity to be entitled to a grant. A grant-in-aid is accorded only to an enterprise located in a designated priority area.

The main difference between the two programs is that with the tax benefits program, the government provides "enhanced" concessions applying to income generated from the establishment or expansion of the enterprise, whereas I with the grants program, the government shares the risk involved in executing the investment by offering the enterprise an actual grant in the process of its establishment or expansion. Moreover, the tax benefits program does not require annual budget approval, while the grants program is limited to the annually approved sum in the budget law.

In general, the grants are available to eligible companies alongside the tax benefits, except for companies that operate in the tourism sector.

2. Incentive Zones

The Law for the Encouragement of Capital Investments divides the country into two priority zones. Development zone A offers the greatest incentives, while Development Zone B offers somewhat lower incentives than Development zone A.[942] Zone A includes low socio-economic municipalities with an unemployment rate of more than 10%. It also includes the city of Jerusalem (regarding high tech companies), spatial industrial zones in the north, the south and the city of Jerusalem, minorities' settlements and settlements near the Gaza Strip. Development zone B includes municipalities with a higher socio-economic level than zone A and with an unemployment rate of more than 8%.

3. Tax Benefits

a. Preferred Enterprise and Special Preferred Enterprise

(1) Definitions

(a) Preferred Company

A preferred company is a company that owns a Preferred Enterprise (as defined below), the business of which is controlled and managed in Israel, and is not a "family company," a "transparent company" or a *kibbutz*.[943] A preferred company may be incorporated as a company or as a registered partnership. The first form requires that the company be incorporated in Israel and that it is not wholly owned by the government. The second form requires that the company be incorporated as a registered partnership under the Partnerships Ordinance. Moreover, all its partners must be companies incorporated in Israel which are not "family companies" or "transparent companies." Moreover, the partnership must not be (indirectly) wholly owned by the government.[944]

(b) Industrial Enterprise

An industrial enterprise is an enterprise located in Israel whose main activity is production activity.[945] It does not include a mine, an enterprise whose activity, partially or fully, is the production of a natural resource or an enterprise for the purpose of oil exploration or production. The rationale for this exclu-

[942] The Law for the Encouragement of Capital Investments, 1959, appendix II. In the past the law divided the country into three zones. The previous division may still apply with respect to certain companies.

[943] The Law for the Encouragement of Capital Investments, 1959, s. 51.

[944] It is also required that: (i) the company keep proper books and records; and (ii) it or one of its officers were not found guilty during the 10 preceding years of certain tax offences.

[945] The Law for the Encouragement of Capital Investments, 1959, s. 51.

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sion is that such enterprises cannot relocate their operations outside Israel.

Production activity includes production of software products, industrial R&D for foreign residents, industrial R&D in the field of renewable energy,[946] and the creation of computerized animation.[947] Production activity does not include packaging, construction, commerce, transportation, storage, provision of communications services, provision of sanitary services or provision of personal services.

(c) Competitive Industrial Enterprise

A competitive industrial enterprise is an enterprise that contributes to the Israeli GDP, and includes the following:[948] (i) an enterprise whose main activity is in the field of biotechnology or nanotechnology which has obtained the approval of the Israel Innovation Authority; (ii) an enterprise whose annual sales revenue in a particular market (state or separate customs market[949]) does not exceed 75% of its annual sales revenue - in other words, the exports of the enterprise amount to at least 25% of its annual sales revenue; (iii) an enterprise whose annual sales revenue in a particular market (state or separate customs market), which has a population of at least 14 million,[950] is 25% or more of its annual sales revenue; and (iv) an industrial enterprise that sells a product that is a component of another product produced by another industrial enterprise to which the tax benefits under the Law for the Encouragement of Capital Investment apply. In other words, under this alternative, an enterprise with "indirect exports" may be considered to be a competitive industrial enterprise.

(d) Preferred Enterprise

An enterprise is considered a preferred enterprise if it is an "ordinary" competitive industrial enterprise or a competitive industrial enterprise in the field of renewable energy.[951]

A preferred enterprise of the first type is described above.[952] A preferred enterprise of the second type is a competitive industrial enterprise whose main activity is in the field of renewable energy based on know-how in this field (and approved as such by the Chief Scientist of the Ministry of National Infrastructures). For this purpose, a sale of electricity from renewable energy is not considered as an activity in this field.

Moreover, a preferred enterprise of the second type also includes an enterprise that serves as a subcontractor in the sense that it sells a product that is a component in a device based on know-how in the field of renewable energy. Moreover, the enterprise must fulfill one of the following conditions: (i) 25% or more of the enterprise's annual sales revenue derives from sales to an Industrial Enterprise whose main activity is in the field of renewable energy based on know-how in that field; (ii) 25% or more of the enterprise's annual sales revenue derives from sales of a product that is used to produce a device based on know-how in the field of renewable energy; or (iii) 25% or more of the enterprise's annual sales revenue derives from sales of the first and the second type (but not less than 15% of the enterprise's annual sales revenue) and from sales to a particular market (state or separate customs market) which has a population of at least 12 million.

(e) Special Preferred Enterprise

A preferred enterprise in which, in a particular tax year, all of the three following conditions are met, is considered a Special Preferred Enterprise.[953]

First, the preferred income of the enterprise is at least NIS 1 billion. Second, the annual revenues of the preferred company were at least NIS 10 billion. Alternatively, the annual revenues of the preferred company, which are included in a consolidated statement, together with the annual revenues of another company, were NIS 10 billion or more. The annual revenues of the other company must be derived from an enterprise that owns it, and that this enterprise operates in the same field as the preferred enterprise owned by the preferred company. Third, the Director-General of the Ministry of Finance, the Director-General of the Ministry of Industry, Trade and Labor and the Director of the Israeli Tax Authority (hereinafter: "Directors") confirmed that according to the business plan submitted to them, the preferred company will make a significant contribution to the Israeli economy. The business plan must include at least one of the following three alternatives:[954]

(i) Investment alternative: purchase of productive assets, excluding buildings, of at least NIS 400 million, regarding an enterprise located in development zone A, and NIS 800 million, regarding an enterprise located in another development zone, within a period of three tax years starts at the beginning of the eligibility period.

(ii) R&D alternative: this alternative includes two sub-alternatives. According to the first sub-alternative, which applies to an enterprise located in development zone A, investment in R&D activity must be made in each tax year during the eligibility period. The investment must be made in an amount higher by at least NIS 100 million when compared to the average amount invested in R&D activity of the Preferred Enterprise during three tax years preceding the tax year in which the Directors' approval was given. According to the second sub-alternative, which applies to other development zones, investment in R&D activity must be made in a preferred technology industry (as determined by the Minister of Economy and Industry), during each tax year in the eligibility period. Moreover, the investment must be made in an amount higher by at least NIS 150 million when compared to the average amount invested in R&D activity of the Preferred Enterprise during three tax years preceding the tax year in which the Directors approval was given.

However, if the average amount invested in R&D activity, during three tax years preceding the tax year in which the

[946] The Law for the Encouragement of Capital Investments, 1959, s. 51.

[947] Order for the Encouragement of Capital Investments (Determination of Production Activity), 2008, s. 2.

[948] The Law for the Encouragement of Capital Investments, 1959, s. 18A(c).

[949] The Law for the Encouragement of Capital Investments, 1959, s. 18A.

[950] From 2013 the number of residents is updated at an annual rate of 1.4%.

[951] The Law for the Encouragement of Capital Investments, 1959, s. 51.

[952] The term Competitive Industrial Enterprise is detailed in (c), above.

[953] The Law for the Encouragement of Capital Investments, 1959, s. 51T(a).

[954] The Law for the Encouragement of Capital Investments, 1959, s. 51T(b).

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Directors' approval was given, exceeds 500 million NIS, the investment in R&D activity in each of the tax years during the benefit period will be higher by at least 50% than the regular amounts in the two sub-alternatives, i.e., NIS 50 million for the first sub-alternative, and NIS 75 million for the second sub-alternative. This relief is intended to encourage companies that already invest significantly in R&D activity.

(iii) Employment alternative: employment of at least 250 new employees regarding an enterprise located in development zone A, and at least 500 new employees regarding an enterprise located in another zone, in each tax year during the eligibility period. The increase in the number of employees is examined in comparison with the number of employees in the year preceding the first year of the benefit period.

(f) Preferred Income

Preferred income is income derived from an activity of a preferred enterprise (less accorded discounts) during the ordinary course of the enterprise's activity in Israel, which is one of the following types of income:[955] (i) income from the sale of goods manufactured by the enterprise, including components of such products manufactured by another enterprise (excluding components originating from a mine, another extraction plant, or an enterprise exploring or producing oil); (ii) income from the sale of semiconductors manufactured by another non-affiliated enterprise with know-how developed by the enterprise; (iii) income from a license of know-how or software developed by the enterprise, as well as royalties for use thereof which the Director of the Authority for Investments and Development of the Industry and Economy approved as incidental to the manufacturing activity of the preferred enterprise in Israel; (iv) income from an incidental service to sales mentioned in (i) and (ii) as well as an incidental service to the licensing of the know-how, software or royalties referred to in (iii); and (v) income from industrial R&D activity carried out for a foreign resident approved by the Head of the Research Directorate for Industrial Development.

Where the preferred company is a partnership, the preferred income does not include income allocated to non-government companies.

Moreover, preferred income does not include income from an intangible asset that is not attributable to the enterprise's manufacturing activity, such as an intangible asset used for marketing purposes.

(2) Preferred Enterprise

The tax benefits for a preferred enterprise are designed to encourage a competitive industrial enterprise including renewable energy enterprises, which contribute to the Israeli GDP. The tax benefits include reduced company tax and accelerated depreciation rates for productive assets. In addition, distribution of the preferred enterprise's profits is taxable at a reduced rate. The entitlement to the tax benefits is examined on an annual basis.

(a) Reduced Company Tax Rate

A preferred company is entitled to a reduced company tax rate on its preferred income derived from the activity of a preferred enterprise.[956] If the preferred enterprise is located in development zone A, company tax at the rate of 7.5% applies and the rate of 16% applies if located elsewhere.

(b) Reduced Dividend Tax

A dividend distributed out of preferred taxable income (net of tax) to an individual or a foreign resident company, is liable to a reduced tax at the rate of 20%[957] (instead of tax at the rate of 25% or 30%). Such a dividend distributed to an Israeli company is exempt from tax.

(c) Accelerated Depreciation

A preferred company is entitled to accelerated depreciation for productive assets used by the preferred enterprise (up to the original price of the asset).[958] The accelerated depreciation deduction is limited to a period of five years starting with the day on which the asset was first put to use. The accelerated depreciation for machinery or equipment is at the rate of 200% over and above the normal rate. The accelerated depreciation for buildings is at the rate of 400% over and above the normal rate, provided that in no event may the rate exceed 20% per year.

(3) Special Preferred Enterprise

Increased tax benefits are accorded to a special preferred enterprise to encourage large multinational companies to carry out significant industrial activities in Israel that will contribute significantly to the Israeli economy and promote its goals.

(a) Period and Terms of Benefits

The tax benefits are accorded for a period of 10 years.[959] The benefit period starts in the year in which a significant part of the required investment was made. As an exception, the benefit period will begin in a later tax year within three years after completion of the investment.

The tax benefits are granted if the following conditions are met:[960] (i) the annual preferred income of the enterprise was at least NIS 1 billion; (ii) the annual revenues of the preferred company were at least NIS 10 billion. Alternatively, the annual revenues of the preferred company, which are included in a consolidated statement together with the annual revenues of another company, was NIS 10 billion or more. The annual revenues of the other company must be derived from an enterprise it owned, which operates in the same field as the preferred enterprise owned by the preferred company; and (iii) the Directors' approval according to which the preferred company will make a significant contribution to the Israeli economy has not been revoked.

Tax benefits are granted on an annual basis. Therefore, failure to meet the conditions in a particular tax year, deprives

[955] The Law for the Encouragement of Capital Investments, 1959, s. 51.

[956] The Law for the Encouragement of Capital Investments, 1959, s. 51P.
[957] The Law for the Encouragement of Capital Investments, 1959, s. 51R.
[958] The Law for the Encouragement of Capital Investments, 1959, s. 51Q.
[959] The Law for the Encouragement of Capital Investments, 1959, s. 51V.
[960] The Law for the Encouragement of Capital Investments, 1959, s. 51U.

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the preferred company of the tax benefits for that year. However, it will not prevent the special preferred enterprise from receiving the tax benefits in the preceding or succeeding years in which the conditions were met.[961]

The Director of the Tax Authority (after consultation with the Director-General of the Ministry of Economy and Industry and the Director-General of the Ministry of Finance) is empowered to examine the meeting of the criteria established for special preferred enterprises. Should the Director determine that the objects of the law were not attained, the status of the enterprise is revoked as of the year following the year of the examination.[962]

(b) Reduced Company Tax Rate

A preferred company is entitled to a reduced company tax rate on its preferred income derived from the activity of a special preferred enterprise.[963] If the preferred enterprise is located in development zone A, company tax at rate of 5% applies, and a rate of 8% applies if located elsewhere.

(c) Reduced Dividend Tax

A dividend distributed out of preferred income (net of tax) to an individual or a foreign resident company, is liable to a reduced tax at the rate of 20%[964] (instead of tax at a rate of 25% or 30%). Such a dividend distributed to an Israeli company is exempt from tax.

Moreover, a dividend distributed out of preferred income (net of tax), by a preferred company that owns a special preferred enterprise, to a foreign resident parent company that holds all of the shares of the preferred company, is liable to tax at the rate of 5% (instead of tax at the rate of 25% or 30%). The reduced dividend tax rate applies only in 2017, 2018, and 2019.[965]

(d) Accelerated Depreciation

A preferred company is entitled to accelerated depreciation for productive assets used by the special preferred enterprise (up to the original price of the asset).[966] The accelerated depreciation applies during the benefit period (10 years) starting with the day on which the asset was first put to use. The accelerated depreciation for machinery or equipment is at the rate of 200% over and above the normal rate. The accelerated depreciation for buildings is at the rate of 400% over and above the normal rate, provided that in no event may the rate exceed 20% per year.

b. Preferred Technological Enterprise and Special Technological Enterprise

The tax benefits accorded to a preferred technological enterprise and a special preferred technological enterprise are intended to encourage industrial activity related to the development of a beneficial intangible assets (as defined below) in high tech companies. The tax benefits are granted only on income derived from R&D activity carried out in Israel to comply with the BEPS standards.

(1) Definitions

(a) Technological Income

Technological income is income of a technological enterprise that was produced or accrued during its ordinary course of business from a beneficial intangible asset, wholly or partly owned by the enterprise, or which the enterprise has the right to use.[967]

Technological income also includes the following types of income:[968] (i) income derived from right to use a beneficial intangible asset; (ii) income derived from service as a software; (iii) income derived from a product made by use of a beneficial intangible asset (such as a medicine whose production is based on a registered patent); (iv) an incidental service to right of use, service, or product specified in the above three cases; (v) income derived from an incidental product to a computer software or incidental product to a product made by use of a beneficial intangible asset, provided that such products were directly related to the beneficial intangible asset. If the production of the incidental or supporting product is based on the use of another beneficial intangible asset the asset may not be owned by the company or a related party, and they may not possess the right to use the asset; (vi) income derived from a sale of R&D services that does not exceed 15% of the enterprise's income; (vii) income derived from payment of damages for infringement of rights, related to a beneficial intangible asset, which is not considered as a capital gain; and (viii) income derived from know-how, developed in Israel by a technological enterprise, that is qualified to be the subject of an R&D program.

Technological income does not include, inter alia, income that is attributable to the production activity of the enterprise and derived from an asset, product, incidental product or incidental service.[969] The reason is twofold: first, the rationale for granting increased tax benefits to a preferred technological enterprise does not apply to production activity. Second, the tax benefits for production activities are regulated under other provisions in the Law for the Encouragement of Capital Investments.

Moreover, technological income does not include income derived from an intangible asset used for marketing (such as a trademark) that is not a beneficial intangible asset.[970]

(b) Preferred Technological Income

Preferred technological income is technological income derived from R&D carried out in Israel.[971]

[961] The Law for the Encouragement of Capital Investments, 1959, s. 51U.
[962] The Law for the Encouragement of Capital Investments, 1959, s. 51W.
[963] The Law for the Encouragement of Capital Investments, 1959, s. 51U.
[964] The Law for the Encouragement of Capital Investments, 1959, s. 51R.
[965] The Economic Efficiency Law (Legislative Amendments for Implementation of Economic Policy for the Budget Years 2017 and 2018), 2016.
[966] The Law for the Encouragement of Capital Investments, 1959, s. 51U.
[967] The Law for the Encouragement of Capital Investments, 1959, s. 51X.
[968] The Law for the Encouragement of Capital Investments, 1959, s. 51X; The Regulations for the Encouragement of Capital Investments (a Preferred Technology Income and Capital Gain for a Technological Enterprise), 2017, s. 1.
[969] The Law for the Encouragement of Capital Investments, 1959, s. 51X; The Regulations for the Encouragement of Capital Investments (a Preferred Technology Income and Capital Gain for a Technological Enterprise), 2017, s. 6.
[970] The Law for the Encouragement of Capital Investments, 1959, s. 51X.
[971] The Law for the Encouragement of Capital Investments, 1959, s. 51X.

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(c) Preferred Technological Enterprise

A Preferred technological enterprise is an enterprise that satisfies, for the entire tax year, all the conditions set out in paragraphs (1) and (2), below, or the conditions set forth in paragraph (3), below, and the conditions stated in paragraphs (4) and (5), as follows:[972]

(1) During the three years preceding the current tax year, the R&D expenses of the enterprise were more than NIS 75 million per year or at least at an average rate of 7% of the total revenues of the company that owns the enterprise. If the enterprise exists for less than three years, this aforementioned condition must be met as of its establishment.

For the purpose of calculating the company's income, certain types of income are excluded: (i) income transferred to a non-related party and (ii) income transferred to a related party whose exclusion was approved by the Director of the ITA.

Note: The Minister of Finance has not yet determined the aforementioned types of income.

(2) The company that owns the enterprise meets at least one of the following conditions: (i) a rate of at least 20% of the salary of the company's employees has been recorded in its financial statements as R&D expenses. Alternatively, the company employs at least 200 R&D employees: (ii) a venture capital fund invested at least NIS 8 million in the company, and the company did not change its field of business activity after the date of investment; (iii) the company's revenues during the three years preceding the current tax year, increased by an average of at least 25% compared with the previous tax year. Moreover, the company's turnover during the current tax year and in each of the preceding three years must have reached at least NIS 10 million; (iv) the number of employees during the three years preceding the current tax year increased by an average of at least 25% compared to the previous tax year. Moreover, during the current tax year and in each of the three preceding years the company must have employed at least 50 employees.

(3) The enterprise is a promoting-innovation enterprise, i.e., the Israeli Innovation Authority has certified that the innovation level of the enterprise, during the examination period, is equal to or higher than the internationally accepted level of innovation in the main technology field in which the enterprise operates.[973]

(4) During the current tax year, the annual revenue of the group to which the company belongs was less than NIS 10 billion.

(5) The enterprise is a competitive industrial enterprise.[974]

(d) Special Preferred Technological Enterprise

A special preferred technological enterprise differs from an "ordinary" preferred technological enterprise in that the annual revenue of the group to which the company belongs, was NIS 10 billion or more.

(e) Beneficial Intangible Asset

A beneficial intangible asset includes, inter alia: (i) a right under the Patents Law, 1967; (ii) computer software protected under the Copyright Law, 2007; (iii) a right under the Plant Breeders' Rights Law, 1973; (iv) a registered right of a generic medication in the Israeli National Drugs Registry, or a medication approved by the U.S. Food and Drug Administration (FDA) or a competent authority of the European Union;[975] and (v) similar rights under the laws of foreign countries.

In addition, a beneficial intangible asset includes know-how owned by small and medium-sized companies engaged in development in various fields of business activity, which does not meet one of the above mentioned four alternatives. With regard to such know-how, the know-how must be developed in Israel by a technological enterprise and the National Authority for Technological Innovation must have certified that the know-how is qualified to be a subject of an R&D program. If the know-how is in the field of renewable energy, the certification must be granted by the Chief Scientist of the Ministry of National Infrastructures, Energy and Water. Moreover, the annual revenues of the company that owns the enterprise may not exceed NIS 32 million. If the company is part of a group of companies, the group's annual turnover may not exceed NIS 211 million.

(2) Period and Terms of Benefits for a Special Preferred Technological Enterprise

A special preferred technological enterprise is entitled to tax benefits for a period of at least 10 years. This period starts from the year in which the Directors' approval, according to which the enterprise will contribute significantly to the Israeli economy and to promote its goals, was granted.[976]

The tax benefits are granted provided that the special preferred technological enterprise purchased a Beneficial Intangible Asset from a foreign resident company in an amount exceeding NIS 500 million.[977]

(3) Reduced Company Tax Rate

A preferred company that owns a preferred technological enterprise, is entitled to a reduced company tax rate on its preferred technological income.[978] If the preferred enterprise is located in development zone A, company tax at the rate of 7.5% applies, and, if located elsewhere, a rate of 12% applies.

[972] The Law for the Encouragement of Capital Investments, 1959, s. 51X.

[973] Instructions for the Encouragement of Capital Investments (Conditions that indicate that the Enterprise is Promoting -Innovation for Defining it as a Preferred Technology Enterprise), 2019.

[974] The meaning of competitiveness regarding an Industrial Enterprise is set out in XVII.A.3.a.(1)(c).

[975] Order for the Encouragement of Capital Investments (Determination of Beneficiary Intangible Asset), 2019; The Pharmacists Ordinance [New Version], 1981, s. 47A (A2) (1).

[976] The Law for the Encouragement of Capital Investments, 1959, s. 51AE.

[977] The Law for the Encouragement of Capital Investments, 1959, s. 51AE.

[978] The Law for the Encouragement of Capital Investments, 1959, s. 51Y.

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Moreover, a preferred company, that owns a special preferred technological enterprise, is entitled to a reduced company tax at the rate of 6%.[979]

(4) Reduced Dividend Tax

A dividend distributed out of preferred technological income (net of tax) to an individual or a foreign resident company, is liable to a reduced tax at the rate of 20%[980] (instead of tax at the rate of 25% or 30%). This tax rate applies also to a dividend distributed out of a capital gain (net of tax) that is liable to a reduced tax rate[981] (as set forth below).

However, such dividends distributed to a foreign resident company, are liable to tax at a reduced rate of 4%, provided that the following conditions are met:[982] First, 90% or more of the distributing company's shares are held directly by a foreign resident company. If the shares are held indirectly, through another company, and a dividend was distributed to the other company, the dividend must be received by the foreign resident company within a year from the date of its distribution by the preferred company. Second, the distributed profits were derived after the foreign resident company purchased the shares of the preferred company that carry the right to receive dividends.

(5) Reduced Capital Gains Tax on Sales of Beneficial Intangible Assets

A capital gain derived from the sale of a beneficial intangible asset, and received by a preferred company that owns a preferred technological enterprise or a special preferred technological enterprise, is liable to a reduced capital gains tax rate. The reduced tax applies only to capital gains attributed to R&D activity carried out in Israel.[983]

A capital gain derived from a sale of a beneficial intangible asset to a related foreign resident company, and received by a preferred company that owns a preferred technological enterprise, is liable to tax at the rate of 12%, provided that the asset was purchased from a foreign resident company from January 1, 2017, and thereafter, at a price of NIS 200 million or more.

A capital gain derived from a sale of a beneficial intangible asset to a related foreign resident company, and received by a preferred company that owns a special preferred technological enterprise, is liable to tax at the rate of 6%, provided that one of the following conditions is met: (i) the enterprise was the first owner of the asset and the asset was created by the enterprise from January 1, 2017 and thereafter; or (ii) the enterprise purchased the asset from a foreign resident company from January 1, 2017 and thereafter.

(6) Restrictions on Deductions and Offsets

To prevent erosion of the Israeli tax base as a result of the transfer of an intangible asset to Israel, various restrictions were legislated regarding the deduction of expenses and a foreign tax credit.[984]

First, the amount of depreciation expenses of a beneficial intangible asset, purchased by a technology enterprise from a related company, may be deducted only against the amount of the increase in the preferred technology income in the year of depreciation compared to the average amount of such income in the two tax years preceding the purchase of the asset.

Second, expenses incurred to produce preferred technological Income may be deducted against this income only.

Where a preferred technological income is lower than the depreciation expenses plus the other expenses, the loss will be offset in the current tax year (against another preferred technological income, if any) or it will be carried forward.

Third, foreign taxes paid on preferred technological income must be offset only against tax paid in Israel on the same income.

c. Beneficial Enterprise

The tax benefits accorded to a beneficial company currently apply only to tourist enterprises and in accordance with the geographical location of the enterprise in Israel.

Comment: The tax exemption accorded to a beneficial company, as set forth below, is in fact a mere tax deferral. This is because, on the distribution of a dividend out of the exempted income, the beneficial company is obliged to pay the company tax from which it was exempted.

(1) Definitions

(a) Beneficial Company

A beneficial company is a company that owns a beneficial enterprise (as defined below), the business of which is controlled and managed in Israel, and may not be a "family company," a "transparent company" or a *kibbutz*.

(b) Tourist Enterprise

A tourist enterprise is a facility that includes at least 11 rooms which provides fee-based accommodation services, as well as incidental services, including catering and recreation services. The accommodation services are to be provided to lodgers for a limited period of time.[985]

(c) Beneficial Enterprise

A beneficial enterprise is a competitive tourist enterprise that contributes to the Israeli GDP, i.e., 25% of its lodgers in the current tax year or in the current tax year and in the preceding two tax years, on average, are foreign residents.[986] However, if the enterprise fails to meet this condition in a particular year, it will be deprived of the tax benefits only during those years in which it did not meet the criterion and not the entire period of benefits.[987]

[979] The Law for the Encouragement of Capital Investments, 1959, s. 51Y.
[980] The Law for the Encouragement of Capital Investments, 1959, s. 51Z.
[981] The Law for the Encouragement of Capital Investments, 1959, s. 51Z.
[982] The Law for the Encouragement of Capital Investments, 1959, s. 51Z.
[983] The Law for the Encouragement of Capital Investments, 1959, s. 51AA.
[984] The Law for the Encouragement of Capital Investments, 1959, s. 51AC.
[985] The Law for the Encouragement of Capital Investments, 1959, s. 18A.
[986] The Law for the Encouragement of Capital Investments, 1959, s. 18A.
[987] The Law for the Encouragement of Capital Investments, 1959, s. 51E.

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Moreover, a minimum qualifying investment must be made for establishing or expanding the enterprise.[988] This investment is made for purchasing productive assets, within three tax years ending with the end of the year of election.[989] In case of a new enterprise, the minimum amount to be invested is NIS 300,000. This amount is linked to the Israeli consumer price index (CPI).[990] In case of an expansion of an existing enterprise, the minimum amount to be invested is the higher of the following two amounts: (i) NIS 300,000 and (ii) an amount equal to the following rates out of the value of all the productive assets of the enterprise, as at the end of the tax year preceding the one in which the capital began to be invested: if the value of all the productive assets is up to NIS 140 million — 12% of this value; above NIS 140 million and up to NIS 500 million — 7%; above NIS 500 million — 5%. For this purpose, the value of a productive asset is the original cost, less depreciation according to the Depreciation Regulations, 1941, and linked to the Israeli CPI.

(d) Beneficial Income

Beneficial income is income derived from an activity of a beneficial enterprise (less accorded discounts) produced or accrued during the ordinary course of the enterprise's activity.

(e) Year of Election

The year of election is the year in which the company informed the ITA that it chose to make use of the tax benefits program.[991]

(2) Period of Benefits

The tax benefits are granted to a beneficial enterprise located in development zone A, for a period of 10 years and for a period of seven years if located elsewhere. The benefits period starts with the tax year in which the beneficial company had, for the first time, taxable income from the beneficial enterprise or the year of election, whichever the later.[992] However, the benefit period shall not exceed 12 years from the beginning of the year of election, and 14 years with regard to establishment of an enterprise located in development zone A.[993]

(3) Exemption and Reduced Company Tax Rate

A beneficial company is entitled, during the benefit period, to a tax exemption or a reduced tax rate, in accordance with the enterprise's geographical location in Israel.[994]

In case that the beneficial enterprise is located in development zone A, the beneficial company is entitled, at its option and during the whole benefit period, to one of the following two benefits: (i) an exemption from company tax, or (ii) a reduced company tax at the rate of 11.5%.

If the beneficial enterprise is located in development zone B, the beneficial company is entitled to an exemption from a company tax for six years beginning with the year of election. During the rest of the benefits period, the beneficial company will be taxed at the regular company tax rate.

If the beneficial enterprise is not located in development zones A or B, the beneficial company is entitled to an exemption from company tax for two years beginning with the year of election. During the rest of the benefits period, the beneficial company will be taxed at a company tax rate.

However, if the company distributes dividends out of exempted income, it will be liable to company tax on the distributed amount and an applied company tax. The tax applicable will be at the rate that would have applied had the income not been exempted.[995] In other words, the tax exemption accorded to a beneficial company is in fact a mere tax deferral.

It should be noted that if a reduced company tax at the rate of 11.5% applied (regarding to enterprise located in development zone A), on the distribution of a dividend out of income that suffered low taxation, the company is not liable for any additional company tax.

(4) Reduced Dividend Tax

A dividend distributed out of beneficial income is liable to a reduced tax at the rate of 20%[996] (instead of tax at the rate of 25% or 30%).

However, dividend distributed to a foreign resident from beneficial income, that was taxed at the rate of 11.5%, is liable to a reduced tax at the rate of 4%.[997]

The beneficial rates applied to the dividend are conditioned on the dividend being paid within 12 years from the termination of the period of benefits.

(5) Accelerated Depreciation

A beneficial company, no matter where located in Israel, is entitled to accelerated depreciation for productive assets used by the beneficial enterprise.[998] The accelerated depreciation deduction is limited to a period of five years starting with the day on which the asset was first put to use. The accelerated depreciation for machinery or equipment is at the rate of 200% over and above the normal rate. The accelerated depreciation for buildings is at the rate of 400% over and above the normal rate, provided that in no event may the rate exceed 20% per year.

[988] The Law for the Encouragement of Capital Investments, 1959, s. 18A.
[989] The Law for the Encouragement of Capital Investments, 1959, s. 51.
[990] The Law for the Encouragement of Capital Investments, 1959, s. 51H.
[991] The Law for the Encouragement of Capital Investments, 1959, s. 51D.
[992] The Law for the Encouragement of Capital Investments, 1959, s. 51C.
[993] The Law for the Encouragement of Capital Investments, 1959, s. 51C.
[994] The Law for the Encouragement of Capital Investments, 1959, s. 51A(a).
[995] The Law for the Encouragement of Capital Investments, 1959, s. 51B.
[996] The Law for the Encouragement of Capital Investments, 1959, s. 51B(c).
[997] The Law for the Encouragement of Capital Investments, 1959, s. 51B(c).
[998] The Law for the Encouragement of Capital Investments, 1959, s. 51A(b).

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d. Approved Enterprise

The tax benefits accorded to an approved enterprise currently apply only to a tourist enterprise. These benefits are accorded with regard to an investment, property or enterprise constituting the subject matter of an approved program.

(1) Definitions

A tourist enterprise is one of the following enterprises:[999] (i) a tourist accommodation facility with at least 11 rooms which provides fee-based accommodation services, as well as incidental services, including catering and recreation services. The accommodation services must be provided to lodgers for a limited period of time; or (ii) a tourist attraction, i.e., a unique tourist facility (excluding a tourist accommodation facility) that provides leisure, recreation and cultural activities, and is a tourist attraction in the area in which it is located.

(2) Period of Benefits

The tax benefits — income tax exemption and reduced income tax rate — are accorded for a period of seven years[1000] beginning with the year in which there was for the first time taxable income. However, the benefit period may not exceed the time limit of 14 years starting the year in which the approval was granted and 12 years starting the year in which the enterprise was put into operation.

In addition, the benefit period regarding the reduced dividend tax is 12 years following the end of the aforementioned seven-year period.

(3) Income Tax Exemption and Reduced Income Tax Rate

A company that owns an approved enterprise located in development zone A, is exempt from tax in respect of its taxable income derived from that enterprise, during the first two years of the benefits period.[1001] However, if the company distributes dividends out of exempted income, it will be liable to a company tax on the distributed amount and an applied company tax. The tax applicable will be at the rate that would have applied had the income not been exempted.[1002] In other words, the tax exemption accorded to a beneficial company is in fact a mere tax deferral.

In addition ,a recipient of a grant-in-aid that owns an approved enterprise located in development zone A, is exempt from tax in respect of its taxable income derived from that enterprise, if certain conditions are met, or at least to a reduced income tax (25% or 35%) during the benefits period.[1003] For this purpose, the recipient must be an individual, a co-operative, a partnership registered in Israel as a limited foreign partnership with all its Israeli partners being corporations, or a partnership registered in Israel (including foreign partnership) with all or part of its partners being individuals and approved by the Administration of Tourism Investments.[1004] For this purpose, the law excludes a recipient (company, cooperation or partnership) fully owned by the government.

Moreover, taxable income derived from an approved investment or approved loan[1005] and received by an individual is liable to tax at a maximum rate of 25%.[1006]

The tax benefits are granted on an annual basis. Therefore, if a tourist accommodation facility fails to meet the eligibility conditions in a particular tax year, it will be deprived of the tax benefits for that year. However, this will not prevent the owner from receiving the tax benefits in the preceding or succeeding years in which the conditions were met.[1007]

(4) Reduced Dividend Tax

A dividend distributed out of taxable income (net of tax) derived from an approved enterprise is liable to a reduced tax at the rate of 20%.[1008] This tax rate also applies to such dividend received by a company and redistributed to its shareholders. In this case, the company is eligible to deduct the redistributed dividend from its taxable income.[1009]

(5) Accelerated Depreciation

An approved enterprise is entitled to accelerated depreciation for productive assets used by it provided they constitute a part of a plan approved by the Administration of Tourism Investments the Investment Center.[1010] The accelerated depreciation deduction is limited to a period of five years starting the day in which the asset was first put to use. The accelerated depreciation for machinery or equipment is at the rate of 200% over and above the normal rate. The accelerated depreciation for buildings is at the rate of 400% over and above the normal rate, provided that in no event may the rate exceed 20% per year.

In special circumstances, where it is proved to the assessing officer that an enterprise suffers from unusual wear and tear of machines or equipment, the rates of accelerated depreciation may be increased to up to 250% over and above the normal rate.[1011]

e. Tax Benefits Program — Summary Table

The following summary table provides an overview of the various benefits accorded under the tax benefits program.

[999] The Law for the Encouragement of Capital Investments, 1959, ss. 40A, 41.

[1000] The Law for the Encouragement of Capital Investments, 1959, s. 51V.

[1001] The Law for the Encouragement of Capital Investments, 1959, s. 47(a).

[1002] The Law for the Encouragement of Capital Investments, 1959, s. 47(a2).

[1003] The Law for the Encouragement of Capital Investments, 1959, s. 47(c)(5).

[1004] The Law for the Encouragement of Capital Investments, 1959, ss. 47(c)(5), 40B.

[1005] The Law for the Encouragement of Capital Investments, 1959, s. 24.

[1006] The Law for the Encouragement of Capital Investments, 1959, s. 46(a).

[1007] The Law for the Encouragement of Capital Investments, 1959, s. 50A.

[1008] The Law for the Encouragement of Capital Investments, 1959, s. 47(b)(2)(a).

[1009] The Law for the Encouragement of Capital Investments, 1959, s. 47(b)(2)(b).

[1010] The Law for the Encouragement of Capital Investments, 1959, s. 42.

[1011] The Law for the Encouragement of Capital Investments, 1959, s. 43.

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Type of Enterprise	Type of Income	Company Tax Rate		Capital Gain Tax Rate	Dividend Tax Rate	Accelerated Depreciation Period[1012]
		Development Zone A	Non-Development Zone A			
Preferred Enterprise	Preferred Income	7.5%	16%	company tax	an individual/a foreign resident company — 20% an Israeli company — 0%	5 years
Special Preferred Enterprise	Preferred Income	5%	8%	company tax	an individual/a foreign resident company — 20% an Israeli company — 0% a foreign resident parent company — 5%[1013]	10 years
Preferred Technological Enterprise	Technological Income	7.5%	12%	company tax or 12%[1014]	an individual/a foreign resident company — 20% an Israeli company — 0% a foreign resident parent company — 4%[1015]	
Special Preferred Technological Enterprise	Technological Income	6%	6%	company tax or 6%[1016]	an individual/a foreign resident company — 20% an Israeli company — 0% a foreign resident parent company — 4%[1017]	

[1012] Machinery or equipment — 200%; buildings — 400%.

[1013] A foreign resident parent company that holds all of the shares of the Preferred Company. The reduced dividend tax rate applies only in 2017, 2018 and 2019.

[1014] A capital gain derived from a sale of a Beneficial Intangible Asset to a related foreign resident company, and received by a Preferred Company that owns a Preferred Technological Enterprise, provided that the asset was purchased from a foreign resident company from January 1st, 2017 and thereafter, at a price of NIS 200M or more.

[1015] A parent company which holds 90% of the distributing company's shares. The distributed profits were derived after the purchase of the shares.

[1016] A capital gain derived from a sale of s Beneficial Intangible Asset to a related foreign resident company, and received by a Preferred Company that owns a Special Preferred Technological Enterprise, provided that one of the following conditions is met: (i) the enterprise was the first owner of the asset and the asset was created by the enterprise from January 1st 2017 and thereafter. (ii) the enterprise purchased the asset from a foreign resident company from January 1st 2017 and thereafter.

[1017] A parent company which holds 90% of the distributing company's shares. The distributed profits were derived after the purchase of the shares.

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Beneficial Enterprise (Tourist Accommodation Facility)	Beneficial Income	0[1018] or 11.5%	0[1019, 1020] company tax	company tax	an individual/a foreign resident company — 20% a foreign resident — 4%[1021]	5 years
Approved Enterprise		0[1022, 1023] company tax		company tax	an individual/a foreign resident company — 20%	5 years

[1018] If the company distributes dividends out of exempted income, it will be liable to company tax on the distributed amount and an applied company tax.

[1019] If the company distributes dividends out of exempted income, it will be liable to company tax on the distributed amount and an applied company tax.

[1020] If the Beneficial Enterprise is located in Development Zone B, the exemption is accorded for six years, and if not located in Development Zones A or B, the exemption is accorded for two years. During the rest of the benefits period, the regular company tax rate applies. During the rest of the benefits period, the Beneficial Company will be taxed at a company tax rate.

[1021] A dividend distributed from Beneficial Income that was taxed at the rate of 11.5%.

[1022] If the company distributes dividends out of exempted income, it will be liable to company tax on the distributed amount and an applied company tax.

[1023] The exemption is accorded for a period of two years. During the rest of the benefits period, the regular company tax rate applies. During the rest of the benefits period, the Beneficial Company will be taxed at a company tax rate.

4. Grants Program

a. Eligibility

A grant-in-aid is accorded if three conditions are met.[1024] First, the recipient must be an Israeli company, a cooperative, a partnership registered in Israel as a limited foreign partnership all of the Israeli partners of which are corporations, or a partnership registered in Israel (including foreign partnership) all or part of the partners of which are individuals and approved by the relevant government authorities.[1025] For this purpose, the law excludes a recipient (company, cooperation or partnership) fully owned by the government.

Second, the enterprise owned by the recipient must receive the approval of the relevant government authorities.[1026] The approval is accorded to a competitive enterprise that contributes to the Israeli GDP[1027] and is beneficial to the Israeli economy.

Third, the recipient owns an approved enterprise that is an: (i) industrial enterprise or (ii) a tourist enterprise which is a tourist accommodation facility or a tourist attraction.[1028]

b. Rate of Grant

Once the enterprise is approved, the recipient is entitled to a grant, which is a percentage of the investment made in the enterprise's fixed assets.[1029] The rate of the grant varies according to the development zone in which the enterprise is located, as follows (as of 2023):[1030]

	Development Zones	
	Zone A	**Zone B**
Industrial Enterprise	20	10
Tourist Accommodation Facility	20	10
Tourist Attraction	10	—

Moreover, if the enterprise is located in the Negev, the city of Sderot, the settlements around Gaza Strip or in low socio-economic municipalities in the north of Israel, the rate of the grant is significantly higher — up to 30%.[1031]

A grant-in-aid is not taxable but it is deducted from the basis of the assets in calculating the depreciation allowed for income tax purposes.[1032]

c. Grants and Tax Benefits

In general, a recipient can be eligible for the grants program side by side with the tax benefits program, except for a recipient operating a tourist accommodation facility.[1033]

5. Rental Buildings

a. The Existing Benefits Route

The Law for the Encouragement of Capital Investments, 1959 provides, in sections 53A, 53B, and 53C, for the granting of specially tailored relief for what is known as a "rental building." A 1988 amendment resolved an ambiguity caused by an apparent overlap of these provisions of the Law and the Income Tax Law (Encouragement of Apartment Renting) (Temporary

[1024] The Law for the Encouragement of Capital Investments, 1959, s. 40B.

[1025] The Law for the Encouragement of Capital Investments, 1959, s. 40B.

[1026] The Law for the Encouragement of Capital Investments, 1959, ss. 40B, 94.

[1027] The meaning of competitiveness regarding to an Industrial Enterprise and a Tourist Accommodation Facility is detailed above under 3.a.(1)(c) and 3.c.(1)(b), respectively.

[1028] An Approved Enterprise includes also an Equipment Rental Enterprise, an Industrial Building, a Renovated Industrial Building, as defined in s. 40A and not further discussed here.

[1029] The Law for the Encouragement of Capital Investments, 1959, s. 40C(a).

[1030] The Law for the Encouragement of Capital Investments, 1959, Appendix I.

[1031] The Law for the Encouragement of Capital Investments, 1959, s. 40C(c) and Appendix I.

[1032] The Law for the Encouragement of Capital Investments, 1959, s. 43A; Income Tax Ordinance, 1961, s. 21(b).

[1033] The Law for the Encouragement of Capital Investments, 1959, s. 40K.

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Measures and Law Amendments), 1981. The later law broadened the definition of a "rental building" qualifying for the benefits of the Law for the Encouragement of Capital Investments, 1959 to encompass buildings in which no more than 50% of the floor area was sold, but provided the benefits to "the owners" of the buildings.[1034] On the other hand, the sections of the Law for the Encouragement of Capital Investments, 1959, referred to above, did not mention the possibility of selling parts of the "rental building," although the benefits under the Law were granted both to the owner of the building and, if the owner was a company, to its shareholders (by way of a reduced rate of tax on the dividends). The Supreme Court held that the definition contained in the Income Tax Law (Encouragement of Apartment Renting) (Temporary Measures and Law Amendments), 1981 should be construed as entitling the shareholders to the same benefits as those available to them under the Law for the Encouragement of Capital Investments, 1959,[1035] and that the 1988 amendment introduced into sections 53A and 53B of the Law the possibility of selling parts of the "rental building."

After the 1988 amendment, a "rental building" is defined by the Law for the Encouragement of Capital Investments, 1959 as "approved property" that constitutes a building with respect to which an application for approval of a project is submitted no later than December 31, 2023, provided at least 50% of its area is designated for rental for residential purposes, and provided its construction was completed after July 31, 1988.[1036] The Law defines a "new rental building" as a rental building that: (i) was approved after December 31, 2006; (ii) was approved before December 31, 2006, but was rented for the first time after that day; or (iii) before December 31, 2006, the rental part of the building was rented for the first time for at least five years, and after that day and at the end of the rental period at least 70% of the rental part was rented for another five years.[1037] The owner of a rental building is entitled to special benefits, provided that at least 50% of the floor area of the building is apartments that were rented for residential purposes for: (i) at least five years out of the seven years commencing with the completion of construction of rental buildings that were first rented between September 1, 1991, to December 31, 2006, or new rental buildings, and that they were not sold within the meaning of this term in section 88 of the Income Tax Ordinance[1038] before five rental years elapsed;[1039] or (ii) at least 10 years out of the 12 years commencing with the completion of construction of all other rental buildings that were not sold, within the meaning of this term in section 88 of the Ordinance, before 10 rental years elapsed.[1040] However, a rental building owner is entitled to the benefits even if the apartments that were to be rented were sold before : (i) the end of the five years of rental — in the case of apartments the construction of which was completed between September 1, 1991, and December 31, 2006; or (ii) the end of the 10 years of rental — in the case of all other apartments, if: at least 50 apartments were sold to a single purchaser who undertook to rent them out as discussed above; the sale is included in a plan approved by the board before the end of the construction; and the conditions laid down by the Income Tax Commissioner with regard to the sale are met.[1041]

The benefits accorded by the law are as follows:

(i) A 10% depreciation rate on an apartment that was rented for residential purposes during the tax year; if the apartment was first rented in the period extending from September 1, 1991, until the end of 2006, or the building was a new rental building, the rate of depreciation is 20% a year, or a proportionate part of that rate if the apartment was rented for only part of the year. The 10% and 20% rates of depreciation referred to above are calculated on a straight line basis over 10 or five years, as the case may be, and if the chargeable income from the rental building is less than the depreciation that the owner of the building is entitled to, and, if five years have not elapsed since rental began, the amount of the depreciation may be deducted or set off only against income from such a rental building, or income from the sale thereof that qualifies for special benefits.

(ii) Income derived from the sale or rent of the building or a part thereof is subject to the following tax rates: foreign investment company — 18%; any other company — the lower of 18% or the tax rates specified in section 47(a1) of the Law for the Encouragement of Capital Investments, 1959 (rates ranging from 10% to 20%, in proportion to the level of foreign investment); individual — 25%; provided that the part of the income that constitutes the inflationary amount (as defined by the Law) is subject to a 10% tax rate, instead of the rates prescribed in the section.[1042] These tax benefits apply even after the expiration of the benefits period set forth in section 45. This relief applies to income subject to tax under the Income Tax Ordinance and to gains subject to tax under the Taxation of Land (Appreciation and Purchase) Law 1963.

(iii) Income derived from the sale or rent of a new rental building is subject to the following tax rates: company — 11%; foreign investment company — the lower of 18% or the tax rates of section 47(a1) of the Law for the Encouragement of Capital Investments, 1959 as referred to above; and individual — 20%.[1043]

The Minister of the Interior, in consultation with the Finance Minister, may exempt the building from all or part of the building fees levied on the issuance of the appropriate construction permit.[1044]

Land that was approved by the Board for purposes of the construction of a rental building is exempted from property tax

[1034] Income Tax Law (Encouragement of Apartment Renting) (Temporary Measures and Law Amendments), 1981, s. 3(a).

[1035] *See* F.H. 2948/95, *Itzlaf Ltd. v. Assessing Officer for Large Enterprises*, Missim K-5 (Oct. 1997), E-101.

[1036] Law for the Encouragement of Capital Investments, 1959, s. 53A(a)(3).

[1037] Law for the Encouragement of Capital Investments, 1959, s. 53A(a)(3A).

[1038] Income Tax Ordinance, s. 88 defines "sale" as including: exchange, renunciation, assignment, disposition, grant, gift or any other occurrence in consequence of which the asset passes from the control of a person, whether directly or indirectly, but not transmission by way of inheritance.

[1039] Law for the Encouragement of Capital Investments, 1959, s. 53B(a).

[1040] Law for the Encouragement of Capital Investments, 1959, s. 53B(b).

[1041] Law for the Encouragement of Capital Investments, 1959, s. 53B(c).

[1042] Law for the Encouragement of Capital Investments, 1959, ss. 53C(b) and 53C(c).

[1043] The Law for the Encouragement of Capital Investments, 1959, s. 53C(b1).

[1044] Law for the Encouragement of Capital Investments, 1959, s. 53D(b).

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(currently the tax is zero, but the law is still valid) as of the year preceding the year when the first ceiling was cast or as of any other date set by the Board, provided that the first year of exemption may not precede the first year after the year in which the building was granted "approved property" status or the 1988 tax year, whichever is later.[1045] As a counterpart to these provisions, section 3(e) of the Income Tax (Inflationary Adjustments) Law, 1985 (no longer in force) was amended in 1988. The amendment provided that the depreciation rates under the Law did not apply to rental buildings. It further provided that the provisions of section 12 of the Law regarding the sale of a "protected" or "fixed asset" did not apply to rental buildings. Under these provisions, a taxpayer who included in his/her return income from the sale of an asset that was not a "fixed asset" under the Income Tax (Inflationary Adjustments) Law, 1985, but that was a "protected asset" under the Income Tax Law (Taxation Under Inflationary Conditions), Law 1982, if the income from that sale constituted income under section 2(1) of the Income Tax Ordinance (i.e., income derived from business) during the tax year, could deduct from chargeable income an amount equal to the amount of the cost of the protected asset, and for a depreciable asset that amount less the amounts of depreciation allowed as a deduction, multiplied by the increase in the cost of living index. The amount of the deduction was charged to tax at the rate of 10%.

A foreign resident selling shares in a "real estate association of foreign residents" (as defined below) is exempt from land appreciation tax and a foreign resident acquiring such shares directly from the association is exempt from purchase tax with respect thereto.[1046]

A "real estate association of foreign residents" is defined as an association:

(i) All the assets of which, whether owned directly or indirectly, are real estate rights, the ownership of any other assets being insignificant to the association's main objectives as prescribed in section 1 of the Taxation of Land (Appreciation and Purchase) Law, 1963;[1047]

(ii) The owners of all the shares of which are individuals who were foreign residents at the time they acquired the shares, none of whom owns or is a controlling shareholder of the association, i.e., one entitled to acquire, directly or indirectly, by oneself or with a relative: more than 5% of the issued share capital or of the voting rights; a right to receive more than 5% of the profits or the assets on liquidation; or a right to nominate a director;

(iii) That has at least 50 shareholders; and

(iv) The major occupation of which is the construction, rental or sale of houses and that owns at least 50 apartments.[1048]

Owners of industrial buildings leased to approved industrial enterprises for a period of at least seven years will be accorded the grants and tax benefits afforded to approved industrial enterprises, i.e., in accordance with the location of the building. Thirty percent of the investment must be in paid-up capital and the building must be of a minimum size.

In addition to the Law for the Encouragement of Capital Investments, 1959, dealing, among other things, with tax incentives for income from rental buildings, the Law for Encouragement of Rental Apartment Building, 2007 offers substantial benefits for rental building income. An enterprise may choose to apply one of these two benefits. The Law offers benefits to a "rental building company." To be entitled to the tax benefits under the Law, the enterprise must be owned entirely by a company registered in Israel, the business of which is controlled and managed in Israel, excluding a "family company," a "transparent company" or a real estate investment trust (REIT). A "rental building company" must meet all the following conditions to be eligible for the tax benefits: (i) the number of apartments in the building must be at least 16, of an average area not exceeding 100 square meters and spread over at least four floors; (ii) the construction of the building must be completed after December 31, 2006; (iii) at least 70% of the building's area must be designated for rental for residential purposes; and (iv) the term during which the building is used for residential purposes must be at least 25 years.

The benefits accorded by the Law are as follows:

(i) A 20% depreciation rate for the rental building on a straight-line basis, excluding the land, provided the building is used for residential purposes for at least 10 years. Where the taxable income derived from the rental building is less than the depreciation the owner of the building is entitled to, and five years have not elapsed since the rental began, the amount of the depreciation may be deducted from income from another rental building or other business income.

(ii) Income derived from the sale of the building is exempt from taxation under the Taxation of Land (Appreciation and Purchase) Law. To be eligible for the tax exemption, the company must meet the following conditions: the building was sold in its entirety; the sale is not to a relative; the building was used for residential purposes for at least 10 years by the company; and the building was sold to another "rental building company" and the total period during which the building is used for residential purposes is at least 25 years.

b. The New Benefits Route

Amendment No. 75 of the Capital Investment Encouragement Law, 1959 was published on November 18, 2021. Under the amendment, the submission of new applications under the existing conditions and benefits route will be allowed until December 31, 2023. The new benefits route will gradually replace

[1045] Law for the Encouragement of Capital Investments, 1959, s. 53D(a).

[1046] Law for the Encouragement of Capital Investments, 1959, ss. 53D1(a) and (b).

[1047] In this respect, the Israeli Supreme Court ruled in C.A. 924/12 *Land Tax Authorities v. Aspan Bniya Vepituch Ltd.* (Jan. 13, 2014) that a rental agreement with respect to a real property owned by the taxpayer should not be considered as a separate asset from the real property. As a result, the Court ruled that the rental agreement does not exclude the taxpayer from a "Real Estate Association." *See also* C.A. 6340/08 *Vilar Nechasim (1985) Ltd. v. The Land Tax Officer of Haifa*, Missim KD/4 (Aug. 2010), E-102.

[1048] Law for the Encouragement of Capital Investments, 1959, s. 53D1(c).

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the existing route, and will provide greater tax benefits than does the existing route, but subject to stricter conditions. The amendment has added to the Law the concept of a "building for institutional rent." There is a distinction between a building that is in a "peripheral area" (i.e., a minority community at least 80% of whose residents are non-Jews or a community classified in socio-economic 1–4) and a "non-peripheral area." A "building for institutional rent is defined as follows:[1049]

> (i) A building with respect to which application for approval of a project was submitted between January 1,2022 and December 31, 2031, before the end of construction;
>
> (ii) If the building is in a peripheral area, a building that comprises at least six apartments or 30% of the apartments whose total floor area is not less than 30% of the entire floor area of the building are for rental purposes;
>
> (iii) If the building is not in a peripheral area, a building that comprises at least 10 apartments or 66% of the apartments whose total floor area is not less than 50% of the entire floor area of the building are for rental purposes; and
>
> (iv) The administration of which is convinced that the apartments will be rented on a long-term rental basis, i.e., for a period of at least 15 years on average out of the 18 years following the completion of the construction.

The owner of a "building for institutional rent" is entitled to special benefits if:[1050]

> (i) The apartments for institutional rent are rented under a long-term lease, for a period of five years on average out of the six years following the first rental date; and
>
> (ii) The apartments for institutional are rented under a long-term lease, for a period of at least 15 years on average out of the 18 years following the completion of the construction.

The new route provides benefits not only to those who built the building, but also those who purchased the apartments for institutional rent from those who built the building or from another continuing lessor.

The following tax rates will apply to the taxable income of the owner of a building for institutional rent resulting from the sale or rental of the apartments:[1051]

Rental Period	Company Tax Rates	Individual Tax Rates
0–5 years	11%	29%
6–10 years	9%	27.5%
11–15 years	7%	25.5%
16 years and above	5%	24%

A continuing lessor who purchases a "building for institutional rent" from the owner that built the building will pay a reduced purchase tax at the rate of 0.5%.[1052] The tax rate on dividends paid that are sourced from income generated from the sale or rent of a building for institutional rent is 20%.[1053] Accelerated depreciation for institutional rent purposes is the annual depreciation rate of 20%.

B. Law for Encouragement of Knowledge-Intensive Industry (Temporary Provision)

1. Background

The Law for Encouragement of Knowledge-Intensive Industry of 2023 ("the Law") is intended to support and maintain Israel as a center for the development of high technology companies. The Law provides for several tax incentives that are designed to encourage investment in early stage domestic technology companies and acquisitions of both Israeli and foreign technology companies. The incentives are available from July 31, 2023 to December 31, 2026.

2. Tax Credit for Investments in Technology Start-Ups

The purpose of this benefit is to incentivize individuals to invest in Israeli high-tech R&D start-up companies. According to section 2 of the Law, an investor in an R&D company (as defined), regardless of its size or form, may apply for a tax credit for his or her investment, provided that the following conditions are met:

> (i) The investor pays the full amount of the investment in cash to the R&D company by December 31, 2026, and the company allocates the shares to the investor;
>
> (ii) The accountant of the R&D company confirms that at the time of the investment the company was an R&D company;
>
> (iii) Improper tax avoidance or tax reduction are not among the main objectives of the investment;
>
> (iv) The investor has no relatives in the R&D company;
>
> (v) The investor directly holds all the shares allotted to him or her in exchange for the investment and does so for the entire benefit period (until the end of 2026); and
>
> (vi) The investor informs the director of the R&D company that the provisions of section 1 would apply to the investment.

The available tax credit is the lower of the qualifying amount of an investment or NIS 4 million, the maximum investment allowed under the Law, multiplied by the tax rate on the capital gains applicable to the investor, had he or she sold their shares for a profit in the tax year in which the investment was made.

If the tax credit has not been used in a tax year, it can be carried forward to subsequent tax years.[1054]

[1049] Law for the Encouragement of Capital Investments, 1959, s. 53A(a)(3A1).
[1050] Law for the Encouragement of Capital Investments, 1959, s. 53B(b1).
[1051] Law for the Encouragement of Capital Investments, 1959, s. 53C(d1).
[1052] Law for the Encouragement of Capital Investments, 1959, s. 53C(d3).
[1053] Law for the Encouragement of Capital Investments, 1959, s. 53C(d2).
[1054] The Law for Encouragement of a High-Tech Industry, 2023, s. 2(d).

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3. Deferral of Capital Gains Tax on Reinvested Proceeds

As an alternative to the tax credit incentive discussed above, individual investors may defer the payment of capital gains tax on sales of shares in Israeli "preferred" companies with a "technological enterprise" (as defined) when such profits are reinvested into an Israeli R&D company (as defined) and until such time as the shares of the latter are sold. According to section 3 of the Law, an individual investor may deduct gains from sales of shares of preferred companies which are reinvested into one or more R&D companies, provided that the following conditions are met:

(i) The investor pays the full amount of the investment in cash to the R&D company by December 31, 2026, and the company allocates the shares to the investor;

(ii) The accountant of the R&D company confirms that at the time of the investment the company was an R&D company;

(iii) Improper tax avoidance or tax reduction are not among the main objectives of the investment;

(iv) The investor has no relatives in the R&D company;

(v) The investment in the R&D company occurs within 12 months after the shares of the preferred company are sold, or within four months prior to such date; and

(vi) The investor holds the shares of the R&D company for at least six months.

The amount that is deductible from the capital gain on the sale of the shares of the preferred company is limited to the amount of the real capital gain resulting from the sale. That is, the same amount that the investor paid in cash for the investment, or a maximum of NIS 5.5 million per investment per company, reduced by the lower of other investments of the investor in the same R&D company for which a tax credit was received or investments in the company by a relative of the investor.

Once an investor has opted for this alternative incentive, the choice cannot be retracted.

4. Expense Deduction for Acquisitions of Technology Companies

This benefit is meant to encourage Israeli preferred companies with a technological enterprise (as defined) to invest in other Israeli preferred companies or R&D companies thereby expanding the operations of the acquiring company and ensuring the continuity of research and development activities in Israel. Additionally, this route offers tax benefits not only for the acquisition of Israeli companies but also for foreign ones, on the condition that, upon completion of the acquisition process, the economic value and activities of the foreign company are transferred to Israel.

According to section 5 of the Law, if a preferred company purchased the means of control of an "Israeli qualifying company," which is a company that owns a beneficiary intangible asset in the year of acquisition, it will be allowed to deduct the acquisition costs from its preferred technological income in the tax year, provided that the following conditions are met:

(i) Within 12 months, the acquiring company purchases at least 80% of the means of control in the qualifying company;

(ii) In the period up to December 31, 2026, the following two conditions are met:

(a) The acquiring company pays the qualifying company 25% of the purchase price or 10% of the net purchase price, whichever is lower; and

(b) A preliminary agreement, which includes the parties' agreements regarding the main terms of the transaction, is drawn up for the first acquisition;

(iii) In every tax year during the reduction period, the acquiring company remains a preferred company with a technological enterprise, and the intangible asset that was owned by the qualifying company on the date of the acquisition remains owned by the qualifying company or the acquiring company; and

(iv) Improper tax avoidance or tax reduction are not among the main objectives of the transaction.

In the case of an acquisition of a foreign company, the conditions to qualify for the deduction are stricter. These conditions include the qualifications discussed above, in addition to the following conditions:

(i) The technological revenue of the acquiring company was at least NIS 75 million on average in the three tax years preceding the acquisition;

(ii) The net purchase amount is for at least US$ 20 million;

(iii) Within 12 months of acquiring control, the business of the qualifying company and of its subsidiaries will be merged, as a "going concern" with the business of the acquiring company and the merger will include the transfer of all the rights in the beneficial intangible assets to the acquiring company; and

(iv) The Israel Innovation Authority, at the request of the acquiring company, either prior to the signing of the purchase agreement or within 90 days from such date, confirms that the intangible asset is owned by the acquiring company and is expected to be used for the development of a technological enterprise in Israel.

If the acquiring company meets the qualifying conditions, the company may deduct the purchase price of the acquired company as an expense, over a period of five tax years, beginning in the year following the year in which the acquiring company achieved control or made the initial purchase payment, whichever is later.

5. Withholding Tax Exemption on Interest Payments to Foreign Lenders

The purpose of this incentive is to decrease the burden of interest-related tax imposed on loan payments by high-tech Israeli companies to foreign financial institutions and thereby encourage foreign lending to the domestic technology sector in place of alternative foreign financing channels, such as equity investments, which dilutes the Israeli holdings in a company. According to section 6 of the Law, the exemption extends to tax on interest, discounting fees, and linkage differences.

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Under the Law, a preferred company with a technological enterprise (as defined) includes both public companies that are registered for trading on the Israeli stock exchange and privately-owned companies in which individual Israeli residents hold at least 5% of the shares. The tax exemption is available provide the following conditions are met:

(i) The preferred company that receives the loan will have technological income of more than NIS 30 million in the tax year prior to receiving the loan;

(ii) The loan is for at least US$ 10 million;

(iii) There is no special pre-existing relationship between the company and the foreign financial institution for four years prior to the start of the loan period, nor for the duration of the entire loan period;

(iv) The loan is used to finance operations, including the acquisition of companies;

(v) During the loan period, neither the number of employees in the technological enterprise of the preferred company nor the cost of their salaries undergo a substantial decrease of 30% or more than the previous tax year;

(vi) The loan is approved by the parties and the full loan is transferred by December 31, 2026; and

(vii) An accountant of the preferred company confirms the fulfillment of these conditions in the company's annual tax return.

Furthermore, the foreign lender must be a resident of tax treaty partner country of Israel.

If one or more of the conditions has not been met, the preferred company will be taxable on the amount it was required to deduct.

C. Relief for Individuals

1. New Residents and Returning Residents

Some of the provisions of the Income Tax Ordinance relating to the taxation of non-residents have already been discussed in XIV., above. This section focuses on special incentives granted to individuals who become residents of Israel, a move that Israel greatly encourages, for its *raison d'eˆtre* is the gathering of the Jews from the four corners of the world to which they were exiled so many years ago. Within the framework of Israel's 60th anniversary, major tax incentives for new residents (*Olim*) and returning residents were enacted under the Income Tax Ordinance (Amendment no. 168), 2008, effective as of January 2007, subject to special transitional provisions.

The incentive amended the definitions of a "returning resident" and a "foreign resident," and added a new definition of a "veteran returning resident."

A "foreign resident" is: (i) a person who is not an Israel resident; or (ii) an individual who resided outside of Israel for at least 183 days each year, during two consecutive tax years, whose primary residence — "center of life" — was not in Israel for two additional tax years. In this context, the term "center of life" is evidenced by a permanent home, ties to the community, the family location, and economic interests much like the center of vital interests test. According to the definition of a "foreign resident," an individual may terminate their Israeli residency instantaneously, after departing Israel.

A "returning resident" is an individual who returned to become an Israeli resident after at least six consecutive years as a "foreign resident." However, in accordance with the transitional provisions, the previous definition, in which the individual was required to live outside Israel for at least three consecutive years, applied to an individual who returned to Israel prior to January 2009. Generally, returning residents are entitled to more modest tax relief than new immigrants and veteran returning residents.

A "veteran returning resident" is defined as an individual who returned to become an Israeli resident after at least 10 consecutive years as a Foreign Resident. However, in accordance with the transitional provisions, during the years 2007 to 2009 the period for foreign residents returning to Israel was reduced to five years.

Immigrant and veteran returning residents are exempt from tax on capital gains from the realization of an asset held outside Israel and sold within 10 years of immigration.[1055] It should be noted that prior to the reform, an immigrant was exempted only with respect to assets that the individual owned before becoming a resident of Israel. Therefore, under prior legislation, if an immigrant purchased assets thereafter and sold them at a profit, the immigrant was liable to the capital gains tax (assuming the transaction was of a capital nature) under section 89(b)(1) of the Income Tax Ordinance based on his/her having become a resident.

Under section 35 of the Income Tax Ordinance, a new immigrant is entitled to special "credit points," as discussed in XII-II.C., above. It is worth noting that, where the taxable income of an individual includes the income of a spouse who is a new immigrant, and the tax on their income is computed jointly, the credit points for the new immigrant's spouse are included in the joint computation. If the spouse's income does not exceed five times the amount of the credit points granted to a new immigrant and those granted under section 38 (credits for a working spouse), his/her income is not included in calculating the chargeable income of the registered spouse (and thus is tax-free) and the credit points granted to the new immigrant may not be brought into account in calculating the tax liability for both of them.[1056] The credit points are granted for a tax year falling wholly or partly within the 54 months during which the credit points are granted, according to the number of months that the immigrant resided in Israel in that year, and are granted only during the immigrant's first stay in Israel. At the request of the individual, a consecutive period of absence from Israel of not less than six months and not more than three years is not included in the calculation of the 54 months.[1057] For purposes of the credit points accorded to new immigrants, a new immigrant (*Oleh*) means a person holding an *Oleh's* visa or certificate under the Law of Return, 1950; a person entitled to such a visa or certificate and holding a visa or permit for temporary residence under the Entry to Israel Law; and a person belonging to a category of persons with respect to whom the Minister of Finance

[1055] Income Tax Ordinance, s. 97(b).
[1056] Income Tax Ordinance, s. 35(b).
[1057] Income Tax Ordinance, s. 35(c).

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has prescribed that they be treated as *Olim* (plural of *Oleh*) for the present purpose.[1058]

Sections 14(a) and 97(b) of the Income Tax Ordinance, which were amended by the 2008 tax reform, exempt from tax the income of a new immigrant and a veteran returning resident during the first 10 years of their residence in Israel, irrespective of whether the income is passive or active, or capital gains accrued or derived from outside Israel, unless they request otherwise. It is worth noting that prior to the reform of 2008, the exemption was not applicable to business income and was limited to five years. Furthermore, exempt income need not to be reported on a tax return. Assets located outside Israel (not gifted by Israeli residents) need not be reported on any net worth declaration requested by the ITA.

Interest income derived from foreign currency deposits of new immigrants is exempt from tax in Israel for 20 years as of the immigration to Israel.[1059]

Section 14(b)(1) of the Income Tax Ordinance, which was also amended by the 2008 reform, defines the term "accommodating year" as the term in which new immigrants and veteran returning residents may elect, within 90 days following their arrival in Israel, to remain for Israeli tax purposes foreign residents during their first year in Israel. The "accommodating year" may be useful if they wish to enjoy exemptions available to foreign investors. Nevertheless, the first year does not stop the 10-year exemption period from running if they eventually stay on in Israel. Section 14(d)(1) of the Income Tax Ordinance, as amended in 2009, empowers the Minister of Finance (with the approval of the Knesset Finance Committee) to extend the period of the tax benefits for another 10 years, as long as the new immigrant or the veteran returning resident made a significant investment in Israel two years from the day that the individual became resident of Israel for the first time or became a veteran returning resident.

The Reform of 2008 determined that, for purposes of the definitions of a "controlled foreign corporation" and "foreign vocation company," the rights of new immigrants and veteran returning residents should not be taken into account as rights of residents for a period of ten years as of their assumption of residence. Furthermore, foreign companies managed and controlled by new immigrants or veteran returning residents will not be considered residents of Israel for 10 years from their assumption of residence if, but for being managed and controlled by the new immigrants or the veteran returning residents, they would not have been classified as residents of Israel.

A non-resident settlor trust" and a non-resident beneficiary trust will not be regarded as having changed its classification as a result of a change in the residence of the settlor or the beneficiary's for 10 years from its assumption of residence, provided the trust's assets are located outside Israel and its income is derived from assets located outside Israel.

New immigrants and veteran returning residents may enjoy this relief in addition to any other relief to which they are entitled.

The following table summarizes the benefits for new immigrants and veteran returning residents before and after the reform:

Benefits	Pre-Reform	Post-Reform
Incidence	Apply to immigrant	Apply to new immigrant and Veteran Returning Residents
Exemption of passive income	5 years exemption, but only for foreign assets purchased prior to becoming an Israeli resident	10 years. No limitation regarding the period in which the asset was purchased
Exemption on active income derived outside of Israel	4 years, but only for new residents on business that existed 5 years prior to the resident became an Israeli resident	Included, but 10-years exemption noted above
Foreign companies that are managed and controlled from Israel, "Controlled Foreign corporations" and "Foreign Vocation Companies"	N/A	Will not be liable to taxes if classification as CFC or FVC due to rights of new immigrants or Veteran Returning Residents
Capital gain exemption	10-year exemption, but only for foreign assets purchased before becoming Israeli resident	10-year exemption

2. Returning and Immigrating Scientists

Under present law new immigrants and veteran returning residents are entitled to tax relief in respect of foreign-sourced royalties paid on know-how developed prior to coming to Israel for 10 years as of arrival in Israel (five years in case of an ordinary returning resident).

[1058] Income Tax Ordinance, s. 35(d).

[1059] Income Tax (Exemption from Tax on Interest Income on a Foreign Currency Deposit) Order, 2002 provides that the exemption is dependent on: (i) the funds being deposited with a banking corporation for a period of at least three months; (ii) the deposit including only funds that the new immigrant held outside Israel prior to his immigration to Israel; (iii) 20 years not having elapsed since the taxpayer first became a resident of Israel; (iv) the interest income not being income from business in the hands of the new immigrant, not being recorded in his books of account and not being liable for such recording; (v) the deposit not having been used as collateral for a loan provided by the banking corporation to a relative of the new immigrant or a corporation in which the new immigrant is a controlling shareholder; and (vi) funds having been deposited within 90 days of their having been transferred to Israel and a declaration with respect thereto having been filed within two weeks of the opening of the deposit account.

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The tax relief[1060] extends the tax exemption to royalties paid by an "application company" owned by an academic institution that invited the taxpayer while still a non-resident to serve with it, for a product developed by the taxpayer. The exemption is granted for a period of five years as of the first year in which royalties are paid.

The exemption is limited to those royalties derived from the use of the product by a non-resident.

The exemption is conditioned on:

(i) The taxpayer becoming a resident of Israel between 2011 and 2015, after having been a non-resident during six years.

(ii) The taxpayer entered within two years of his/her arrival in Israel into an agreement with the "application company" according to which he/she will be entitled to royalties as a result of the use of a product of the company developed or discovered under the agreement.

(iii) The product is based on R&D approved by the Chief Scientist.

(iv) The Director of the ITA certified that avoidance or undue reduction of taxes does not figure in the main aims of the agreement.

3. Approved Specialists

To encourage persons with special skills to contribute to the economy of Israel, section 50 of the Law for the Encouragement of Capital Investments, 1959 grants special tax benefits to an approved specialist, i.e., "a person who, while being a non-resident, was engaged by an enterprise, with the consent of the Director, to work in the enterprise as a specialist whose work is likely to assist the attainment of the objects of this Law, and who has not previously been a resident." A "foreign specialist," as well as a "guest lecturer," as defined in the Regulations,[1061] may deduct certain sojourn expenses during the first year of his stay in Israel.

Under section 50 of the Law for the Encouragement of Capital Investments, 1959, the employment income derived by an "approved specialist" is subject to a 25% maximum tax rate during a three to eight year period, as from the first year in which such income was liable for taxes. For purposes of fixing the maximum rate, the income is regarded as being the "top slice" of the "approved specialist's" income.

D. The Law for the Encouragement of Industry (Taxes)

Substantial relief from taxation was brought about with the enactment of the Law for the Encouragement of Industry (Taxes), 1969, which has since been amended on numerous occasions and has by now lost most of its importance. The Law accorded industrial companies, as defined by it, various tax incentives designed to enhance the industrial development of Israel and the modernization of its industrial enterprises.

An "industrial company" is defined as a company resident in Israel deriving at least 90% of its income in a tax year[1062] from an "industrial enterprise" owned by it. It should be noted that the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), 2013 altered the definition of an "industrial company." Under the revised definition, only a company incorporated in Israel may be considered as an "industrial company" (in addition to the original requirements set forth in order to meet the definition of the "industrial company"). Furthermore, the company's "industrial enterprise" should be located in Israel or in the "area" as defined in section 3A of the Israeli Income Tax Ordinance.

An "industrial enterprise" is a term of art that applies to companies engaged primarily in production.[1063] The schedule to the Law for the Encouragement of Industry (Taxes), 1969 defines various activities as nonproductive. Foremost among these are construction, commerce, transportation, communications, storage and the rendering of personal services. On various occasions, the question of how to define the nature of certain income-producing activities came before the courts, which held that the main criterion was whether the activity in question created a new tangible asset out of tangible raw material and did not merely change the form of the material, for such a change of form does not in itself amount to production.[1064] However, activities involving tangible materials, forming a chain in the production thereof and adding economic value, are deemed to be productive, although no change in the form of the material has occurred. It was held that the repair and overhauling of engines,[1065] freezing and refrigerating,[1066] the marketing of self-ground coffee beans,[1067] activities involving storage in silos,[1068] laundry services,[1069] the sale of advertising space, collecting and editing information to be included in telephone directories,[1070] computerized data processing[1071] and scrap-iron restoration[1072] are not productive activities. In certain circumstances, the publishing business is deemed to be productive,[1073] while in other circumstances it has been held to be nonproductive.[1074] The courts have also reached contradictory decisions with respect

[1060] The Law for Increasing the Economic Efficiency (Legislation Amendments for Implementation of the Economic Plan for the Years 2011–2012), 2011 s. 22.

[1061] Income Tax (Deduction of Sojourn Expenses for Foreign Residents) Regulations, 1979. See X.

[1062] Other than income from compulsory loans and certain passive income, including capital gains as per the Encouragement of Industry (Taxes) (The Circumstances in Which a Company Shall Continue to Be Deemed an Industrial Company-Certain Income) Order, 1986.

[1063] Law for the Encouragement of Industry (Taxes), 1969, s. 1.

[1064] D.A. 63/72 *Mifalei Kerur BaTzafon Ltd. v. The Assessing Officer*, 6 P.D.A. 27.

[1065] D.A. 2/72 *Technomotor Ltd. v. The Assessing Officer*, 6 P.D.A. 24.

[1066] See n. 861, above.

[1067] D.A. 30/72 *I. Cohen Ltd. v. The Assessing Officer* (not published).

[1068] D.A. 78/72 *Tachanat Kemach "Mifrats" Ltd. v. The Assessing Officer Haifa*, 7 P.D.A. 197.

[1069] D.A. 4/73 *Machbesat Galia Ltd. v. The Assessing Officer*, 6 P.D.A.345.

[1070] C.A. 741/86 *Assessing Officer Tel-Aviv v. Dapey Zahav, Hotzaa Laor Ltd.*, Missim C-4 (July 1989), E-79.

[1071] C.A. 798/85 *Assessing Officer Jerusalem v. "Nikuv" Sherutei Machshev Beyerushalayim (1979) Ltd.*, (1988) 42(4) P.D. 162.

[1072] I.T.A. 160/84 *Mifaeli Matechet Lod v. Assessing Officer (Large Enterprises)*, 13 P.D.A. 22; *but see* I.T.A. 244/87 *Zvi Savo Ltd. v. Assessing Officer Netanya*, Missim E-3 (June 1991), E-69.

[1073] H.C.J. 441/86 *Masada Ltd. v. The Assessing Officers for Large Enterprises*, (1987) 40(4) P.D. 788; D.A. 5414/99 *Ieton Zafon 1 v. Nahariya Municipality*, Missim N-2 (Apr. 2000), E-350.

[1074] C.A. 1960/90 *Assessing Officer Tel-Aviv v. Hevrat Ra´ayonot Ltd.*, Missim G-2 (Apr. 1993), E-74.

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to data processing.[1075] Iron formation was regarded as a productive activity,[1076] but not scrap iron restoration.[1077] An illuminating analysis of the vague term "productive activity" and its contradictory interpretations and conclusions was rendered in the *Ráayonot* case, with regard to a small publisher.[1078]

By virtue of a special Order promulgated in 1978 and effective as of the 1975 tax year, a "foreign owned company" qualifies as an "industrial company"[1079] even if it derives only 70% of its income from its industrial activities in lieu of the 90% ordinarily required. A "foreign owned" company is defined as a company that is resident in Israel, the entire issued share capital of which is, directly or indirectly, in the hands of a company residing outside Israel and the shares of which are traded on a recognized stock exchange for purpose of section 5 of the Currency Control Permit, 1978, i.e., the stock exchanges of Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, The Netherlands, New Zealand, Norway, Singapore, South Africa, Spain, Sweden, Switzerland, the United Kingdom, and the United States (including over the counter trading in New York).[1080]

Moreover, no more than 30% of the income in any tax year, other than income from defense loans, may be derived from transactions with the company's parent company or companies controlled by the parent company and from other sources outside the company's industrial enterprise, and not more than 10% of its income may be from such other sources (i.e., not from its industrial enterprise). In tax parlance, this Order is known by the name of the company, Motorola, for which it was apparently enacted — the Motorola Order.

Until 1987, substantial tax relief was accorded by the Law for the Encouragement of Industry (Taxes), 1969, for example, favorable depreciation rates (for example, 50% on machinery and equipment), lower income tax (but not company tax), a special deduction for inventory and tax relief to encourage mergers. These benefits are no longer available.

Today, the scope of benefits accorded by the Law for the Encouragement of Industry (Taxes), 1969 is quite narrow. Amortization at the rate of 12.5% per annum is granted with respect to patents, process rights and know-how acquired by an industrial company.[1081] The Law for the Encouragement of Industry (Taxes), 1969 also provides for special relief where shares of industrial companies were issued to the public and registered for trade before the end of 1995. The expenses incurred with respect to such registration, if carried out on the TASE or on certain foreign exchanges, are still deductible over a three-year period as from the year during which the company incurred them.[1082] Moreover, while section 101 of the Income Tax Ordinance provided that the registration of shares on the stock exchange was deemed to constitute a sale of such shares and to bring with it liability for tax,[1083] shareholders of industrial companies were relieved of this liability on the sale of their shares five years after their registration for trade on the stock exchange, if the registration occurred before December 31, 1995.[1084] Special regulations were promulgated to assist industrial companies in raising foreign currency by issuing shares to the public on certain overseas stock exchanges.[1085] These regulations provide that exchange rate differentials derived as a consequence of the deposit of the amounts raised from the issue of shares do not affect the "industrial" status of the company. These exchange rate differentials are exempt from Israeli taxes provided certain conditions are met.[1086]

As a rule, consolidated tax returns may not be filed for income tax purposes, although consolidated accounts must be filed under the Securities Law, 1968.[1087] However, an exception to this rule applies to industrial companies, which, subject to strict limitations, may file consolidated returns.[1088] Special provisions restrict the set off of losses incurred prior to consolidation; however, these losses may still be set off as if the consolidation had not occurred.[1089]

It should be noted that the benefits discussed above do not preclude entitlement to benefits under the Law for the Encouragement of Capital Investments, 1959, discussed in II.A.2., above, and XVII.A., above.

E. Research and Development

In the last decade, many skilled scientists and engineers immigrated to Israel from the former Soviet Union, leading to a surge in research and development (R&D) expenditure. Moreover, Israel is a renowned center for the development of computer and communications technologies. Indeed, the government has increasingly aided local science-based industry in its

[1075] C.A. 653/86 *Assessing Officer Tel-Aviv 5 v. Nikuv Sherutei Machshev (1976) Ltd.*, 43(3). P.D. 47; I.T.A. 33/94 *Hilan (89) Ltd. v. The Assessing Officer*, Missim J-6 (Dec. 1996), E-112.

[1076] C.A. 273/89 *Dir-Chana Iron Ltd. v. Assessing Officer Nazareth*, Missim E-4 (Aug. 1991), E-72.

[1077] I.T.A. 160/84 *Mifalei Matechet Lod v. Assessing Officer for Large Enterprises*, 13 P.D.A. 22. Lately, the principles of the *Ra´ayonot* case have been applied in the context of municipal property tax: D.A. 127/95 *Bezeq v. Municipal Property Tax Manager*, Missim K-2 (Apr. 1997), E-59. D.A. 5414/99 *Ieton Zafon 1 v. Naehariya Municipality*, Missim N-2 (Apr. 2000), E-350.

[1078] C.A. 1960/90 *Assessing Officer Tel-Aviv v. Hevrat Ra´ayonot Ltd.*, Missim G-2 (Apr. 1993), E-74.

[1079] As detailed above, the definition of an "industrial company" was revised, and only a company incorporated in Israel may be considered as an "industrial company" (in addition to the original definition of the "industrial company"). Furthermore, the company's "industrial enterprise" should be located in Israel or in the "Area" as defined in section 3A of the Israeli Income Tax Ordinance.

[1080] Encouragement of Industry (Taxes) (Change of Rate) Order, 1978.

[1081] Law for the Encouragement of Industry (Taxes), 1969, s. 2.

[1082] Law for the Encouragement of Industry (Taxes), 1969, s. 5B.

[1083] Income Tax Ordinance, s. 101(a)(1): "The registration of shares on the stock exchange shall be regarded as the sale thereof on the date of registration…."

[1084] Law for the Encouragement of Industry (Taxes), 1969, s. 21A. Although s. 21A was repealed, its provisions continued to be valid, provided the submission of the application to issue the prospectus was filed before Nov. 7, 1994, and provided the registration occurred before Dec. 31, 1995.

[1085] Encouragement of Industry (Taxes) (Circumstances in which a Company Raising Capital on a Stock Exchange Shall be Deemed to Continue to be an Industrial Company) Regulations, 1982.

[1086] Income Tax (Exemption from Tax on Exchange Rate Differentials Derived by Israeli Company Selling Shares on a Stock Exchange Outside of Israel) Regulations, 1981; Income Tax (Exemption from Tax on Exchange Rate Differentials Derived by an Israeli Company Selling Shares on a Stock Exchange Outside of Israel) Regulations, 1982.

[1087] Securities (Preparation of Financial Reports) Regulations, 1969, s. 46; C.A. 218/96 *Iscar Ltd. v. Discount Hashkaot Ltd. Takdin (Elyon)* 97(3), 513.

[1088] Law for the Encouragement of Industry (Taxes), 1969, s. 23. D.A. 269/88 *Yachin Hevra Haklait Ltd. v. The Assessing Officer of Large Enterprises*, Missim D-3 (June 1990), E-155.

[1089] Law for the Encouragement of Industry (Taxes), 1969, s. 26.

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R&D efforts, which are designed primarily to enable the local manufacturing or international licensing of sophisticated products. In this regard, a few enactments deserve special mention.

First, section 20A of the Income Tax Ordinance, which became effective on April 1, 1981, allows for the deduction of R&D expenses. As first enacted, section 20A provided that, in determining the chargeable income of a taxpayer who incurred expenses, including capital expenses on scientific research in the field of industry, agriculture, transportation or energy that were approved by the competent authority, these expenses would be allowed as a deduction from income in the year in which they were paid, provided:

> (i) The research was undertaken by the owner of an enterprise in one of the fields referred to above or at the owner's request, for the development and enhancement of the enterprise; or
>
> (ii) The expenses were incurred by the taxpayer conducting the research (not being the owner of the enterprise engaged in one of the fields referred to above), or the expenses were a contribution to the financing of research undertaken by a person other than the taxpayer in consideration for a reasonable right to the fruits of the research, provided that, in both cases, the state participated in the financing of the research by means of a grant in aid. For purposes of this provision, a "grant in aid" was defined to include a loan designated as such by the Minister of Finance with the approval of the Finance Committee of the Knesset.

A "grant in aid," as defined above, granted by the State for purposes of financing research, was deducted from the amount of the expenses allowed as a deduction under section 20A of the Income Tax Ordinance. No deduction is allowed for any expense incurred for the procurement of an asset with respect to which depreciation is allowed under section 21 of the Income Tax Ordinance.

It should be noted that, where the R&D investor claims a deduction for an investment, the investor must bear a "real loss"; i.e., sums invested solely on the basis of "revolving credit" do not qualify,[1090] nor does a sum invested by a third party suffice for a deduction for the taxpayer unless it was recorded as income by the receiving taxpayer.[1091]

In 1983, section 20A of the Income Tax Ordinance was amended by the "Elscint Law," as it is commonly referred to.[1092] Section 14 of this Law, which introduced amendments to the Income Tax Ordinance, provides that, with respect to the expenses described above, a deduction is to be allowed on a ratable basis, i.e., the amount allowed is that part of the expenses that the number of months after the month in which the expense was incurred until the close of the tax year bears to the total number of months in the tax year (12), with the remainder being allowed as a deduction in the succeeding tax year. In computing this ratable part, an undertaking to pay the expenses in 12 equal monthly installments is regarded as payment of the entire amount on the making of the first payment. Moreover, the amendment allows for the set-off of the "tax saved" as a result of the deduction against the tax levied on the taxpayer's income, whether employment, business, or vocation income, as of the month following the month during which the expenses were incurred. Any balance is allowable as a set-off on the filing of the return for the tax year under consideration. The amendment also defines "tax saved" as the amount that the taxpayer was exempt from paying as a result of the deduction taken, but with respect to advance payments (applicable to companies and to self-employed individuals), the amount saved is calculated at the rate of 55% in the case of an individual (notably, higher than the current highest tax bracket, which is 46%) and at the effective rate of tax for the preceding year of the company, if a company incurs the expense. The amendment further provides that, if the person undertaking the R&D raised capital for purposes of the R&D project and this sum, together with the amount expended by the person carrying out the R&D project, exceeds the amount actually invested in the project, the excess amount is regarded as income taxable at the rate of 100% and no deduction is allowed with respect to such income. Moreover, the excess amount, which constitutes the entire tax, is linked to the consumer price index and carries interest at the annual rate of 4%, in accordance with the provisions of section 159A of the Income Tax Ordinance, as of the date of its coming into existence.

Capital expenditure on scientific research incurred by a person for the advancement or development of their enterprise, to which the provisions referred to above do not apply, may be deducted in three equal annual installments, beginning with the tax year during which it was incurred. The amount of the grant referred to above, given by the state to finance scientific research, is to be subtracted from the amount of deductible expenses under this provision.[1093]

Of great importance are the provisions of section 20A1 of the Income Tax Ordinance, which provide that in no event may the amount deductible under section 20A(a) exceed 40% of the chargeable income of the taxpayer in the tax year in which the expenses were incurred. A special provision deals with an "industrial holding company," to which this restriction does not apply. Finally, the amount of tax saved by virtue of the deduction afforded by section 20A(a) is added to the amount of tax taken into account in determining advances payable in accordance with section 175 of the Income Tax Ordinance. In determining a reduction of the advance payments in accordance with section 190A in any tax year, the amount of tax saved by a taxpayer in accordance with his/her return, as a result of participating in the financing of an R&D project undertaken by another person in accordance with section 20A(a), is not taken into account. Moreover, the deduction is further limited by section 46A of the Ordinance, so that the aggregate amount of the credit for charitable contributions, together with deductions under section 20A of the Ordinance, may not exceed 50% of taxable income.

[1090] I.T.A. 115/88 *Feldman v. Assessing Officer*, Missim D-5 (Oct. 1990), E-106.

[1091] C.A. 547/86 *Amin Bakara Vehana'a Hashmalit Ltd. v. Assessing Officer Jerusalem*, Missim D-1 (Feb. 1990), E-65; I.T.A. 87/87 *Inbar v. Assessing Officer Gush Dan*, Missim D-4 (Aug. 1990), E-63; C.A. 4125/90 *Inbar v. Assessing Officer Gush Dan*, Missim H-3 (June 1994), E-50.

[1092] Elscint, a major producer of sophisticated medical equipment, was the main lobbyist for this law, which was officially designated, until repealed in 1988, the Income Tax (Incentives for Investment in Securities whose Proceeds Are Designated for Scientific Research) Law, 1983.

[1093] Income Tax Ordinance, s. 20A(1A)(2). *See* Law for the Encouragement of Research and Development in Industry, 1984.

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As noted above, these provisions were introduced into the Income Tax Ordinance by the Elscint Law, which itself allowed a taxpayer to reduce his/her taxable income for investments made by him in securities of certain companies engaged in R&D projects. The Law was repealed in 1988; however the amendments to the Ordinance contained therein remain in force.

F. Securities Traded on Tel-Aviv Stock Exchange

Under section 97(b2) of the Income Tax Ordinance, a non-resident is exempt from capital gains tax on gains from the disposition of securities listed on the local stock exchange, except in the following cases:

(i) The gain is attributable to a permanent establishment of such a non-resident;

(ii) The gain was derived from the sale of a share of a REIT or from the sale of a bond or a government loan of the State of Israel registered on the stock exchange, its due date being less than 13 months from its issuance date ("short time government loan"); or

(iii) The gain was derived from forward transactions on an underlying asset constituting a Short Time Government Loan.

Within the framework of the 2003 Reform, special regulations were promulgated (the Income Tax (Exemption from Tax of a Non-Resident with Respect to a Capital Gain from a Sale of a Security) Regulations, 2003) that exempt non-residents from capital gains tax on sales of securities traded simultaneously in Israel and abroad.

Income Tax Ordinance (Amendment no. 169), 2008, in effect as of January 1, 2009, aims to encourage foreign investors to continue investing in Israel. The amendment elaborates and simplifies the tax exemptions for foreign residents. The main benefits include: (i) an exemption for foreign residents on interest income, discount fees and exchange differentials derived from corporate bonds traded on the TASE (the exemption applies to all foreign residents on the date of receipt of the interest, even if the bonds were acquired prior to January 2009); and (ii) a capital gains tax exemption on the sale of Israeli securities acquired after January 2009. As noted above, prior to the amendment, only treaty country residents who met certain conditions were exempt from capital gains tax on the sale of non-traded Israeli securities.

G. Intensive Research and Development Companies

A special exemption from capital gains tax was accorded to non-residents with respect to gains derived from the sale of a share, allotted after January 1, 2003, in an "intensive research and development company."[1094] The latter was defined by reference to regulations issued under section 103A(b) of the Income Tax Ordinance, which provide that: (i) the company concerned must be mainly active in R&D; (ii) all its assets, whether directly or indirectly, must be employed for purposes of the R&D activities; (iii) at least 75% of its R&D expenses must be expended in Israel (unless otherwise consented to by the Commissioner on the advice of the Chief Scientist and with respect to clinical trials that could not be performed in Israel); and (iv) the company must not own real estate other than that used for the R&D. For purposes of the definition, R&D includes the interim manufacturing and marketing stages, provided always that the state approved the R&D or accorded it a grant-in-aid.[1095]

However, section 97(b1) of the Israeli Income Tax Ordinance was abolished in Amendment No. 169 and is no longer in force. Nevertheless, shareholders who purchased their shares prior to January 1, 2009, may still enjoy the exemption provided under section 97(b1), as the amendment is applicable only with respect to shareholders who purchased their shares after January 1, 2009.

H. Income of Companies Controlled from Abroad

A special provision of the Income Tax Ordinance, section 14A, formerly contained in the Law for the Encouragement of Capital Investments, 1959, provides that, on the application of a foreign company the business and management of which are controlled from outside Israel, the Minister of Finance may direct that income derived or accrued outside Israel but taxable in Israel due to its receipt in Israel be subject to a 15% tax or, in "special cases," be entirely exempt from tax. After the reform of 2003, no tax is levied on the "remittance" basis and this relief is no longer necessary.

I. Non-Creditable Foreign Taxes

Section 16A of the Income Tax Ordinance authorizes the Minister of Finance to grant a tax rebate to a non-resident taxpayer where the Israeli tax borne by the taxpayer is not creditable in the taxpayer's country of residence even if the credit is derived because of provisions in that country requiring the set-off of losses. This authority has been delegated to the Commissioner of Income Taxes, who makes quite frequent use of it, especially for venture capital funds.

In October 2001, the Israeli tax authorities reached a special agreement with the Association of Venture Capital Funds. The agreement was necessary in view of the Israeli position that venture capital funds (tax-transparent partnerships) maintained PEs in Israel and that their local profits were taxable as ordinary business income, while foreign countries regarded the same income as capital gains. The result was that the local Israeli tax was not creditable in the investor's country of residence. Under the agreement, until 2004, no Israeli tax was levied on the gains of venture capital funds, provided 20% of their capital was invested in companies registered and active in Israel if the capital was raised before the end of 2002, and 30% if the capital was raised thereafter. After 2004, venture capital funds may file a request to pay company tax at a reduced rate in accordance with a special arrangement enforced by a pre-ruling with the tax authorities. This rate was set at 20% with respect to that part of the income of a venture fund that bears to it the same proportion as the investments of the non-residents bear to the entire investments in the fund. The distribution of the profits of the venture fund, after the payment of the reduced company tax, is not liable to tax in the hands of the investors and is not considered a taxable event.

[1094] Income Tax Ordinance, s. 97(b1).

[1095] Income Tax (Reorganization of Intensive R&D Companies) Regulations, 1994.

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The sale of units in a venture fund is not liable to Israeli tax, except where the seller is a "tax liable investor" and the sale is made to an exempt investor (provident funds and public institutions residing outside Israel that are tax exempt under the law in their country of residence). The receipt of the preruling is conditioned on the venture fund raising a minimum amount of US$20 million, the establishment of an office in Israel that will serve as its permanent place of business, and the fund's investing in Israeli companies at least 90% of the capital raised (not including administration fees). Where the amount raised exceeds US$75 million, the minimum amount that must be invested in Israeli companies is reduced to 66%. All amounts invested in Israeli companies must be invested in intensive R&D companies and not more than 15% of the capital of the fund may be invested in any one such company. The venture fund may not invest in real estate and may not hold monetary deposits or short-term securities, subject to exceptions where these are held for its own use.

With respect to transaction in securities, three provisions are of special importance to non-residents.

- First, the sale of shares by a non-resident does not give rise to the levying of tax on the otherwise taxable "inflationary amount" (see V.C.4.b.(1), above), where this amount is calculated by reference to the foreign currency used to purchase the shares.[1096] This relief is of diminishing value, as the inflationary amount accrued since 1994 is exempt from tax altogether.

- Second, under the Land Appreciation Tax (Exemption from Tax on the Transfer of Shares from a Foreign Company to its Shareholders) Regulations, 1980, a transfer of shares in a "real estate association" from a foreign company to its shareholders is free of land appreciation tax and purchase tax (a tax paid on the consideration, in place of the former transfer tax known as the "additional tax"), where such a transfer is necessary to enjoy relief granted under a double taxation agreement. In such cases, the date of acquisition and the cost of the shares are the same as those of the real estate in the hands of the foreign company. The exemption is, therefore, in essence, a deferral of tax.

- Third, under a special Order, an Israeli resident company, the shares of which are held entirely by a non-resident, is exempt from tax on the sale of its shares in a non-resident company to the extent of the amount of the gain attributable to the devaluation of the U.S. dollar.[1097]

J. Petroleum Industry

Following the discovery of large offshore gas reserves, the Scheshinsky Committee, which was commissioned by the government, made a number of recommendations.

First, it recommended that the depletion allowance be done away with.

Second, it recommended that a special levy, gradually rising from 20% to 50%, be levied on the profits of oil and gas companies. Before the special levy be levied, the taxpayer would be allowed to recover net of the levy 150% of its investment in the exploration.

Third, the Committee recommended that the present royalties of 12.5% remain in effect.

The Committee did not recommend a computation of the income of each field separately. Thus, exploration costs in one field could be used to offset income of another field.

The Taxation of Petroleum Profits Law, 2011, adopted the Scheshinsky Committee's recommendations and provides that a special levy will be levied on petroleum profits of an owner of a petroleum right in a petroleum enterprise, in accordance with his/her relative profit, as follows:

(i) If the relative levy coefficient is less than 1.5: 0%;

(ii) If the relative levy coefficient is 1.5 to 2.3: 20% and 37.5% of the difference between the relative levy coefficient and 1.5. In any case the sum will not exceed 50% less the product of 0.64 and the difference between the companies tax rate and 18%;[1098]

(iii) If the relative levy coefficient exceeds 2.3: 50% less the product of 0.64 and the difference between the companies tax rate and 18%.

The petroleum profits will be calculated at the end of each year, as the difference between the current receipts (which include the receipts received during the tax year, except exploration receipts and establishment receipts) and the current payments (which include the payments incurred for the production of receipts; establishment expenses; royalties, according to section 32 of the Petroleum Law, 1952; and payments for exploring a new petroleum field in the petroleum right field).

The "relative levy coefficient" for each month, is the ratio between the accumulated receipts and the accumulated payments for the previous tax year ("levy coefficient") and a "difference coefficient" multiplied by the number of months as of the last tax year and until the end of the current month for which the relative levy coefficient is calculated.

The "difference coefficient" is the difference between the levy coefficient at the end of the tax year and the levy coefficient of the previous tax year.

The relative levy coefficient postpones the levy until the accumulated receipts exceed the accumulated payments by 50%, which means that the enterprise has made a profit of 50% on its investments. Thus, the levy will be levied only once petroleum profits exceed 50% of the investment.

A loss incurred in petroleum activity can be carried forward and set off against petroleum profits, and interest at the rate of LIBOR + 3% will be added to it. An owner of a petroleum right will notify the Director of the ITA (an irrevocable election) of an election of depreciation deductions, as follows: (i) A flat rate deduction of 10%; or (ii) a variable rate deduction so that in each tax year the total depreciation for depreciable assets elected will be at the level of the taxable income before

[1096] Income Tax (Exemption from Capital Gains Tax on the Inflationary Excess upon the Sale of Shares by a Non-resident) Order, 1978.

[1097] Income Tax (Partial Exemption from Capital Gains upon Sale of Shares of Israeli Resident in a Foreign Company) Order, 1981. However, since the inflationary amount is exempt from tax as of 1994, these provisions benefit only taxpayers who have held their shares for a long time prior to 1994.

[1098] 50% − 0.64 × (X − 18%), where X = the companies tax rate. In 2021, the companies tax rate is 23%, so the additional levy will not exceed 50% − 0.64 × (23% − 18%) = 46.8%.

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the special depreciation deduction for petroleum rights and after the flat 10% deduction according to section (i), but in any case the depreciation deduction for each asset will not exceed 10% of the original price. This deduction rule is in lieu of depreciation granted under section 21 of the Ordinance.

The Director of the ITA may declare that a number of petroleum enterprises be deemed a sole enterprise as long as industrial production has not begun and subject to the following conditions: (i) The petroleum rights in the petroleum enterprise are in the same petroleum field; (ii) the petroleum rights in the petroleum enterprises belong to the same owner; (iii) most of the facilities that will serve the enterprises are common; and (iv) the Director was convinced that the main reason for the union is not a tax reduction. Moreover the Director may declare that a sole enterprise will be deemed as a number of enterprises, in the following circumstances: (i) There are a number of petroleum fields in the area of the petroleum right of the petroleum enterprise, or that there are a number of kinds of petroleum in separate geological layers that may be derived in industrial quantities; (ii) most of the facilities that will serve the enterprises are separate; (iii) the sale of the petroleum from each field or kind of petroleum is handled separately; and (iv) the Director was convinced that the main reason for the union is a tax reduction.

Before the Taxation of Petroleum Profits Law, 2011 was enacted, special tax benefits were available to holders of petroleum interests as defined under the Income Tax (Deductions from Income of Owners of Petroleum Rights) Regulations, 1956. These deductions were used to create highly leveraged tax shelters, which were severely curtailed by a Supreme Court precedent. The Court held that where the investor in an oil exploration partnership received a benefit by way of a partial refund of their investment from a party interested in the venture, the deduction was to be limited to their "real" outlay expressed in real terms, i.e., was to be capitalized where a low interest bearing loan was used for the expenditure.[1099] Some of the tax benefits still exist and are described in 1. to 5., below.

1. Exploration Expenses

A holder of a petroleum interest is granted the option of treating exploration expenses as either: (i) expenses incurred in the production of income and hence as deductible in the year in which incurred; or (ii) depreciable assets according to the Taxation of Petroleum Profits Law, 2011. The holder of the petroleum interest must exercise this option by no later than the date for the filing of the return for the first tax year in which the exploration expenses were incurred. Once the option has been exercised, the choice of the holder is applicable to all the holder's exploration expenses with respect to the interest for the tax year in which they were incurred and for all subsequent tax years. However, if oil was struck after the option was exercised, the holder of the right may change the election within one year of the strike. Moreover, with the permission of the Commissioner, a holder of a petroleum right may change an election, pursuant to the above, at any time.

2. Cost of Land

Capital expenses incurred by the holder of a petroleum interest for purposes of acquiring land required for the exploration, production or development of the petroleum are allowed as a deduction from income. The deduction is prorated over the period the possessor is allowed to possess the land. Therefore, the amount allowed as a deduction in any taxable year is the amount expended, divided by the number of years during which the holder is allowed possession of the land. A deduction is allowed during the year in which the expense was incurred and in all subsequent years until the entire amount expended has been deducted in full.

Where the right of the holder to possess the land for the acquisition of which the expenditure was made expires before all these expenses were deducted, the undeducted portion of the expenses may be deducted during the tax year in which the right to possess the land expires.

3. Abandonment Losses

Where a holder of petroleum interests abandons or discontinues operations and, as a result, a depreciable asset (i.e., an asset for which depreciation has been accorded under the relevant regulations under the Income Tax Ordinance) has become useless, a deduction from income is granted to the extent of the cost of the asset, less the depreciation deductions taken with respect to it and its salvage value.

4. Carryover

Where the holder of a petroleum interest cannot deduct the full amount of deductions available, owing to the lack of sufficient profits or gains to enable such a deduction, that portion of the allowable deductions not set off against income may be carried over to succeeding years until it is fully absorbed.

5. Oil Exploration Partnerships

Regulations enacted with respect to oil exploration partnerships[1100] widened the scope of the relief afforded to participants in oil and gas exploration. The main purpose of these regulations was to allow for a deduction of the amount paid for the acquisition of partnership units essentially constituting petroleum rights if an equivalent amount was spent on oil and gas exploration by the issuer. Under the regulations, a "partnership" is defined as a registered partnership incurring most of its expenses for purposes of oil and gas exploration, development or production and approved for purposes of the regulations by the Commissioner. (The Commissioner's approval encompasses the terms of the partnership contract, changes therein, the partnership's investment in the exploration and the requirements of various returns.) A "unit" is defined as a unit traded on the TASE and entitling its holder to rights in a partnership, whether those rights are direct rights or partake of the nature of a beneficiary's rights in a trust. A "closed partnership" is a terminated partnership as defined in Income Tax (Rules for the Computation of Tax in Respect of the Holding and Selling of Participation Units in an Oil Exploration Partnership) Regu-

[1099] I.T.A. 87/87 *Inbar v. Assessing Officer Gush Dan*, Missim H-3 (June 1994), E-50.

[1100] Income Tax (Rules for the Computation of Tax in Respect of the Holding and Selling of Participation Units in an Oil Exploration Partnership) Regulations, 1988.

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lations, 1988, and is regarded as a company under the Income Tax Order. "Exploration expenses" are defined by reference to their definition in the Income Tax (Deduction from Income of Owners of Petroleum Rights) Regulations, 1956 (the "Oil Regulations") and include expenses incurred for the current operations of the partnership with respect to oil exploration. Special rules apply to the computation of expenses incurred with respect to the acquisition of geological and other information.

Under the 1988 regulations, an "entitled holder" is deemed to be a holder of a "petroleum interest," and thereby allowed the deductions accorded under the oil regulations. An entitled holder is a holder of a unit who held the unit at the close of the last day of the tax year (December 31) or at the close of the day on which the unit was removed from trading on the Exchange. The provisions of the Income Tax Ordinance and the Income Tax (Inflationary Adjustments) Law regarding the taxation of partnerships (see VIII., above) applied to an entitled holder, pro rata to his share in the partnership, including his share in the partnership's exploration expenses. These regulations also applied to a holder who was not obliged to keep his books of account in accordance with the double entry method, provided that the deduction for inflation would not exceed the amount by which his share of the partnership's capital exceeded his share of the partnership's exploration expenses in that year.

The provisions of the Income Tax Ordinance regarding the taxation of income and capital gains apply to the sale of a unit by a holder ("sale" is defined to include the removal of the unit from the list of traded securities on the Exchange), provided that, in computing the tax applicable on the sale of the unit, the original cost of the unit (for purposes of capital gains tax) is deemed to be the amount paid by the holder for the unit, less the amounts the holder was allowed to deduct, plus amounts included in his income in preceding tax years out of the partnership's expenses and revenues, less amounts paid by the partnership to the holder or to another person on account of the holder's indebtedness. The entire capital gain is deemed to be a real gain. These provisions also applied to the sale of a unit by a holder who was an entitled holder in the preceding year and who was not obliged to keep books of account in accordance with the double entry method, but the amount of the income or capital gain the holder derived from the sale of the unit was reduced by the amount of the inflationary deduction attributed to the holder multiplied by the index of the month before the month of the sale and divided by the index of the last month of the year in respect of which the holder held the unit. If the deduction resulted in a negative figure, the negative figure was deemed to be a business loss.

The provisions of the Income Tax Ordinance regarding the taxation of income or capital gains, as the case may be, also apply to a holder that is not obliged to keep his books of accounts in accordance with the double entry method, and that was not an entitled holder with respect to the same unit in the preceding tax years. However, financing expenses with regard to the acquisition of units are not allowed as a deduction in the computation of the income of a holder that does not keep books of accounts in accordance with the double entry method.

The deductions of an entitled holder with respect to a unit may not exceed the amount paid for the acquisition of the unit, less the amount allowed to be deducted, plus the amount included in the holder's income, less tax deducted at source by the partnership and attributed to the holder with respect to that unit in preceding tax years out of the partnership's expenses and income. In computing the amount allowed as a deduction from the amount included in the holder's income from the holder's share of the partnership's income or expenses because of the holder's possession of the unit, inflationary additions and deductions attributed to the holder by the law were not taken into account.

K. Film Production

Israel promotes the development of its motion picture industry. Generally speaking, expenses incurred in the production of a film are allowed as expenses and therefore do not require amortization.[1101] Thus, the expenses can be offset against other income and are thereby a "tax shelter."

In practice, most ventures count on a number of participants who, at the risk of a tax-deductible loss, seek the chance of obtaining a large return on their investment.

Special regulations were promulgated in 1990 to encourage the production of motion pictures. A "film" is defined in the regulations to include a cinema, video or television film produced in Israel and approved by the special advisory committee to the Motion Pictures Production Encouragement Fund for purposes of the regulations, provided that its production costs exceed a yearly-adjusted amount (NIS 691,161 for 2013, linked to the Israeli price index). The "production of a film" contemplates by its definition all that is necessary to produce the first copy of a film for commercial screening. Expenses incurred both in Israel and abroad are included within the meaning of "film production expenses." "Israeli production expenses" include expenses incurred in Israel for purposes of acquiring services and assets in Israel, except for: (i) expenses that are not allowed as a deduction under certain sections of the Income Tax Ordinance; (ii) expenses incurred for the acquisition of land or of depreciable assets; and (iii) expenses incurred for the acquisition of personal services from a person whose income is not subject to Israeli tax. Also included are expenses incurred abroad and deductible under section 17 of the Income Tax Ordinance, provided they do not exceed 15% of the defined Israeli production costs.

The main thrust of the regulations is to permit a current deduction for an investment in the production of a film. To that end, the regulations envisage both an independent production and a production carried out by a partnership. The latter is defined as a partnership registered in Israel, the entire business of which consists of the production of the motion picture, whether jointly or on its own and that enjoys a right to income from the motion picture at an accepted ratio *vis-a`-vis* its investment therein. The regulations envisage that the partnership will sell "units" to finance the production of the motion picture and to that end, define a "unit" as a unit traded on the TASE granting a right in the partnership, whether directly or indirectly, including the right of a beneficiary in a trust. The latter inclusion is meant to assist in the raising of capital for, under section 3 of the Israeli Partnership Ordinance (New Version), 1975, a com-

[1101] Income Tax (Deductions from Income of Investments in a Film Israel) Regulations, 1990. *See* C.A. 215/87 *Dar'ad Ltd. v. Assessing Officer Ashkelon*, Missim E-2 (Apr. 1991), E-44; and I.T.A. 238/90 *Aloni Zvi v. Assessing Officer Tel-Aviv 3*, Missim G-4 (Aug. 1993), E-94.

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mercial partnership may not consist of more than 20 members. The issuing of units to a trustee does not increase the number of partners and allows the partnership to raise the necessary capital from those willing to take on themselves the risk of production in return for the profits that may be derived therefrom. The regulations define a person holding a unit on December 31 of the tax year, or holding it on the day it was eliminated from trading on the stock exchange, as an "entitled holder." An entitled holder falls within the definition of an "investor," which also includes a person who invested cash directly in a partnership the units of which are not traded on the stock exchange and whose investment, in the opinion of the assessing officer, is reasonable in view of the person's right to the profits of the partnership.

The investor is entitled to a deduction of his/her prorated part of the expenses incurred in the production of the motion picture by the partnership,[1102] for the part of the production effected in that year. The deduction is decreased by the amount that the investor received, directly or indirectly, as a grant or a loan for purposes of making the investment in the motion picture from a person affiliated with the production, from an entity subject to the State Controller's review or from a National Institution, unless the loan was granted on ordinary commercial terms. Income derived from the "pre-sale" of the motion picture is regarded as income arising during the tax year beginning 18 months after completion of the motion picture or when actually received, whichever is earlier, except that, if the deriving of the income was influenced by a special relationship between the parties, it is deemed to have arisen on the execution of the agreement relevant thereto. In short, the regulations allow the cost of the production of the motion picture to be deducted as if it were incurred directly by the holder of the unit or the immediate investor. In computing the taxable income of an investor, the amount deducted is adjusted by reference to the consumer price index at the middle point between the date of purchase of the unit and the end of the tax year.

The regulations impose a limit on the deductible amount. The amount allowed as a deduction, together with those amounts allowed under section 46A of the Income Tax Ordinance (which deals with limitations on amounts allowed as deductions for contributions to charity and R&D), may not exceed 50% of the otherwise taxable income of the investor. In addition, where the investor computes their income in accordance with the laws regulating the taxation of inflationary profits, the investor may not take a deduction in excess of the lesser of: (i) his/her ratable part of the capital investment in the partnership during the tax year, as adjusted from the date of the investment until the end of the tax year in which the investment was made, by reference to the consumer price index (in the years following the year of the investment, the amount invested in the capital of the partnership is the balance of the investment as adjusted for the close of the previous year but less the amounts allowed as a deduction from income); or (ii) the amount that was actually paid for the units or the rights in the partnership as adjusted by the consumer price index for the month during which they were purchased until the end of the tax year. Sums deducted pursuant to the regulations are deducted from this amount, as are sums paid by the partnership on account of liabilities of the investor; and sums included by virtue of the regulations in the income of the investor are added to the amount expended on the purchase of the units or rights, all adjusted in accordance with the consumer price index.

Where a capital gain is derived from the sale of a unit or a right in the partnership, the amounts allowed as a deduction are charged against the costs thereof, all adjusted in accordance with the consumer price index.

Finally, the Regulations require that the production be completed two years after its commencement and that the partnership meet certain conditions with respect to the reporting of its income. All income derived by the investor from the motion picture must be subject to Israeli taxation to enjoy the benefits of these regulations. The regulations are currently in force until December 31, 2015, and are extended periodically.

In 2008, the Law for the Encouragement of Film Production in Israel was enacted. The Law prescribes that an "Israeli production company" will be entitled to a grant based on its production expenses (payments to local residents for the production of a film, the renting or provision of services, and one-shot equipment used in Israel, including interest and other payments designated by Ministerial Order). The grant amounts to 17% in the case of a "foreign production," 13% in the case of a "joint production" in which non-residents finance 75% of the film's cost, and 9% in the case of other "joint productions." The grant is made by allowing the company to decrease withholding tax on payments subject to such withholding, i.e., to retain the grant for itself. Nevertheless, in computing the company's taxable income, only the actual payment is allowed as a deduction. Services provided to a non-resident are zero-rated for VAT purposes, thus allowing the production company to recapture its VAT input tax.

In 2009, the Income Tax (Deductions from Income of Investments in an Israeli Film) (Temporary Provision) Regulations, 2009 were enacted for the tax years 2010–13. The purpose of the regulations is to encourage the production of Israeli films. The regulations define an Israeli film as a film, to which one of the following applies: (i) An Assisting Public Institute (API) entered into an agreement with the producer of the film, in which the API guaranteed to participate to the extent of at least 10% of the production expenses; or (ii) a committee, which was set up according to the regulations, confirmed that the film implemented the requisite conditions for being recognized as an Israeli film. One such condition usually included is that the film's production expenses must be at least NIS 600,000. The regulations provide that: (i) 15% of the expenses in and outside Israel of the production of an Israeli film are deductible against any income; and (ii) expenses outside Israel that exceed the amount of 15% are deductible only against income derived from the film that exceeds the deductible expenses under (i). The taxpayer may elect not to deduct the expenses against capital gains, interest or dividend income if the tax rate on such income is less than 20%.

The regulations were extended and were in force until December 31, 2021.

L. Interest and Linkage Differentials

Of particular interest to non-resident taxpayers are the provisions relating to the exemption of interest and linkage differ-

[1102] C.A. 536/88 *Etz Lavud Taasiot Vehaskaot v. Assessing Officer for Larger Enterprises*, Missim F-6 (Dec. 1992), E-60.

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entials from Israeli tax. In this context, several important provisions of the Income Tax Ordinance deserve special mention.

Section 9(14B) of the Income Tax Ordinance exempts a company from tax on exchange rate differentials accruing on deposits of foreign currency derived from payments by non-residents on account of the acquisition of shares in such a company, where the funds of such deposits were not used, provided, however, that most of the share capital of the company, the voting rights, and the rights to its profits are held by non-residents. This section is aimed at allowing companies raising capital in foreign currency to maintain the amounts received on account of shares in local bank accounts without incurring a tax on the rate differentials resulting from a conversion of these deposits into local currency.

Section 9(15) of the Income Tax Ordinance grants an exemption from tax with respect to "exchange rate differentials on a loan made by a non-resident" except when made by an Israeli PE of the non-resident. This is a most important exemption as it offers non-residents the opportunity to make loans to Israeli enterprises and pay taxes only on the real profit as opposed to the profit attributable to the fluctuations of the Israeli shekel against the foreign currency used to make the loan. This exemption should be read together with section 17(1) of the Income Tax Ordinance, which provides that exchange rate differentials are a deductible expense, and with the former provisions of the Income Tax (Inflationary Adjustments) Law, 1985, which taxed benefits derived by taxpayers from the leveraged acquisition of inflation-proof assets (the Income Tax (Inflationary Adjustments) Law is no longer in force as of January 2008).

An amount received by a non-resident under an insurance policy aimed at insuring against a change in the rate of exchange of the Israeli currency is also exempt from tax where the insurance relates to the principal of a loan made by the non-resident in foreign currency lawfully held by the non-resident or in Israeli currency derived from the lawful conversion of foreign currency and, according to its terms, the loan is repayable in shekels without linkage differentials, provided that the exempted amount may not exceed the amount of the differentials resulting from the change in the rate of exchange of the Israeli currency.[1103]

A non-resident is tax-exempt with respect to "interest on a debenture issued by virtue of a law exempting the holder from tax on the interest if he or she is a non-resident and the interest is payable to a person who was a non-resident when he or she acquired the debenture."[1104] The aim of this provision is to allow for the immigration of persons who were non-residents when they acquired such debentures without incurring negative tax results on the payment of the interest due on the debentures. Interest received by a non-resident on deposits in foreign currency, provided the non-resident does not engage in a business or a profession in Israel, whether in the hands of the state or of a banking institution, is also exempt from tax.[1105] Similarly, interest on fixed term deposits of foreign currency received by a resident of Israel during the first 20 years of their residence in Israel is exempt from tax,[1106] and liable to tax at the rate of 20% thereafter.

Section 16 of the Income Tax Ordinance empowers the Minister of Finance to exempt from tax interest derived by a non-resident not engaged in business in Israel from a loan made to a corporate body, if the loan was made for one of the purposes enumerated in section 1 of the Law for the Encouragement of Capital Investments, 1959. According to this authorization the Minister has issued an Order pursuant to which the interest paid by a body of persons resident in Israel to a non-resident that does not carry on a business or vocation in Israel, on a loan made in foreign currency, is exempt from tax provided the Minister approved the conditions, principal, term and rate of interest of the loan, and the loan is taken out for a purpose enumerated in the Law for the Encouragement of Capital Investments, 1959.[1107]

Pursuant to another Order, issued under section 16B of the Income Tax Ordinance, the income of a "non-residents' mutual fund" in the form of interest, linkage differentials or foreign currency deposited with a banking corporation or paid by the state, as well as interest and dividends on foreign securities, is exempt from tax.[1108] For purposes of the Order, a "non-residents' mutual fund" is a "tax liable mutual fund," which for these purposes is defined in section 88 of the Ordinance, as a fund approved by the Commissioner as a "non-residents' mutual fund" intended exclusively for non-residents, with all units being purchased from funds in non-resident accounts.

By virtue of an Order issued in 1984,[1109] practically all linkage differentials that accrue to an individual outside the pursuit of a vocation or business are tax-free. This Order renders, among others, the following linkage differentials tax-free:

(i) Linkage differentials for property affected by a scheme in accordance with section 197 of the Planning and Building Law, 1965.

(ii) Linkage differentials from the sale of an asset, not including an asset used in business or trade or an asset the sale of which is taxable according to the first Chapter of Part B of the Income Tax Ordinance (ordinary income).

(iii) Linkage differentials for an overpayment of a private expense as defined by section 32(1) of the Income Tax Ordinance, provided the assessing officer is satisfied that no special relation exists between the individual and the payee and the overpayment was made in good faith.

(iv) Linkage differentials paid under law with respect to a sum paid as compensation, for the amount of the claim or for a waiver of the claim provided this sum is exempt from tax or does not constitute income.

[1103] Income Tax Ordinance, s. 9(15A).

[1104] Income Tax Ordinance, s. 9(15C).

[1105] Income Tax (Exemption from Tax on Deposits of Non-residents) Order, 2002 (see XVII.B.1.).

[1106] Income Tax (Exemption from Tax on Interest on Deposits of Foreign Currency) Order, 2002 (see XVII.B.1.).

[1107] Income Tax (Exemption from Tax on Interest Paid by an Israeli Resident on a Loan Made by a Non-Resident) Order, 1988.

[1108] Income Tax (Exemption from Tax of Certain Income of a Liable Non-residents Mutual Fund) Order, 2003. Such a mutual fund is also exempt from tax on its profits from the sale of Israeli traded securities if acquired subsequent to their registration for trade, on future transactions and on foreign securities.

[1109] Income Tax (Exemption from Tax on Linkage Differentials) Order, 1984.

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(v) Linkage differentials derived from the annulment of the acquisition of an asset, provided the assessing officer was satisfied that both the acquisition and the annulment were made in good faith.

(vi) Linkage differentials on a loan made by one individual to another individual provided that:

(vii) The loan was made by the lender not in the course of the lender's business or vocation and was not recorded in the books of account of that business or vocation; and

(viii) The lender supplied written approval from the assessing officer to the effect that the linkage differentials are not a deductible expense for the borrower and are not or cannot be added to the cost of the borrower's assets;

(ix) Linkage differentials received by an individual with respect to a deposit at the time of its repayment, on condition one of the following holds true:

(x) A deposit was repaid and linkage differentials were paid to an individual after the departure of the individual from an old age home in which he or she lived, on condition that the individual is at least 65 years old at the time of the repayment and payment;

(xi) A deposit was repaid and linkage differentials were paid to an individual after he or she waived his or her right to be admitted to an old age home, on condition that: the individual is at least 65 years old at the time of the repayment and payment and that at least two years have elapsed since the deposit was made; or it was proven to the assessing officer's satisfaction that the individual paid the amount of the deposit and linkage differentials immediately after his or her acceptance by another old age home; or

(xii) A deposit and linkage differentials were repaid to the heirs of the person who made the deposit.

If two spouses made deposits for purposes of their admission to the same old age home, and if one of them reached the age of 65, then — for purposes of the above first two subparagraphs — their spouse is also deemed to have reached the age of 65.

The respective definitions as stated in that subparagraph are as follows:

(a) "Deposit" — a deposit made by an individual with a company to be admitted to an old age home owned by the company where — under the rules of admission to the old age home and in accordance with the agreement between the individual and the company — the individual is entitled to a refund of all or part of the deposit if he/she leaves the old age home or waives his/her right to be admitted to it, or where the individual's heirs are entitled to a refund of a deposit on his/her death, on condition that the amount of the deposit and the terms of agreement do not differ from those customary in this economic sector;

(b) "Old age home" — a permanent place of residence for at least 50 individuals aged 65 or more that holds a license under the Homes (Supervision) Law, 1965; and

(c) "Company" — includes cooperative societies or nonprofit organizations, and also includes partnerships between companies, cooperative societies and nonprofit organizations.

M. Apartment Rental and Construction of Rental Dwellings

In 1981, the Israeli parliament passed the Income Tax Law (Encouragement of Apartment Renting) (Temporary Measures and Law Amendments), 1981. The primary objective of this law was to induce the holders of apartments to rent them out and to encourage building contractors to build new rental dwellings. Under the Law, the owner of an apartment that was rented during the tax year for at least 10 months was entitled, at his/her request, to deduct from his/her income 3% of the value of the apartment (adjusted in accordance with the rise in the consumer price index) in lieu of the normal depreciation allowances. Where the apartment was rented for a period of less than 10 months during the tax year, the deduction was prorated according to the number of months during which the apartment was rented. The main benefit derived from this law by apartment owners was the revaluation of the original purchase price of the apartment for purposes of the special depreciation deduction.

This law was abolished for the tax year 1989 and following years. The Minister of Finance was authorized in section 21(d) of the Income Tax Ordinance to promulgate regulations with the approval of the Knesset Finance Committee to authorize the revaluation of apartments for purposes of depreciation relief, which, with effect from 1990, is set at 2% of the adjusted value.[1110] Some rental buildings qualify for alternative tax relief under the Law for the Encouragement of Capital Investments, 1959, and the Law for Encouragement of Rental Apartments Building, as discussed in XVII.A.4., above.

Yet, another option is offered by the Income Tax (Exemption from Tax on Rental of an Apartment) Law. Pursuant to this law, an individual deriving residential rental income during a tax year is exempt from tax on such income, provided it does not exceed the sum of approximately NIS 5,654 as of 2024, for any month during that tax year. For purposes of the exemption, any rental income of a spouse residing with the individual or a child of the individual up to 18 years of age is deemed to be the individual's income.

Within the framework of the 2003 Reform and the efforts to widen the tax base, section 122 of the Income Tax Ordinance was amended. Prior to the Reform, section 122 provided for a 10% tax on the income (gross) derived from the renting of a residential dwelling insofar as this amount did not exceed a statutory limit. The Reform amended section 122 by eliminating the statutory limit. The reduced tax rate of 10% is conditioned on the income not being derived from a business and on the payment of the tax within 30 days of the receipt of the rent. The election for the reduced rate under section 122 prohibits the deduction of depreciation on the rental dwelling as well as any other expenses incurred in relation to the rental activities.

An owner of a single apartment who simultaneously rents it out for residential purposes, and rents an apartment for his or her own residence, may deduct the rent he pays as a tenant

[1110] Income Tax (Rate of Depreciation for an Apartment Rented for Residential Purposes) Regulations, 1989.

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(up to NIS 90,000 a year) from the rent he or she receives as a landlord/landlady and pay tax at a 10% rate only on the difference.[1111]

Section 122A of the Income Tax Ordinance, which was added in 2003, provides for a reduced rate of 15% on rental income from any real estate derived by an individual from a source outside Israel, insofar as such income is not derived from a business and no expenses are deducted against the rental income. Unlike section 122 (discussed above), depreciation allowances are allowed in computing the taxable income liable for the 15% tax rate. No credit for foreign tax is available once a taxpayer has elected to pay the tax under section 122A with respect to the income so taxed.[1112]

N. Apartment Sales

The Taxation of Land (Appreciation and Purchase) Law, 1963 (formerly known as the Land Appreciation Tax Law, 1963) provided an exemption from tax for capital gains derived from the sale of a "qualifying residential apartment," defined as a dwelling used for residence for: (i) a period of four years prior to the sale; or (ii) a period equal to 4/5 of the period of appreciation of the dwelling.[1113] Prior to Amendment no. 76, the exemption was granted if either of the following applied:[1114]

(i) The qualifying residential apartment was the taxpayer's only residence in Israel, and the taxpayer did not sell any residence tax-free during the 18 months preceding the sale under consideration; or

(ii) The taxpayer did not sell another residence tax-free during the four years preceding the sale under consideration.[1115]

However, it should be noted that the second alternative was abolished in Amendment no. 76 of the Taxation of Land (Appreciation and Purchase) Law, 1963, as further detailed below.

A 1993 amendment[1116] annulled a former controversial precedent,[1117] according to which if a sale of an apartment was necessary in the process of the distribution of an estate it was tax-exempt under section 4 of the Land Appreciation Tax Law, 1963. According to the amendment, a sale of an apartment in the course of dealing with an estate is deemed to be a sale by the heirs, and therefore subject to tax according to the special circumstances of each heir (for example, prior sales made by the heir, etc.).

A 1997 amendment (which was followed by several additional amendments)[1118] altered the conditions for exemption under the Law. In general, the amendment denied the exemption with respect to apartments that were not used for a certain period for residential purposes (mostly such apartments were used as offices). The amendment grants certain relief to owners of two small apartments who wish to sell them and purchase an alternative apartment instead. The amendment may be summarized as follows:

(i) Denial of the exemption on the sale of an apartment not used for "residential purposes:"

- Prior to the enactment of the amendment, the exemption applied to an apartment that was designated for "residential purposes," even if the apartment was in fact used for other purposes (such as an office).
- The amendment applies the criterion of actual use of an apartment strictly for "residential purposes." Quantitative criteria were established for the area (50%) and time dimensions.
- A later amendment provides that educational activities (such as those of nurseries and kindergartens) and religious activities (such as those of synagogues) are regarded as "residential purposes" and are therefore exempt. The nature of a dwelling for these purposes is to be determined by the Minister of Finance in regulations to be approved by the Knesset Education Committee.
- As to the time dimension, the period for "residential purposes" must equal at least 80% of the period during which the relevant appreciation took place, or the four years preceding the sale under consideration during which no sale of a residential apartment took place.

(ii) Restriction of the exemption for owners of single apartments:

- The amendment provides that the exemption for an owner of a single residential apartment applies only if, during the 18 months preceding the sale under consideration, no other similar sale took place; and
- The amendment provides that the seller may sell his or her old apartment within a period of one year from the date of purchase of the alternative apartment (instead of nine months, as provided for prior to the amendment).

Section 49E of the Land Taxation (Appreciation and Purchase) Law, 1963 is a special provision granting a resident individual an exemption from tax on the sale of an apartment, even if the individual fails to meet the requirements of section 49B of the Law. Under section 49E, on the sale of a "qualifying residential apartment," a resident will be granted an exemption from tax if all the following conditions are fulfilled:

(i) He or she sold another tax-exempt apartment ("the first apartment") in accordance with Chapter 5 of the Law within the 12 months preceding the tax-exempt sale under consideration;

(ii) The aggregate value of the first apartment together with the apartment sold ("the second apartment") does not exceed NIS 1,986,000; and

(iii) He or she purchased during the year prior to the sale of the second apartment, or will purchase within the year succeeding the sale, another apartment (defined as a "res-

[1111] Income Tax Ordinance, s. 122(f).

[1112] Income Tax Ordinance, s. 122A(b).

[1113] Land Taxation (Appreciation and Purchase) Law, 1963, s. 49.

[1114] Land Taxation (Appreciation and Purchase) Law, 1963, s. 49B.

[1115] Pursuant to an Ad-Hoc Law, during the five years between 1992 and 1996, the sale of an apartment was exempt from land appreciation tax at the vendor's request provided certain conditions were met. Special provisions applied to apartments received as gifts and to inherited apartments.

[1116] Land Appreciation Tax Law (Amendment No. 24), 1993.

[1117] C.A. 499/85 *Shpaer v. Land Appreciation Tax Commissioner*, Missim D-5 (Oct. 1990), E-42.

[1118] Land Appreciation Tax Law (Amendment No. 34), 1997; Land Appreciation Tax Law (Amendment No. 36), 1997.

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idential apartment") in Israel or in the region, for at least three quarters of the aggregate value of the two apartments referred to above in (ii).

Furthermore, notwithstanding the provisions of section 49B of the Law, where (i) and (ii) apply where a resident individual sells a second apartment, and the aggregate amount of the first and the second apartment together does not exceed NIS 3,303,000, the individual will be entitled to a tax exemption on the sale of the second apartment, on the amount equal to the difference between NIS 1,986,000 and the sale price of the first apartment. The balance of the price of the second apartment will be regarded as a payment for another land right bearing the ratio that the consideration for the apartment bears to the entire sale consideration.

The prices referred to above are adjusted at the beginning of each tax year.

An exemption under this section will only be granted once.

However, to cool the real estate market, a provisional provision in effect from January 1, 2011, until May 5, 2013 (originally, until December 31, 2012), provided that a sale of two apartments would be exempt from appreciation tax provided the value of each sold apartment did not exceed NIS 2,200.[1119]

Another provisional provision in effect from August 1, 2011, until June 30, 2013, provided that the sale of an apartment that did not qualify as a "qualifying residential apartment" and, therefore, was not entitled to the appreciation tax exemption, would be entitled to an appreciation tax exemption according to the aforementioned provisions and under the following conditions: (i) the seller did not receive the apartment as a gift between June 5, 2011, and June 30, 2013; (ii) the apartment was not sold to a relative; and (iii) the apartment would serve as a residential dwelling for at least two years after its purchase. If the apartment would not be so used during the two years, a purchase tax at the rate of 15% would be levied on the purchaser. This appreciation tax exemption was available in addition to the other appreciation tax exemptions so that three exemptions were available during the said period.

If, when a qualifying residential apartment is sold, the price paid was affected by existing or anticipated options for building an area larger than the area of the existing apartment, the seller is entitled to an exemption, equal to the sale value up to the amount that is expected to be derived from the sale of the apartment. If the value of the apartment is less than NIS 1,777,600, the seller is entitled to another exemption, equal to the difference between NIS 1,777,600 and the value of the apartment, whichever is lower. The total exemption amount for selling an apartment whose construction and purchase was completed by April 1,1997 may not be lower than NIS 445,500.

To further try to deal with the increasing prices in the Israeli residential real estate market, and decrease the demand for residential properties, the Israeli legislature promulgated Amendment no. 76 to the Land Taxation (Appreciation and Purchase) Law, 1963 as part of the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014) which provided significant amendments with respect to the exemption from land tax on the sale of apartments.

Generally, as of January 1, 2014, only the owner of a single apartment is entitled to the exemption from land tax on the sale of an apartment.[1120] The exemption from land tax provided with respect to the sale of an apartment every four years was abolished.

It should be emphasized, that the provisions of Amendment no. 76 also significantly affect foreign investors who wish to invest in the Israeli residential real estate market. The provisions of Amendment no. 76 provide, inter alia, that foreign residents seeking to utilize the "single apartment exemption" as provided in section 49B to the Land Taxation (Appreciation and Purchase) Law, 1963 should provide a certificate from the tax authorities in their country of residence, providing that such foreign residents do not own an apartment in their country of residence.

In addition, the exemption from Land Appreciation Tax provided with respect to owners of single residential apartments is limited to the amount of NIS 4.5M. As a result, any consideration received above the amount of NIS 4.5M will be subject to tax at the rate of no more than 25%.

O. Capital Investments in Agriculture

The Law for the Encouragement of Capital Investments in Agriculture, 1980 came into effect on April 1, 1981. This law is modeled after the Law for the Encouragement of Capital Investments, 1959. Section 1 states its three primary objectives: (i) the improvement of the balance of payments of the state through the development of the export of agricultural products and the development of substitutes for imported produce; (ii) the efficient exploitation of the natural conditions of Israel, its economic ability, technical knowledge and experience in the agricultural field; and (iii) the encouragement of the agricultural sector as a pioneering, defense, and social factor.

To attain these objectives, section 2 of the Law for the Encouragement of Capital Investments in Agriculture, 1980 provides grants, exemptions from tax, reductions of tax, and other tax relief on the basis of an "approved plan." The Law establishes an Agricultural Investment Center, which is in charge of its implementation. To enjoy the benefits of the Law, a "plan" must be submitted and approved, and thereby become an "approved agricultural enterprise."

Such an enterprise is entitled to a grant in aid in the amount of 10% to 20% of the cost of the investments in it and its infrastructure, depending on the geographical location of the enterprise.[1121] The grants are tax-free; however, they are not taken into account for purposes of computing depreciation under section 21(b) of the Income Tax Ordinance. Section 31 of the Law

[1119] Taxation of Land (Increasing the Supply of Residential Apartments — Provisional Provision) Law, 2011 s. 6, as extended.

[1120] It should be noted that, according to the Appeal Committee's ruling in the A.P. 1346/08 *Tel-On Ahzakot Vepituch 1990 Ltd. v. Land Tax Authorities*, Missim KG/2 (Apr. 2013), E-399, a "family company" (which is a pass-through entity) is not entitled to the exemption from land tax on the sale of an apartment.

[1121] Law for the Encouragement of Capital Investments in Agriculture, 1980, s. 24, as amended in the Law for Regularization in the State's Economy (Law Amendments for the Achievement of Budget Objectives) 1996, s. 5. The division of the country into two zones (A and B) is provided in the Decree of Encouragement of Capital Investments in Agriculture (Determination of Development Zones A and B), 2013.

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for the Encouragement of Capital Investments in Agriculture, 1980 grants accelerated depreciation at 200% of the rates fixed under the regulations issued in accordance with the Income Tax Ordinance pertaining to personal property and at 400% of the ordinary rates (but not to exceed 20% a year) with respect to real estate. In extraordinary cases, where the wear and tear of chattels is more rapid than usual, the rate granted under section 32 of the law is 250% of the ordinary depreciation rates. A company owning an approved agricultural enterprise is liable for up to 25% company tax and no further direct tax is charged on its income. Dividends distributed by a company out of income derived from an approved agricultural enterprise are subject to a 15% tax. An individual owning such an enterprise is subject to income tax at a maximum rate of 30%. Under section 33 of the Law, companies distributing dividends out of dividends received from companies owning approved agricultural enterprises pass through the 15% rate on distributed dividends. The special income and corporate tax rates are granted for a period of five years from the year in which the approved agricultural enterprise first derived taxable income, provided that not more than 12 years have elapsed since the granting of approval. The board may, in special circumstances, extend the 12-year period. Dividends are taxed at the special tax rates during these five years and for a period of 10 years thereafter.

Special rules were promulgated in January 1986 concerning the calculation of the taxable income of an approved agricultural enterprise.[1122] Under the rules, the taxable income of an approved agricultural enterprise is computed by attributing to the approved enterprise the relative part of the overall income of the agricultural enterprise (from both approved and nonapproved parts), according to a formula based on the proportion of "units" (animals or square meters, as applicable to the enterprise in question) used in the approved part of the enterprise to the overall amount of units used by the enterprise.

An alternative benefits option is offered in lieu of all the tax benefits and grants referred to above. This option is available to a company owning an agricultural enterprise approved after January 1, 1992 (or prior to that date, provided it did not receive a state grant on account of the approval). The alternative benefits option grants a tax exemption for chargeable income for five years from the year in which the enterprise first derived chargeable income, provided that not more than 12 years have elapsed since the granting of approval; however, in special circumstances, the Board may at its discretion extend this period. If the company distributes dividends out of its exempt income, it is liable to company tax on the amount distributed at the rate it would have been subject to, had it not opted for the alternative benefits, i.e., at the rate of 25%.

The tax exemption under the alternative benefits does not apply to a company renting equipment or renting a building with an option to buy it, or renting a building owned by a person affiliated to the company, all of which (equipment or building) received a state grant on account of the company being an approved enterprise.

[1122] Encouragement of Capital Investments in Agriculture (Computation of Taxable Income in an Approved Agricultural Enterprise) Rules, 1986.

P. Eilat Free Trade Zone

The free trade zone in Eilat (Tax Exemptions and Reductions) Law, 1985 offers handsome advantages that partake of the nature of a reduction in both direct and indirect taxes with regard to the Eilat zone (Israel's southernmost port).

Section 3(a) of the Free Trade Zone in Eilat (Tax Exemptions and Reductions) Law, 1985 grants an exemption from "indirect taxes" with respect to the "import of goods into the Eilat zone," provided these goods are to be sold by a specially authorized vendor to tourists or Israeli residents leaving the country via air or sea, and provided further that the goods are paid for in foreign currency. The sale of goods manufactured in Israel and sold to such a vendor is deemed, for all purposes, to constitute their export from Israel. Permits are issued in accordance with regulations, subject to certain conditions specified therein.

The exemption from value added tax (VAT) on the import of goods into the Eilat Zone for the purposes of sale and consumption in the same area is limited in that it does not apply to certain goods. The sale of land in the Eilat zone is free of VAT; however, if the real estate is owned by an association categorized as a "real estate association," the sale of the shares of the company is exempt only when all the land belonging to the association is located in the Eilat Zone.

Services rendered in the Eilat zone by its residents are exempt from VAT; however, where the services are rendered with respect to an asset or an event, the exemption is limited only to the performance of services in connection with an asset located in the Eilat Zone or an event occurring in the Eilat zone.

Zero-rate VAT is imposed on certain transactions relevant to the Eilat zone. The zero-rate VAT is imposed on the sale of goods by a "dealer" who is not a resident of the Eilat zone to a "dealer" who is so resident, where the goods are used for the latter's business, and also on certain services rendered by a dealer who is resident in the Eilat zone, provided the services are for the latter's business conducted in the Eilat zone.

Yet another benefit conferred on persons deriving income in the Eilat zone is a total exemption from the employers tax, as imposed by the Employers Tax Law, 1975. The normal rate of the tax in other areas is 0% as of June 1992, and therefore Eilat residents do not currently derive any advantage or relief as regards the employers tax.

Individuals residing in the Eilat zone or in the Eilat Regional Council were entitled to a tax credit at the rate of 10% of their chargeable income, up to the amount of 227,640 NIS, if the income originated from a business, vocation or employment in the Eilat zone.

An employer resident in the Eilat zone and paying employment income for work carried out in the Eilat zone is entitled to a special deduction of 20% of the employment income paid by him, but that may not exceed the taxes that should have been withheld from that employment income.[1123] This benefit was conferred on employers in the Eilat zone to encourage

[1123] An amendment to the Free Trade Zone in Eilat (Tax Exemptions and Reductions) Law, 1985 determines that the deduction is computed for each employee separately; thus, employees under the tax threshold do not entitle the employer to a deduction.

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them to increase their payrolls and to reduce the effective cost of labor in this special area of the country.

The free trade zone in Eilat (Tax Exemptions and Reductions) Law, 1985 defines the "Eilat Zone" as the city of Eilat; however, by virtue of section 17 of the Law, it also applies to any individual or "body of persons" (corporation) operating within one kilometer from the borders of the town, provided that the individual or body of persons meets all the other requirements specified in the special definition of an "Eilat zone resident." By virtue of this same section 17, this condition also applies to goods imported into, or existent or sold in the one kilometer area. Services rendered in the same area also entitle the taxpayer rendering them to the special benefits of the Law.

"Eilat zone resident" is a definition reserved for both individuals and companies. When applied to an individual, it refers to a natural person who permanently resides in Eilat and has resided in the city for at least three consecutive months before applying for a benefit available under the free trade zone in Eilat (Tax Exemptions and Reductions) Law, 1985.[1124] When applicable to a "body of persons," as defined in the Income Tax Ordinance, the Law refers to a business that is run in the Eilat zone, is registered as a "dealer" under the Value Added Tax Law, 1975, and meets the special prescriptions with respect thereto.[1125] The term "import into the Eilat zone" refers to any direct import of goods into the Eilat zone, including imports through the Eilat free trade port and imports through any other area in Israel when the goods are transferred to the Eilat zone under the control of the customs authorities.

For purposes of the law, "indirect taxes" refer to customs tax, purchase tax, excises or levies in accordance with the Emergency Regulations (Compulsory Payments), 1958,[1126] and deposits that are, in some instances, required as a condition for the import of certain goods.

Finally, Eilat is also a free trade port and, under special regulations issued in 1985, further benefits were conferred on enterprises in the Eilat free trade port area. First, chargeable income of a licensed enterprise[1127] in the free trade port area is exempt from income tax for a period of seven years from the year in which income was first derived. Second, on the expiration of its seven-year period, the income of an enterprise is not subject to company tax at a rate in excess of 30% (with the present company tax rate being lower, this relief is of no value). Dividends paid out of such income are subject to a 15% tax. Moreover, in computing capital gains, a licensed enterprise is exempt from the 10% tax usually levied on the "inflationary amount," i.e., the amount representing the inflationary part of the capital gains until the end of 1993. Third, total exemption from capital gains tax is granted if the seller of a right in the enterprise is a foreign resident who acquired the right with foreign currency. Fourth, the assets of a licensed are exempt from property tax (currently the rate of property tax is zero, but the tax has not been abolished). However, it should be noted that the aforementioned incentives are actually not available as the free trade port committee was never established, and therefore, the "licensed enterprise" status was never granted.

Q. Employee Stock Option Plans

Section 102 of the Income Tax Ordinance, as amended by the tax reform of 2003, provides tax relief by means of designated employee stock option plans (ESOPs).[1128] The Ordinance distinguishes between trustee-ESOPs[1129] and other ESOPs that do not involve a trustee. Trustee ESOPs are divided for tax purposes into two taxation categories, discussed in 1. and 2., below.

1. Employment Income Category

The employee is not taxed on the allocation of the stock. Taxation is thus deferred until a gain is realized by the employee.[1130] This category taxes the income derived by the employee (on realization) as employment income, and a corresponding deduction is allowed to the employer.

2. Capital Gains Category

Like the employment income category (see 1., above), the capital gain category allows for tax deferral on the allocation of the stock. The employee is taxed only on the realization of the gain, but in this case the gain is considered a capital gain liable for tax at the rate of 25%. The employer however, is not entitled to any deduction (not even the amount taxed at the employee's level).

3. Other Employee Stock Option Plans

Other ESOPs (i.e., those that do not involve a trustee) are taxed as follows. On the allocation of the option, the employee is deemed to receive employment income. The realization of capital gains thereafter is taxed according to the regular rules of the Income Tax Ordinance. The exception to this rule concerns the allocation of options that are not registered on a stock exchange. Such an allocation is taxed as employment income at the time of realization by the employee.

Section 102 of the Income Tax Ordinance also provides for a series of administrative rules to be decreed by the Minister of Finance in regulations.

[1124] Working in Eilat for four days a month, as a dentist, and spending 12 nights a month there, especially on weekends, is insufficient to confer qualification as a resident of the zone: *see* C.A. 1117/92 *Londner v. Excise and VAT Department*, Missim G-3 (June 1993), E-59.

[1125] *See* D.A. 1627/99, *Dan Grossman Architects Eilat 1993 v. V.A.T. Eilat*, Missim 0-5 (Oct. 2001), E-24; C.A. 9453/10 + 2641/12 *Israir Aviation and Tourism Ltd. and Others v. the Assessing Officer of Eilat and Other*, Missim KH/4 (Aug. 2014), E-65.

[1126] These emergency regulations were repealed in 1991, but not deleted from the Free Trade Zone in Eilat (Tax Exemption and Reductions) Law, 1985; Orders issued according to the Emergency Regulations (Compulsory Payments) 1958, were in effect, at the latest, through 1992. *See* Levy on Commerce Law, 1991, ss. 64 and 65.

[1127] The "licensed enterprise" status is granted by the Free Trade Port Committee. Such a committee was supposed to be established under the Free Trade Port Areas Law, 1969.

[1128] The tax relief is granted with respect to both shares and options.

[1129] For an employee stock option plan (ESOP) to be considered a "trustee ESOP," the shares (or options) must be deposited with the trustee for a period of at least 12 or 24 months (depending on the taxation track — employment income or capital gains, respectively), a notice must be given to the Assessing Officer at least 30 days prior to the allocation, and the Assessing Officer's approval is required.

[1130] That is to say, on the earlier of: the receipt of the stock from the trustee or the disposal of the stock.

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R. Seed Companies

Section 20 of the Law for Increasing the Economic Efficiency (Legislation Amendments for Implementation of the Economic Plan for the Years 2011–2012), 2011 — known as the "Angel law" — was enacted to induce investments in high tech companies at the seed stage, during which they are engaged in the first phase of their R&D, when high risk is involved. According to section 20, an individual or a partnership of individuals will be entitled to deduct their investment in such company to the extent of NIS 5 million against income from any source ("qualifying investment"). Thus, the cost of the investment (shares) is deductible also against income which is taxable at a marginal rate reaching 47% (instead of a deduction of the original cost only upon the sale of the shares which will give rise to capital gains tax at the rate of 25%). The deduction will extend over three years, as of the year in which the investment was made ("benefit period"). The annual deduction amount will be determined by the investor. The investor may deduct the full amount of the investment in the first year of the benefit period.[1131] The investment can be made in either of the following companies:

A target company—

(i) The company was incorporated in Israel and its business is controlled and managed from Israel;

(ii) During the benefit period, the company's shares were not listed for trade on a stock exchange;

(iii) At least 75% of the investment is used for R&D expenditures, not later than the end of the benefit period. Until the year in which this condition is met (including that year), at least 70% of the company's annual expenditures are R&D expenditures;

(iv) At least 75% of the R&D expenditures incurred during the Benefit Period were incurred in Israel;

(v) During the first two years of the three-year Benefit Period, the company's income did not exceed half of the R&D expenditures; and

(vi) During the benefit period, the R&D expenditures were incurred to further and enhance an enterprise owned by the company.

A starting company—

(i) The company was incorporated in Israel and its business is controlled and managed from Israel;

(ii) The investment was made within 48 months (60 months if the company operates in national priority zone A) from the date of the company's incorporation, and within 12 months from the day in which the company was given a grant for starting companies (if such grant was given);

(iii) Prior to the date of the investment:

- The annual sales turnover did not exceed NIS 2 million, and the cumulative sales turnover did not exceed NIS 4.5 million;
- The annual expenditure did not exceed NIS 3 million, and the total expenditure did not exceed NIS 12 million;
- The total amount of investment in the company (including the qualifying investment) and loans granted to the company did not exceed NIS 12 million;
- At least 70% of the company's expenditure was incurred on a product based on R&D performed by the company; and
- The product and all the rights deriving therefrom are owned by the company from the date on which the product was created.

The significant advantage of investment in a starting company — compared to investment in a target company — is that, on the date of the investment, it is possible to determine whether the company is considered a starting company.

To be entitled to the tax benefit, additional conditions must be met:

(i) The investment in target company must be made between January 1, 2011, and December 31, 2019, and regarding a starting company, between January 1, 2016, and December 31, 2019;

(ii) The investment must have been made in cash;

(iii) In return for the investment, the investor must have been issued shares which the investor held during the entire benefit period; and

(iv) Avoidance or undue reduction of taxes is not one of the primary objectives of the investment.

In effect, this tax relief seeks to grant equal fiscal treatment to a direct R&D investment (section 20A of the Ordinance) and to an indirect investment by means of the acquisition of shares.[1132]

S. Small High Technology Israeli Companies

A company investing in a small Israeli high-tech company will be entitled to write off its investment in five years in equal installments. The write-off will be granted where the investing company purchases the shares of the target company not by way of an allotment, as a set off against its income during five tax years commencing with the year of acquisition.

The amount allowed as a write-off is limited to the excess of the investment over the company's own capital (the value of know-how and goodwill of the target company which were not reflected in its financial statements) in order to deny a deduction for assets already depreciated by the target company or for assets purchased by the target company and ineligible for depreciation (cash and monetary assets).

The net result is the advance of the reduction of the basis from the gain achieved upon the sale of the shares whereupon the write-off is recovered.

The following conditions must be met to obtain the write-off:

[1131] Income Tax Circular 12/2011, s. 9.2.

[1132] The Law for Increasing the Economic Efficiency (Legislation Amendments for Implementation of the Economic Plan for the Years 2011–2012), 2011, s. 20.

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(i) The purchase was made between January 1, 2011, and December 31, 2015;

(ii) The purchase will accord the purchaser 80% of the controlling interests of the target company;

(iii) On the day prior to the acquisition, the target company and the acquiring company were unrelated;

(iv) Avoidance or undue reduction of taxes is not one of the aims of the acquisition as certified by the Director General of the ITA;

(v) During the year of the investment, the target company's shares are not registered for trade on a stock exchange; and

(vi) The target company and the acquiring company fulfill the following conditions during the year of acquisition and the entire write-off period:

- The companies are beneficial or preferred companies;
- The R&D expenditure of the acquiring company and the target company constitutes at least 7% of their income and at least 20% of the employees of each company hold an academic degree and are employed in the field of their studies (during the year of acquisition the above figures are 25% and 40%, respectively, for the target company so as to ensure that is in the nature of a start-up company engaged in R&D in relation to the acquiring company);
- During the year of acquisition, the target company will not own land or a right in a real estate association in Israel or abroad and will not own shares in any corporation unless the activities of the latter are ancillary to its own activities; and
- All the R&D expenses incurred by the target company during the five-year write-off period are for purposes of furthering and advancing an enterprise owned by it or by the acquiring company and at least 75% of those expenses were incurred in Israel.

If during any year the conditions were not met, the write-off is denied without prejudice to the preceding or succeeding years during which the conditions were met, provided the five-year period did not elapse and that a denied write-off will not be written-off in a succeeding year.[1133]

[1133] The Law for Increasing the Economic Efficiency (Legislation Amendments for Implementation of the Economic Plan for the Years 2011–2012), 2011, s. 21.

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XVIII. Avoidance of Double Taxation

A. Foreign Tax Credit

1. Basis of Taxation

As of January 2003, the Israeli tax basis underwent a major reform pursuant to which it shifted from being primarily a territorial system to a tax system based on the personal nexus of the taxpayer to Israel, with the required nexus being residence. As a result, Israeli residents are taxed on their worldwide income. Nonresidents are taxed only on income, including capital gains, sourced in Israel. This change required the enactment of special rules to avoid double taxation and to enforce provisions of treaties designed to prevent double taxation.

2. Foreign Tax Credit

In principle, Israel allows a credit for foreign tax provided it does not exceed the Israeli tax payable on the foreign income concerned.

Israel taxes income by attributing it to a specific source. Therefore, the foreign tax credit system is devised to be based on the attribution of the foreign income to its enumerated source in the Income Tax Ordinance and thus limited the "spillover" of unused foreign tax credit against tax on other foreign income on which the Israeli tax was higher than the foreign tax. This system is known in the local jargon as the "basket system."

a. In General

In general, the foreign tax credit offered by Israel credits the foreign income taxes levied on non-Israeli sourced income from a specific source against the Israeli income levied on the same income from the same source (the same "basket"). Section 199 of the Income Tax Ordinance defines "foreign income from a specific source" as "foreign income categorized in accordance with the sources of income enumerated in section 2, Part E or Part E-3, after deduction of expenses allowed therefrom and losses allowed as a setoff against it, all in accordance with the provisions of the Ordinance."

The Tax Authorities take the position that they may establish "sub-baskets" of income from a specific source. Thus, while section 2(4) of the Income Tax Ordinance enumerates one source as "dividends, including dividends paid out of capital gains of a company, interest, linkage differentials and discount," the Tax Authorities contend that dividend income constitutes a separate source of income and is therefore different and separate from income derived from interest or linkage differentials.[1134]

b. What Is a Foreign Tax?

Section 199 of the Income Tax Ordinance defines "foreign tax" as "taxes paid by an Israeli resident to tax authorities of a State other than Israel, on income derived or accruing in that State, including taxes paid to States which are part of a Federation or to Regional Authorities who form part of that State, which are computed as a percentage of the income, excluding municipal taxes."

c. Credit Method

Foreign taxes, converted into Israeli currency (NIS), paid on foreign-source income liable to tax in Israel are allowed as a credit against the Israeli taxes levied on that foreign income under the Income Tax Ordinance, but no credit will be accorded unless the taxpayer is a resident of Israel during the tax year in which the foreign tax credit is taken advantage of.[1135]

d. Israeli Exempt Income

Under section 201(a) of the Income Tax Ordinance, a foreign tax credit will be accorded only with respect to foreign income liable to Israeli taxes. No credit will be given for a foreign tax payable with respect to income not taxed by Israel. However, relief accorded to a taxpayer who made use of the special provisions granting relief from Israeli taxes on dividends payable by companies who paid Israeli taxes on the income out of which the dividends were distributed[1136] will be deducted from the tax payable under the Ordinance on such dividends.[1137]

e. Israeli Resident Corporations

The amount of the foreign tax credit to which an Israeli resident corporation will be entitled with respect to foreign income from a specific source may not exceed the amount of the corporate tax for which it is liable with respect to that income.[1138]

With respect to dividends, the Income Tax Ordinance allows companies to choose between two methods of crediting the foreign tax levied thereon.

One method is the "indirect credit." Under this method, the foreign income will be liable to Israeli tax at the company tax rate, against which will be applied by means of a credit the foreign tax levied on the income of the company (underlying tax) as well as the tax withheld at source on the distribution of the net dividend.[1139] Naturally, the credit in such cases is limited to the amount of the Israeli company tax payable on the foreign-source income.

The other method is a "direct credit." In this case the dividend income is taxed at the flat rate of 25% after being grossed up for the foreign tax and a credit is allowed for the foreign tax withheld on the dividend but not for the underlying tax.

f. Individuals

An individual resident in Israel is entitled to a foreign tax credit with respect to any foreign income from a specific source provided the income is not subject to a special rate of tax in Israel, and the credit does not exceed the "credit ceiling" computed by multiplying the entire tax due on the ordinary income of the individual, prior to any credit for the foreign tax, by the ratio that the foreign income from a specific source not subject to a special rate of tax in Israel bears to the entire ordinary in-

[1134] Income Tax Circular 26/2002.

[1135] *See* Income Tax Ordinance, s. 200(b).
[1136] *See* Income Tax Ordinance, s. 163.
[1137] *See* Income Tax Ordinance, s. 201(b).
[1138] *See* Income Tax Ordinance, s. 203(a).
[1139] *See* Income Tax Ordinance, s. 126(c) and s. 203(b).

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come of the individual. Where the foreign income is subject to a special rate of tax in Israel, the foreign tax paid thereon may be credited to the extent of the Israeli special rate tax levied thereon.

g. Excess Credits

In accordance with section 205A of the Income Tax Ordinance, any excess foreign tax credit on foreign income from a specific source may be carried over to the next succeeding five tax years, linked to the cost-of-living index, as a foreign tax credit against foreign income from the same specific source.

In a memorandum from September 2023, the ITA proposes allowing the surplus credit to be transferred to future years until utilized, rather than subject to a five-year limitation. At the same time, however, it narrows the definition of surplus credit.

If the excess foreign tax credit was derived from the setting off of a loss incurred outside Israel from foreign income from a specific source against income from another such source, the unused foreign tax credit may be used to credit against Israeli tax on income from that source with respect to which the loss was incurred.

h. Dividends Received from Corporations Considered Israeli Resident

Where a corporation resident in Israel receives a dividend from a corporation regarded as being a resident of Israel due to the "control and management" of its business in Israel and the dividend distributed by it was subject to withholding at source in a foreign country, the corporation will be entitled to a foreign tax credit for the foreign tax against the Israeli corporate tax due. Where the recipient of the dividend is an individual, the foreign tax withheld at source will also be allowed as a credit against the Israeli tax levied on the dividend.

The September 2023 memorandum proposes to expand the eligibility to receive an indirect tax credit with respect to intercompany dividends paid out of income generated abroad, including from dividends originating from abroad.

i. Date of Payment of Foreign Tax

Foreign tax paid is creditable against Israeli tax provided the tax was paid in a foreign state within 24 months after the end of the tax year in which the credit is taken. Foreign tax paid after this period may be deducted only in the year it is paid to the foreign state and against Israeli tax due with respect to foreign income from the same source.

3. Losses Incurred Outside Israel

Notwithstanding any other provision regarding the set-off of losses (see V.C.7., above), section 29 of the Income Tax Ordinance contains special provisions with respect to the setoff of losses incurred outside Israel.

A loss incurred by a resident of Israel that, had it been income, would have been foreign passive income,[1140] may be set off against any passive income derived from outside Israel. However, a loss incurred from the renting of real estate, attributable to depreciation, may be set off against a capital gain derived from the sale of the rented real estate.

Where the loss cannot be set off in the tax year in which it was incurred, it may be carried over to succeeding years, provided that it is set off during the first year in which the taxpayer is allowed to set it off, and that the set-off is made against passive income derived from outside Israel during those years. It should be stressed that where the loss could have been set off in any one-year and the set-off was not made, the taxpayer will not be able to carryover the loss to succeeding years.[1141]

Where the taxpayer incurred a loss in a business or vocation carried on outside Israel that, had it been a profit, would have been taxable in Israel, the set-off rules set forth in section 29(2) of the Income Tax Ordinance apply, as follows:

(i) A current loss will first be set off against the taxable income, including capital gains, derived from a business or vocation outside Israel.

(ii) Any excess loss will be allowed as a set-off against foreign passive income available for such a set-off after the set-off of a passive loss against it.

(iii) Any excess loss, not set off pursuant to the above, and derived from a business "controlled and managed" from Israel may be used as a set-off against income derived in Israel during the same taxable year.

(iv) Should there still remain any loss not set off after the set-off referred to above, it will be carried over to succeeding years and will be available for set-off against the taxable income of the taxpayer derived from foreign sources constituting a business or vocation, including capital gains.

(v) At the request of the taxpayer, the taxpayer may set off any excess loss from a business outside Israel that is "controlled and managed" from Israel, against taxable income, including capital gains and the tax levied on real estate gains, derived from a business or vocation in Israel.

(vi) Finally, no set-off will be allowed for a loss incurred outside Israel if, had it been a profit, it would not have been taxable in Israel, and no such set-off will be allowed where a taxpayer did not file a return with respect to such a loss for the year during which it was incurred.

B. Tax Treaties

1. Income Tax Treaties

Israel is a party to tax treaties with 60 countries. Most of Israel's tax treaties are based on the Organisation for Economic Cooperation and Development (OECD) Model Convention and are similar to most treaties of this type. Basically, commercial and industrial profits are taxed only where attributable to a permanent establishment (PE) — for further discussion on Israel's approach to nexus and PE issues, see Section VI.A. Passive income is subject to a low withholding tax rate in the source country, except where its production involves the participation of a PE. Shipping and other transport profits are free of tax in the source country and taxed only by the country of residence of the recipient. Income from immovable property

[1140] Interest, linkage differentials, dividends, rent, royalties; *see* Income Tax Ordinance, s. 29(1)(a).

[1141] *See* Income Tax Ordinance, s. 29(1)(B).

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is taxed in both the country where the property is located and in the country of residence of the recipient. Special provisions apply to teachers, students, trainees, and commercial travelers. All the treaties contain provisions with respect to mutual agreement procedures[1142] and exchange of information and, of course, allow for the prevention of double taxation, mainly by the foreign tax credit method. Most of these treaties also include a "tax sparing" clause under which a tax spared by Israel as a result of its encouragement of certain sectors of its economy is regarded as having been paid to Israel for purposes of the crediting of Israeli taxes in the country of residence of the foreign taxpayer. Thus, the tax "spared" by Israel does not find its way into the coffers of the country of residence of the foreign taxpayer.[1143]

For a list of Israel's tax treaties and other tax-related agreements, see International Tax Treaties.

2. Creation of Income Tax Treaty Relationships

Israel's tax treaties are largely based on the version of the OECD Model Convention, with adjustments to Israel's internal law, special conditions and policy on tax treaties.

Negotiations on tax treaties are conducted by government officials from the Israel Tax Authority (ITA) and the Ministry of Finance. Before the negotiation begins, there is typically a pre-negotiation which involves evaluating the economic and trade relationship between the two countries and identifying potential areas of double taxation. During the negotiation, the countries can discuss various topics, such as allocation of taxing rights, how to treat different types of income, and exchanging different information. Once the countries reach an agreement, it must be politically approved in each country (in Israel normally by the Knesset or the Finance Committee). Once the agreement is approved, the agreement is adopted into Israeli law through primary legislations or regulations. Then the agreement becomes legally binding and enters into force according to the agreed effective date.

The ITA often publishes explanatory materials in order to interpret the applications of the double taxation agreement. The explanatory materials include different topics, such as interpretation of specific provisions, guidance on determining residency for tax purposes, and clarifications on the treatment of various types of income.

3. Administrative Measures Dealing with Tax Treaty Provisions

The ITA issues circulars and guidelines to provide interpretations, explanations, and administrative guidance regarding the application of tax treaty provisions. The circulars help taxpayers understand the rights, obligations, and procedures related to the tax treaty. The circulars address specific issues, clarify uncertainties, and provide guidance on the applications of the treaty.

Article 25 of the OECD Model Convention institutes a Mutual Agreement Procedure (MAP) for resolving difficulties arising at the application of the Convention. The ITA administers the MAP process and provides a mechanism for taxpayers to resolve disputes related to the tax treaties. Article 25 invites the authorities to consult together for the elimination of double taxation in cases that are not provided in the Convention.

The ITA issued Income Tax Circular 01/2023 which addresses the MAPs for Israel's tax treaties. The purpose of this Circular is to elucidate the characteristics of MAPs, with the ITA's interpretation of the MAP article in treaties involving Israel, and to formulate a policy guiding Israeli taxpayers when approaching the competent authority to initiate the procedure. It should be noted that this tax Circular, replaces the Income Tax Circular 23/2001, and is more comprehensive and contains several clarifications.

Israeli tax treaties include a MAP designed to facilitate a procedure aimed at preventing the imposition of taxes that contradict the provisions of the treaty. There are three situations in which this procedure can be employed:

(i) A private case in which a claim arises when an action by one or both jurisdictions results in, or has potential to result in, the imposition of tax in a taxpayer that goes against the provisions of the treaty;

(ii) A procedure aimed at reaching an agreement on the interpretation of the guidelines of the treaty, in general and regardless of an individual case; or

(iii) A consultation procedure regarding cases that were not specifically regulated in the treaty to prevent double taxation.

MAPs are conducted between the jurisdictions through each jurisdiction's designated competent authority. The competent authority in Israel is the International Taxation Department in the Professional Division of the Israeli Tax Authority.

According to the Circular, if an Israeli resident perceives that an action by either one or both treaty jurisdictions may result in the imposition of taxes contrary to the treaty's provisions, the resident must submit the request to the competent authority in Israel. An Israeli resident taxpayer may apply to the competent authority in Israel to commence a MAP concurrently with the competent authorities of multiple treaty jurisdictions. This is applicable when the matter at hand pertains to the application of Israel's tax treaties with each of those jurisdictions.

The time period for submitting a MAP under the majority of Israel's tax treaties is three years "from the date of the first notification of the action that resulted in taxation being charged not in accordance with the provisions of the treaty." The date

[1142] The Tel-Aviv District Court has reviewed the priority (in time) between the mutual agreement procedure (MAP) and the appeal procedure. It was held that the MAP should be entered into prior to the appeal. I.T.A. 1255/02 *Gtech Technologies Ltd. v. Assessing Officer Kfar-Saba*, Missim S/3 (June 2005), E-196.

[1143] 1970 Israel-Austria tax treaty, Art. 24(2); 2000 Israel-Bulgaria tax treaty, Art. 22(4); 1975 Israel-Canada tax treaty, Art. XXIII(2); 1966 Israel-Denmark tax treaty, Art. 23(2); 1997 Israel-Finland tax treaty, Art. 23; 1962 Israel-Germany tax treaty, Art. 18(1)(c); 1995 Israel-Italy tax treaty, Art. 19(2); 1984 Israel-Jamaica tax treaty, Art. 24(2); 1997 Israel-Korea (ROK) tax treaty, Art. 23(2); 1999 Israel-Mexico tax treaty, Art 23(2); 1997 Israel-Romania tax treaty, Art 24; 2005 Israel-Singapore tax treaty, Art. 20(2); 1999 Israel-Slovak Republic tax treaty, Art. 24B; 1978 Israel-South Africa tax treaty, Art. 23(1)(b); 1999 Israel-Spain tax treaty, Art. 24(2); 1959 Israel-Sweden tax treaty, Art. XVII(2); 1996 Israel-Thailand tax treaty, Art. 24(3); 1996 Israel-Turkey tax treaty, Art. 22(2); 1962 Israel-United Kingdom tax treaty, Art. XVIII(2); and 1998 Israel-Uzbekistan tax treaty, Art. 23(2). Some tax treaties to which Israel is a party allow partial "tax sparing": 1995 Israel-France tax treaty, Art. 23(1)(e); and 1973 Israel-Netherlands tax treaty, Art. 26A(4).

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of the first notification is the date on which the taxpayer is required to pay tax at issue, either in an assessment or in another way (e.g., by withholding). The competent authority will examine the request and its justification. A request will be justified if there is or may be taxation that is not in accordance with the treaty in Israel or the other country. When the issue is examined, the competent authority's position will be based on the principles of interpretation, the explanatory notes of the OECD, and the domestic law of Israel.

If after reasonable efforts the competent authorities were unable to maintain the procedures for MAP or they were unsuccessful in reaching an agreed solution, the Israeli competent authority is not obliged to unilaterally prevent double taxation, if it finds that the taxation in Israel complies with the provisions of Israeli law and the relevant tax treaty.

If the applicant accepts the result of the MAP, the agreement is final, and there is no right to obtain or appeal. If the applicant notified his or her disagreement with the results or did not give consent to the results within the required timeframe, the agreement between the competent authorities will not be binding and the state may not implement it.

The implementation of the results of a MAP must be in accordance with Israeli law, subject to the provisions of the relevant treaty. The Israeli competent authority is not responsible for the implementation of the agreement by the other country. If there is a concern that due to the internal law of the other country the applicant may be harmed, the taxpayer must take care to settle the matter with the tax authorities in the other country.

4. Treaty Interpretation

Israel interprets tax treaties based on principles of international tax law, domestic legislation, and guidance from international organizations such as the OECD. The interpretation of tax treaties aims to ensure consistency, fairness, and effective tax administration.

Israel interprets the provisions of tax treaties according to the agreement itself, and the ordinary meaning of the context. The language used in the agreement is analyzed to determine the interpretation of the agreement.

Israel refers to the OECD Model Convention and the associated commentary to interpret a tax treaty. The commentary provides explanations, examples, and interpretations of the model treaty articles, which help to interpret corresponding provisions.

Israel's domestic tax also laws help interpret tax treaties. According to section 196 of the Income Tax Ordinance, any agreement that was concluded with a certain state to afford double taxation relief on taxes of a similar character imposed by the laws of that state, will have effect in Israel, notwithstanding any provision of any statute.

The official languages used in Israel's tax treaties are English, Hebrew and the language of the other contracting state. Where an agreement has more than one official language, it is often agreed that English is the prevailing language in the event of divergent interpretations between the contracting parties.

5. OECD Multilateral Instrument

Israel signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument" or "MLI") on June 7, 2017, and the MLI entered into force on January 1, 2019. Israel elected to have the MLI cover all of its tax treaties.

The MLI sets standard rules on an international scale that allow less room for tax avoidance. The MLI is based on the OECD Model Convention. Over 100 countries have signed the MLI, which also helps to eliminate double taxation by modifying bilateral tax treaties.

The MLI applies only to tax treaties between treaty partners that have signed the MLI. The MLI has no effect on taxation issues related to jurisdictions with which Israel does not have a tax treaty.

Article 6 of the MLI addresses the purpose of the MLI, which is not only to eliminate double taxation but also to prevent the creation of opportunities for achieving non-taxation or reduced taxation through tax evasion or avoidance. It was decided to state explicitly that "treaty shopping" is one way to avoid tax and that a treaty should not create the ability to engage in the practice.

Article 3(1) of the MLI deals with situations in which a foreign entity is defined as wholly or partly transparent for tax purposes in one contracting state and generates income sourced in the other contracting state but is defined as non-transparent in that other state. The benefits of a covered tax agreement (CTA) are granted only with respect to that part of the income that is considered for tax purposes to be income of the resident of the other contracting state, still adhering to the principles of beneficial ownership. The benefits will only be granted where the contracting states are able to check and examine who owns the rights in the transparent entity and that person's residency status.

Article 4 of the MLI deals with how to decide on the residence status of dual resident entities, based on mutual agreement between the contracting states and depending on the facts and circumstances. Israel has chosen to apply Article 4 by adopting the language used in the model treaty. The parameters that will be examined include the effective management test, the place of incorporation and other relevant factors. The decision will be made based on a joint examination on a case-by-case basis and does not prioritize one factor over the other. In the absence of mutual agreement between the relevant competent authorities, an entity that has dual residence will not be entitled to any relief or tax exemption under the relevant CTA.

Article 14 of the MLI is intended to prevent the circumvention of the provision in Article 5 of the Model Convention that sets a minimum period of 12 months for which a construction site, or construction or assembly project must exist to constitute a PE. The provision opens up options for abuse, including the splitting-up of contracts into a number of different contracts lasting for shorter periods than the minimum period and also attributed to different companies in the same group. Article 14 prevents situations in which the existence of a PE is artificially avoided via the splitting-up of contracts. Article 14 provides that various periods of time during which a foreign enterprise operates in a treaty country will be included in the minimum period referred to above if: (i) the foreign enterprise carries on activities at a construction site for a period exceeding 30 days but less than the minimum period; and (ii) a party or number of parties closely related to the foreign resident con-

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duct "related activities" at the same construction site, for a period cumulatively exceeding 30 days.

Article 13 of the MLI deals with business activities that fall outside the general definition of a PE by virtue of the exemption for preparatory and auxiliary activities. Only in situations where the activities of the foreign enterprise in the other contracting state are by nature preparatory and auxiliary will they be excluded from creating a PE. An activity that is a core activity of the business will not be regarded as a preparatory and auxiliary activity. In addition, the article prevents the splitting of a business activity into several sub-activities.

Article 12 of the MLI provides that a "dependent agent" acting in a contracting state creates a PE in that state of a foreign enterprise that is its principal. This does not require that the agent should sign the relevant contracts, but only that the agent should routinely play a central role leading to the signing of the contracts. The fact that an agent works closely with foreign corporations that are not closely related parties does not necessarily mean that it will be regarded as an independent agent and therefore as not giving rise to a PE.

Article 15 of the MLI provides an additional definition of a "person closely related to an enterprise" that includes two alternatives: (i) the substantive alternative — a party is considered a closely related party of another party if it has control over the other party or both it and the other party are controlled by the same person; and (ii) the technical alternative — the first party holds directly or indirectly more than 50% of the rights in the other party or the same person holds more than 50% of the rights in both parties.

Article 16 of the MLI deals with the mutual agreement procedure (MAP). Israel's tax treaties with contracting countries that are party to the MLI will now prescribe a three-year limitation period for submitting a MAP request. The article provides that a decision made by the competent authorities via a MAP is to be implemented notwithstanding any time limitation in the domestic law of the contracting sates (i.e., an agreement between the competent authorities will be implemented even if the domestic law statute of limitations has expired).

6. Israel-United States Tax Treaty of 1975

The 1975 Israel-U.S. tax treaty,[1144] which entered into force on January 1, 1995, and came into effect with respect to withholding tax rates on February 1, 1995, and with respect to other taxes for taxable years beginning on January 1, 1995, applies only to income taxes levied at the national level.[1145] It also includes among taxes "involuntary defense loans" formerly levied in Israel.[1146] Residence under the treaty is based on "fiscal residence," which generally assigns residence to the country with which the taxpayer has the greater personal link, subject to the specific provision that *Olim* (new immigrants to Israel) are deemed to be residents of Israel, if so treated by Israel.[1147] The treaty establishes basic geographic source rules for income: income from the disposition of property is derived from the situs of the disposition, except that certain gains from the sale of stock in Israeli companies by U.S. residents are treated as arising in Israel.[1148] Industrial and commercial profits attributable to a PE that the recipient, a resident of one of the states, has in the other state are treated as income from the situs of the PE. A PE is defined as a fixed place of business in one of the contracting states through which a resident of the other contracting state engages in industrial or commercial activities. The provisions of the PE article are extensive and detailed. Substantial processing of goods in a contracting state, or the mere sale there of goods purchased in the same state, may cause the activity to be deemed to be a PE in that state.[1149]

The 1975 Israel-U.S. tax treaty seeks to limit the taxation of nonresidents to income derived by them from sources within the taxing country.[1150] Industrial or commercial profits may be taxed only in the country of residence of the recipient unless derived by a PE in the other contracting state.[1151] An Israeli company is exempt from the U.S. personal holding company tax unless 10% or more of its outstanding stock is held by a resident or a citizen of the United States.[1152] An Israeli company is exempt from the U.S. accumulated earnings tax unless it has a PE in the United States and at least 25% of its holding stock is owned by citizens or residents of the United States.[1153]

Dividends, interest and royalties may be taxed by both contracting states, subject to specific limitations.[1154] The tax rates on dividends vary; the general tax rate is 25% of the gross dividend. The rate is 12.5% if the dividend paying company paid the dividend out of income on which it is not entitled to a reduced tax rate with respect to an "approved enterprise," provided: (i) during a certain prescribed period, at least 10% of the voting rights in the paying company were owned by the dividend receiving company; and (ii) not more than 25% of the gross income of the paying company in the year preceding the date of the dividend payment is comprised of interest and dividends (other than interest emanating from managing a banking, insurance or financing business, and interest or dividends received from subsidiaries, 50% or more of whose issued voting rights were owned by the paying company at the time of the receipt of the dividends or interest). Where the dividend is paid out of income derived during a period in which the paying company was entitled to a reduced tax by reason of its being an approved enterprise under the Law for the Encouragement of Capital Investment, 1959, the tax rate on the gross dividend is 15% provided the conditions specified above in (i) and (ii) are met.

Dividends paid by a company of one contracting state to a person who is not a resident of the other contracting state (and if the dividend is paid by an Israeli company — to a person who is not a citizen of the United States) are exempt from tax in the other contracting state.

[1144] A. Rafael & D. Efrati, *The United States-Israel Tax Convention*, 12 *Israel L. Rev.* 413 (1977); G. Klugman & M. Kapota, The U.S.A. Israeli Tax Treaty.

[1145] In certain circumstances, the ITA has agreed to credit taxes levied at the state level.

[1146] 1975 Israel-U.S. tax treaty, art. 1(1)(b).

[1147] 1975 Israel-U.S. tax treaty, art. 3(2)(a).

[1148] 1975 Israel-U.S. tax treaty, art. 4.

[1149] 1975 Israel-U.S. tax treaty, art. 5.

[1150] 1975 Israel-U.S. tax treaty, art. 6.

[1151] 1975 Israel-U.S. tax treaty, art. 8(1).

[1152] 1975 Israel-U.S. tax treaty, art. 6(5).

[1153] 1975 Israel-U.S. tax treaty, art. 6(5).

[1154] 1975 Israel-U.S. tax treaty, arts. 12, 13 and 14.

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The 1975 Israel-U.S. tax treaty provides for limitations with respect to the treatment described above where the dividends are regarded as business profits and also with regard to dividends paid by U.S. entities such as regulated investment companies (RICs) or real estate investment trusts (REITs), and by certain Israeli entities such as "family companies" or "house companies." Capital gains earned by a nonresident are generally exempt, except for gains from real estate.[1155] Where a nonresident individual was present in the contracting state for more than half of the taxable year, or where a nonresident individual has a substantial interest in an Israeli company, a gain derived from the sale of those shares is not exempt.[1156] Independent personal services performed by a nonresident are exempt from tax in that contracting state, unless the nonresident was present in that state for more than half the tax year.[1157]

An investment or holding company that enjoys special tax benefits in its country of residence is denied the benefits afforded with respect to dividends, interest, royalties and capital gains, if 50% or more of its capital is held by individuals who are not residents of the company's home state.[1158]

It is worth noting that the United States allows as a credit against U.S. tax the appropriate amount of taxes paid or accrued to Israel; however, the 1975 Israel-U.S. tax treaty contains no tax sparing provisions.[1159] In the case of a U.S. company owning at least 10% of the voting stock in an Israeli company from which it received dividends in the taxable year, the United States also allows a credit for the appropriate amount of taxes paid or accrued to Israel by the Israeli company paying the dividends with respect to the profits out of which the dividends are paid.[1160] This tax credit is very similar to that afforded by section 902 of the U.S. Internal Revenue Code.

Another special feature of the 1975 Israel-U.S. tax treaty is the exclusion from gross income of grants made by Israel, a political subdivision of Israel or any agency of either, to a resident of the United States.[1161] If the U.S. resident is a U.S. company, the amount of the grant may be treated as a contribution to its capital.[1162] The U.S. resident is considered to have contributed the amount of the grant to the Israeli company designated in the grant as a shareholder; but, significantly, the basis of the U.S. resident's stock may not be increased by the amount so contributed.[1163] A qualifying cash grant is one approved by Israel for investment promotion in Israel, but does not include any amount that, in whole or in part, directly or indirectly, is: (i) in consideration for services rendered or to be rendered or for the sale of goods; (ii) measured in any manner by the amount of profits or tax liability; or (iii) taxed by Israel.[1164] As a practical matter, the grants covered by the provisions of the treaty are those made under the Law for the Encouragement of Capital Investments, 1959 and the Law for the Encouragement of Capital Investments in Agriculture, 1980. As already noted (in II.A.2.i., above), where the owner of an approved enterprise receives a grant in aid with respect to property of the enterprise or with respect to an industrial building, the amount of the grant in aid, for purposes of determining Israeli depreciation of the basis of an asset, is deducted from the original cost of the property or from the expenditure incurred by the owner with respect to the acquisition of the property. The grant in aid is taxed indirectly because the basis of depreciation is only the original cost of the acquisition of the property, and, on the sale of the asset, the capital gain is calculated as if the grant were not part of the original investment.

The 1975 Israel-U.S. tax treaty specifically deals with trusts, which has led some practitioners to conclude that U.S. trustees otherwise subject to Israeli tax will not be taxed on their non-Israeli source income.

7. Information Exchange Agreements

a. FATCA Intergovernmental Agreement

On June 30, 2014, Israel and the Unites States signed an agreement to improve international tax compliance and to implement the U.S. Foreign Account Tax Compliance Act (FATCA). The FATCA Intergovernmental Agreement includes two annexes: The first deals with the due diligence for identifying and reporting accounts of residents or citizens of the United States. The second annex details a list of financial institutions and financial accounts that are exempt from the aforementioned reporting. On July 1, 2016, the Income Tax Ordinance, 5761-1961, was amended to implement the FATCA Intergovernmental Agreement.[1165] The amendment came into force on August 4, 2016, with the publication of the Income Tax Ordinance Regulations (Implementation of the FATCA Agreement), 5766-2016.

b. OECD Common Reporting Standard

In October 2014, Israel announced that it will begin to implement the automatic exchange of tax and financial information, according to the Common Reporting Standard developed by the OECD, at the end of 2018. In July 2016, the Knesset approved Amendment 227 to the Income Tax Ordinance, which constitutes the legal infrastructure for the automatic exchange of information. In February 2019, the income tax regulations (implementation of a uniform standard for reporting and checking the adequacy of information on financial accounts), 2019 (the "CRS Regulations") were published. Financial institutions must now identify clients who are foreign residents for tax purposes and transfer information regarding their accounts to the ITA, which will then transfer the information to the relevant countries of residence. The ITA has published a list of participating countries to which Israel will transfer information under the CRS Regulations.

Amendment 272 to the Income Tax Ordinance, which establishes a standard with respect to the exchange of information on request (EOIR) in order to implement international standards on tax transparency was published in April 2024. Under the EOIR standard, tax authorities can request information from their counterparts to allow them to process their tax informa-

[1155] 1975 Israel-U.S. tax treaty, art. 15(1).
[1156] 1975 Israel-U.S. tax treaty, art. 15(1)(d) and (e).
[1157] 1975 Israel-U.S. tax treaty, art. 16.
[1158] 1975 Israel-U.S. tax treaty, art. 25.
[1159] 1975 Israel-U.S. tax treaty, art. 25.
[1160] 1975 Israel-U.S. tax treaty, art. 26(1).
[1161] 1975 Israel-U.S. tax treaty, art. 10(1)(b).
[1162] 1975 Israel-U.S. tax treaty, art. 10(1)(a).
[1163] 1975 Israel-U.S. tax treaty, art. 10(1)(c) and (d).
[1164] 1975 Israel-U.S. tax treaty, art. 10(2).

[1165] Income Tax Ordinance, 5761-1961, S. 135B – 135H.

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tion, with a view to ensuring that taxpayers are charged in accordance with the provisions of an applicable tax treaty.

c. Multilateral Convention on Mutual Administrative Assistance in Tax Matters

On November 24, 2015, Israel signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The Convention was ratified by Israel on August 31, 2016. Israel has elected to apply the Convention to the following taxes:[1166] income tax, company tax, capital gains tax, tax imposed on gains from the alienation of property according to the Real Estate Taxation (Appreciation and Acquisition) Law 5723-1963, and tax imposed under the Taxation of Profits from Natural Resources Law, 5771-2011.

[1166] For the full list of Israel's reservations, see www.coe.int/en/web/conventions/search-on-treaties/-/conventions/treaty/127/declarations.

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XIX. Inflationary Effects on Tax

As of January 2008, the provisions dealing with inflationary adjustments were abolished due to the decrease in the rates of inflation.

Comment: Since Israel's annual inflation rate has increased to more than 5% in recent months, it may be too early to mourn the demise of the Income Tax (Inflationary Adjustment) Law, 1985 and other provisions which deal with inflationary adjustments.

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XX. Distribution of Revaluation Profits

The International Financial Reporting Standards (IFRS) generated certain inconsistencies between financial statements of Israeli companies and their tax returns prepared according to the Income Tax Ordinance. One of the most significant of these inconsistencies concerns the issue of the revaluation of assets according to their fair market value. Generally, according to the Income Tax Ordinance, a taxable event occurs only when an asset is actually sold or disposed of by the taxpayer. Thus, revaluation profits derived from revaluations of assets without an actual disposition of such assets generate income for accounting purposes under the IFRS regulations, but for purposes of the Income Tax Ordinance there has been no taxable event. As a result, such profits are, generally, not subject to company tax at the level of the company.

Prior to Amendment no. 197 of the Israeli Income Tax Ordinance, a company was able to distribute to its shareholders certain profits derived from the revaluation of its assets under applicable IFRS regulations based on the argument that such profits met the "profits test" provided in the Companies Law. As such revaluation profits were not subject to tax under the Income Tax Ordinance, the distributee of such profits managed to distribute cash to its shareholders with no corporate tax liability at the level of the company. This approach was not clear from doubts, and was challenged by the Israeli Tax Authorities in the *Aviad Perel*[1167] case. The Israeli Supreme Court ruled in the *Aviad Perel* case with respect to distribution of revaluation profits, that the distribution of such profits may negatively affect the company's ability to pay its liabilities, and may prejudice the tax authorities' ability to collect tax in particular and harm the public's interest in general.

Therefore, in the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014) the Israeli legislature promulgated section 100A1 of the Israeli Income Tax Ordinance with respect to the distribution of revaluation profits. According to the provisions of section 100A1, any distribution of revaluation profits will result in a taxable event with the revaluated asset being deemed (notionally) to have been sold by the distributee on the day of the distribution of the revaluation profits arising from such an asset (according to its fair market value on such day). According to the provisions of section 100A1 the asset's basis for tax purposes will be stepped-up respectively, subsequent to the notional sale.

However, a company which reports revaluation profits in addition to its ordinary profits (profits that were subject to company tax) may determine the order in which its profits will be distributed and determine that the ordinary profits will be deemed distributed prior to the distribution of its revaluation profits.

Finally, it should be emphasized that Amendment no. 197 empowered the Minister of the Treasury to promulgate certain regulations to determine which revaluation profits will be subject to the provision of section 100A1. In addition, such regulations should set forth certain provisions that will prevent double taxation with respect to assets located outside of Israel.

[1167] C.A. 8500/10 *Aviad Perel v. The Assessing Officer of Jerusalem 1*, Missim KF/5 (Oct. 2012), E-176.

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