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

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.

[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.

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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 *Ra´ayonot* 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 pre-ruling 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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