V. Taxation of Domestic Corporations

A. *Corporate Income Tax*

1. Corporate Residence

Companies incorporated in Israel and companies that exercise the control and management of their business from Israel are considered resident in Israel. Resident corporations are taxed on their worldwide income; nonresident corporations are taxed only on their Israeli-source income.

2. Income Determination

Taxable income is based on financial statements, which are prepared according to generally accepted accounting principles.

Under the Israeli Income Tax Ordinance, corporate income tax is levied on: (i) income from a business, trade, vocation or any transaction or "adventure in the nature of trade"; (ii) dividends, interest, linkage differentials, rents, franchise payments, premiums, lease premiums and other profits derived from real estate; (iii) income from the sale of patents or designs; (iv) income from employment, pensions and annuities; (v) income from agriculture; (vi) profits and gains from betting and lotteries; and (vii) gains or profits derived from any source not enumerated above (see V.C.4., below).

Expenses are deductible if they are wholly and exclusively incurred in the production of taxable income, and incurred with respect to income generated in the same year that the expenditure was incurred. However, as a practical matter, where an expense is of a mixed nature, the Assessing Officer will allow an allocation, so that the part allocable to the production of income is indeed recognized as a business expense. The deduction of some expenses is limited or forbidden (see V.C.5. and 6., below).

Rates of depreciation are determined by statute. Higher rates of depreciation are allowed for some assets and industrial enterprises. Depreciation for tax purposes is generally calculated on a straight-line basis (see V.C.5.g., below).

Inventories are valued at the lower of cost or market value. A first in first out (FIFO) or weighted average basis of valuation is acceptable.

3. Capital Gains

A capital gains tax is imposed on capital gains accrued on the disposal of fixed assets other than real estate. The general rule is that the basis of the asset concerned is stepped up to compensate for the inflation since acquisition. The capital gain is therefore divided into a "real gain" and an "inflationary amount":

(i) The "inflationary amount," which represents the inflationary gain in nominal terms, is taxed at the flat rate of 10% on that part accrued until December 31, 1993, and at 0% on the part accrued after that date; and

(ii) The "real gain" of a corporation is generally taxed at the rate of the corporate tax.

A capital gains (appreciation) tax on gains accrued on the sale of real estate is imposed at the following rates:

(i) The "inflationary amount" is taxed at the flat rate of 10% on that part of the gain accrued until December 31, 1993, and at 0% on the part accrued after that date; and

(ii) The "real gain" of a company is generally taxed at the rate of the corporate tax.

4. Group Taxation and Intercompany Dividends

Consolidated tax returns for corporate groups are allowed only in case of an industrial company controlling another company in the same line of business, or a parent company controlling an industrial company and having at least 80% of its assets invested in industrial companies.[541]

Dividend income received from another resident company is free of tax in the hands of the recipient company if the income out of which the dividend is distributed is sourced in Israel.

Dividends distributed from income sourced outside Israel are taxed, at the company's choice:

(i) At the rate of 25% of the gross dividends paid, with a credit for the tax withheld at source; or

(ii) At the regular company tax rate on the income out of which the dividend was paid, with a credit for the applicable ratable underlying tax paid by the paying company and for the tax withheld at source on the dividend itself (see V.C.4.c., below).

5. Losses

Business losses may be offset against income from any source in the same year. Loss carrybacks are not allowed. Unrelieved business losses may be carried forward for an unlimited number of years to offset business income and capital gains derived from business activities. There are limitations regarding the offset of losses accrued abroad against income that accrued in Israel (see V.C.7., below).

Unrelieved capital losses may be carried forward for an unlimited number of years to offset capital gains. However, a capital loss derived from the sale of securities may be offset in the year of the sale against interest or dividend income derived from that security, or against interest or dividend income derived from other securities, provided the income from dividends or interest is subject to tax at a rate that does not exceed 25%. As a result of the fact that the Income Tax Law (Inflationary Adjustments), 1985 is not in effect as of January 2008, losses are no longer adjusted to the cost of living index.

6. International Aspects

The non-treaty withholding tax rate for payments of a dividend to companies or individuals is 25%/30% (depending on whether the company or individual is a substantial shareholder). Payment of interest and royalties is taxed at a rate of 23%.

Resident companies that derive or receive income accrued outside Israel are entitled to double taxation relief in the form of a foreign tax credit, provided the foreign tax concerned was imposed as a percentage of the income and is not a municipal tax.

[541] Industry Encouragement Law (Taxes), 1969, s.23.

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The taxable income of a "controlled foreign corporation," as specifically defined by the Income Tax Ordinance, is ascribed to its Israeli resident shareholders as if it were a dividend distributed to them.

The income of a foreign vocation company, i.e., the income of a foreign company controlled by Israeli professionals that derives income from the profession of its shareholders, is taxed as if the company were an Israeli resident.

Israeli banks must withhold tax, generally at a rate of 25%, from most overseas remittances unless the remittances relate to imported goods, or when a lower rate applies under an applicable tax treaty.

7. Other Significant Taxes

There are no local taxes other than annual municipal taxes on property.

Value added tax (VAT) is generally levied at the rate of 18%. Exports of goods and certain services are zero-rated and certain transactions are exempt; see IV.E., above.

Any purchase of real property is subject to purchase tax at the rates of 0.5% to 10%.

8. Tax Incentives

To attract foreign investment, Israel has devised an elaborate system of incentives. The incentives are designed to encourage investments in manufacturing facilities, tourism, housing projects, industrial rental buildings, rental dwelling units and agriculture, as well as to attract foreign specialists. The incentives include, inter alia, beneficial tax rates; cash grants (for investments in fixed assets); accelerated depreciation; and a zero rate of value added tax (VAT) on goods and services exported from the country. For further discussion, see XIV., below.

9. Administration

The Israeli tax year is normally the calendar year.

Companies are generally required to file audited annual tax returns and financial statements within five months of the end of the tax year.

Companies must file monthly or bi-monthly returns regarding corporate income tax advances and report withheld taxes, tax advances with respect to nondeductible expenses, etc. (see XII., below).

10. Reportable Opinions and Positions

Rules for reporting the existence of tax opinions and a "reportable position" have been adopted pursuant to the Tax Benefits and Tax Advice, legislative amendments, 2015, published December 9, 2015. The law applies to income tax, VAT, customs, purchase tax and excise tax. The reporting taxpayer, for income tax purposes, is either an individual or a corporation (excluding an exempt public body), which derived income in excess of NIS 3 million during the tax year; or the consideration received by the taxpayer upon the sale of a capital asset, in the tax year exceeded NIS 1,5 million (the tax opinion rendered being in respect of said consideration).

An "opinion" is defined as a written opinion executed by the person rendering it, directly or indirectly, provided: the fee (being at least NIS 100,000) is contingent in whole or in part, upon the achievement of a "tax advantage" or the opinion is an "off the shelf opinion." A "tax advantage" is defined to include (a) a reduction of tax, tax relief, decrease of the tax liability or an advance payment or tax avoidance; (b) the abstaining from the performance of a duty or obligation to withhold tax at source, expenses or taking into account a loss; and (c) the deferral of a tax.

An "off the shelf tax opinion" is defined as: (a) a tax opinion of a standard content concerning the same subject matter rendered, directly or indirectly, to at least three persons (except those excluded therefrom) within a period of two years and which is not dependent mainly on the particular circumstances of the recipient; and (b) a tax opinion which the author initiated and the recipient agreed to keep confidential in whole or in part.

A person in receipt of an opinion as defined above will report its existence in his annual return by submitting a form to be published by the Director of the Israel Tax Authority (ITA). The form will report the existence of the opinion, the act or asset constituting the subject matter of the opinion and the issues raised in the opinion. The opinion itself need not be filed. A person rendering an "off the shelf opinion" must notify the third recipient and every other recipient of its nature. If the opinion was tendered after the filing of the annual return, the taxpayer must file a special return with the aforesaid particulars of the opinion.

A reportable position relates to a position which is contrary to a published position of the Tax Authority and the tax advantage exceeds:

- Income tax: NIS 5 million or NIS 10 million in no more than four tax years;
- VAT/Customs: NIS 2 million or NIS 5 million in no more than four tax years.

The Tax Authority is permitted to publish 50 positions each year except that in 2016 and 2017 it was entitled to publish 100 positions each year. In 2019, the Tax Authority published 23 positions (income tax and international taxation — 22; motor fuel excise — 1) bringing the total published positions to 112 (income tax and international taxation — 80; VAT — 12; customs — 19; motor fuel excise — 1).

Failure to comply with the new rules will be deemed a failure to file a return. Fines may also be levied for a deficit in payment resulting from the failure to file.

B. What Is a Domestic Corporation?

Section 1 of the Israeli Income Tax Ordinance defines "a resident in Israel" or "a resident," when applied to a "body of persons," as:

"(1) A body incorporated in Israel;

(2) Any body of persons the control and management of whose business are exercised in Israel."

Pursuant to the Reform of 2008, foreign companies managed and controlled by new immigrants or Veteran Returning Residents will not be considered residents of Israel for 10 years from their assumption of residence if, but for being managed and controlled by the new immigrants or the Veteran Returning residents, they would not have been classified as corporate residents of Israel.

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The first part of the definition was introduced into the Ordinance in 2003. The “place of incorporation” criterion substituted the former “place of registration of the company” criterion coupled with the “location of its main place of activities” criterion. The substitution of the former criteria (place of registration and principal activities) will draw greater attention to the second part of the definition, i.e., the “control and management” criterion.

The Israeli Supreme Court has not handed down any decisions or laid down any binding precedents with respect to the location of corporate residence. The question came before the District Court of Haifa,[542] which held that each of the terms “control” and “management” is a separate and independent term and, therefore, if either is exercised outside the country, the company will not be regarded as an Israeli resident. The court viewed the term “control” as applicable to the shareholdings in the company under consideration. The case was not appealed.

Comment: In the author’s opinion as well as that of the tax authorities, the court wrongly held that “control” and “management” are distinguishable and failed to see that the subject matter of the exercise of the “control and management” under consideration is the “business” of the corporate entity.

The source of the second part of the definition is U.K. case law, and although the case law test there has since been supplemented by the introduction of a statutory “place of incorporation” test in 1988, it is more than likely that the precedents of the U.K. courts will have a persuasive effect in the construing of that part of the definition for purposes of the Israeli Income Tax Ordinance, once the question arises again.

The U.K. courts adopted the principle that a company maintains its residence where it conducts its business. Furthermore, a company is considered to conduct its business where its central management and control is located.[543] Clearly, the Income Tax Ordinance codified the final result of this formula. The central management and control are located where the body charged with the responsibility for the formulation and direction of the company’s policies exercises its functions.[544] This body is normally the board of directors. Therefore, the rule of thumb for purposes of the second part of the definition of corporate residence is that the geographic site where the board of directors continually performs its duties determines the location of corporate residence. In the context of the definition of corporate residence, management and control under U.K. tax law are not to be confused with the powers of the shareholders nor are they to be confused with the powers inherent in running the day-to-day operations and business of the company. It is between these two extremes that central management and control lie.

The residence of a subsidiary company is determined in the same manner as that of any other company. Where its central control and management are exercised by the parent company and the latter has no affiliation with the state, the subsidiary is nonresident.[545] However, because of the first part of the definition, if the subsidiary is Israeli incorporated, the location of the central management and control is disregarded.

Under the U.K. decisions, a company may enjoy a dual status.[546] However, this is a rare phenomenon and the Israeli courts have not yet handed down a decision as to whether such dual status is recognized under Israeli law.

In 2002, the Israel Tax Authority (ITA) stated its position with respect to the location of the control and management of a company’s business. It is worth noting that the position taken by the ITA does not, of necessity, reflect the position adhered to by the courts in interpreting the provisions of Israeli tax law, but solely the position of the income tax authorities. The tax authorities take the position that “control and management” are one criterion and not two separate criteria of “control” and “management” and that locating the place at which control and management are exercised involves a multi-phase examination. First, according to the tax authorities, the place at which it is necessary to adopt material resolutions governing the business activities of the company must be identified. Second, the controlling and managing organ of the company should be examined and identified. The criteria used to make this identification should not be technical, i.e., the board of directors should not always be assumed to be the organ exercising control and management over the business of the company. Where, for example, the board of directors authorizes another organ to adopt resolutions governing the business affairs of the company and entrusts it with wide authority, the latter will be the organ in possession of the control and management of the business of the company. The circular goes on to stress that the criterion of the place at which the board of directors convenes has lost its predominance and importance in modern times and that criteria of substance should replace technical criteria in locating the place at which control and management of the business of the company is exercised.[547]

In one case, the District Court held that, in the case of a foreign company whose business was operated by its Israeli shareholders, the control and management of the company was in Israel because its foreign directors were not involved in its daily affairs.[548]

C. Taxation of Worldwide Income

1. In General

Israel taxes individuals and corporations on their worldwide income, irrespective of whether the income is ordinary income or capital gains, and irrespective of whether the tax is income tax or the company tax imposed on corporations. Section 2 of the Income Tax Ordinance provides that Israeli company

[542] I.T.A 175/90 *Solel Boneh v. Assessing Officer (Haifa)*, Missim H-2 (Apr. 1994), E-74.

[543] *De Beers Consolidated Mines Ltd. v. Howe* (1906) A.C. 455. *See* Rafael & Efrati, *The Residence of a Company for Tax Purposes*, 29 Hapraklit 573, in Hebrew.

[544] *American Thread Co. v. Joyce*, (1912) 6 T.C. 627; *Calcutta Jute Mills Co. Ltd. v. Nicholson*, (1876) 1 Ex. D. 428; *New Zealand Shipping Co. Ltd. v. Stephens*, (1907) 5 T.C. 553.

[545] *Unit Construction Co. Ltd. v. Bullock*, (1960) A.C. 351; *Gramophone and Typewriter Ltd. v. Stanley*, (1908) 2 K.B. 89.

[546] *Swedish Central Rail Co. v. Thompson*, (1925) A.C. 495.

[547] Income Tax Circular 4/2002, *Guidelines for the location of control and management*, Missim P-2, C-6.

[548] I.T.A 1029/00 *Niego v. Assessing Officer Kfar Sava*, Missim 26/1 E-90. See also I.T.A 1090/06 *Yanko Weiss Ahzakot 1996 Ltd. v. Assessing Officer Holon* (Dec. 18, 2013).

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tax be levied on the worldwide income of Israeli resident corporations and on the Israeli-source income of nonresident corporations. Until 2003, the year in which Israel moved to a full personal basis of taxation, Israel's basis of taxation was quasi-territorial; in theory, the basis was territorial, but as a practical matter, due to statutory fictions introduced into the Israeli Income Tax Ordinance with respect to the location of the source of income, the tax system was, to a large extent, based on the personal ties of the taxpayer to Israel.

With the adoption of the personal basis of taxation in 2003, source rules were enacted through the introduction of section 4A into the Income Tax Ordinance. These provide that:

(i) Business income will be sourced at the place at which the income-producing activities take place;

(ii) Income from "an adventure in the nature of trade" or from a transaction partaking of the nature of a business transaction will be sourced at the place of execution of the transaction;

(iii) Vocational income will be sourced at the place where the service is rendered;

(iv) Employment income will be sourced at the place where the services are performed;

(v) Interest, discount and linkage differentials will be sourced at the place of residence of the payor;

(vi) Rental income will be sourced at the situs of the use of the property;

(vii) Profits, including royalties, from intangible assets will be sourced at the place of residence of the payor;

(viii) Pensions, annuities and maintenance payments will be sourced at the place of residence of the payor;

(ix) Agricultural income will be deemed to arise where the asset giving rise to the income is located; and

(x) Dividends will be sourced at the residence of the corporation paying the dividend.

Notwithstanding these rules, income will be treated as arising from an Israeli source if:

(i) The income is of a passive nature (excluding dividends) and is deducted as an expense by a permanent establishment (PE) of the payor in Israel; or

(ii) The income is employment income and the employer is the State of Israel, a subdivision thereof or a national body specifically mentioned in the Ordinance.

Conversely, passive income (not including dividends) is deemed to be from a source outside Israel when it is taken as a deduction in computing the profits of a PE of an Israeli resident maintained outside Israel.

See Section VI.A., below for further discussion on PE matters.

2. *Meaning of Israeli Citizen*

Section 3A of the Income Tax Ordinance broadens the scope of Israeli taxation even further. Under section 3A(a), an "Israeli citizen" is defined to include a company controlled by an Israeli citizen. "Control" for this purpose is the direct or indirect ownership of at least 10% of the issued shares of the company or of the voting rights, or the right to hold at least 10% of the issued shares or the voting rights, or a right to receive at least 10% of the profits, or a right to nominate a director.[549] Under section 3A(b) of the Ordinance, the income of an Israeli citizen that accrued in, or was derived from Judea or Samaria ("the Area"), is considered to be income accrued in Israel.[550]

Income of an Israeli citizen residing in the Area that did not accrue or was not derived from Israel or the Area is considered to be foreign-source income.[551] Where an Israeli company paid tax under the provisions of section 3A of the Income Tax Ordinance referred to above to authorities in the Area, Israel credits the amount of the tax paid in the Area against the Israeli tax levied on the income.[552] If an Israeli citizen owns less than 10% of the various rights in the company, although the company is not regarded as an Israeli citizen, the Israeli citizen's proportionate right to the company's income is deemed to be his/her income and is considered to be income accrued in Israel if the income of the company accrued in Israel or the Area. The income is considered to have accrued abroad in all other circumstances. Dividends received by an Israeli citizen out of such income are not subject to any further Israeli taxation.[553] The definition of "the Area" was amended[554] to reflect the establishment of the Palestinian Authority. The definition now specifically states that the Area includes, for purposes of section 3A of the Income Tax Ordinance, all areas under the control of the Palestinian administration. This might result in non-relievable double taxation in certain cases (where there is Palestinian Authority taxation of Israeli-source income), as the agreements between Israel and the Palestinian Authority do not yet contain provisions for the prevention of such double taxation.

Section 89(b)(1) of the Income Tax Ordinance bases capital gains taxation on the Israeli residence of the seller — defined to include an Israeli citizen resident in the Area — irrespective of the location of the sale or the asset. If the seller is a nonresident, section 89(b)(3) provides that the gain will have an Israeli source if: (i) the asset sold is located in Israel; or (ii) the asset is located outside Israel and constitutes a direct or indirect right to an asset, stock-in-trade or an indirect right to real estate or an asset of a real estate association located in Israel; (iii) the asset is a share or a right to a share in an Israeli resident corporation; or (iv) the asset is a right to a share in a foreign corporation most of the assets of which are located in Israel or are rights, directly or indirectly, to assets located in Israel.

3. *Accounting*

The accounting profession developed with the enactment, by the British Mandatory Authorities, of the Companies Or-

[549] Amendment No. 81, 1990. The Court held that several Israeli shareholders, each holding less than 10%, but holding jointly more than 10%, are to be considered as controlling the company in question: I.T.A. 101/97 *Maa'le Hever v. Assessing Officer Jerusalem*, Missim K-4 (Aug. 1997), E-19.

[550] Income Tax Ordinance, s. 3A(b).

[551] Income Tax Ordinance, s. 3A(b1).

[552] Income Tax Ordinance, s. 3A(e), with no additional credit under Income Tax Ordinance, s. 199.

[553] Income Tax Ordinance, s. 3A(c).

[554] Law for the Amendment of the Income Tax Ordinance (Amendment No. 101), 1994.

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dinance and the Cooperative Societies Ordinance in 1929 and 1920, respectively. These Ordinances provided for an annual audit of the accounts of companies and cooperative societies. In 1941, the Income Tax Ordinance was enacted, instituting reporting requirements and the requirement to maintain books of account. The profession further developed as a result of the need for tax planning, filing tax returns and contesting assessments of the tax authorities. With the establishment of the State, foreign currency investments grew substantially and the capital market developed significantly. Businesses grew and many small companies became medium-sized publicly held companies by issuing shares to the public or by becoming affiliated with investment companies the shares of which were held by the public.

Gradually the tax code became more complex and greater sophistication was required to deal with its various provisions. These developments served as an additional catalyst to the greater reliance placed on accountants. Moreover, laws such as the Law for the Encouragement of Capital Investments, 1959 (see II.A.2.c., above), placed great emphasis on certified accountants for purposes of obtaining the benefits of the Law, while other laws, such as the Securities Law, 1968, set standards for financial reporting and proper disclosure.

Accounting in Israel has reached a proficient level mainly as a result of the readiness of the profession to adopt and apply the concepts and practices of foreign countries in which accountancy has reached high standards. While the profession was guided during its infancy to a great extent by developments in the United Kingdom, in later years it has been greatly influenced by U.S. accounting concepts; however, neither the U.K. nor the U.S. concepts are applied as such.[555]

Under the Companies Law, 1999, an auditor is appointed by a company at the annual general meeting of the shareholders, although the general meeting is entitled, if so specified in the company's articles of association, to appoint the auditor for a longer period, which may not exceed three years.[556] The auditor may be removed only by a general meeting of the shareholders.[557] The Companies Law, 1999 grants the auditor the right of access to the company's books and vouchers, as well as the right to attend any general meeting of the company and board meeting in which the audited books and reports are to be discussed.[558]

The auditing standards prescribed by the Institute of Certified Accountants and incorporated in the Auditors' (Mode of Performance) Regulations, 1973 are almost identical to those adopted by the American Institute of Certified Public Accountants.

In 1997, an Israeli Accountancy Standards Board was established. This institute is intended to fulfill a role similar to that of the Financial Accounting Standards Board in the United States. The Israel Accounting Standards issued by the Israeli Accounting Standards Board are often based on and may include parts of the International Accounting Standards published by the International Accounting Standards Committee (London). Once published, they are binding on members of the profession. In November 2005, the Israeli Accountancy Standards Board published a resolution adopting the International Financial Reporting Standards (IFRS), applicable to financial statements of public companies effective as of January 2008, for periods commencing thereafter. It reads as follows:

> Where the opinion of an auditor is unqualified, it is couched in the following terms: We have audited the accompanying balance sheets of ABC Company ("the Company") as of December 31, 200_ and 200_, and the related statements of operations, changes in shareholders' equity and cash flows, for the years then ended. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audit in accordance with generally accepted auditing standards, including those prescribed under the Auditors' Regulations (Auditor's Mode of Performance), 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> The aforementioned financial statements have been prepared on the basis of historical cost, adjusted to reflect changes in the general purchasing power of the Israeli currency in accordance with pronouncements of the Institute of Certified Public Accountants in Israel. Condensed nominal Israeli currency data, on the basis of which the adjusted financial statements of the Company were prepared, is presented in Note XYZ.

[555] Public Auditors Law, 1955, s. 2. The profession is regulated by the Auditors' Council, which was created under the Public Auditors' Law, 1955, and the Institute of Certified Public Accountants in Israel. The Auditors' Council comes under the jurisdiction of the Ministry of Justice and implements the Public Auditors Law referred to above. The Council is composed of 14 members, including a Chairman, appointed by the Minister of Justice, five members who represent various government departments or agencies, six auditors, appointed by the Minister of Justice who represent the Institute of Certified Public Accountants, a senior member of the accountancy academic staff and a jurist. It grants licenses to practice, conducts qualifying examinations and supervises the upholding of ethical and professional standards. The Institute of Certified Public Accountants is a voluntary institute; however, most accountants in Israel belong to it. The Institute contributes to the standards of the profession and voices its views on accounting matters, taxation, and similar issues. The rules and standards adopted by the Institute usually serve as a basis for formal regulations promulgated by the Minister of Justice (in accordance with Public Auditors Law, s. 11). To practice as an accountant, the applicant must be at least 23 years of age, and must have passed or been exempted from the qualifying examinations. In addition, a two-year period of apprenticeship is required, either in Israel or abroad (Public Auditors Laws, s. 4). Most new candidates hold academic degrees, although this is not a prerequisite.

[556] Companies Law, 1999, s. 154.

[557] Companies Law, 1999, s. 162.

[558] Companies Law, 1999, s. 168.

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In our opinion, the financial statements, present fairly, in all material respects, the financial position of the Company as of December 31, 200_ and 200_, and of the results of its operations, changes in shareholders' equity and cash flows for the years then ended, in accordance with generally accepted accounting principles.

Pursuant to section 168 of the Companies Law, 1999, we hereby state that we received all of the information and explanations which we requested and that our opinion on the financial statements is given on the best of the information and explanations which we received and as reflected in the books of the Company.[559]

If the company being audited is a public company, the last paragraph will refer to the requirements of the Securities (Preparation of Financial Statements) Regulations, 1993.[560]

The form of the auditor's report, therefore, differs from the U.S. form in two respects. First, the auditor does not certify that the accounting principles were applied on a consistent basis. The auditor addresses the issue of consistency only where he/she is of the opinion that an accounting change was improper or where an accounting change has occurred and the auditor concurs, but believes that no adequate disclosure of the change and its effect was made in the financial statements. Second, while the Statement on Auditing Standard Number 2, section 49 provides that, when financial statements of the previous year are presented as a measure of comparison with those of the current year, the auditor should report on the comparative statements if he/she has examined them, the Institute has issued an opinion that where the audited reports present comparative figures, such comparative figures will be deemed to have been audited regardless of any reference to that effect.

Another Opinion of the Institute describes the circumstances in which the auditor must render a qualified opinion or must refrain from the expression of an opinion as to a specific action or must express a negative opinion. The Opinion follows the recommendations adopted in the United States; however, a piecemeal opinion is permitted and has received statutory confirmation through the Mode of Performance Regulations, 1973.

The Israeli Accounting Standards Board has issued standards on the following issues:

(i) Holdings of Venture Capital Funds: the Standard sets the measurement rules and disclosure requirements for venture capital funds regarding their venture capital investments.

(ii) Construction of Buildings for Sale: the Standard determines the manner in which builders should report their income and expense, assets and liabilities.

(iii) Capitalization of Borrowing Costs: the Standard requires the capitalization of borrowing costs on qualifying assets, which are assets under construction whose preparation for their ultimate use consumes a considerable time and that fall under either of the following groups: assets designated for self-use; or assets designated for sale whose construction period is either abnormally long, expected to last over three years or entails an unusually large investment relative to the business.

(iv) Construction-Type Contracts: the Standard sets the income measurement rules for construction-type contracts. According to the Standard, revenues should be recognized on a percentage-of-completion basis once certain revenue recognition criteria are met.

(v) Corrections and Clarifications Concerning Accounting and Reporting Principles of Not-For-Profit Organizations: the Standard makes some corrections to the previous Opinion 69 (issued by the Israel Institute of Certified Public Accountants) and introduces certain changes to that Opinion.

(vi) Disclosure about New Accounting Standards in Periods Prior to Their Adoption.

(vii) Post Balance Sheet Events: the Standard is based on International Accounting Standard (IAS) No. 10.

(viii) Discontinuing Operations: the Standard is based on IAS No. 35. The purpose of the Standard is to prescribe the presentation of information regarding major discontinuing operations separately from continuing operations.

(ix) Contingent Liabilities and Contingent Assets: the Standard is based on IAS No. 37. The Standard prescribes the accounting and disclosures for all provisions and contingent assets and liabilities. The Standard was approved but has not yet entered into force.

(x) Segment Reporting: the Standard is based on IAS No. 14. The objective of the Standard is to establish principles for reporting financial information by segments. The disclosure requirements in the Standard do not differ from those included in IAS No. 14 in any material way.

(xi) Discontinuance of Adjusting Financial Statements for Inflation: the purpose of the Standard is to abolish the Opinions (mainly Opinion No. 36) issued by the Institute of Certified Public Accountants in Israel related to inflation reporting due to the current low inflation rates (0% in year 2000, 1.4% in year 2001 and 6.5% in year 2002). The starting point for nominal reporting was set for the year ended December 31, 2003.

(xii) The Effects of Changes in Foreign Exchange Rates: the Standard is based on IAS No. 21 and deals with the translation of foreign currency transactions and the translation of financial statements of foreign entities for incorporation into the financial statements of the reporting enterprise. The Standard became operative for financial statements covering periods beginning after December 31, 2003, for enterprises with December 31 fiscal year-ends. For enterprises with other fiscal year-ends, the Standard became operative for financial statements covering periods beginning on or after September 29, 2003.

(xiii) Interim Financial Reporting: the Standard, which is based on IAS No. 34, supersedes Opinion 43 and Opinion 60 issued by the Institute of Certified Public Accountants in Israel. This Standard became operative for finan-

[559] In accordance with Opinion Nos. 61 and 63 published by the Israeli Institute of Public Certified Accountants.

[560] Securities Law, 1968, s. 36.

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cial statements covering periods beginning on or after January 1, 2003.

(xiv) Impairment of Assets: the objective of the Standard, which is based on IAS No. 36, is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through the use or sale of the asset. If this is the case, the asset is described as impaired and the standard requires the enterprise to recognize an impairment loss. The standard also specifies when an enterprise should reverse an impairment loss and prescribes certain disclosures for impaired assets. It does not cover impairment of inventories, deferred tax assets, assets arising from construction contracts, assets arising from employee benefits or most financial assets. The effective date for implementing the Standard was for accounting periods beginning on or after January 1, 2003, but it was recommended as a standard for 2002.

Since January 2008, public companies have had to implement the IFRS. The Israeli Generally Accepted Accounting Principles (GAAP) apply to nonpublic companies that have chosen not to apply the IFRS.

The governing principle in financial reporting is that of fair presentation so that the financial statements present fairly the financial position of the audited company at the balance sheet date and the operating results and cash flow statement for the period indicated. Therefore, hidden reserves are not permitted in financial statements. The statements are prepared based on historical cost but, under Opinions No. 36 and 50 (which were abolished according to Standard 12 as of 2003), were adjusted to reflect changes in the general purchasing power of Israeli currency during the relevant year. In some cases "dollar financial statements" are allowed. Cost of inventories is computed using the FIFO method or the average method basis with items such as tools, implements, and spare parts generally taken in using the base stock method. The last in first out (LIFO) method for the valuation of inventory is not used. The cost of goods includes raw materials, labor and overhead; however, in some cases, periodic overhead costs are not included. Inventory is valued at the lower of its book value or fair market value. In comparing the fair market price to the historical cost, the fair market price is taken as the net realizable value. The comparison between the market price and the historical cost is made for each item or for each group of similar items.

Depreciation is generally computed using the straight-line method; however, the residual value is not taken into account. Interest incurred during periods of construction is capitalized and depreciation is computed accordingly.

Investments in associated companies (i.e., companies controlled to the extent of 20% or more) are usually presented by applying the equity method. Bonus shares are not independently recognized and all other investments in shares of nontraded companies that are not subsidiaries or associated with the audited company are stated at cost unless their value has declined below cost. Special rules apply to the presentation of both marketable and unquoted linked bonds. All outstanding balances in foreign currency or in accounts linked to an index are presented in accordance with the exchange rate or the index prevailing at the date of the balance sheet.

Goodwill is regarded as an asset if it has been acquired for consideration and is amortized in the case of a decrease in its value. Goodwill usually arises from an excess of the costs of an investment in subsidiary companies over the equity in net assets at acquisition, after appropriate values have been assigned to all assets acquired. Research and development (R&D) costs are generally regarded as an expense when incurred; however, in some instances these costs are amortized over a period of three to five years. Patents are amortized in the case of a decrease in their value. Organizational expenses are amortized over a period of three to five years.

Reserves are set up for contingent liabilities as well as for taxes, where timing differences occur between tax accounting and general accounting rules. For income tax purposes, reserves are regarded as an expense only where the liability is indeed contingent. However, the taxpayer may dispute the liability and nevertheless demand that a reserve be set aside to meet it. A reserve may not exceed the total amount of the claimed liability.[561]

The nominal financial statements must further be adjusted for tax purposes.[562] The adjustment concerns mainly the timing of the recognition of expenses or income, the disregarding of the revaluation of assets, and such matters as the investment grant, on which no depreciation is allowed. As of 1982, special adjustments had to be made pursuant to special laws, discussed in XIX., below, designed to prevent the taxation of inflationary gains but, as of January 2008, the inflationary adjustment legislation was abolished due to the decrease in the rate of inflation.

Income is reported for each tax year separately. The tax year begins on January 1 and ends on December 31. However, under section 7 of the Income Tax Ordinance, the Commissioner may allow the use of a different 12-month period in very limited cases, including in the case of a company whose share capital and voting rights are held to the extent of 51% by a nonresident company whose shares are traded on a foreign stock exchange or in the case of a company where the rights to 51% of its profits are invested in such a company.

4. *Calculation of Gross Income*

a. *In General*

The Israeli notion of income is derived from the U.K. tax system and is similar to that employed by the Internal Revenue Code of the United States. There is no single determinative test indicating whether a receipt partakes of the nature of income. The features most relied on in characterizing a receipt as income include its periodicity, the nature of the asset involved in its derivation, the structure of the receiving enterprise and the consideration given for the receipt.[563]

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[561] For tax purposes, see C.A. 190/58 *The Assessing Officer (Large Enterprises) v. Nakid*, 14 P. 2237; I.T.A. 392/82 *Hahevra HaAmerikait Yisraelit LeGas v. Assessing Officer (Large Enterprises)*, 16 P.D.A. 50; C.A. 600/75 *Tel-Ronen Kablanim Ubonim v. Assessing Officer Tel-Aviv*, (1977) 31(2) P.D. 763. I.T.A. 43/95 *Hahevra HaAmerikait Yisraelit LeGas v. Assessing Officer (Large Enterprises)*, Missim O-2 (Apr. 2001), E-69.

[562] Income Tax Ordinance, s. 131(c).

[563] For example, the Court held that the consideration given to a retiring manager for a covenant not to compete stems from the knowledge and expertise

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Under the Income Tax Ordinance, income tax is levied only on income from the sources enumerated in the Ordinance in the following order:

(i) Business, trade and vocation or any transaction or adventure in the nature of trade;

(ii) Employment;

(iii) Dividends, interest, linkage differentials and discounts;

(iv) Pensions, annuities and payments in the nature of maintenance;

(v) Rents, franchise payments, premiums on leases, premiums and other profits derived from real estate;

(vi) Profits derived from property other than real estate;

(vii) Agriculture;

(viii) The sale of patents or designs (to which the Patents and Designs Ordinance, 1924, or the Designs Law, 2017, are applied) by their inventors or the sale of copyrights by their creators, where the invention or creation concerned does not result from the ordinary business of the inventor or creator;

(ix) Profits and gains from betting and lotteries; and

(x) Gains or profits derived from any source not enumerated above.

It is evident that the importance of ascribing income to a statutorily designated source has decreased since the addition of the last subsection — the "catch all" clause.

It has been held that the sources enumerated above are descriptive rather than conclusive and that the classification of income must be made on a functional basis. Income that can be classified under two of the sources will be classified under one source since the different sources exclude each other.[564]

Regarding the first source of income, a distinction must be drawn between "business" and "any transaction or adventure in the nature of trade," since the classification of income as belonging to one of these sources bears significant different consequences. For example, the right to separate filing and tax computation is accorded to spouses mostly with respect to income derived by a spouse from personal exertion in a business, vocation or employment and not with respect to a transaction or adventure in the nature of trade.

One of the most important features of a "business" is its continuous and recurring organized activity[565] in contrast to other commercial activities that lack institutionalization;[566] however, in one case,[567] the Supreme Court ruled that, for purposes of the loss carryforward provisions, there was no need to distinguish between a "business" and an "adventure in the nature of trade." There is no conclusive test, and each case must be determined on its merits and with regard to its special circumstances.[568]

b. Capital Gains

(1) In General

Capital gains are taxed under two separate laws. Capital gains derived from the sale of real property located in Israel and the Area, including shares in real estate associations, are taxed in accordance with the provisions of the Land Taxation Law (Appreciation, Sale and Purchase), 1963.[569] All other capital gains come under the aegis of Part E of the Israeli Income Tax Ordinance. In both cases, the method of taxation is quite complex. The general rule is that the basis of the asset is stepped up to compensate for the inflation since its acquisition. The capital gain is therefore divided into the "real gain" and the "inflationary amount." The "inflationary amount," which represents the inflationary gain in nominal terms, is taxed at the flat rate of 10% on that part accrued up until December 31, 1993, and at 0% with respect to the inflationary amount accrued thereafter.[570] The "real gain" was formerly taxed as if it were ordinary income and was considered to be at the "highest slice" of the taxpayer's taxable income.

Within the framework of the tax reform introduced in 2003, as amended in a 2011 amendment, the "real gain" is taxed as follows:

"Real Gain" Accrued:	Tax Rate — Individuals	Tax Rate — Companies
Before Jan. 1, 2003 (determining date)	Marginal rate (up to 48%)	25%
Jan. 1, 2003 – Dec. 31, 2011	20%/25%	25%
As of Jan. 1, 2012	25%/30%	25%

Real estate is generally taxed as follows:

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gained throughout his employment, and therefore should be classified as employment income or income from a vocation: I.T.A. 353/91 *Holtzman v. Assessing Officer Tel-Aviv 4*, Missim I-6 (Dec. 1995), E-71. *See also* I.T.A. 7/94 *Beit Horim Ronit 1988 Ltd. v. Assessing Officer Acre*, Missim J-3 (June 1996), E-100; I.T.A. 110/95 *Gez v. Assessing Officer Hadera*, Missim K-1 (Feb. 1997), E-179.

[564] I.T.A. 62/85 *Kiryat Yehudit v. The Assessing Officer (Large Enterprises)*, 14 P.D.A. 24, settled by the parties during the course of an appeal before the Supreme Court, with the Tax Authorities conceding the principle of the exclusivity of sources. *See also* I.T.A 143/91 *Mordechai v. Assessing Officer Haifa*, Missim I-3 (June 1995), E-80; I.T.A 134/92 *Mahagna Josef v. Assessing Officer Hadera*, Missim I-3 (June 1995), E-125.

[565] C.A. 111/83 *Elmor v. The Commissioner of Value Added Tax*, 39(4) P.D. 1; I.T.A. 35/82 *Mizrahi v. Assessing Officer Jerusalem*, 1984 (2) P.M. 338; I.T.A. 286/91 *Eliezer v. Assessing Officer Netania*, Missim I-3 (June 1995), E-106; I.T.A. 155/97 *Brener v. Assessing Officer Gush Dan*, Missim M-2 (Apr. 1999), E-201; I.T.A. 120/98 *Fares Vahabi v. Assessing Officer Zafad*, Missim M-4 (Aug. 1999), E-252; I.T.A. 1093/98, 1094/98, *Hazan v. Assessing Officer Netania*, Missim Q/5 E-189.

[566] C.A. 597/75 *Bernstein v. The Assessing Officer*, 9 P.D.A. 157; I.T.A. 17/92 *Harel v. Assessing Officer Acre*, Missim G-6 (Dec. 1993), E-196.

[567] I.T.A 92/84 *A.H.A. Goldstein Ltd. v. The Assessing Officer*, 13 P.D.A. 211.

[568] C.A. 504/65 *Esel v. The Assessing Officer*, 29(3) P.D. 365; I.T.A. 195/90, 31/93 *Azam v. Assessing Officer Haifa*, Missim H-5 (Oct. 1994), E-104; C.A. 9412/03 *Hazan v. Assessing Officer of Netanya*, Missim S-2 (Apr. 2005), E-104.

[569] In 1999, the Land Appreciation Tax Law, 1963, was radically amended, and was given a new name: The Taxation of Land Law (Appreciation and Purchase), 1963. One of the most important changes in the 1999 amendment was the introduction of the sales tax (enforced with effect from Jan. 1, 2000).

[570] Income Tax Ordinance, s. 91(c); Taxation of Land Law (Appreciation and Purchase), 1963, s. 48A.

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"Real Gain" Accrued:	Tax Rate — Individuals	Tax Rate — Companies
Before Nov. 7, 2001 (determining date)	Marginal rate (up to 48%)	25%
Nov. 7, 2001 – Dec. 31, 2011	20%/25%	25%
As of Jan. 1, 2012	25%/30%	25%

The "real gain" accrued during the period between January 1, 2003, and December 31, 2011, is taxed at the rate of 20% for an individual and at the company tax rate for companies (not including shares sold by a substantial shareholder (holding at least 10%) that are taxed at 25%). A "real gain" accrued as of January 1, 2012, is taxed at the rate of 25% (while shares sold by a substantial shareholder are taxed at 30%). The same rule applies for "real appreciation" ("real gain" accrued on real property), except for the determining date.

With respect to the disposition of assets purchased prior to the determining date, the tax rate will be a weighted average between the three tax rates (48%, 20%/25% and 25%/30%) in accordance with the ratio of the holding periods of the asset in each period.

However, a provisional provision in effect from November 15, 2010, until December 31, 2012, provided that an individual would be taxed at the rate of 20% on the "real gain" on the following conditions: (i) the real property was purchased between April 1, 1961, and November 6, 2001, and sold between November 15, 2010, and December 31, 2011; (ii) there is a plan (according to the Planning and Building Law, 1965) to build at least eight apartments on the land; and (iii) within 36 months from the date of the sale, the building of eight apartments or 80% of the apartments designated for residence were completed.[571] With respect to these assets, the tax rate was a weighted average between the former tax rate and the newer tax rate in accordance with the ratio of the holding periods of the asset prior to and after December 31, 2002. However, where the asset disposed of was real estate, and the sale took place between November 7, 2001, and December 31, 2002, a 20% reduction of the tax was granted, and where the sale took place in 2003 a reduction of 10% was granted. These reductions were also granted on the disposition of real estate purchased between November 7, 2001, and December 31, 2002 (a reduction of 20%, i.e., a tax rate of 20%), and on a disposition of real estate purchased during 2003 (a reduction of 10%, i.e., a tax rate of 22.5%).

The real gain derived by an individual from the sale of shares and securities on the Tel-Aviv Stock Exchange is subject to a 25% tax, provided the seller is not a substantial shareholder (i.e., a shareholder who holds at least 10% of the stock and is consequently subject to a 30% tax). However, corporations are subject to the company tax rate on the realized gain.

Under a special Order of the Minister of Finance, nonresidents are exempt from tax on the "inflationary amount" where the "inflationary amount" is calculated based on the foreign currency used to purchase shares of a company.[572]

(2) Transfers of Shares and Liquidations

Before 2003, special provisions of the Income Tax Ordinance provided that, on the sale of the shares of a company, the undistributed profits, as defined by the Ordinance, were to be taxable at the 10% rate, as part of the "inflationary amount."[573] This provision was designed to equalize the treatment of current dividends and liquidation dividends, and the use of the term "inflationary amount" was of a technical nature, due to the former 10% tax rate levied on the "inflationary amount" (now zero), and had nothing to do with inflation. In most instances, taxpayers found it worthwhile to realize the gain before a liquidation process was initiated and thereby create a surplus that constituted part of the "inflationary amount." These provisions also applied in the case of the liquidation of a company.[574] The Ordinance also provided that tax on the sale of capital assets during the process of liquidation was to be credited against the tax due from the shareholder on the net liquidation dividend, thus granting undue double relief for the underlying company tax.

Nevertheless, the Supreme Court nullified this double relief in a ruling. In *Mano*,[575] the Supreme Court ruled that one of the important principles of tax law is the assessment of taxes on the real income of the taxpayer. Double tax relief infringes this principle, and was consequently held inapplicable by means of purposive construction of the Ordinance.

With the introduction of the reform of 2003, the part of the real gain equal to the earnings surplus was no longer regarded as an inflationary amount. In accordance with the new provisions, that part of the real gain equal to the surplus will usually be taxable at the rate of 25%/30%. The two exceptions to this rule are that: (i) where the shares sold were purchased prior to December 31, 2002, that part of the surplus attributable to the period ending on December 31, 2002, will be liable to a tax levied at the rate of 10%; and (ii) where the distribution of the dividend to the selling corporate shareholder would not have been liable to tax, the amount of the real gain equal to the surplus will be exempt from tax to equalize its treatment with that of the exemption accorded to intercompany dividends (see c., below, regarding intercompany dividends).

As of January 1, 2006, shareholders are no longer able to claim the tax credit for the tax paid by the company on liquidation; and all gains accrued by the company during the liquidation process are considered regular profits, so that corporate shareholders pay no additional tax on them ("earnings surplus"). As for individual shareholders, the "earnings surplus" provision was cancelled regarding shares purchased after January 1, 2003; in any event the rate of tax on dividends and capital gains is identical.

571 Taxation of Land (Increasing the Supply of Residential Apartments — Provisional Provision) Law, 2011, s. 5.

572 Order — Re Exemption from Capital Gains Tax on Inflationary Excess upon the Sale of Shares of Nonresident, 1978, s. 1.

573 Income Tax Ordinance, s. 94B.

574 Income Tax Ordinance, s. 94B(b).

575 C.A. 1194/03 *The Assessing Officer of Haifa v. Esther Mano*, Missim KD/3 (June 2010), E-257.

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(3) *Bonus Shares*

Bonus shares are treated in the same way as "the principal shares" on which they are issued.[576] A bonus share is deemed to have been acquired on the day on which the principal share was acquired,[577] so that the cost of an individual bonus share or principal share is always the amount bearing to the cost price of the aggregate of the bonus shares and principal shares the same proportion as the nominal value of the individual share bears to the nominal value of the aggregate of those shares.[578]

(4) *Incorporation Rollover*

Under section 104 of the Income Tax Ordinance, a deferral of tax in the form of a "rollover" is granted for assets transferred to a new company in return for at least 90% of its shares, provided certain requirements regarding continuity of interest for a two-year period are met.[579] The court has held that section 95(a) (the predecessor of section 104) was enacted to prevent the taxation of a transfer of property to a company for most of its shares because such a transfer does not economically affect the ownership of the property. The wording of section 95(a) required that "immediately after the sale" the transferor held 90% of the share capital of the transferee. The Court held that this wording should be construed narrowly, i.e., the transferor did not have to hold 90% of the voting power for any specific period of time, provided the transferor held it immediately after the sale.[580] These rules have been modified by the criteria enacted by the legislation referred to above, in force since 1994.

On the sale of any property acquired by a company in the above circumstance, or on the sale of the shares received for any such property, the basis of the property in the hands of the seller is the basis of the property transferred. The same holds true for the date of acquisition of the assets exchanged in the tax-free exchange. Thus, the exempting provisions are in essence tax-deferral provisions. Special rules permit the preservation of the deferral even where there is a transaction involving a decrease in the holdings of the transferor during the two year period, for example, a public issue of shares or a private placement of no more than 25% of the company's shares.

(5) *Corporate Reorganizations*

Since 1994, the tax treatment of corporate reorganizations has been consolidated in part E2 of the Income Tax Ordinance. Part E2 was amended in 2000 to achieve greater uniformity of the Ordinance with the Companies Law, 1999. In addition to the provisions of section 104 regarding the incorporation rollover, discussed in (4), above, sections 103 and 105 of the Ordinance allow for tax-free mergers, consolidations and spin-offs, provided certain conditions are met. Such reorganizations are exempted from tax under the Income Tax Ordinance, the Income Tax (Adjustments for Inflation) Law, 1985, and the Taxation of Land (Appreciation and Purchase) Law, 1963,[581] as well as from VAT and stamp duties on the transactions and documents related to the reorganization process. The assets transferred under these provisions preserve their basis and date of original acquisition, and hence the "exemption" is actually a deferral of tax until the assets are realized by the transferee.

Most of the conditions that must be satisfied to qualify for a tax-exempt merger[582] or spin-off are similar:

(i) The reorganization plan requires the prior consent of the Income Tax Commissioner.[583]

(ii) The participating companies may be Israeli resident companies or cooperative societies, or "foreign companies" under the Companies Ordinance or the Companies Law, 1999 (see III.A.4., above). The participation of foreign companies is subject to the approval of the Commissioner.[584]

(iii) The reorganization must be based on valid economic and business reasons, with tax avoidance not being the predominant aim.[585] To that effect, the corporations resulting from the reorganization are required to continue the "main economic activity" of the original companies for a specified period (the "required period").[586] In the case of a spin-off, only one of the new companies is required to continue the original activities, but the others are all required to conduct independent business activities.

(iv) The majority of the assets transferred as part of the reorganization may not be disposed of during the required period and should be used in the transferee's business. For that purpose, "the majority of the assets" means assets with a value of at least 50% of the market value of the company prior to the merger or spin-off.[587]

(v) The ownership structure after the reorganization should reflect the preservation of economic interests. In a merger, the transferor's shareholders should be allotted shares in the transferee reflecting the ratio of the market value of the transferred assets to the market value of the total assets involved in the merger.

The shares allotted should constitute the sole consideration (directly or indirectly), i.e., no "boot" is allowed.[588]

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[576] I.T.A. 935/70 *Kenes v. The Assessing Officer (Large Enterprises)*, 6 P.D.A. 8.

[577] Income Tax Ordinance, s. 94(a)(1).

[578] Income Tax Ordinance, s. 94(a)(2).

[579] The rollover relief does not cover the transfer of assets by a partnership or by individual partners (Income Tax Ordinance, s. 104A(b)), unless the requirements of s. 104B(d) are met.

[580] C.A. 83/81 T.M.B. *Tachzukat Mifalim Ltd. v. The Assessing Officer*, 40 P.D. 402.

[581] In some cases, the sale of real estate on a corporate reorganization will be subject to a reduced purchase tax rate of 0.5%.

[582] The 2000 amendment enables the merging companies to merge again within a short time (a chain of mergers) without jeopardizing the tax rights under this section.

[583] Income Tax Ordinance, s. 103I(a).

[584] Income Tax Ordinance, s. 103C(7) (mergers), and s. 105C(5) (splits).

[585] Income Tax Ordinance, ss. 103C(1) and 105 C(1).

[586] Income Tax Ordinance, s. 105 C(3); the required period is the longer of the following periods: (i) the period up to two years after the reorganization; or (ii) the period up to the end of one year following the end of the tax year in which the court reorganization decree was rendered, or in which the reorganization was approved by the court. Income Tax Ordinance, s. 103C(3).

[587] Income Tax Ordinance, s. 105 C(2).

[588] Cash consideration is allowed only if there is a court order for the acquisition of the shares of any minority shareholders dissenting to the merger: Income Tax Ordinance, s. 103D.

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Furthermore, after the merger, the shareholders participating in the merger must together hold at least 25%[589] of the rights in the merged company.[590] To alleviate the strictness of the requirements under the Ordinance, under a 2000 amendment, the shareholders may dispose of the shares received on a merger after one year, provided they dispose of all the shares and receive cash in return, and the purchaser is deemed to be a shareholder as of the date of the merger.[591]

(vi) Certain market value limitations are imposed prior to a merger. Thus, the market value of any party may not exceed nine times the market value of any other party.[592] Moreover, the value of the rights received by the transferor's shareholders must equal at least 10% of the total market value of the rights in the transferee during the required period.[593] This requirement is relaxed for companies among which "special relations" exist, i.e., a parent and subsidiaries, or companies under common control.[594] In a spin-off, the market value of any company after the spin-off may not exceed four times the market value of any other company involved in the spin-off. Furthermore, the market value of the assets transferred to each transferee and the assets remaining in the ownership of the transferor (if any) must be no less than 10% of the total market value of the assets prior to the spin-off.

(vii) Net operating losses accrued before the reorganization may be transferred and set-off against future profits; however, for a period of five years after the reorganization, the amount set off may not exceed 20% of the total amount of losses transferred or 50% of any transferee's taxable income, whichever is lower.

(viii) In a spin-off, the liabilities of the transferor are split between the transferees proportionally to the market value of the assets transferred to them, whereas accrued losses are split proportionally to each transferee's equity.

(ix) Benefits granted under the Law for the Encouragement of Capital Investments, 1959 (see XVII.A., below) may be carried over to the transferees after the reorganization. Such a carryover of benefits requires the approval of the Investment Center.[595]

(6) Unlinked Loans Transferred with Shares

Where an unlinked non-interest bearing loan is made to a company by a shareholder and is transferred three years after its making, together with shares or other rights in the company, the consideration for the loan is deemed to be part of the consideration for the shares, to the extent of the adjusted basis of the loan. Where, on the sale of the shares, a capital loss arises as a result of this calculation, it is set off, shekel for shekel, against the capital gain from the loan.[596] In essence, the Income Tax Ordinance recognizes that the financing of small companies is usually effected by shareholders' loans that in effect are similar to share capital invested in the company. Therefore, the Ordinance requires that the provisions applicable to the treatment of a loan as share capital apply only where the loan is unlinked and bears no interest. In the event that a loan is linked, the linkage differentials are allowed as a deduction to the company and constitute taxable income in the hands of the shareholder,[597] unless they are exempt under special regulations.[598]

(7) Exchanges of Depreciable Assets

Section 96 of the Income Tax Ordinance provides for a deferral of tax on the exchange of a depreciable asset used for the production of income for another, similar asset.[599] Where a capital gain arises from the sale of depreciable property and, within 12 months after or four months before the day of the sale, the taxpayer acquired other property to replace the sold property at a price exceeding the balance of the adjusted basis of the property sold, the taxpayer may require that only the amount by which the consideration received for the sold property exceeds the price of the acquired property be regarded as a capital gain. The taxpayer may do so with respect to the whole capital gain or only with respect to the "real gain." Pursuant to such an election of the taxpayer, the tax deferred on the sale of the property sold will be collected on the sale of the new property unless the taxpayer again chooses the section 96 route. Depreciation will be calculated on the basis of the cost of the new asset reduced by the amount of the capital gain on which the tax was deferred. It should be noted that the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for The Years 2013 and 2014), 2013 stipulated that section 96 does not apply with respect to rights in real property located outside of Israel, certain private vehicles, and property sold in a notional sale under section 100A1 of the Income Tax Ordinance.[600]

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[589] A draft bill published in November 2024 suggests amending the Income Tax Ordinance proposed to abolish the 25% holding requirement following corporate restructuring under various sections of the Ordinance.

[590] Income Tax Ordinance, s. 103C(8).

[591] Income Tax Ordinance, s. 103C(9A).

[592] Income Tax Ordinance, s. 103C(6)(b).

[593] Income Tax Ordinance, s. 103C(6)(a).

[594] Income Tax Regulations (Merger of Companies Among Which Special Relations Exist), 1995.

[595] Law for the Encouragement of Capital Investments, 1959 s. 74B.

[596] Income Tax Ordinance, s. 94A.

[597] Income Tax Ordinance, s. 17(1), as regards the company; Income Tax Ordinance, s. 2(4), as regards the shareholder.

[598] Income Tax (Exemption from Tax of Linkage Differentials on a Loan Advanced by a Controlling Shareholder) Regulations, 1986; and as of Jan. 1, 1998, Income Tax (Exemption from Tax of Linkage Differentials Resulting From a Positive Balance of a Controlling Shareholder) Regulations, 1998.

[599] Income Tax Ordinance, s. 96 applies only if the exchanged asset is a depreciable asset: C.A. 130/81 *The Assessing Officer v. Ashkenazi*, 12 P.D.A. 229; I.T.A. 8/84 *Aharon Joseph v. The Assessing Officer*, 14 P.D.A. 3. The similar asset that was acquired does not have to be a depreciable asset, although it must be an "asset": *The Assessing Officer v. Ashkenazi*, 12 P.D.A. 229. It was held that the exchanged asset must replace the sold asset: I.T.A. 6, 7/77 *Baumel v. The Assessing Officer*, 9 P.D.A. 149, but, in more recent years, cases have taken a more liberal approach from the taxpayer's point of view and the deferral of tax will be allowed if the exchanged asset may serve to perform an alternative to one of the functions of the asset disposed of. *See* I.T.A. 193/89 *Cherni v. Assessing Officer Acre*, Missim E-3 (June 1991), E-85; C.A. 499/87 *Einhorn v. Assessing Officer Jerusalem*, Missim D-1 (Feb. 1990), E-106; and I.T.A. 185/90 *Moaza Mekomit Yahud v. Assessing Officer Petach Tikva*, Missim G-1 (Feb. 1993), E-127.

[600] *See also* I.T.A *Amot Hashkaot Ltd. v. The Assessing Officer for Large Enterprises*, Missim KG/6 (Dec. 2013), E-227.

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(8) Conversions to Inventory

Special provisions apply to the conversion of property into inventory. Where the Assessing Officer is satisfied that a person has converted any property owned by that person into inventory or has converted any fixed asset in his/her business into inventory in his/her business, the tax levied depends on the time that has elapsed from the date on which the taxpayer acquired the property. Where four years have elapsed from the date on which the taxpayer acquired the property to the date of the transfer, the transfer is regarded as a sale, but the taxpayer is not required to pay the tax on it except where the inventory is sold in whole or in part. If the taxpayer sells a part of it, the taxpayer is not required to pay tax in excess of the consideration received by him on that sale.[601] Where four years have not elapsed, the transfer is not regarded as a sale and the original basis of the property is the cost of the inventory.[602]

(9) Publicly Traded Securities

Until the tax reform introduced in 2003, capital gains derived from the sale of securities traded on the Tel-Aviv Stock Exchange (TASE) were free of capital gains tax. This exemption served as an incentive to induce companies to register their shares for trade on the TASE and thereby grant their shareholders an opportunity to derive tax-free income.

As of 2003 and until the end of 2005, real capital gains derived from the disposition of shares traded on the TASE were taxed at a reduced rate of 15%. A 10% tax was levied on the nominal gain derived from the sale of unlinked notes, bonds and similar securities traded on the TASE.

With effect from January 1, 2006, these rates have changed to 20% and 15%, respectively, regarding individual shareholders who are not substantial shareholders (who are subject to tax at the rate of 20% or 25%), whereas the applicable tax rate for companies is 23%. Regarding the tax regime prior to January 1, 2006, a taxpayer wishing to enjoy the reduced rates was not entitled to deduct interest and linkage differentials incurred in the production of the income derived from the securities sold and had to be outside the scope of the law regulating taxation under inflationary conditions. It is worthwhile noting that the tax on capital gains derived from the sale of securities traded on the TASE applies only to gains derived after January 1, 2003, and that the computation is done on a linear basis (see b.(1), above).

To induce foreign investors to invest in securities traded on the TASE, section 97(B2) of the Income Tax Ordinance grants a tax exemption to nonresidents on capital gains derived from the sale of securities traded on the TASE.[603] In addition, section 97(B3) of the Ordinance, enacted as part of Amendment No. 147, provided for a tax exemption for residents of Israel's treaty partner countries on the sale of securities otherwise taxed by Israel, provided the securities were purchased between July 1, 2005, and December 31, 2008.

Amendment No. 169,[604] effective as of January 1, 2009, aims to encourage foreign investors to continue investing in Israel. The Amendment elaborates and simplifies the tax exemptions for foreign residents. The main benefits include: (i) an exemption for foreign residents on interest income, discount fees and exchange differentials derived from corporate bonds on the TASE (the exemption applies to any foreign resident on the day of payment even if the bonds were acquired prior to January 2009); and (ii) a capital gains exemption on the sale of Israeli securities acquired after January 1, 2009 (as noted above, prior to the amendment only treaty country residents who met certain conditions were exempt from capital gains on the sale of non-traded Israeli securities).

In the past, capital gains derived from the sale of securities traded on the TASE (and in some cases on a stock market abroad) were accorded preferential tax treatment. To counter tax avoidance by means of registering shares for trade on the stock market, the provisions of section 101 of the Income Tax Ordinance were enacted. Under these provisions, the registration of shares on the stock exchange was regarded as the sale of the shares on the date of their registration. However, when filing a first return after the registration, the holder of the shares had the right to request that the registration not be regarded as a sale.[605] If the holder made such a request, the exemption from capital gains tax on the sale of the shares did not apply on the sale of the shares and the holder was taxed accordingly. Moreover, the holder of the shares has the right to withdraw the request at the time of the actual sale and pay the tax that would have been due had the registration been regarded as a sale, together with linkage differentials and such interest as is imposed by the Income Tax Ordinance on all late payments.[606]

Section 101 of the Income Tax Ordinance dealt with a notional sale, and did not provide for the computation of the consideration, which is essential for the computation of the capital gain. The Court held that the notional consideration was the amount that would have been paid by a voluntary buyer had there been an actual sale.[607] Such consideration is a matter of assessment. Where it was determined in trading on the stock exchange on the day of the registration of the shares, such a determination governed. Otherwise an assessment based on the closest transaction to the registration, whether prior to or immediately after it, was made.

In 1984, the Minister of Finance issued a special order designed primarily to prevent the avoidance of the tax imposed by section 101 of the Income Tax Ordinance by the use of options and warrants.[608] With the amendment of section 101 in 2002, this order was annulled and section 101 then covered the entire spectrum of the taxation of notional income on the registration of securities for trading on a stock exchange.

A District Court decision held that section 101 applied only to registration on the TASE,[609] since the definition of a "stock

[601] Income Tax Ordinance, s. 100(1).

[602] Income Tax Ordinance, s. 100(2); C.A. 358/87 *VAT Director v. Akala*, Missim D-1 (Feb. 1990), E-98.

[603] Income Tax Ordinance, s. 105L(c).

[604] Income Tax Ordinance (Amendment 169), 2008.

[605] *See also* I.T.A. 178/97 *Rosenboim v. The Assessing Officer Tel-Aviv 4*, Missim N-3 (June 2000), E-98.

[606] Income Tax Ordinance, s. 159A.

[607] C.A. 111/87 *Rubinstein Ltd. v. The Assessing Officer (Large Enterprises)*, Missim I-3 (June 1995), E-56.

[608] Income Tax (Exemption from Tax on Capital Gain from the Sale of Shares) Order, 1981, as amended in 1984, which was designed to close the loophole left by Income Tax Ordinance, s. 101.

[609] I.T.A. 48/94 *Levin v. Assessing Officer Tel-Aviv*, Missim J-6 (Dec. 1996), E-122.

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exchange" in section 1 of the Income Tax Ordinance referred to stock-exchanges of only two sorts: those that received a permit under the Securities Law, 1968 (currently only the TASE), and those designated by the Minister of Finance for that purpose, who had not at that time made such a designation. As explained hereinafter this decision was upset by the reform of 2003.

Within the framework of the reform introduced in 2003, the provisions of section 101 of the Income Tax Ordinance required amendment so as to reflect the fact that the reform introduced a reduced tax on capital gains derived from the sale of securities traded on the TASE. Therefore, the Ordinance differentiates between securities registered for trade prior to 2003, and those registered thereafter. With respect to securities registered for trade prior to 2003, on which the tax was paid on their registration for trade, the capital gain on their sale will go untaxed until January 1, 2003, and the remainder of the real gain will be liable to the reduced tax rate. Securities registered for trade after January 1, 2003, with respect to which the taxpayer requested the deferral of tax until their actual sale and did not withdraw his/her request, will on their sale be taxed at the regular company tax rate and the remainder of the gain will be taxed according to the applicable tax rates depending on the shareholder and on the date of sale. Where the taxpayer withdrew his/her request to defer the tax, the real gain up to the registration will be subject to tax at the regular company tax rate with interest and linkage differentials, the inflationary amount will be subject to tax at a rate of 10% up to December 31, 1993, and the remainder of the gain up to January 1, 2003, will be exempt from tax; however, with effect from 2003 and thereafter, any gain will be taxed at the applicable rate for the real capital gain depending on the shareholder and on the date of sale. Securities registered for trade after 2003, with respect to which no request for a deferral of tax was made, will be liable to tax until 2003, at the regular company tax rate on the real gain (10% on the inflationary amount until December 31, 1993) and the remainder of the gain from 2003 and until the registration will be liable to tax on the real gain according to the applicable tax rates depending on the shareholder and on the date of sale. The gain derived after registration will be liable to a reduced tax on the real capital gain. Should the taxpayer request the deferral of the tax until the actual sale and not withdraw his/her request, the gain up to January 1, 2003, will be taxed at the regular company tax rate on the real gain (10% of the inflationary amount until December 31, 1993) and the remainder, until the date of the sale, will be liable to tax on the real gain according to the applicable tax rates depending on the shareholder and on the date of sale. Should the taxpayer decide to withdraw his/her request to defer the tax event, that part of the capital gain derived up to 2003, will be liable to the regular company tax rate on the real gain and 10% on the inflationary amount up to December 31, 1993, to which will be added interest and linkage differentials. The remainder of the gain arising from 2003 up to the date of registration will be liable to tax according to the applicable tax rates depending on the shareholder and on the date of sale, to which will be added interest and linkage differentials. The last part of the gain derived after 2003 up to the actual sale will be liable to the reduced tax rate on the real gain.

To bring its provisions into line with the tax reform introduced in 2003, section 101 of the Income Tax Ordinance now provides that it will also apply to stock exchanges outside Israel insofar as its provisions pertain to companies that are residents of Israel for tax purposes. The debate as to whether section 101 of the Income Tax Ordinance applied only to the TASE or to other stock exchanges as well has therefore been brought to an end. It will also apply to shareholders of nonresident companies registering their shares on the TASE.

As implied above, with the abolition of the preferred tax regime governing capital gains derived from the sale of securities traded on the stock exchange (with effect from January 1, 2006), section 101 of the Income Tax Ordinance no longer applies, except as described above.

(10) Sales of Foreign Securities

An Israeli resident corporation is liable to tax on its worldwide income, including capital gains derived from the sale of assets outside Israel (see (1), above). To encourage investment in Israeli securities, the 2003 tax reform safeguarded a special tax of 35% on the real capital gain levied on transactions in foreign securities. This rate was in effect until 2004. A "real capital gain" accrued after 2004 was taxed at the rate of 15% in the case of sales that took place before January 1, 2006, and is taxed at 20%, in the case of sales taking place after that date, provided the seller is not a substantial shareholder subject to a 25% tax. Capital gains derived from the sale of foreign securities purchased prior to 2005 but sold thereafter, are taxed in accordance with the ratio of the holding period ending on December 31, 2004, to the period commencing on that date and ending on the date of sale, so that on a linear basis the tax on the gain derived from the first holding period will be 35% while the tax on the remaining period will be levied at the prevailing rate. The tax is computed in all cases on the gain expressed in the currency used to purchase and sell the foreign security. A foreign security includes any foreign security that is traded on a stock exchange or on a regulated market outside Israel, other than those of Israeli resident corporations and securities publicly traded both in Israel and abroad. Capital gains derived from the sale of foreign securities of non-traded corporations will be liable to tax at the ordinary rates, i.e., the standard corporate tax rate on the real gain up until 2003 and thereafter 25%, with the inflationary amount up to the close of 1993 being taxed at 10%.

(11) "Departure" Tax

Section 100A of the Income Tax Ordinance provides that an asset (not including Israeli real estate) owned by an Israeli resident (be it a company or an individual) that ceased to be an Israeli resident, is deemed to be sold on the day preceding the day on which the taxpayer lost his or her tax residence status. However, such a taxpayer may choose to defer the payment of the tax until the actual disposal of the asset.

In a decision handed down in November 2019, the Supreme Court of Israel[610] upheld a district court ruling that an exit tax applicable to the assets of a resident of Israel who moves to another country applies to assets situated both inside Israel and outside Israel. The tax calculation will be based on the increase in value of the assets up to one day before the end

[610] C.A 5694/18, *David Koenig. v. Assessing Officer Tel Aviv 3*, Missim (Nov. 2019).

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of the taxpayer's residency. Should the taxpayer refrain from paying the tax on that date, he or she will be deemed to have requested deferral of the tax payment to the date on which the asset is realized and, if there is a tax treaty between Israel and the country to which the taxpayer moves, its provisions will not apply to deny Israel taxing rights.

However, in cases where the exit tax results in double taxation (i.e., in Israel and the country to which the taxpayer moves), the tax authorities of both countries will resolve the question of dual taxation by mutual consent procedures. ("Mutual Agreement Procedures").

> *Example:* The original price of a property is NIS 100; the property was held for three years and sold for NIS 700 (assuming inflation is zero). The seller became a foreign resident two years before he sold the property and did not pay the tax in Israel on that date. In this example, "the portion of the taxable profit" is NIS 200: the real capital gain is multiplied by one-third (i.e., the holding period from the date of purchase until the date the seller became a foreign resident, divided by the period from the date of purchase to the date of realization).

(12) Capital Losses

Capital losses are set off against capital gains under section 92 of the Income Tax Ordinance.[611] Since a capital gain is divided into the "real gain" and the "inflationary amount," a special method had to be found to allow for an equitable set-off of capital losses. The Ordinance therefore provides that a capital loss is first set off against the "real gain" and each shekel of the balance is set off against three and a half shekels of the "inflationary amount." For purposes of the set-off, a gain or a loss within the meaning of the Taxation of Land (Appreciation and Purchase) Law, 1963 is deemed to be included in the capital gain or capital loss, as the case may be. Where an amount is not set off in whole or in part as provided above, the procedure outlined above is followed for the next succeeding tax years; however, the taxpayer is obliged to set off the loss in the first year in which such set-off is possible. Furthermore, a capital loss derived from the sale of a security may be set off in the year of the sale against interest or dividends derived from that security, or against interest or dividend income from other securities, provided the income from dividends or interest is subject to a tax rate that does not exceed 25%. Since the Income Tax (Inflationary Adjustments) Law is no longer in effect as of January 1, 2008, losses are no longer adjusted to the cost-of-living index. Capital losses sourced outside Israel must be first set off against capital gains sourced outside Israel; only thereafter may they be applied against capital gains derived from Israel.

(13) Land Appreciation and Purchases

For a discussion of the Taxation of Land (Appreciation and Purchase) Law, 1963, see IV.C., above.

(14) Cryptocurrencies and Other Digital Assets

Cryptocurrencies are digital assets that rely on a consensus mechanism for validation. The mechanism involves a network of individual computers working together to verify and record transactions, creating a shared and verifiable ledger known as the Blockchain. The participants responsible for validating transactions are referred to as "miners."

Crypto miners play a crucial role in maintaining the integrity of cryptocurrency network. They use their computational power to solve complex mathematical problems and validate transactions. When a transaction is initiated, it is broadcasted to the network, and miners compete to validate and add the transaction to a new block on the blockchain. This process ensures the validity of a transactional, prevents double-spending, i.e., spending a digital token more than once, and secures the integrity of the ledger.

In cryptocurrency exchanges, the transferer and transferee rely on the blockchain to verify availability of funds before and during a transaction. This design makes it highly unlikely for manipulation and fraud to occur. There is a small fee that is bestowed upon the transferer to compensate the miners.

What sets different cryptocurrencies apart is their distinct organizational structures and underlying blockchain technologies. Each cryptocurrency operates on its own blockchain, which determines how transactions are verified and recorded. Today there are thousands of currencies with only a few specifically popular ones.

The Israeli Tax Authority (ITA) classified cryptocurrency as a tradeable asset and not as a currency.[612] Accordingly, all profits and losses associated with cryptocurrencies are regarded as of capital nature. The District Court in *Noam Kopel v. Assessing Officer* Rehovot,[613] stated that cryptocurrencies are capital assets that give rise to capital gains, and not foreign currencies that are exempt from tax according to section 9(13) of the Income Tax Ordinance. As stated in the definitions in the Bank of Israel Law,[614] in order for a currency to be considered as "banknotes or coins" it must have a physical-tangible expression. Cryptocurrencies do not have a physical aspect, and therefore do not meet the definition prescribed by law. As the court stated, cryptocurrencies are not considered a real substitute for coins or banknotes in any country.

Capital gains are taxed at 25%[615] and taxpayers are required to provide records when filling their tax returns in order to support their claims of gains or losses.

Income from cryptocurrency can also be classified as business income. For example, if the income of an individual taxpayer that is derived from cryptocurrency is the main income, and the taxpayer is intensively involved in mining or trading cryptocurrencies. In this case, the income from digital assets will be considered as business income, and the tax will be calculated according to the personal income tax brackets, which can get up to a 50% tax rate. If a corporation is using cryp-

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[611] A capital loss may not be set off against current income: I.T.A. 258/72 *Rotberg v. The Assessing Officer*, 6 P.D.A. 159. Furthermore, the Income Tax Ordinance allows the set off only of losses that, had they been profits, would have been subject to capital gains tax. Therefore, a loss incurred on the sale of personal assets that were exempt from tax, may not be set off against capital gains: C.A. 14/85 *The Assessing Officer v. Goldstein*, 15 P.D.A. 59.

[612] Income Tax Circular 05/2018.

[613] T.A. (Merkaz) 11503-05-16 *Kopel v. Assessing Officer Rehovot* (Published on Nevo, 2019).

[614] Bank of Israel Law, 2010.

[615] Income Tax Ordinance, s. 91(b)(1).

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tocurrencies for business purpose, the applicable tax rate will be 23%, and in addition, VAT will apply at the rate of 18%.

On November 2024, a memorandum was published proposing amendments to the Income Tax Ordinance that focus on the taxation of digital currencies and assets. The proposed amendment introduces new definitions of "Foreign Currency," "Distributed Ledger Technology" (DLT) and "Digital Asset." The proposed changes make it clear that profits from the sale of digital currencies will no longer be considered tax-exempt income under Section 9(13), even if the currency is legal tender in a foreign country if it was not issued by an official monetary authority. Additionally, the amendment proposes that the geographic source of capital gains from the sale of Digital Assets will be considered to be in Israel in certain circumstances, for example, when the seller is an Israeli resident or when the Digital Asset reflects rights related to assets in Israel. The purpose of the amendment is to ensure the effective taxation of profits from Digital Assets with a connection to Israel.

In addition, on November 2024 the Minister of Finance informed the OECD of Israel's commitment to implementing the Crypto Asset Reporting Framework (CARF), which establishes a regulatory framework for information exchange in the digital currency sector.

The CARF project was introduced following a request from G20 leaders in October 2022 to develop a comprehensive, transparent and effective information exchange system for the digital currency sector. The project is spearheaded by the Global Forum under the OECD, with the aim of enhancing transparency and facilitating tax-related information exchanges.

c. Dividend Income

The ordinary income tax was imposed in addition to the corporate tax, but it was abolished as of tax year 1992 and only the corporate tax is now in effect.[616]

Dividends received from another corporation are free of tax in the hands of the recipient if the income out of which the dividend was distributed is sourced in Israel. Thus, if the distributing corporation distributes its entire Israeli-sourced income, consisting of dividends received from another company, the dividends received by the distributing corporation are not subject to tax in its hands.[617] It is taxed (corporate tax) when derived as income by the payor and is taxed again (income tax) when received by the ultimate, non-corporate shareholder.[618] The Income Tax Ordinance takes into consideration the fact that the income out of which the dividend was paid has already been subject to corporate tax. It therefore sets the rate of tax on dividends received by individuals at 30% for substantial shareholders and at 25% for other shareholders.[619] In *Oz Technologies (1972) Ltd. v. Large Enterprises Tax Assessor*, the Tel Aviv District Court held that the provisions of Section 126(b) of the Income Tax Ordinance may be applied to dividends distributed out of funds that represent depreciation amounts claimed by the company solely for tax purposes and that were not recorded as an expense in the company's financial statements as a result of the adoption of the fair value model.[620]

Until the 2003 tax reform, any dividend distributed by an Israeli resident corporation to another Israeli resident corporation was exempt from company tax. Within the framework of the 2003 tax reform, the exemption was curtailed in that it now applies only to dividends distributed out of income sourced in Israel. Dividends distributed from income sourced outside Israel, irrespective of whether the distributing corporation is a resident of Israel, are taxed, at the taxpayer's choice either: (i) at the rate of 25% of the gross dividends paid with a credit for the tax withheld at source; or (ii) at the regular corporate tax rate on the income out of which the dividends were paid with a credit for the applicable ratable tax paid by the paying corporation and for the tax withheld at source on the dividends themselves.

The 2003 amendment of the Income Tax Ordinance attempts to neutralize the beneficial effect of a number of tax treaties entered into by Israel, especially the 1973 Israel-Netherlands tax treaty. Thus, Article 26(4)(b) of that treaty provides that dividends distributed by a company resident in The Netherlands to an Israeli company owning at least 25% of its share capital, will be liable to tax in Israel as if the distributing corporation was an Israeli resident corporation. In the past, when all dividends distributed between Israeli resident corporations were free of tax, this article of the treaty accorded, as a practical matter, an exemption from the tax on dividends distributed by corporations resident in The Netherlands to Israeli resident corporation owning at least 25% of their share capital. After the amendment, since dividends attributable to income from sources outside Israel no longer qualify for the statutory dividend exemption, the treaty article has lost its tax appeal.

Under Article 20(3) of the (old) 1971 Israel-Singapore tax treaty, a dividend paid by a corporation resident in Singapore to a corporation resident in Israel owning at least 25% of its share capital was free of Israeli tax. The Treasury entered into negotiations with Singapore to amend this specific article, and it was indeed amended in the (new) 2005 Israel-Singapore tax treaty. Although the effective date of the treaty is generally January 1, 2006, this provision (Article 22(3)(ii)) entered into force on January 1, 2008. The provision applies only to companies that were residents of Singapore prior to the effective date of the new treaty. Negotiations with other countries to block other escape routes will most likely follow.

Nonresident corporations are also subject to a 25% income tax on dividends (see V.C.8.a., below).

Dividends paid on foreign securities, i.e., securities traded on stock exchanges outside Israel (shares of Israeli resident corporations traded outside Israel are not included in this definition), were liable, through the close of 2004, to tax at the rate of 35% and since then, the tax on such dividends has been equal to that paid by regular Israeli companies (the choice between 25% or the regular corporate tax rate on the income from which the dividends were paid with a suitable foreign tax credit, including a credit for the underlying tax).

d. Controlled Foreign Corporations

The reform of 2003 introduced provisions regarding the taxation of controlled foreign corporations (CFCs). In accor-

[616] Income Tax Ordinance, s. 126(a).
[617] Income Tax Ordinance, s. 126(b).
[618] Income Tax Ordinance, s. 2(4).
[619] Income Tax Ordinance, s. 125B.

[620] Tax Appeal 26652-02-222 *Oz Technologies (1972) Ltd. v. Large Enterprises Tax Assessor,* Tel Aviv District Court, Income 26.9.24.

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dance with these provisions, the taxable income of a CFC, as specifically defined by the Income Tax Ordinance, is ascribed to its Israeli resident shareholders as if it were a dividend distributed to them. The Ordinance lays down a set of conditions that have to be met for tax to be levied on the Israeli resident shareholders of a CFC: (i) that the foreign corporation's income must consist mainly of passive income, and that the tax rate it suffers may not exceed 15% of its taxable income (20% prior to Amendment No. 198 of the Israeli Income Tax Ordinance); that more than 50% of its "means of control" (i.e., the right to participate in a distribution of profits; the right to appoint a director; the right to liquidation proceeds; and the right to instruct another person with respect to exercising an aforesaid right, whether such rights are accorded by shares or any other means, including a trust) must be held by Israeli residents; and that its shares must be unregistered; and (ii) that the shareholder must be a controlling shareholder, i.e., a resident of Israel holding directly or indirectly, at least 10% of the means of control of the corporation. Where these two conditions are met, the controlling shareholders are deemed to have received a dividend in the amount that they would have received had such a dividend been declared and distributed by the company.

The Reform of 2008 prescribes that, for purpose of the definition of a CFC, the rights of new immigrants and Veteran Returning Residents will not be taken into account as rights of residents for a period of 10 years from their assumption of residence.

The CFC provisions were necessitated by the introduction of the personal basis of taxation within the framework of the tax reform of 2003. They are designed to prevent the avoidance of tax on financial income by the erection of an artificial tax barrier between the ultimate Israeli resident beneficiary of the income and the income itself, in the form of a tax haven corporation.

Section 75(B)(c) of the Income Tax Ordinance provided that, in computing the tax liability of the controlling shareholder, a foreign tax credit would be granted for the tax that would have been withheld at source by the country of residence of the CFC on the actual distribution of the dividend. This notional credit could have been used to avoid tax by the "screen saver" technique, i.e., the use of a CFC registered and resident in a country that withholds tax at the rate of 30% on its dividends, thereby annulling any Israeli tax that could be levied on the notional dividend.

The Bill with respect to the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), 2013 included certain amendments with respect to the CFC regime which were enacted later in the Law for the Amendment of the Israeli Income Tax Ordinance (No. 198), 2013 and are effective as of January 1, 2014.

Amendment No. 198 includes, inter alia, revision of the requirements for the exclusion of publicly traded companies from the CFC regime; exclusion of certain dividend income from the CFC allocable to its shareholders (i.e., certain dividends received will not be considered as passive income to the extent that the profits that produced such dividends were taxed at a rate higher than 15% and to the extent that certain minimum holding requirements are met); expansion of the definition of "passive income" to include certain securities sold by the CFC; provisions with respect to sale of CFC shares by a controlling shareholder to enable the shareholder to deduct from the consideration received certain deemed dividends that were included in his/her income; and provisions with respect to the calculation of the CFC income and profits. One of the most significant provisions promulgated in Amendment No. 198 with respect to the CFC regime is the abolishment of the "notional credit" provision. Under the pre-Amendment No. 198 CFC regime, Israeli shareholders in CFCs were able to utilize the "notional credit" to avoid tax by using the "screen saver" technique as detailed above. However, under the amended CFC provisions, the foreign tax credit will be available to shareholders in CFCs only to the extent that such tax was actually paid by the shareholder (i.e., in the year the CFC's profits were actually distributed or in the year that such tax was withheld at source).

e. *Foreign Vocation Companies*

The introduction of the personal basis of taxation within the framework of the tax reform of 2003 was accompanied by another anti-avoidance measure with respect to foreign income — the foreign vocation company (FVC) provisions of section 5(5) of the Income Tax Ordinance, now repealed.

These provisions were designed to prevent the avoidance of tax on foreign vocational income by the erection of an artificial tax barrier between the ultimate Israeli resident beneficiary of the income and the income itself, in the form of a foreign corporation.

Section 5(5) of the Income Tax Ordinance deemed part of the income of an FVC, to the extent of the Israeli shareholder's rights in the FVC, to be Israeli-sourced income. An FVC is defined as a closely held company within the meaning of that term in section 76(a) of the Ordinance, where: (i) 75% or more of its means of control is owned by Israeli residents; (ii) the Israeli residents holding at least 10% of the rights, who hold together at least 50% of the rights in the company, serve the company in a special vocation;[621] and (iii) most of the company's income is derived from a special vocation.

The Reform of 2008 prescribed that, for purpose of the definition of a Foreign Vocation Company, the rights of new immigrants and Veteran Returning Residents would not be taken into account as rights of residents for a period of 10 years from their assumption of residence.

It should be noted that prior to Amendment No. 198 (as detailed below), although leading to a quite similar tax result, the FVC provisions taxed the foreign company's income as Israeli-source income, whereas the CFC provisions tax a deemed dividend distributed by the foreign company to the Israeli shareholder. This difference had led a number of practitioners to contend that the FVC provisions were invalid as they were in conflict with the provisions of Israel's tax treaties.

As a result, and due to the ineffectiveness of the FVC regime, the Bill with respect to the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014), 2013 provided a few amendments with respect to the FVC regime which were later enacted in the Law for the Amendment of the Israeli In-

[621] A "special vocation" is defined in Income Tax (Determining of Special Vocation) Decree, 2003.

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come Tax Ordinance (No. 198), 2013 and are in force as of January 1, 2014. The Amendment abolished the provisions of section 5(5) and promulgated section 75B1 of the Income Tax Ordinance which sets forth the provisions with respect to FVCs. The Amendment provides comprehensive modifications to the FVC regime in order to match the FVC regime with the CFC regime. According to the revised FVC regime, the foreign company's income will no longer be considered as Israeli-source income, however, section 75B1 provides that the FVC's income (generated from special vocation) attributable to its Israeli controlling shareholders shall be included in their income for Israeli tax purposes as a notional dividend subject to a tax equal to the company tax set forth in section 126(a) of the Israeli Income Tax Ordinance.

f. Stock Options

Stock options are a common form of employee remuneration in Israel. Section 102 of the Income Tax Ordinance was amended within the framework of the 2003 tax reform and provides three alternative rules on the taxation of stock options as follows:

(i) When an option is granted without the involvement of a trustee, the grant itself is not a taxable event so long as the option is not negotiable on a stock exchange; where the option is so negotiable, the employee is taxed at the ordinary rates on the value of the option at the time of its grant, the amount treated as income is allowed as a deduction to the employer, and the employee is liable for capital gains tax on exercising the option;

(ii) When an option is granted to a trustee on behalf of an employee, the employee is liable to income tax at ordinary rates applicable to employment income upon receipt of the option from the trustee, or upon its exercise, in accordance with its value, and the relevant amount may be deducted by the employer as an expense;

(iii) When an option is granted to a trustee on behalf of an employee but the employee is liable only for capital gains tax upon the receipt of the option or upon its exercise, the employer is not entitled to take any deduction on the capital gain attributed to the employee.

Employers must provide notice of plans involving trustees to the Assessing Officer.

g. Notional Income

Under section 3(i) of the Income Tax Ordinance, where a person exercises a right that the person previously received to acquire any property or service and at the time of exercise there is a difference between the price normally payable for such property or service and the price paid by that person, the difference is regarded as employment income, if the right was accorded in conjunction with an employee-employer relationship. This difference is regarded as business income under section 2(1) of the Ordinance if the right is given to a supplier, and as income under section 2(4) of the Ordinance if the right is given by a company to a controlling shareholder or a relative of a controlling shareholder. At the application of the taxpayer, the tax on the difference on the exercise of the right is calculated as if the difference were income received in equal installments over a period extending from the time of the conferring of the right until its exercise, but not exceeding six years ending within the year of exercise. In practice, the Income Tax Authorities reserve taxation under section 3(i) to options that are not dealt with by section 102 of the Ordinance (for example, options to purchase assets other than shares), such as options granted to controlling shareholders.[622]

Under section 3(i) of the Income Tax Ordinance, where a person is given, directly or indirectly, an interest-free or a low interest loan, the difference between the interest (and linkage differentials) payable on the loan and the interest rate set for this purpose by the Minister of Finance is regarded as employment income if the loan is given in conjunction with an employer-employee relationship, as business income under section 2(1) of the Ordinance, if it is given to a supplier,[623] or as income under section 2(4) of the Ordinance, if it is given to a controlling shareholder or a relative of a controlling shareholder. Case law provides that a "loan" for purposes of section 3(i) does not necessarily involve a transfer of money from a creditor to a debtor. When a person retains money due to another, with the latter's consent, such retention is tantamount to a loan.[624] Case law further provides that a loan is considered interest-free if in the same tax year no interest was charged or paid with respect to it.[625]

The regulations provide that the taxable interest difference is the difference between the interest accumulated on the balance of the principal (during a certain period) according to the specific terms of the loan and the interest that would have accumulated had its rate conformed to the increase in the consumer price index together with interest charged at 3.87%.[626]

Amendments (No. 67 and 68) to the Income Tax Ordinance added section 3(j), which provides that where a person grants an interest-free or a low-rate interest loan, the person granting the loan will incur income tax on the difference between the interest payable under the interest rate set for this purpose by the Minister of Finance and the interest (and linkage differentials) payable on the loan. With the repeal of the Income Tax (Inflationary Adjustments) Law as of January 2008, section 3(j) was amended to make the difference between the interest payable and the interest rate determined by the Minister of Finance subject to companies tax and deductible or usable to offset a loss. Section 3(j) applies only to loans that are recorded in double entry account books and to the extent provided to a related party. Section 3(j) does not apply to certain loans, debts and deposits that are specified in the definition of a "loan" and in section 3(i). Furthermore, the section does not apply to international loans, which are treated as "international transactions"

[622] In C.A. 7034/99 *Assessing Officer Kfar Sava v. Yair Dar*, Missim R-3, (June 2004), E-5, the Supreme Court held that pre-reform options for nontraded securities were taxed on exercise and that no tax liability attached to their grant.

[623] C.A. 32/86 *Rimon Bituach Vefinansim v. The Assessing Officer Tel-Aviv 20*, P.D.A. 103; C.A. 533/89 *The Assessing Officer (Large Enterprises) v. Zilberstein and Mintz*, Missim G-5 (Oct. 1993), E-62.

[624] I.T.A. 97, 98/85 *Etinger Ltd. v. The Assessing Officer*, 16 P.D.A. 227; I.T.A. 56, 57/82 *Malts Ltd. v. The Assessing Officer*, 12 P.D.A. 115; C.A. 32/86 *Rimon Bituach Vefinansim Ltd. v. The Assessing Officer*, 20 P.D.A. 103; I.T.A. 44/85 *Etsion v. The Assessing Officer*, 13 P.D.A. 313.

[625] I.T.A. 88/86 *Sharon Ltd. v. The Assessing Officer*, 16 P.D.A. 259 *as approved in* C.A. 758/88 *Sharon Ltd. v. The Assessing Officer*, Missim F-3 (June 1992), E-66.

[626] Income Tax (Setting of Interest Rate) Regulations, 1985.

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as defined in section 85A, and therefore subject to the transfer pricing regulations.

h. Other Inclusions in Gross Income

Generally, the accounting methods described above are used to measure the gross income of a corporation. Linkage differentials arising as a result of foreign exchange deposits deserve special attention. The Income Tax Authorities have interpreted the statute to require the inclusion of these differentials in gross income even when the foreign currency was not realized and case law supports this interpretation.[627] Section 8C of the Income Tax Ordinance provides that even taxpayers on a cash basis method of reporting income must include exchange rate differentials in income whether or not a realization (conversion) of the foreign currency took place. In the case of a revaluation of the Israeli currency, the linkage differentials are taxable except where specifically exempt.

i. Exclusions from Gross Income

Excluded from gross income are those items of income that are specifically exempted by statute, namely: (i) certain linkage differentials;[628] (ii) dividends (as described in c., above); (iii) exchange rate differences on a company's foreign currency deposit accruing from payments made by a foreign resident on account of its shares;[629] and (iv) exchange rate differences in the hands of a resident company accruing from the deposit of proceeds from an issue of shares until use is made of the proceeds and provided the exemption period does not exceed two years from the issue date.[630]

5. Business Expenses

a. In General

Section 17 of the Income Tax Ordinance provides that "for the purpose of ascertaining the chargeable income of any person there shall be deducted, save insofar as the deduction is limited or disallowed under section 31, all outgoings and expenses "wholly and exclusively" incurred during the tax year by such person in the production of the income… ." Section 17 adopts an approach, similar to the U.K. approach, whereby an expense is deductible only if it is incurred "wholly and exclusively" in the production of income. However, as a practical matter, where the expense was of a mixed nature, the Assessing Officer would allow an allocation so that the part allocable to the production of income would indeed be recognized as a business expense.

After the Supreme Court ruled that childcare expenses were compatible with the rule of section 17 and hence deductible,[631] the Court held that, in case of a mixed expense, the income-producing portion is deductible.

Amendment No. 170 to the Ordinance amended section 32(1) to deny the deduction of expenses that are not "bound and integrated" in the production of income. The section defines an "expense bound and integrated in the production of income" as an expense that is integrated with the natural process of deriving income and with the natural structure of the source of the income, so as to constitute an inseparable part of the income-producing process.

While section 17 enumerates a number of important expenses, this enumeration does not preclude the deduction of other expenses.[632] The enumerated expenses include interest and linkage differentials,[633] rent, repairs,[634] bad debts,[635] a portion of sums paid by an employer to a provident fund, and expenses incurred to prevent soil erosion and other disasters, as well as expenditures incurred with respect to air raid precautions,[636] depreciation, and expenses incurred in connection with the preparation of returns and the handling of tax matters in any assessment or appeal proceedings.

The statutory scheme relevant to the deduction of business expenses is embodied in a number of provisions of the Income Tax Ordinance. While section 17 allows for the deduction of all expenses and costs incurred "wholly and exclusively" in the production of income, its rule is subject to the provisions of section 31, which empowers the Minister of Finance, with the

[627] C.A. 510/80 *Assessing Officer Jerusalem v. Dfus Mercaz Ltd.*, 36(4) P.D. 589.

[628] Income Tax Ordinance, s. 9(13A).

[629] Income Tax Ordinance, s. 9(14B).

[630] Income Tax (Exemption from Tax of Exchange rate differences of an Israeli company which sells shares on a Foreign Stock Exchange) Regulations, 1981.

[631] C.A. 4243/08 *Vered Peri v. The Assessing Officer (Gush Dan)*, Missim X-3, E-90.

[632] C.A. 475/68 *Rehov Pinsker 42 Ltd. v. The Assessing Officer*, 2 P.D.A. 98; I.T.A. 234/88 *Merkaz Ramir Ltd. v. Assessing Officer (Large Enterprises)*, 19 P.D.A. 156; C.A. 735/86 *Ben-Shachar Zraim Ltd. v. Assessing Officer Tel-Aviv 3*, 18, P.D.A. 10.

[633] Linkage differentials were traditionally recognized only when paid on a business loan and not on credit extended to buyers: C.A. 408/82 *Mifalei Tnua Le'Israel v. Assessing Officer (Large Enterprises)*, (1986) 40(2) P.D. 693. A Tel-Aviv District Court decision departs from this tradition by determining that suppliers credit constitutes a business loan for income tax purposes: I.T.A. 181/84 *Bernstein v. Assessing Officer Tel-Aviv*, (1987) 15 P.D.A. 179. See I.T.A. 138/87 *Tambour Ltd. v. Assessing Officer Haifa*, (1988) 16 P.D.A. 163, for the deduction of exchange rate differentials; *see also* I.T.A. 638/85 *Malon Plaza Ltd. v. Assessing Officer (Large Enterprises)*, Missim D-5 (Oct. 1990), E-49; C.A. 3515/97 *Assessing Officer Beer Sheva v. Beit Merkahat Ilan*, Missim P-4 (Aug. 2002), E-1.

[634] The tests for determining whether an expense is of a capital or ordinary income nature are applicable in determining whether expenses paid for repairs or renewals of capital assets are deductible: C.A. 43/61 *Mercaz Ha"Hamzan Ltd. v. Assessing Officer (Large Enterprises)* (1961) 15(3) P.D. 2512; I.T.A. 54/87 *Tslivi v. Assessing Officer Jerusalem*, (1989) 17 P.D.A. 349, a controversial decision permitting the deduction of the expenses of overhauling a car engine; I.T.A. 16, 87, 88, 93/92 *Artan v. Assessing Officer Haifa*, Missim G-1 (Feb. 1993), E-168, dealing with expenditures on real estate repairs; I.T.A. 54/87 *Blue Zliby v. Assessing Officer Jerusalem*, Misssim C-4 (July 1989), E-24; I.T.A. 138/00 *Mano v. Assessing Officer Haifa*, Missim Q-2 (Apr. 2003), E-18.

[635] Bad debts are recognized only in the same tax year as that in which they became bad, and only if incurred or suffered in connection with the taxpayer's business: I.T.A. 168/79 *Sochnut Hasharon Le Haspakat Delek v. Assessing Officer Petach Tikva* (1971) 4 P.D.A. 172; I.T.A. 43/95 *Hahevra HaAmerikait Yisraelit Le Gas Ltd. v. Assessing Officer (Large Enterprises)*, Missim O-5 (Oct. 2001), E-96; and I.T.A. 334/85 *Ugda Hashkaot Ltd. v. Assessing Officer Tel-Aviv 4* (1989) 17. P.D.A., 459; I.T.A. 1146/99 *D.N.G. v. Assessing Officer Rehovot*, Missim R-6 (Dec. 2004), E-16.

[636] According to C.A. 406/72 *Kolnoa "Rina" BeHolon Ltd. v. Assessing Officer Tel-Aviv 3*, 27(2) P.D. 630, the purpose of this provision is to encourage taxpayers to take certain security measures encouraged by the legislator, thus including purely nonrevenue expenses in Income Tax Ordinance, s. 17; *see* I.T.A. 316/88 *Ef-Shar Ltd. v. Assessing Officer Tel-Aviv* (1991) 19 P.D.A. 304; I.T.A. 149/92 *Fischer v. Assessing Officer Haifa*, Missim H-2 (Apr. 1994), E-19, and I.T.A. 296/91 *Goldberg v. Assessing Officer Tel-Aviv*, Missim G-1 (Feb. 1993), E-163, in which it was held that the deduction could not be taken by an individual against income with no relation to the deduction.

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approval of the Knesset Finance Committee, to promulgate regulations curtailing or prohibiting the deduction of certain otherwise allowable business expenses.

While section 17 of the Income Tax Ordinance provides a list of examples of deductible expenses, section 32 lists specific nondeductible expenses. Section 30 restricts the deduction of expenses in excess of those necessary, in the opinion of the Commissioner, for the production of the taxpayer's income.[637] Finally, section 33 of the Ordinance authorizes the disallowance of deductible expenses where proper books and records were not maintained.

b. Organizational Expenses

In general, organizational expenses, such as the expenses incurred on the registration of a company or the fees paid with respect to the preparation of the business vehicle, are not considered to be expenses "wholly and exclusively" incurred in the production of income and are therefore disallowed as a deduction.[638] In one case,[639] the court ruled that expenses incurred in developing a market were allowable as a deduction, even though the company did not produce any income as a result of incurring them. The company attempted to act as an intermediary between producers and consumers; therefore, the expenses were deemed to be business expenses. However, a salary paid to a physician, while the physician specialized at another hospital, by a hospital not yet opened to the public was not allowed as a deduction.[640]

c. Travel and Entertainment Expenses

Under special regulations issued by the Minister of Finance,[641] the deduction of travel and entertainment expenses is severely restricted.[642]

The regulations do not allow any entertainment expenses to be deducted unless the person being entertained is a nonresident.[643] Expenses incurred for travel abroad are further restricted; the deduction must not only be "wholly and exclusively" incurred in the production of income but also "necessary"[644] and may not exceed the specific *per diem* amounts as well as air fare rates set forth in the regulations.

Under a complex formula governing the deduction of expenses for company cars, the deduction is restricted so that not all such expenses are allowed.[645] The formula employed attempts to neutralize expenses for the private use of a vehicle (the test is mathematical). Moreover, the notional value of a company car put at the disposal of an employee constitutes income in the hands of that employee[646] in the amounts designated from time to time by the Minister of Finance with the approval of the Finance Committee of the Knesset.[647]

d. Interest

Section 17(1)(a) of the Income Tax Ordinance provides that sums payable as interest or linkage differentials on money borrowed by the taxpayer may be allowed as a deduction if they are payable on capital used in deriving the taxpayer's income. It has been held that a taxpayer in the financing business who takes out interest-bearing loans to re-lend the money to others may deduct the interest as an expense even though the money that the lender lends bears no interest in the same tax year.[648] However, a person deriving income in the form of interest or dividends (i.e., passive income) is not allowed to deduct interest paid as an expense if the person did not derive interest or dividend income during the same tax year, since the expense was not incurred in the production of that income.[649] In *Pazgas*,[650] it was held that interest incurred on a loan taken out to allow for a distribution of dividends was not deductible. However, in *PiGlilot*,[651] it was held that even if only an indirect nexus exists between the loan taken out for the distribution of the dividends and the production of income such interest is deductible. Such an indirect nexus exists where, from an economic point of view, financing by loans or equity leads to the same result. The following cumulative conditions must be met to attain that result:

> (i) The distribution of the dividend must meet the criteria in the Companies Law, i.e., the company may distribute a dividend only out of its profits[652] ("the profit test") and subject to the company's ability to pay off its current and prospective debts ("the payment test"). If met, this two-tiered test qualifies the company to make a "permitted distribution." The court may grant its approval to a distribution that fails to meet the conditions of the profit test, provided it is not doubtful that despite the distribution, the company will meet its current and future obligations.[653] A company may purchase its own shares without the court's sanction only out of funds from which it could make a "permitted distribution."

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[637] I.T.A. 319–321/82 *Pirchey Bickel Ltd. v. Assessing Officer Kfar-Sava*, Missim D-5 (Oct. 1990), E-71; I.T.A. 306/88 *Zinometal Ltd. v. Assessing Officer Netanya*, Missim E-2 (Apr. 1991), E-65; I.T.A. 198/89 *Laor v. Assessing Officer Tel-Aviv 4*, Missim E-4 (Aug. 1991), E-125; I.T.A. 20/95 *P.H. Hachzakot v. Assessing Officer Tel-Aviv 3*, Missim K-3 (June 1997), E-148.

[638] I.T.A. 132/00, *Chevrat Nihul Kenyonim D.H.P Ltd. v. Assessing Officer Haifa*, Missim P-6 (Dec. 2002), E-144.

[639] C.A. 316/67 *Sides v. The Assessing Officer (Large Enterprises)*, 21(2) P.D. 291, later cited in C.A. 338/78 *Elco v. The Assessing Officer (Large Enterprises)*, 10 P.D.A. 215.

[640] I.T.A. (T.A.) 809/67 *Ne´ot Margalit Inc. v. The Assessing Officer*, 1 P.D.A. 234.

[641] Income Tax (Deduction of Certain Expenses) Regulations, 1972.

[642] Income Tax (Deduction of Certain Expenses) Regulations, 1972, s. 2.

[643] Income Tax (Deduction of Certain Expenses) Regulations, 1972, s. 3.

[644] Income Tax (Deduction of Certain Expenses) Regulations, 1972, s. 2(2).

[645] Income Tax (Deduction of Vehicle Expenses) Regulations, 1995.

[646] Income Tax Ordinance, s. 2(2).

[647] Income Tax (Value of the Use of Vehicles) Regulations, 1987.

[648] C.A. 191/61 *Hevra Lepituach T'veria v. the Assessing Officer*, 15 P.D. 2455; I.T.A. 108/91 *Shacheviz v. Assessing Officer (Large Enterprises)*, Missim N-2 (Apr. 2000), E-112.

[649] C.A. 314/67 *The Assessing Officer Tel-Aviv 4 v. Nichsey Coha'nim Ltd.*, 21(2) P.D. 748; I.T.A. 52/91 *Burlington Israel Ltd. v. The Assessing Officer (Large Enterprises)*, Missim H-5 (Oct. 1994), E-71. In a more recent case, the Court refused to apply accounting principles to fix the amount of the debt, and allowed the full amount of interest paid as an expense, given the fact that the loan was actually used to derive taxable income: I.T.A. 150/92 *Hevrat Israeli Dov Hashkaot Ltd. v. Assessing Officer Tel-Aviv 1*, Missim J-5 (Oct. 1996), E-99.

[650] C.A. 6557/01 *Pazgas v. the Assessing Officer (Large Enterprises)*, Missim W-6 (2006), E-51; I.T.A. CA.

[651] 8301/04 *PiGlilot v. the Assessing Officer (Large Enterprises)*, Missim X-3 (2007), E-98.

[652] Companies Law, 1999 s. 302(a), (b).

[653] Companies Law, 1999 s. 303(a).

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(ii) The undistributed profits were used to produce income and substituted for the taking out of a loan.

(iii) The cost of financing the distribution of the dividend with equity was more expensive than the cost of financing it with loan capital.[654]

Furthermore, a company suffering from financial difficulties arising from the use of its resources for purposes other than the production of income may not deduct interest on loans that were obtained for use in the production of income,[655] if at the time the non-income-producing investment was made, the need for investment in an income-producing source (for which the loan was taken out) was foreseen.[656]

As stated above, only financial expenses incurred in the production of income are allowed as a deduction. However, section 11 of the Income Tax (Inflationary Adjustments) Law, 1985, provided that interest on capital used for the acquisition of a fixed asset before the asset was used for the production of income was deductible, provided the amount of the deduction did not exceed the cost of the fixed asset, less interest charged to the asset cost, multiplied by the index increase from the later of the beginning of the tax year or the month in which an amount paid for the asset's acquisition constituted a "negative change," until the earlier of the month in which the asset began to serve in the production of income or until the end of the tax year. The amount of the deduction was not added to the original price of the asset in calculating depreciation for purposes of determining the capital gain or the land appreciation tax due on the sale of the asset. Section 11 is no longer in force as of 2008, following the repeal of the Income Tax (Inflationary Adjustments) Law effective January 2008.

Income Tax Circular No. 88/20 provides that fees paid to a bank or insurance company in an effort to "hedge" future transactions, as well as rate differentials payable on such transactions, must be treated in the same manner as the "hedged" transaction itself. When the taxpayer engages in futures transactions to protect his/her current operations' exposure, such as raw materials purchased for export sales, the cost of hedging is a current expense and is therefore allowed as a deduction. When the hedge is entered into to protect a capital transaction, such as the purchase of new machinery, the cost of hedging is a capital expenditure.

e. Royalties

Royalties are deductible in full if incurred "wholly and exclusively" in the production of income. The tax authorities verify the nature of royalties to disallow a deduction when tangible or intangible property is acquired and to differentiate them from payments for services (for example, the installation of machinery, training, etc.).

f. Taxes

Generally speaking, taxes incurred in the production of income are allowed as a deduction, except for income taxes, which are not considered to have been incurred in the production of income but rather to have been incurred after the production of income.[657] The Supreme Court has denied the deduction of foreign income taxes for the same reason.[658] Local taxes (business taxes, etc.) are allowed as a deduction.[659] Fees in the nature of taxes, incurred in the production of income, are also allowed as a deduction in determining the taxable income of a taxpayer. Linkage differentials and interest accrued on a tax debt resulting from the failure to transfer withholding tax are allowed as a deduction.[660]

g. Depreciation and Amortization

Section 21 of the Income Tax Ordinance provides that "there shall be allowed a deduction in respect of depreciation of any building, machinery, plant or furniture, or other assets including live and agricultural stock, and plantations, owned by the taxpayer and used for the purpose of producing his/her income." No depreciation is granted with respect to land. Depreciation is computed in accordance with the straight-line method as a percentage of the original cost and in accordance with regulations of the Minister of Finance, except in the case of certain taxpayers who may use the declining balance method. For purposes of depreciation, the tenancy of immovable property for a period of 49 years or more is treated as ownership.[661]

Depreciation is allowed only with respect to assets that are used for the production of income. Therefore, depreciation is not allowed with respect to assets that were not used at all for this purpose, or were not so used in their natural function or in the ordinary course of business.[662] However, depreciation is allowed with respect to assets that constitute part of the manufacturing apparatus of the taxpayer even though they were temporarily out of service for a reasonable period of time.[663] Where a grant in aid was received with respect to an asset used in the production of income, or where a debt originating from a loan for the acquisition of such an asset is forgiven or written off within five years from the year of its receipt, or where VAT was paid with respect to the acquisition of the asset and deducted as "input tax," the original cost of the asset may not include the grant in aid, the debt, or the input tax, as the case may be.[664] A 1981 amendment to the Income Tax Ordinance, embodied in

[654] I.T.A. (T.A.) 284/79 *Friction Materials Corp. v. The Assessing Officer (Large Enterprises)*, 1981 (2) P.M. 51; C.A. 638/85 *The Assessing Officer (Large Enterprises) v. Malon Plaza Ltd.*, Missim D-5 (Oct. 1990), E-55. If such an allocation is not possible, the entire expense is disallowed: I.T.A. 163/88 *Shaham v. Assessing Officer Tel-Aviv*, Missim I-3 (June 1995), E-93.

[655] C.A. 425/79 *Angel v. The Assessing Officer*, 36(3) P.D. 829 and C.A. 787/86 *Moran v. The Assessing Officer Tel Aviv 3*, Missim E-5 (Oct. 1991), E-53; C.A. 3515/97 *Assessing Officer Beer Sheva v. Beit Merkahat Ilan*, Missim P-4 (Aug. 2002), E-1.

[656] C.A. 787/86 *Moran v. Assessing Officer Tel-Aviv*; 19 P.D.A, 426; I.T.A. 149/72 *Chior Ltd. v. Assessing Officer Haifa*, 6 P.D.A. 254.

[657] Income Tax Ordinance, s. 32(7).

[658] C.A. 212/69 *Moller Textile (Israel) 1961 Ltd. v. The Assessing Officer Haifa*, 24(1) P.D. 73.

[659] I.T.A. 13/93 *Herman Itzhak v. Assessing Officer Haifa*, Missim H-2 (Apr. 1994), E-152; I.T.A. 72/92 *Hof Galia Ltd. v. Assessing Officer Haifa*, Missim H-2 (Apr. 1994), E-128.

[660] C.A 10691/06 *Sarig Electric Ltd. v. Assessing Officer Jerusalem 1*, Missim 25/1 E-70. *But see* C.A 438/90 *Assessing Officer Haifa v. Hed Hakrayot*, Missim O-1, E-1.

[661] Income Tax Ordinance, s. 21(a).

[662] C.A. 158/57 *Tsemer Plada Tsoor Ltd. v. The Assessing Officer*, 12 P.D. 177; I.T.A. 99/95 *Fried & Fried Ltd. v. Assessing Officer Haifa*, Missim K-1 (Feb. 1997), E-171.

[663] C.A. 158/57; I.T.A. 135/64 *Mori v. The Assessing Officer*, 47 P.M. 135.

[664] Income Tax Ordinance s. 21(b).

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section 21(c), allows a 16.5% rate of depreciation for special facilities constructed for invalids in public buildings where such facilities were required by the planning authorities. In 2003, with the abolition of the favorable tax treatment on a sale of goodwill, special regulations were issued to allow for the amortization of goodwill over 10 years.[665] Special provisions restrict the increase of the basis of an asset for purposes of depreciation by means of a transfer in which the taxpayer does not relinquish his/her control over the asset.[666]

In no event may the aggregate depreciation allowance exceed the cost of the asset. The cost of the asset for this purpose is the purchase cost and not the market price.[667] The cost of the asset includes not only the amount paid for its purchase but also the incidental expenses that were incurred for this purpose (i.e., legal expenses, registration fees, transportation and assembly expenses, customs, etc.).[668] Where the whole or part of the depreciation cannot be deducted in a particular tax year because the source with respect to which depreciation is claimed did not yield sufficient income in that year, the amount not deducted is regarded as a loss within the meaning of section 28 of the Income Tax Ordinance, which deals with the carrying over of net operating losses.[669]

It is worth noting that the original cost of the asset (i.e., the basis) is expressed in shekels. Therefore, in times of inflation, depreciation in accordance with the regulations issued by the Minister of Finance becomes rather meaningless.

Special provisions were enacted in the Law for the Encouragement of Capital Investments, 1959,[670] and the Law for the Encouragement of Industry (Taxes), 1969 (see XVII.C., below), to grant favored enterprises accelerated depreciation. In accordance with these provisions, the depreciation rates are much higher than those accorded under the regulations of 1941. Under the 1941 regulations, the depreciation rate for equipment and machinery is 7% with some exceptions, which attain a rate of 9% or 10%. According to special regulations, the depreciation rate for personal computers is 33%.[671]

A company owning an "approved enterprise" or "beneficial enterprise" may elect for accelerated depreciation under the Law for the Encouragement of Capital Investments, 1959, or depreciation in accordance with the regulations. Accelerated depreciation calls for 200% of the ordinary rate for equipment, 400% of the ordinary rate for buildings, provided that no more than 20% be allowed in any one year, and 250% for equipment used in shifts.

One of the salient features of the laws regarding the taxation of inflationary profits is the indexing of the depreciation deduction in accordance with the Israeli rate of inflation. However, due to the repeal of the Income Tax Law (Inflationary Adjustments) Law as of January 2008, the indexing of depreciation deduction is no longer available. These laws provide that, notwithstanding the provisions of any other law, depreciation rates with regard to fixed assets are to be computed under their special provisions. The Income Tax (Inflationary Adjustments) (Depreciation Rates) Regulations, 1986, provide for depreciation rates with regard to specific fixed assets. The regulations are valid despite the repeal of the Income Tax (Inflationary Adjustments) Law.

Under the regulations, an "industrial company" that owns equipment used in its "industrial enterprise" may use the declining balance method. A taxpayer electing to use the declining balance method for a specific depreciable asset is bound by the election for the entire period during which the asset is in use. The rates of depreciation are augmented and are conditional on the first usage of the asset in Israel.

The regulations further provide that certain fixed assets, if qualifying under the Law for the Encouragement of Capital Investments or the Law for the Encouragement of Capital Investments in Agriculture for a special rate of depreciation, enjoy the accelerated rates accorded by these laws.

Fixed assets that are subject both to "Encouragement Laws" and the regulations may enjoy one of the different rates provided by them, at the owners' choice.

To encourage economic activity in Israel during the Coronavirus crisis, on November 10, 2020, the Israeli Minister of Finance approved the Income Tax Regulations (Accelerated Depreciation During the Coronavirus Period) (Temporary Provision), 2020 (the "Accelerated Depreciation Regulations").

The Accelerated Depreciation Regulations provide for a depreciation rate double the rate otherwise allowed under any applicable law for equipment purchased by taxpayers, subject to certain conditions.

Specifically, it appears that taxpayers are even entitled to double accelerated depreciation rates to which they are entitled, and of which they have availed themselves, under the Law for the Encouragement of Capital Investments, 1959 or the Income Tax Regulations (Adjustments for Inflation) (Depreciation Rates), 1986. As a result, in certain cases, the Accelerated Depreciation Regulations may effectively make it possible for a taxpayer to deduct the entire, or almost the entire, cost of acquiring equipment in the tax year of acquisition.

Since the application of the Accelerated Depreciation Regulations is not limited to taxpayers operating in particular economic fields, any taxpayer, regardless of the field in which it operates, is entitled to accelerated depreciation for eligible equipment.

The main conditions set out in the Accelerated Depreciation Regulations concern the equipment that is eligible for the benefit, though it should be noted in this context that the Regulations do not explicitly define what is meant by "equipment." They provide only that the term includes machinery and certain "work vehicles" other than trucks (intangible property is excluded), where all the following criteria are satisfied:

(i) The equipment was acquired during the period beginning on September 1, 2020 and ending on June 30, 2021;

(ii) The equipment was put into use in the production of income in Israel within three months from the date on which it was acquired or by June 30, 2021, whichever is later. This period is extended to nine months in the case of equipment that cannot be put into use within three months

[665] Income Tax (Rate of Depreciation for Goodwill) Regulations, 2003.

[666] Income Tax (Rate of Depreciation for Goodwill) Regulations, 2003, s. 24.

[667] I.T.A. 218/70 *Bahar v. the Assessing Officer*, 3 P.D.A. 279.

[668] 508 C.A. 233/55 *Mekorot Ltd. v. Municipal Tax (Arnona) Director*, 10 P.D. 261; C.A. 487/79 *Chimovile Ltd. v. The Assessing Officer*, 12 P.D.A. 96.

[669] Income Tax Ordinance, s. 22.

[670] Law for the Encouragement of Capital Investments, 1959, ss. 42, 43, and 43A.

[671] Income Tax Regulations (Depreciation) (Amendment), 1996.

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and equipment that was used by an Industrial Enterprise, as defined in the Encouragement Law; and

(iii) The equipment is used in Israel.

h. Obsolete Equipment

Section 27 of the Income Tax Ordinance provides a special deduction with respect to the replacement of machinery or equipment, but not of any other asset. The deduction is granted only to taxpayers engaged in a business or vocation that, during a particular tax year, spent a specific amount on the replacement of machinery and equipment that is or has been used for the purpose of that business or vocation. The deduction is equal to the amount of the expenditure incurred by the taxpayer on the acquisition of the old machinery and equipment, less the aggregate of the amount of the depreciation deducted by the taxpayer with respect to that machinery and equipment, and the amount received by him on its sale, or is equal to the amount expended by the taxpayer on the new machinery and equipment, whichever is less.

Where an amount has been deducted pursuant to these provisions, any loss that could have been set off under the provisions of Part E of the Income Tax Ordinance with respect to the sale of the old machinery and equipment, is reduced by that amount.

These provisions do not apply to private motor vehicles within the meaning of the Traffic Ordinance.

i. Charitable Contributions

Section 46 of the Income Tax Ordinance provides that a taxpayer making a contribution in excess of a statutory minimum (NIS 180 in 2023) to a National Fund[672] or to a "Public Institution,"[673] is entitled to a tax credit at the rate of 35%, in the case of an individual, or the company tax rate, in the case of a corporation, on the amount contributed, provided that no credit is allowed in a given tax year in excess of 30% of the taxable income for that tax year or a statutory ceiling (NIS 9,000,000 in 2023), whichever is lower. These amounts are adjusted yearly in accordance with the rise in the cost-of-living index.

Moreover, section 46A of the Ordinance provides that the aggregate amount of the credit in accordance with section 46, together with deductions claimed for expenses incurred in R&D activity under provisions of the Income Tax Ordinance that are of particular interest to a foreign investor, may not exceed 50% of the taxpayer's taxable income. A public institution failing to meet the requirements set forth in the Ordinance, or with an essential part of its activity not aimed at achieving a public cause, runs the risk of losing its tax-exempt status.[674]

[672] The Jewish Agency, the World Zionist Organization, the United Jewish Appeal and the Keren Kayement Le-Israel.

[673] A corporate body of at least seven members, most of which are not affiliated with one another or a religious trust whose trustees are not affiliated with one another, that exists and acts for a public cause, whose assets and revenues are used solely for achieving the public cause, and that has filed an annual return with respect to its assets, revenues and expenses to the satisfaction of the Assessing Officer.

[674] Income Tax Ordinance, s. 46(A1); for "public objective," see H.C.J. 637/89 *Huka LeMedinat Israel v. The Minister of Finance*, 21 P.D.A. 19.

j. Capital Losses

Capital losses are not allowed as a deduction in determining ordinary chargeable income. Such losses may only be offset against capital gains as discussed in V.C.4.b.(12), above. As will be noted in 7., below, a net operating loss may be used to offset a capital gain.

k. Casualty Losses and Thefts

The Income Tax Ordinance does not contain any provisions with respect to casualty losses, but the courts have held that damages caused by fire may be deducted.[675] In a number of cases, the courts have held that thefts give rise to a deduction, provided they do not result from an embezzlement of funds or goods by senior executives within the enterprise concerned.[676]

l. Reserve Accounts

Generally, amounts set aside to reserve accounts are not allowed as a deduction.

There is an exception to this rule in the case of reserves for contingent liabilities. Under the decided cases, a taxpayer may set aside a reserve and claim a deduction with respect to a contingent liability that the taxpayer contests, provided the contingent liability meets three conditions:

(i) In accordance with generally accepted accounting principles the taxpayer must set aside a reserve or else be deemed to have misstated his/her income;

(ii) The facts of the case and the accounting techniques allow for the accurate ascertainment of the amount of the liability; and

(iii) The contingent liability will most probably become final in the near future.

By setting aside the reserve, the taxpayer is not barred from contesting the liability and, should the taxpayer succeed in his/her efforts, taxable income will be increased accordingly.[677] It is common practice to set aside a reserve for contested indirect tax liabilities. No contingent liabilities may be reserved for and deducted, if specifically prohibited by the Income Tax Ordinance, for example, where there is a requirement that actual payment be made.[678] The Supreme Court has held that, in certain circumstances, a taxpayer may set aside and deduct a reserve for future liabilities and that the taxpayer may adjust the reserve in accordance with the rate of inflation and thereby

[675] C.A. 735/86 *Ben-Shachar Zra´im Ltd. v. Assessing Officer Tel-Aviv*, Missim D-1 (Feb. 1990), E-71.

[676] C.A. 475/68 *Rehov Pinsker 42 Ltd. v. The Assessing Officer*, 2 P.D.A. 89; I.T.A. (T.A.) 170/71 *Express Tours Ltd. v. The Assessing Officer*, 5 P.D.A. 27; I.T.A. 101/97 *Zoher v. Assessing Officer Nazareth*, Missim L-6 (Dec. 1998), E-25; C.A. 735/86 *Ben-Shachar Zra´im Ltd. v. Assessing Officer Tel-Aviv*, Missim D-1 (Feb. 1990), E-71.

[677] C.A. 190/58 *The Assessing Officer (Large Enterprises) v. Nakid*, 13 P.D.A. 1453; C.A. 600/75 *Tel-Ronen Kablanim Ubonim v. The Assessing Officer*, 3 P.D.A. 86; I.T.A. 85/83 *Aharon v. The Assessing Officer*, 14 P.D.A. 307; C.A. 860/75 *Isranil Ltd. v. The Assessing Officer (Large Enterprises)*, 9 P.D.A. 138; I.T.A. 157/89 *Ramado Ltd. v. Assessing Officer Haifa*, Missim E-2 (Apr. 1991), E-68; I.T.A. 5082/97 *Yang Ltd. v. Assessing Officer Haifa*, Missim N-3 (June 2000) E-127; C.A. 1124/03 *Ganey Ofer v. Assessing Officer Tel-Aviv 1*, Missim V-2 (Apr. 2005), E-3.

[678] Income Tax Ordinance, s. 18(b).

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decrease his/her taxable income.[679] In one case it was held that a gas supplier was not entitled to deduct linkage differentials accruing on deposits, received as collateral for equipment (gas tanks), despite their linked refundability on termination of the contract pursuant to which they were made.[680]

m. Bad Debts

Section 17(4) of the Income Tax Ordinance provides for the deduction of "bad debts incurred in any business or vocation, proven to the satisfaction of the assessing officer to have become bad during the tax year and doubtful debts to the extent that they are reasonably estimated to the satisfaction of the assessing officer to have become doubtful during the said year, notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said year." For a debt to be recognized as a "bad debt," it is insufficient for the debtor to declare insolvency. Only with the commencement of liquidation or bankruptcy proceedings does it become so recognized.[681] Section 17(4) further provides that all sums recovered during a tax year on account of amounts previously written off or allowed with respect to bad and doubtful debts, for purposes of the Ordinance, are to be treated as receipts of the business or vocation for that year.

n. Inventory Write-Downs

Inventory is valued at cost or market value, whichever is lower, in accordance with generally accepted accounting principles. Thus, an unrealized loss is allowed as a deduction where the value of the inventory drops below its cost.

In times of inflation, the carrying of inventory became a major source of concern for many taxpayers. The concern is the taxation of inflationary profits. The burden was alleviated in the past, to a great extent with respect to industrial enterprises, by means of a special deduction based on the adjustment of the price of the inventory. A special committee formed by the government to determine a method of taxation during times of inflation concluded that the entire fiscal regime should be revised to avoid the taxation of inflationary profits.[682] Its recommendations brought about the enactment of the Income Tax (Taxation under Inflationary Conditions) Law, 1982, superseded by the Income Tax (Inflationary Adjustments) Law, 1985 (see XVI., below), which is now no longer in force due to low inflation. The tax authorities have agreed to allow a write down for real estate held as inventory by developers.[683]

o. Rents

Section 17(2) of the Income Tax Ordinance provides that "rent paid by any tenant of land or buildings occupied by him for the purpose of acquiring income" is allowed as a deduction. As already mentioned (see a., above), the list of deductions contained in section 17 is not a closed, exclusive list and rental payments incurred with respect to movable assets are also allowed as a deduction.[684] Rent paid for premises before their occupation by a business must be capitalized.

A lease transaction is treated as either a genuine lease or an installment purchase contract. The basic guidelines for the classification of a lease as either a sale or a "true" lease have been laid down by the Israeli courts in several key precedents on the matter[685] that tend to focus on the economic substance of the transaction in question, i.e., whether the terms of the agreement imply an intention of the parties thereto to affect a sale or a lease. Based on this principle, in 1989, the Israeli income tax authorities issued criteria regarding the taxation of leasing transactions.[686] The provisions set forth four criteria, the existence of which will entail the classification of a lease as a financial lease. A lease will be classified as a financial lease if:

(i) Under the terms of the agreement, the lessee gains title to the leased equipment at the end of the lease term;

(ii) The lessee is granted an option to purchase the equipment at the end of the lease term at a price that is — as of the date of the agreement — significantly below the expected market value of the equipment at the end of the lease term;

(iii) The lease term is 75% or more of the economic useful lifetime of the leased equipment; and

(iv) The present value of the rent amounts to 90% or more of the present market value of the equipment.

The provisions do not specify whether all four criteria must be met for a lease to be classified as a financial lease.

In addition to these criteria, regulations have been promulgated entitling lessees to elect, subject to certain conditions, that their lease be regarded as an operating lease even if the terms of the lease meet the criteria set out above.[687] The regulations apply to a leasing contract if the contract meets the following conditions:

(i) It calls for rental payments to be made on fixed dates;

(ii) Intervals between payments are no more than three months and the last payment is made less than three months before the end of the lease;

(iii) Each rental payment is calculated based on a fixed percentage of the cost of the equipment, to which are

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679 C.A. 159/79 *K.B.A. Kvutsat Boney Arim v. The Assessing Officer (Large Enterprises)*, 35(3) P.D. 572; I.T.A. 392/82 *Hahevra HaAmericait Yisraelit LeGas Ltd. v. The Assessing Officer (Large Enterprises)*, 16 P.D.A. 50; I.T.A. 135/88 *Balalis v. Assessing Officer Afulla*, 18 P.D.A. 220.

680 I.T.A. 43/95, 31/96 *Hahevra HaAmerikait Yisraelit Le Gas Ltd. v. The Assessing Officer (Large Enterprises)*, Missim O-2 (Apr. 2001), E-69.

681 I.T.A. (T.A.) 239/83 *Elia'hu Baranes v. The Assessing Officer*, 14 P.D.A. 203, I.T.A 43/95 *Hahevra HaAmerikait Yisraelit LeGas v. The Assessing Officer (Large Enterprises)*, Missim O-5 (Oct. 2001), E-96.

682 Report of the Committee Established to Examine Taxation During Inflationary Times, Jerusalem, Mar. 1980, p. l.

683 Income Tax Circular 12/2004, *The Taxation Treatment of the Decline in Inventory Value of Building Contractors and Real Estate Dealers*, Missim R/3 C-1.

684 C.A. 431/69 *The Assessing Officer Tel-Aviv 5 v. Derby Chimicalim Ltd.*, 24(2) P.D. 24; I.T.A. 48/78 *Golombe v. Assessing Officer Tel-Aviv*, 10 P.D.A. 68.

685 I.T.A. (T.A.) 376/80 *Klitit Rechev Ltd. v. The Assessing Officer (Large Enterprises)*, 12 P.D.A. 341; I.T.A. (T.A.) 181/84 *Bernstein Gil v. The Assessing Officer*, 15 P.D.A. 179; I.T.A. 7/94 *Beit Horim Ronit 1988 Ltd. v. Assessing Officer Acre*, Missim J-3 (Aug. 1996), E-100.

686 Income Tax Authorities' Operational Provision No. 40/89.

687 Income Tax Regulations (Special Deductions of a Leased Equipment User), 1989.

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added reasonable interest rate and exchange differentials; and

(iv) The lease period covers at least 75% of the depreciation period allowed for tax purposes, and in the case of certain taxpayers, the entire period.

An important prerequisite contained in the regulations is that the lease contract must be approved in advance by the Director of the Israel Tax Authority for the regulations to apply to it and classify it as an operating lease.[688]

A lessee electing to apply the regulations may deduct the rental payments. Nonetheless, the consideration from the sale of the leased equipment by the lessee is treated as a real capital gain. In sum, in the case of a lease for a period of less than 25 years, the lessee may deduct the lease payments under the provisions of section 17(2), provided the economic substance of the lease is not a purchase agreement.

Under 1977 special regulations, a lessee of real estate for a term of less than 49 years may deduct rental payments and, if they are paid in a lump sum, may amortize them over the term of the lease.[689] Special provisions apply to the amortization of investments in such premises. Other, 1998 regulations[690] provide for the amortization of improvements made by a lessee in leased premises at the rate of 10% annually, with the balance being deducted at the end of the lease term.

In *PiGlilot*,[691] the taxpayer claimed that rental payments on the lease of real estate for a period of 49 years, which included an option to extend the term for an additional 49 years, were deductible because the lease was an "operational lease" (the 1977 regulations were not relevant because the lease term exceeded 49 years). The Supreme Court determined that when the term of a lease exceeds 25 years, deductibility under section 17 is conditional on the lease being an "operational lease" and not a "financial lease." The court determined that the rights given to the lessee in this case were similar to ownership rights and, therefore, the lease could not be classified as an "operational lease."

p. Salaries and Wages

Under section 18(a) of the Income Tax Ordinance, a retirement grant, leave pay, convalescence pay, holiday pay, sick pay and other similar expenses may be deducted under section 17 only in the tax year in which they were actually paid to the person entitled to them or to a provident fund within the meaning of section 47. Payments made to a provident fund with respect to the last month of the tax year are deemed to have been made during the tax year, if they were made within one month after the end of the tax year. "Similar expenses" are the subject of the *Dikla* case in which the Supreme Court held this provision applicable to gold watches presented as a gift on retirement and hence denied a deductible reserve therefor.[692]

Salaries and wages are deductible on a current basis. It is important to note that section 18(b) of the Income Tax Ordinance provides that any salaries, wages, management fees, interest or linkage differentials and other payments paid by a company controlled by not more than five persons, within the meaning of section 76 of the Ordinance, to any of its controlling members are to be allowed as a deduction only: (i) if they are paid during the tax year in which the deduction is claimed; (ii) if the person credited with such amounts includes them in their annual return for the same year; or (iii) if the tax to be withheld at source under the provisions relating to withholding taxes on wages was in fact withheld within three months after the closing of the tax year and transferred to the Assessing Officer within seven days of its withholding, together with interest and linkage differentials from the end of the tax year or the special accounting period until the date of withholding.

Under section 17(5) of the Income Tax Ordinance, a special deduction is allowed for sums paid by an employer (up to a ceiling set by the Ordinance), subject to the conditions and at the rates prescribed by regulations, for the purpose of section 47 of the Ordinance, by way of ordinary annual contributions to a provident fund (for various objectives such as pension, severance pay, etc.), approved by the Commissioner for purposes of section 17(5). The amount allowed as a contribution of the employer is limited to 7.5% of the employee's wages (subject to certain conditions) up to a maximum amount adjusted according to the rate of inflation, with any contribution in excess thereof constituting taxable income in the hands of the employee.

q. Life Insurance

According to Income Tax Circular 20/88, a company is allowed to deduct premiums paid to insure the lives of key personnel (but not, for example, of inactive "partners"), provided the insurance policy is meant to protect the company against the loss of their services. The expenses are not deductible when other persons, such as family members, are the beneficiaries.

With respect to controlling members, deductibility is restricted under the terms of section 32(9) and (10) of the Income Tax Ordinance.

r. Economic Counseling and Management Fees

Economic counseling expenses that are related to the current management of the business and management fees are allowed as a deduction if sufficient proof of their nature as such is provided.[693] However, such expenses, if related to the acquisition of a capital asset or to the establishment of a new business, are not deductible.[694]

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[688] Income Tax Regulations (Special Deductions of a Leased Equipment User), 1989, s. 7(a).

[689] Income Tax Regulations (Deductions of Leasing Fees), 1977.

[690] Income Tax Regulations (Deductions for the Adjustments of Rented Premises), 1998.

[691] 8301/04 *PiGlilot v. the Assessing Officer (Large Enterprises)*, Missim U-3 (2007), E-98.

[692] C.A. 3348/97 *Assessing Officer (Large Enterprises) v. Dikla Hevra LeNihul Kranot Neemanut Ltd.*, Missim O-5 (Oct. 2001), E-64.

[693] I.T.A. 234/88 *Mercaz Ramir Ltd. v. Assessing Officer (Large Enterprises)*, 19 P.D.A. 156.

[694] I.T.A. 1003/69 *Hevrat M.D.M. Ltd. v. The Assessing Officer*, 4 P.D.A. 82; C.A. 263/70 *Mifaley Musika Israelim v. The Assessing Officer*, 4 P.D.A. 169; C.A. 414/78 *Rechev Israeli Ltd. v. The Assessing Officer*, 10 P.D.A. 207; C.A. 761/77 *Avna'al Ltd. v. Assessing Officer (Large Enterprises)* (1978) 32(2) P.D. 494; C.A. 495/88 *Greenberg Ltd. v. The Assessing Officer Tel Aviv*, Missim F-3 (June 1992), E-53.

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s. Treatment of Child Care

Under section 17 of the Income Tax Ordinance, an expense is deductible only if it is incurred "wholly and exclusively" in the production of income. A decision of the Supreme Court[695] held that certain childcare expenses are necessary for the production of income by their parents and, therefore, deductible under section 17. However, an amendment to section 32 of the Ordinance overturned the ruling by providing that childcare expenses are not deductible.

t. Academic Studies

The Supreme Court held in *Bank Yahav*[696] that an employer's payment for academic studies should be treated as employment income since, generally, academic studies are more beneficial to the employee than the employer. In this context, the Supreme Court held that academic study expenses of an employee or a self-employed individual are usually not deductible, as they create a persistent advantage to the taxpayer. Furthermore, the courts held that even specific M.B.A. studies create such a persistent advantage.[697] It is worth noting that, as of 2005, a resident holding an academic degree is entitled to 1 or 1/2 credit point depending on the circumstances.

u. Meals

In Amendment 179 of the Ordinance expenses for meals while at work whether at the work location or elsewhere were barred from deduction. However, section 17 of the Ordinance allows the deduction of expenses for a breakfast included in deductible lodging expenses.

6. Capital Expenditure

Capital expenditure is not allowed as a deduction from current and ordinary income. Section 32(3) of the Income Tax Ordinance specifically denies the deduction of "any capital withdrawn or any sum employed or intended to be employed as capital." Section 32(4) denies a deduction for "the cost of any improvements." Capital expenditure must therefore be capitalized and written off in accordance with the depreciation allowed with respect to the asset for which the expenses were incurred.[698]

It is worth noting that the income tax authorities regard expenses incurred in the prevention of competition on the acquisition of a business or when an employee retires as aimed at gaining a long-term business advantage and thus as capital expenses. The only exception to this may be expenses incurred because of a probable economic need to prevent competition during a very short term.[699]

[695] C.A. 4243/08 *Vered Peri v. The Assessing Officer (Gush Dan)*, Missim X-3, E-90 (2009).

[696] C.A 3501/05 *Assessing Officer (Jerusalem) v. Bank Yahav*, Missim U-6, E-113 (2007).

[697] I.T.A 807/06 *Yair Zorea v. Assessing Officer (Hadera)*, Missim X-6, E-148 (2008).

[698] As a rule, expenses incurred for raising capital are not deductible; however, under section 5B of The Law for the Encouragement of Industry (Taxes), 1969, such expenses when incurred in raising equity capital on the stock exchange are amortized and deducted over three years. The same holds true for options, I.T.A. 1059/98 *Cementcal v. Assessing Officer (Large Enterprises)*, Missim R-2 (Apr. 2005), E-132.

7. Loss Carryovers

Under section 28 of the Income Tax Ordinance, the amount of a loss incurred by any person during the tax year in any business or vocation that, had it been a profit, would have been taxable under the Ordinance, may be set off against that person's total chargeable income from other sources in that year.

It should be emphasized that: (i) although losses incurred in any business or vocation may be set off against income from other sources during the same year, losses incurred from any other source of income may not be set off against income from a business or vocation;[700] (ii) a loss incurred outside Israel (a "foreign loss") may be set off against foreign income in accordance with the "basket system" as explained in XVII.A.2., below);[701] and (iii) a loss must be incurred by the same taxpayer as the taxpayer against whose income it is set off, so that losses incurred by a company may not be set off against its owner's income or vice versa.[702] Furthermore, the purchase of a loss company for purposes of setting off its losses against its future income may be deemed to be an artificial transaction for purposes of section 86 of the Income Tax Ordinance.[703] A 2007 amendment to the Income Tax Ordinance[704] allows an individual to set off their business loss against their employment income upon termination of the business and assumption of new employment.

Under section 28(b) of the Income Tax Ordinance, the balance of a business or vocational loss from an Israeli source that could not be used during the year in which it was incurred may be carried forward indefinitely. However, such a balance may be set off only against Israeli or foreign-sourced income from a business or a vocation and it must be set off during the first year in which such a set-off is possible. The Ordinance does not require that the set-off be against income from the same business or vocation as that in which the loss was incurred. When a loss is carried forward, it may also be used to offset a capital gain incurred in any business or vocation. However, section 28(c) grants the taxpayer an option: the taxpayer may opt not to set off a business loss against the "inflationary amount" of a capital gain or against a capital gain, dividend or interest liable to a 25% maximum tax. The reason for this is clear. The tax on the "inflationary amount" is limited to 10% on the inflationary amount accrued until 1994 and exempt thereafter, while the maximum ordinary rates of tax on business and vocation income reach 48% for individuals and the regular company tax rate for companies. Curiously enough, in the past it might have

[699] Income Tax Circular No. 20/88; I.T.A. 346/70 *Assessing Officer Haifa v. Off Haifa Ltd.*, 4 P.D.A. 107.

[700] I.T.A. 83/77 *Pegasus Ltd. v. The Assessing Officer*, 10 P.D.A. 12; C.A. 615/85 *The Assessing Officer v. A.H.A. Goldstein Ltd.*, Missim D-6 (Dec. 1990), E-36; C.A. 128+375/75 *The Assessing Officer v. Haachim Mark*, 8 P.D.A. 121.

[701] Income Tax Ordinance, s. 29.

[702] C.A. 404/65 *Pardes Syndicate Ltd. v. The Assessing Officer*, 20(3) P.D.; C.A. 210/67 *Paz-Gas Ltd. v. The Assessing Officer*, 22(1) P.D. 64.

[703] C.A. 3415/97 *Assessing Officer for Large Enterprises v. Rubinstein*; C.A. 265/67 *Mephi Ltd. v. The Assessing Officer (Large Enterprises)*, 21 P.D. 503; C.A. 414/78 *Rechev Israeli Ltd v. The Assessing Officer*, 10 P.D.A. 207; C.A. 495/88 *Baruch Grinberg Ltd. v. Assessing Officer Tel-Aviv*, 20 P.D.A. 171.

[704] Income Tax Ordinance (Amendment 154), 2007.

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been worthwhile for the taxpayer to set off the loss against a capital gain that was an "inflationary amount" despite the difference in the tax rate. For, in an inflationary economy, it must always be remembered that the "value" of the loss diminishes in accordance with the rate of the inflation. Indeed, the laws regulating the taxation of inflationary profits linked the loss to the cost-of-living index and thereby maintained its "value" in real terms. Thus, the loss remained a loss and did not become a hidden profit subject to tax, as before the enactment of these laws. Nevertheless, due to the repeal of the inflationary adjustments law, as of January 2008 losses are no longer linked to the cost-of-living index. The reason for granting a taxpayer the option not to set off a loss against a capital gain or favorably taxed dividend or interest is similar: to allow the taxpayer not to offset favorably taxed income with a loss that can be used to offset higher taxed income. A foreign loss incurred in a business or vocation that could not be set off against income in the year in which it was incurred, may be carried forward to subsequent tax years and set off against the foreign income of the taxpayer derived from a business or vocation including capital gains, provided that the set-off is made in the first year during which income is available for the set-off. However, the taxpayer does have an option to set off a foreign business loss that was carried forward against Israeli business or vocational income, provided the foreign business loss was derived from a business controlled and managed in Israel. In such a case, the amounts so set off will not be available for a set-off against foreign-sourced business or vocational income and capital gains.

In a landmark case in 2003,[705] the Supreme Court ruled that where the sole motive for the acquisition of the shares of a company was the enjoyment of its losses by the infusion of income from a new activity into the company, the carryover of the loss would be denied despite the fact that under a literal interpretation of the statute, the set-off should have been allowed. The court ruled that the purchase of a "loss" solely for the purposes of enjoying its income tax advantages was an "artificial transaction" within the meaning of section 86 of the Income Tax Ordinance. However, in 2008, the Supreme Court held in *Ben Ari*[706] that even where a "loss" was acquired solely for the purposes of enjoying its income tax advantages, in some cases, such a loss may be set off against future income. Ben Ari was the owner of 32% of the rights in a garage. The garage had substantial losses and ceased its activities. Ben Ari purchased 68% of the shares of the garage company and transferred to it a profitable activity of insurance. The Supreme Court held that 32% of the loss was deductible at the company level since it reflected Ben Ari's ownership prior to the purchase of the remaining 68% of the shares from the other shareholders.[707]

According to the language of section 28 of the Income Tax Ordinance and considering the purpose and the legislative intent of the provision, losses cannot be set off against income generated in tax years preceding the year in which the losses were generated. In *Hirschzon*, the court held that section 28 constitutes a complete, comprehensive, and orderly provision, and that its failure to address losses arising in certain circumstances does not amount to a legislative lacuna.[708]

Notwithstanding these provisions regarding the set-off of losses, section 29 of the Income Tax Ordinance contains special provisions with respect to the set-off of losses incurred outside Israel.

A loss incurred by a resident of Israel that, had it been income, would have been foreign passive income[709] may be set off against any passive income derived from outside Israel. A loss incurred from the renting of real estate attributable to depreciation may be set off against a capital gain derived from the sale of the rented real estate.

Where the loss cannot be set off in the tax year in which it was incurred, it may be carried over to succeeding years, provided it is set off during the first year in which the taxpayer is allowed to do so, and that the set-off is made against passive income derived from outside Israel during those years. It should be stressed that where the loss could have been set off in any one year and the set-off was not made, the taxpayer will not be able to carry over the set-off to succeeding years (see section 29(1)(B) of the Income Tax Ordinance).

Where the taxpayer incurred a loss in a business or vocation carried on outside Israel that, had it been a profit, would have been taxable in Israel, the relevant set-off rules are contained in section 29(2) of the Income Tax Ordinance and are as follows:

(i) A current loss will first be set off against the taxable income, including capital gains, derived from a business or vocation outside Israel;

(ii) Any excess loss will be allowed as a set-off against foreign passive income available for such a set-off after the set-off of a foreign passive loss against it;

(iii) Any excess loss, not set off pursuant to the above, derived from a business "controlled and managed" from Israel may be set off against income derived in Israel during the same taxable year;

(iv) Should there still remain any loss not set off after the above set-off, it will be carried over to succeeding years and will be available for set off against the taxable income of the taxpayer derived from foreign sources constituting a business or vocation including capital gains; and

(v) At the request of the taxpayer, the latter may set off any excess loss from a business outside Israel that is "controlled and managed" from Israel against taxable income, including capital gains, and the tax levied on real estate located in Israel.

Finally, no set-off will be allowed for a loss incurred outside Israel that, had it been a profit, would not have been tax-

[705] C.A. 3415/97, *Assessing Officer for Large Enterprises v. Yoav Rubinstein*, Missim Q-4 (Aug. 2003), E-3.

[706] C.A. 738706 *Ben Ari v. The Assessing Officer (Jerusalem)*, Missim V-3, E-71 (2008).

[707] In *Signon Sherutey Tikshuv Ltd. v. The Assessing Officer of Petah-Tikva*, Missim KE/4 (Aug. 2011), E-182, the Israeli Supreme Court ruled that a capital loss incurred on the sale of shares by an Israeli corporation subsequently after a dividend was distributed constituted an "artificial transaction" according to section 86 of the Israeli Income Tax Ordinance as it lacked "economic substance." Such a method used by the taxpayer is known as "dividend stripping."

[708] Further Civil Hearing 2308/15 *Rehovoth Tax Assessor v. Damari*, [Nevo Publishing] (12/09/17).

[709] I.e., interest, linkage differentials, dividends, rent, royalties; *see* Income Tax Ordinance, s. 29(1)(a).

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able in Israel, and no such set-off will be allowed where a taxpayer did not file a return with respect to such a loss for the year in which it was incurred.

8. *Tax Rates and Calculation of Taxable Income*

a. *In General*

Under section 126 of the Income Tax Ordinance, the chargeable income of a company is subject to companies' tax at the rate of 23%.

The maximum rate of tax on dividends distributed to individuals and nonresident companies is 30%.[710] As indicated in V.C.4.c., above, in calculating taxable income for purposes of applying the company tax, "income from dividends or from the distribution of profits received directly or indirectly from another body of persons liable to Israeli company tax derived from a source located in Israel shall not be included, nor will any income enjoying a special tax rate be so included." Thus intercompany dividends are free from company tax in Israel, provided the company tax was borne by the dividend-paying company and the source of the income from which the dividend is distributed is Israeli.[711]

Dividends distributed out of the profits of an approved or beneficial enterprise[712] are subject to a 20% income tax and the same applies to dividends paid by a company out of such dividends.[713] In the latter case, the company is entitled to deduct from its taxable dividend income, dividends it distributed in the same year, or in preceding years.

"Real" capital gains are subject to company tax. The inflationary amount is taxed at the rate of 10% (with respect to the inflationary amount accrued until 1993) and 0% (with respect to the inflationary amount accrued thereafter).[714]

Taxation under the Taxation of Land (Appreciation and Purchase) Law, 1963 is similar to the taxation of capital gains described in the previous paragraph.

b. *Family Companies and Transparent Companies*

In 1978, a special amendment was introduced into the Income Tax Ordinance to allow for the "pass through" of income and losses of "family companies."[715] The main objective of the legislation was to allow shareholders of such closely held companies to be taxed directly on their profits and thereby reduce the income tax liability they would have suffered had they received dividends from their companies. However, a "family company" was not taxed as a partnership. Instead, the shareholder entitled to the greater amount of the profits of the company or, in the case of two or more such equal shareholders, the consenting shareholder nominated by the company, had to be appointed the sole taxpayer for all the income of the "family company."

The income of a "family company" was computed at the company level, and then attributed to the taxpaying member. The income was then subject to the taxpayer's (individual) tax rates and special concessions,[716] and the taxpayer could offset his/her personal income with losses incurred by the company.[717]

Losses incurred by the taxpaying member prior to the period in which the company became a "family company" may not be used to offset "family company income."[718] Losses incurred by the company prior to its becoming a "family company" may not be set off against the taxpaying member's current income.[719] In addition, the Israeli courts ruled that dividends received from income generated during the period in which the company was considered a "family company" and were offset at the level of the company against losses generated during the period in which the company was not considered a "family company" — are subject to tax despite the provisions of s. 64A(a)(1). That section provides that distribution of profits generated during the period in which the company was considered a "family company" shall be disregarded.[720]

The Ordinance does not require the taxpaying member of the "family company" to be a resident of Israel; however, the member must be a "relative" of the other shareholders within the meaning of section 76(d)(1) of the Income Tax Ordinance.[721] The Income Tax Authorities used to contend that all members of the family had to be directly related to each other and that relations through an intermediary did not suffice.[722] This interpretation of the Ordinance was challenged, and the Supreme Court held that the criteria of the Ordinance are met where all shareholders are related to each other through a "chain," even if some members are not directly related to each other.[723] Moreover, the Income Tax Authorities contended that, where a spouse was chosen as the taxpayer, the income of the "family company" was to be added to his/her spouse's income, an absurd result but one that the language of the statute certainly supports.

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[710] Income Tax Ordinance, s. 125B.

[711] Income Tax Ordinance, s. 126(b).

[712] Subject to the conditions set forth in Law for the Encouragement of Capital Investments, 1959, s. 47(a)(3) or (4), s. 47 (a1), s. 51(b) or s. 53c(b).

[713] Law for the Encouragement of Capital Investments, 1959 s. 47(b)(2).

[714] Income Tax Ordinance, s. 91(a).

[715] Income Tax Ordinance, s. 64A.

[716] I.T.A. 93, 114/87 *Feldenstein and Others v. The Assessing Officer*, 19 P.D.A. 329: the Court held that the elected taxpayer is subject to a special levy imposed only on individuals, even though the income was derived by a company. I.T.A. 58/90 *Hevrat Alef Zara Ltd. v. Assessing Officer Tel-Aviv 4*, Missim F-6 (Dec. 1992), E-175; C.A. 896/90 *Assessing Officer Haifa v. Halevi*, Missim I-4 (Aug. 1995), E-56: the Supreme Court held that the exemption from tax granted to an invalid applies to "family company" income attributed to him. I.T.A. 12/94 *Atzmon v. Assessing Officer Jerusalem*, Missim J-2 (Apr. 1996), E-81: the exemption granted for rental income earned by an individual applies to rental income derived by a "family company" and taxed at the individual's level.

[717] C.A. 3574/92 *Assessing Officer Gush Dan v. Pereg*, Missim K-1 (Feb. 1997), E-55.

[718] Income Tax Ordinance, s. 64A(a)(6).

[719] I.T.A. 1222/02 *Shkalarsh v. Assessing Officer Ramla*, Missim U-2 (Apr. 2004), E-27; I.T.A. 82/94 *Bi-Gud Michal Ltd. v. Assessing Officer (Large Enterprises)*, Missim K-6 (Dec. 1997), E-105. In a recent decision, the Supreme Court changed this ruling by giving effect to a compromise agreement entered into between the parties. (*See* C.A. 6742/97 *Assessing Officer (Large Enterprises) v. Bi-Gud Michal Ltd.*, Missim S-3 (June 2002), E-1.)

[720] I.T.A. 39456-01-12 *Mauric Herchko v. The Assessing Officer of Rehovot* (June 10, 2014); I.T.A. 1130-06 *Beges Carlos v. The Assessing Officer of Tel Aviv 4* (July 15, 2013).

[721] "Relative," for this purpose, means "spouse, brother, sister, parent, grandparent, descendant and descendant of spouse and spouse of those enumerated."

[722] Income Tax Circular No. 78/16 Appendix 1, s. 1.

[723] H.C.J. 61/81 *Mahtesh Ltd. v. The Assessing Officer (Large Enterprises)*, 35(1) P.D. 1. The Income Tax Authorities consequently apply this ruling. *See* Income Tax Implementation Instruction 84/42.

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The advantages of a "family company" were significantly eroded by the reduction in company tax and the elimination of income tax on companies, when the rate of tax applicable to companies on undistributed income (67%) was set significantly lower than the highest rate imposed on individuals. The "family company" became advantageous when the choice was between an individual's own business and a dividend distributing company.

With the 2003 tax reform came the introduction of section 64A1 of the Income Tax Ordinance. As a result of its enactment, "family companies" no longer exist. Instead, taxpayers have a choice between ordinary companies and "transparent companies." A "transparent company" is a private company resident in Israel whose shareholders are all individuals resident in Israel that elected to be classified for income tax purposes as a "transparent company." These companies may have up to a maximum of 50 shareholders. The taxation of the profits of a "transparent company" is similar to that of the profits of a partnership, i.e., the taxable income of the "transparent company" is ascribed to the shareholders in accordance with their ratable share of the profits and is deemed their income whether distributed or not. In short, a "transparent company" is not a tax paying entity, and therefore, any dividend from a "transparent company" does not create a taxable event. Until the reform of 2003, transparency taxation was limited to "family companies" and to "real estate companies" (i.e., companies whose sole business was the holding of real estate and the deriving of income therefrom). On the issuance of special regulations, which will render these provisions effective, the transparent entities known as the "real estate company" and the "family company" will vanish, with all "family companies" becoming "transparent companies," unless an election to the contrary is made. Transparent companies will only be available to taxpayers after the issuance of regulations relating to their taxation. It is worth mentioning that due to the amendments concerning the "family company" regime as detailed below (which concept is very similar to the provisions of the "transparent company" regime), it appears that such prospective regulations with respect to the "transparent company" regime are not expected to be promulgated in the near future.

To prevent certain tax planning opportunities that were available under the "family company" regime, the Israeli legislature stipulated certain amendments to the "family company" regime as part of the Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014) 2013. The amendments are primarily designated to deal with tax planning opportunities that were available with respect to the representative shareholder in a "family company," under which such shareholder was able to elect the "family company" status in certain taxable years in which the company incurred losses and would offset such losses against his/her taxable income. Furthermore, under the previous "family company" regime, the representative shareholder was able to revoke the "family company" status in subsequent years to the extent that the company generated taxable income (or *vice versa*) and no longer generated losses that were deductible against the representative shareholder's income.

Under the new "family company" regime, with effect as of January 1, 2014, a company may elect to be treated as a "family company" for tax purposes only in the three months subsequent to its incorporation. Furthermore, a "family company" which does not meet the conditions in section 64A will lose its "family company" status as of the beginning of the taxable year in which the conditions were not met. However, dividends received by the company in such a taxable year will be included in the representative shareholder's income and will be subject to a 25% tax (30% in the case of a substantial shareholder). The latter provision shall not apply to the extent that the company lost its "family company" status as a result of the death of one of its shareholders or the acquisition of at least 25% of its shares.

Another significant amendment to the "family company" regime provides that a company which lost its "family company" status or elected not to be treated as a "family company" may not elect to be treated as a "family company" in the future. This provision is applicable to current "family companies" and to new "family companies" incorporated after January 1, 2014. Additional amendments to the "family company" regime include: certain provisions with respect to tax-free reorganizations will not apply with respect to "family companies"; a new method of calculation of the distribution of the "family company's" profits and with respect to the allocation of the consideration from the sale of shares in a "family company"; certain tax benefits (e.g., tax exemption available with respect to foreign residents on the sale of shares in an Israeli company) will apply with respect to income generated by the "family company" only to the extent that such tax benefits are applicable to the representative shareholder, and will apply pro rate according to the income allocable to such shareholder; and additional reporting requirements in the case of failure to meet with the conditions provided under section 64A.

It is worth mentioning, that a "family company" that is interested in terminating its "family company" status is required to submit such a notification with the Israeli Tax Authorities no later than a month before the beginning of the taxable year it is interested in terminating its status. As detailed above, such a company may not elect to be treated as a "family company" in the future.

c. *Closely Held Companies*

Closely held companies controlled by five or fewer people, in which the public has no substantial interest, are subject to certain provisions concerning a deemed distribution of dividends.[724]

The Director of the Israeli Tax Authority may order the relevant assessing officer to act as if part of the closely held company's undistributed profits were actually distributed. The notional distribution is limited to 50% of those undistributed profits, minus the amount of the profits that were actually distributed as dividends.

The issuance of such an order is subject to the following conditions:

1. The company did not distribute to its shareholders at least 50% of its profits for the relevant tax year, during a five-year period after the end of the relevant tax year;

[724] Income Tax Ordinance, ss. 76–77.

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2. The company's accumulated profits exceed 5 million NIS;

3. The company is able to distribute its profits — fully or partially — without damage to the existence and development of its business activity;

4. The non-distribution of profits results in tax avoidance or tax reduction;

5. The order of the Director was rendered after consultation with a special advisory committee;

6. The company was given an adequate opportunity to present its arguments before issuance of the order; and

7. Following the notional distribution, the accumulated profits did not fall below 3 million NIS.

d. Personal Service Companies

A personal service company, also known as a "wallet company," is a company used by its individual shareholder for providing certain services. Those services usually should be provided directly by the individual shareholder — as an employee or as a self-employed, but are provided indirectly by the company in order to reduce the income tax rate and the national insurance payments. Therefore, in certain cases, and to prevent abuse of the "two tier taxation method," the Wallet Company's income is considered as the income of the individual shareholder.

The taxable income of a wallet company, which is a closely-held corporation (and not a foreign vocation company), which derives from the business activity of its individual significant shareholder (i.e., a shareholder who holds at least 10% in one or more of the company's means of control), will be considered as the income of the individual shareholder, in one of the following cases:[725]

1. The closely-held corporation's income derives from the services provided by its individual shareholder to another company (including a party related to it), such as officer services, management services, etc. In addition, it is a prerequisite that the individual shareholder or the closely-held corporation are officers in the company that receives the services, and that the individual shareholder is not a significant shareholder, directly or indirectly, in that company. In this case, the income will be classified as business income, as personal exertion income or as income from other sources.

2. The closely-held corporation's income derives from the services provided by its individual shareholder to another party, and these services are of a type usually performed by an employee for his employer. The term "another party" includes a party related to it but does not include a party for which the individual is a significant shareholder, directly or indirectly, or a partner. In this case, the income will be classified as personal exertion income.

In this regard, the services will be considered as usually performed by an employee for his employer if all the following conditions are met:

(i) During the relevant tax year, the source of 70% or more of the closely-held corporation's income or its taxable income — excluding special income and special gains — derives from the services;

(ii) The services are provided by the individual shareholder or his/her relative, including the closely-held corporation's employees, directly or indirectly, including a related closely-held corporation;

(iii) The services are provided for one party or its relative, during a period of 30 months at least, within a period of four years. A service which is provided to a partnership by one of its partners will not be considered as a service of one party; and

(iv) The closely-held corporation employs three or fewer employees, and the individual shareholder and his or her relative are considered to be one employee.

A law for the taxation of undistributed profits in closely held companies was passed in November 2024. The law imposes an additional 2% tax on accumulated profits that are not distributed as dividends. The law outlines the conditions for imposing this tax, which specifically targets profits that were invested in passive assets. A temporary provision for 2025 exempts from taxes the transfer of assets and funds from a dissolving company to its individual shareholders (taxes on surplus distributions). Transfers of real estate to an individual shareholder will be exempt from purchase tax. The law also includes provisions for calculating the additional tax, determining accumulated profits and accounting for various factors that may affect the calculation. Additional measures are introduced to prevent tax evasion, ensure proper coordination across tax years and establish the law's effective commencement date. Overall, the law aims to tighten tax obligations with respect to the undistributed profits of privately-held companies and ensure these profits are not shielded from tax through manipulations such as deferred dividend distributions or asset transfers.

9. Special Cases: Shareholder Withdrawals of Company Funds and Use of Company Assets

An amendment to the Income Tax Ordinance of 2017[726] prevents the withdrawal of funds from a company or the use of its assets for a long period from being classified by the shareholder as a temporary use (i.e., loan, lease, etc.) of the company's assets, to avoid payment of dividend tax at the rate of 30% for the full amount of the funds or the asset and, instead, to pay taxes only for the use of the funds or the assets (i.e., income tax on the interest/rent).

According to the amendment, the withdrawal of funds from a company or the use of its assets by a substantial shareholder or related party is considered as income in the hands of the shareholder, unless the funds or the use thereof were fully taxed. The income will be classified as a dividend to the extent of the share of the shareholder in the company's profits, and the balance as income from other sources, depending on the circumstances.

These provisions are subject to the following transitory measures:

[725] Income Tax Ordinance, Sec. 62A.

[726] Income Tax Ordinance, Sec. 3(i1).

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1. Withdrawal of funds:

• The term "withdrawal of funds" includes providing a guarantee for a substantial shareholder, but it does not include the amount of cumulative withdrawals that did not exceed NIS 100,000 on any day in the relevant tax year and the preceding tax year.

• The date of the taxable event is at the end of the tax year following the tax year in which the funds were drawn.

• The income is equal to the amount of the withdrawal of funds less: (a) the credit balance of the shareholder which is recorded in the financial statements of the company and; (b) a loan from a bank for a period exceeding two years, which was transferred within 60 days to the shareholder, on the condition that he bears the loan costs and that the company did not provide any guarantee against that loan.

• Until the date of the taxable event, the shareholder will be liable to tax for the imputed interest income (the rate of the interest is determined on a yearly basis by the Minister of Finance).

2. Provision of company's assets for use of its shareholders

• The term "asset" includes only the following assets: (a) an apartment, including its contents, whose use is for personal use of a substantial shareholder; (b) works of art or jewelry; (c) aircraft and vessels whose main use is for personal use of a significant shareholder; and (d) other assets determined by the Minister of Finance in this regard.

• The date of the taxable event is at the end of the tax year in which the asset was provided, and at the end of each year thereafter until the asset is returned to the company.

• The income is equal to the cost of the asset less: (a) the credit balance of the shareholder which is recorded in the financial statements of the company and; (b) if the property is an apartment, the loan on which a fixed charge was registered, and the fixed charge is for a period of at least three years.

During the period of the use of the asset until its restoration to the company, income is attributed to the shareholder, at the market value of the use or at the rate prescribed in the Income Tax Ordinance, whichever is higher, less payments made by the shareholder for the use of the asset.

3. Intercompany loans:

A loan given to another company for a financial purpose will not be considered as a withdrawal of funds or use of an asset on the condition that the recipient is not a fiscally transparent corporation, provided all its shareholders are not companies liable to corporate tax in Israel.

10. Pillars One and Two

As the number of MNEs has increased significantly in the last decade, it is in the interest of countries around the world to agree global taxation arrangements. The Two Pillar Solution, developed by the OECD, aims to prevent profit shifting to tax shelters, and at the same time, reduce unnecessary tax burdens on taxpayers. Israel is committed to applying the model, and for the last couple of years, the Israeli legislature has been developing the infrastructure on which the Two Pillar Solution will be implemented.

As of April 2024, the model has not been implemented in the Israeli taxation system and it is too soon to determine its impact on taxpayers. However, according to the Bank of Israel review, this model should have relatively little effect regarding tax benefits for foreign investors whose investment in Israel is not their sole enterprise. Also, since Pillar One relates to the largest MNEs in all the countries that they operate in, investments in Israel will probably be affected by it no differently as from investments elsewhere. The impact of Pillar Two, however, will depend on both an investment's geographical criteria and the nature of the investment, as noted in the chapters on the Encouragement Laws (see II.A.2.c., above).

In August, 2024, the Israel Tax Authority published an announcement regarding the implementation of the Subject to Tax Rule (STTR) as part of the OECD's Pillar Two initiative (STTR rules have not yet been incorporated into any tax treaty signed by Israel).

In addition, the Minister of Finance announced plans to adopt a Qualifying Domestic Minimum Top-Up Tax (QDMTT) starting from the 2026 tax year, which would be applicable to multinational groups based in Israel with an annual turnover of 750 million euros or more. At this stage, no additional tax collection mechanisms (i.e., the Income Inclusion Rule (IIR) and the Under-taxed Payments Rule (UTPR)) will be implemented with respect to income of group companies that are not resident in Israel, with this issue to be revisited following the implementation of the QDMTT. The adoption of these rules will require appropriate legislation.

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