

INTRODUCTION TO THE TAXATION SYSTEM IN ISRAEL

1. INTRODUCTION

The Israeli tax system is based on UK tax principles with substantial modification. On January 1, 2003, Israel introduced a substantial tax reform that makes Israeli residents subject to Israeli tax on worldwide income. Previously, a modified territorial basis was applicable.

2. TAX SYSTEM

a. **General concepts of tax liability**

i. *Companies*

Resident companies are subject to Israeli tax on their worldwide income. A company is resident in Israel for Israeli tax purposes if it is incorporated in Israel, or its business is controlled and managed in Israel.

In principle, expenses are deductible if they are wholly and exclusively incurred for the production of taxable income. Additional rules apply to some expenses.

ii. *Individuals*

Resident individuals are subject to tax on their worldwide income and capital gains.

An Israeli resident is defined as an individual whose centre of living is in Israel, taking into account the person's family, economic and social links, including the following considerations:

- permanent home, even if someone else temporarily occupies it;
- place of residence of the individual and that individual's family;
- habitual place of business, permanent place of employment and the place where assets and investments are situated; and

- place of membership in organizations, associations and institutions.

A rebuttable presumption of Israeli residency will apply in either of the following circumstances:

- the individual is present in Israel at least 183 days in a tax year ending December 31; or
- the individual is present in Israel at least 30 days in the current tax year, and 425 days cumulative in the current and two preceding tax years.

New immigrants enjoy certain income tax, capital gains tax, import tax and other benefits for specified periods.

b. Rates and tax incentives

i. *Companies - ordinary income*

Regular rates:

The regular rate of company tax is currently scheduled to be 34% in 2005, 32% in 2006 and 30% in 2007 and thereafter. Proposals exist to further reduce the regular rate of company tax to 31% in 2006, 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter Readers should check the latest situation in specific cases.

Incentives:

Companies in industry or tourism can choose between various incentives as follows:

- Tax holiday package - for a “Privileged Enterprise”: Tax exemption applies to undistributed profits for 2-15 years depending on location and foreign ownership. Low company tax rates (10% -

25%) apply to distributed and subsequent profits. The total period of tax benefits is 7 – 15 years.

or

- Grant / low tax package - for an “Approved Enterprise”: Fixed asset grants (up to 32%) and low company tax rates (0% to 25%) for 7 to 15 years.

Dividend withholding tax also applies at a rate of 4% or 15% depending on the package selected.

The tax holiday package can be elected for a “Privileged Enterprise” if certain conditions are met, without needing to obtain approval. In particular, a minimum qualifying investment must be made in fixed assets in industry or in a hotel in Israel.

There is an optional advance ruling procedure if investors wish to check eligibility for Privileged Enterprise benefits.

In addition, Privileged Enterprises and Approved Enterprises must be competitive and not be overly dependent on the market of any one country.

Large investments (NIS 600 - 900 million = US\$ 137 - 206 million approx) in Privileged Enterprises by large groups in certain areas of Israel may qualify exemption from company tax for both retained and distributed profits as well as exemption from dividend withholding tax. This only applies to groups with annual revenues exceeding NIS 13 – 20 billion (US\$ 3 – 4.6 billion approx.)

Approved enterprise status has been available many years, but taxpayers may now choose Privileged Enterprise status for new and

expanded enterprises with a year of election of 2004 or thereafter, unless the Investment Center granted Approved Enterprise status by the end of 2004.

ii. *Companies - capital gains*

Resident companies are taxable on worldwide capital gains. Capital gains are divided into inflationary and real components. The inflationary component is exempt from tax to the extent that it accrued on or after January 1, 1994, and is generally taxable at a rate of 10% to the extent that it accrued before that date. The time-based portion of real gains that accrue after January 1, 2003 (Israeli real estate - after November 7, 2001) will be taxed at a rate of 25%, with real gains accruing before then at the regular rate of company tax. Companies doing business in Israel will generally be subject to company tax at the regular rates on the entire amount from publicly traded securities of Israeli or foreign companies.

iii. *Individuals - ordinary income*

In 2005, personal tax rates range from 10% to 49%. These tax rates are expected to be reduced gradually in future years.

Israeli-resident individuals are entitled to personal tax credits and deductions.

National insurance contributions are generally payable on taxable income as calculated for income tax purposes. In the case of residents, national insurance contributions are payable on the first NIS 34,820 of monthly income at rates ranging up to: employers 5.93%, employees, 10.38%, self-employed 15.42%, non-employment income 15.2%.

In the case of non-residents, national insurance contributions are payable on the first NIS 34,820 of monthly income at rates ranging up to: employers 0.84%, employees, 0.69% self-employed 0.64%.

52% of national insurance contributions paid in a tax year on self-employment and non-employment income is deductible for income tax purposes in that year. Israel has entered into social security totalization agreements with Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Sweden, Switzerland, the United Kingdom and Uruguay.

iv. *Individuals - capital gains*

Individuals are subject to broadly similar rules to those which apply to companies regarding capital gains. Real capital gains (adjusted for inflation or devaluation) accruing prior to 2003 (Israeli real estate: after November 7, 2001) are taxable at rates ranging up to 49%. Real gains accruing after then are taxable at 25%. It is proposed to reduce this rate to 20% - commencing in 2006 - unless the seller is selling shares in a company in which he or she holds 10% or more of any means of control of the company (as defined in detail)..

c. Tax evasion and avoidance

Israeli tax authorities have broad powers to obtain information and re-open cases. In the international area, anti-avoidance provisions are broad and include the following:

- artificial or fictitious transactions or arrangements may be disregarded;
- foreign companies controlled and managed in Israel will be deemed resident and taxable in Israel;
- transfer pricing rules;
- Controlled Foreign Company (“CFC”) rules which target certain foreign companies controlled over 50% by Israeli residents that derive mainly passive income or profits taxed abroad at a rate of 20% or less;

- Foreign Professional Companies (“FPC”) controlled 75% or more by five or fewer Israeli residents will be deemed to be controlled and managed in Israel, and hence taxable as normal in Israel;
- rules requiring Israeli banks to withhold 25% tax at source from most payments to non-residents unless they relate to imported goods or unless advance clearance is obtained for a lower withholding tax rate from the Israeli tax authorities - e.g. pursuant to a tax treaty;
- rules denying benefits intended for foreign residents in the case of foreign companies controlled 25% or more by Israeli residents;
- income and capital gain geographical source rules;
- foreign residents conducting any part of their activity in Israel must appoint (a) resident fiscal representative(s) for income tax and value-added tax (“VAT”) purposes; and
- foreign residents may be taxed in the name of any trustee, guardian, committee or attorney holder, agent, receiver, branch or director in Israel.
- It is proposed to allow the Director of the Israeli Tax Authority (ITA) to require disclosure of “tax planning” (i.e. tax shelters) – details are awaited. Disclosure may lead to a partial or full “best judgement” assessment by the ITA. Stringent sanctions are proposed for non-disclosure.

d. Taxable periods and filing requirements

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 after the end of their fiscal year, but extensions may be obtained. Businesses must normally file monthly or bimonthly reports and make payments with respect to: tax instalments, supplementary tax instalments on non-deductible expenses, tax withheld from salaries and suppliers, and VAT.

For employees and taxpayers maintaining single-entry books, the due date for filing annual tax returns is April 30 following the year-end. Taxpayers maintaining double-entry books must file annual tax returns by May 31 following the year-end. The tax authorities may grant filing extensions.

Due to the withholding tax system, individuals are not always required to file annual personal tax returns in Israel. Individuals who are currently required to file annual tax returns include the following:

- foreign residents who accrue or derive income in Israel. (However, an exemption from filing may apply if tax is withheld at source and if the income is derived either from a business or profession conducted for no longer than 180 days in the tax year or from salary, dividends, interest or royalties.);
- 10% or greater shareholders;
- trust settlors;
- recipients of over NIS 100,000 from trusts; and
- trust beneficiaries.

3. INTERNATIONAL

a. Residents with foreign investments/transactions

As mentioned, Israeli-resident companies and individuals are subject to Israeli tax on their worldwide income and gains. A credit for foreign taxes is available for federal and state taxes but not municipal taxes. An excess foreign tax credit may be offset against Israeli tax on income from the same type in the following five tax years.

With regard to foreign dividend income, an Israeli company may receive a direct and an underlying tax credit for foreign taxes, subject to detailed rules.

b. Expatriates

If no treaty exemption applies, expatriate non-residents working in Israel lawfully for an employer may enjoy the following benefits:

- deduction for accommodation expenses incurred and a daily living expense deduction of up to NIS 260, for up to 12 months for “foreign experts” legally present in Israel after being so invited by an Israeli employer that is not an employment agency. ; and
- tax rate of 25% for up three – to four years for foreign journalists, sportsplayers and “approved specialists” in industry or tourism, subject to various conditions and procedures.

c. Non-residents

Non-resident companies and individuals are subject to Israeli tax on income accrued or derived in Israel, unless otherwise provided for in an applicable tax treaty.

Unless a tax treaty provides otherwise, non-residents are in principle subject to Israeli tax on their capital gains relating directly or indirectly to assets in Israel.

Foreign residents not doing business in Israel may qualify for exemption from capital gains tax on dispositions of the following investments:

- securities traded on the Tel-Aviv stock exchange;
- securities of Israeli companies traded on a designated foreign stock exchange;
- shares in a research-intensive company that were issued to the foreign resident investor by the company on or after January 1, 2003; and
- investments in certain venture capital funds that obtained an advance tax ruling from the Israeli tax authorities.

d. Tax treaties

Israel has tax treaties with the following countries: Austria, Belgium, Bulgaria, Canada, China, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, India, Ireland, Jamaica, Japan, Korea, Mexico, Netherlands, Norway, Philippines, Poland, Romania, Russian Federation, Singapore, Slovak Republic, South Africa, Spain, Sweden, Switzerland Thailand, Turkey, UK, USA, and Uzbekistan.

4. TAXATION OF TRUSTS

Currently Israel has few rules regarding taxation of trusts. Revocable trusts are disregarded and the settlor remains fully taxable if the settlor or the settlor's spouse have any control or influence over the trust, or if children under the age of 20 at the beginning of the tax year receive trust income. Incapacitated persons remain taxable even if they have a trust or guardian to administer their affairs. Nominee arrangements relating to Israeli real estate are disregarded for tax purposes if the Land Registry is notified of the arrangement within 30 days (or possibly longer in restricted cases).

On July 24, 2003, a Public Commission published proposals to reform the Israeli taxation relating to trusts. Legislative proposals are expected to be published shortly that would seek to tax trusts established directly or indirectly by Israeli resident settlors unless all the beneficiaries are foreign residents or invalids or invalid institutions. The income of underlying companies of a trust would be attributed to the trust. The trustee would be required to file annual tax returns. Trusts settled entirely by foreign residents may remain outside the Israeli tax net if certain conditions are met according to the proposals. It is also proposed that Israeli resident professional trustees may be engaged without affecting the taxability of the trusts. These proposals, if enacted, are expected to take effect at the beginning of 2006.

5. TAXATION OF ESTATES

a. Estate and gift taxes

Israel does not have any tax on estates or gifts.

b. Taxation on death

Israel does not have any tax on estates or gifts.

6. OTHER TAXES

The table below summarizes other significant taxes.

NATURE OF TAX	RATE (%)
VAT, standard rate	17
Payroll levy on salaries of foreign employees	8.5
Real property sales tax	0 - 2.5
Acquisition tax, imposed on purchasers of real estate rights, maximum rate for 2004	5
Annual municipal taxes on property	Various
Stamp duties, generally	Up to 2%
Capital or wealth tax	None

7. ESTATE PLANNING ISSUES

Other alternative estate planning vehicles include life insurance policies and charitable donations in bona fide circumstances.

8. ANTICIPATED DEVELOPMENTS

- A participation exemption regime for dividends and capital gains derived by certain Israeli holding companies from active foreign resident companies in which they hold a 10% or more interest.
- A REIT (Real Estate Investment Trust) tax regime.
- Capital gains tax exemption in certain circumstances for investors in Israeli securities that have been residents for 10 years in a country that has a tax treaty with Israel.

9. CONCLUSION

Resident individuals and companies are subject to Israeli tax on their worldwide income and capital gains. Personal tax rates range from 10% to 49%. The regular rate of company tax is currently scheduled to be 34% in 2005, and it will decline in the coming years. Real gains that accrue after January 1, 2003 (Israeli real estate - after November 7, 2001) will be taxed at a rate of 25% whether earned by an individual or by a company. Real gains accruing before then will be taxed at the regular rate of the seller.

Non-resident individuals and companies are subject to Israeli tax on income accrued or derived in Israel and in principle are subject to Israeli tax on their capital gains relating directly or indirectly to assets in Israel.

Special benefits, incentives and exemptions are provided to different types of local and foreign individual and companies.

This article can be found in STEP International Year Book.

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