

Israeli Tax Reform of 2005

The Israeli Parliament approved on July 25, 2005 the proposed income tax reform legislation (the “Tax Reform”) pursuant to the recommendations of a committee appointed by the Israeli Minister of Finance (the “Committee”). This Tax Reform has been legislated a relatively short time after a major tax reform enacted in 2003 (“2003 Tax Reform”) which itself incorporated fundamental changes in Israeli tax law. PricewaterhouseCoopers, Israel, provides a brief summary of the main aspects of the Tax Reform, with an emphasis on those subjects that may be of most interest to foreign investors.

The Tax Reform has many attractive features for taxpayers including providing for a gradual reduction of income tax rates for both individuals and corporations over the next 5 years; a reduction in the VAT rate; and moving towards uniformity in the taxation of financial interest, dividend and capital gains from securities. Also introduced are tax laws applicable to local and foreign trusts and beneficiaries which is an area that has been of great interest but uncertainty especially since the 2003 Tax Reform. On the international tax level, an exemption from capital gains tax for certain foreign investors and a new participation exemption regime have been introduced.

Most of the amendments to the tax law are effective as of January 1, 2006, subject to certain exceptions. Transition rules apply in certain circumstances.

Set forth below is a brief summary of the main aspects of the Tax Reform, with an emphasis on those subjects that may be of most interest to foreign investors.

I. TAX RATES

INDIVIDUAL

The integrated tax brackets imposed on income (which are comprised of income tax, national insurance and health tax) are amended gradually over the next 5 years (2006-2010), effectively reducing the total tax liability burden of individual taxpayers. The maximum combined tax rate for income tax, national insurance and health tax will be reduced from the current rate of 49% to 44% by the year 2010. The major reduction is in the income tax rates with the national insurance and health tax rates, applicable up to prescribed income ceilings, being increased.

CORPORATE

Prior to the Tax Reform, the 2005 corporate tax rate of 34% was scheduled to be reduced to 32% in 2006 and 30% in 2007.

The Tax Reform further reduces the corporate tax rate to 31% in 2006, 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010.

By the year 2010, the corporate tax rate of 25%, integrated with the 25% tax rate on dividends distributed to a company’s controlling individual shareholders will constitute an aggregate tax rate of 43.75%, which will be comparable to the maximum marginal tax rate for individuals of 44%.

VALUE ADDED TAX (“VAT”)

The VAT rate is to be reduced from 17% to 16.5% with the effective date anticipated to be September 1, 2005. The Committee recommends that the VAT rate should be further reduced to 16% during 2007.

II. FINANCIAL INCOME AND CAPITAL GAINS

A. INTEREST AND DIVIDENDS

Subject to a non-resident enjoying a lower tax rate under certain provisions of the Israeli tax legislation or a relevant tax treaty, set forth below are the main changes in the tax rates applicable for interest and dividend income derived from Israeli sources.

INDIVIDUAL

Interest

The tax rate on interest income from financial instruments (e.g. bonds, savings plans, bank deposits) linked to the Israeli Consumer Price Index ("CPI") or to foreign currency will be increased from 15% to 20%.

Where the interest income from financial instruments is not linked to the CPI or to foreign currency, the tax rate will be increased from 10% to 15%.

In certain cases (e.g. where the interest is considered as ordinary business income; where interest expenses are claimed against the interest income; where interest is received from a company in which the person is a significant shareholder [1]; or other cases where the payer and payee have a special relationship), the interest income will be taxed at the person's marginal tax rate.

Dividends

The tax rate on dividend income received from an Israeli or foreign company will be reduced from 25% to 20%. Dividends received by a significant shareholder at the time of distribution or during the preceding 12 month period will remain subject to a 25% tax rate.

A 15% tax rate generally applies to dividends paid from profits of an Approved Enterprise to an individual or corporate shareholder. [2]

CORPORATE

A company will generally continue to be subject to Israeli tax on interest income at the corporate tax rate applicable for the year the income is received.

The exemption from tax on dividends received by an Israeli resident corporate shareholder paid by another Israeli company out of regular profits remains unchanged [3].

The tax rate on dividend income distributed from regular income sources received by a foreign resident corporate shareholder will be reduced from 25% to 20%. Such dividends received by a significant shareholder at the time of distribution or during the preceding 12-month period will remain subject to a 25% tax rate.

B. CAPITAL GAINS

INDIVIDUAL TAX RATES

Prior to the Tax Reform, real capital gains of individuals derived from the sale of unlisted securities or other capital assets purchased was generally taxed at a rate of 25%. Real capital gains derived from publicly traded securities in Israel or overseas was subject to tax a reduced rate of 15% [4].

The Tax Reform now provides for the following new rate structure:

- real capital gains from the sale of capital assets (including securities) whether publicly traded or not shall be subject to a uniform rate of 20%;

- where the individual is a significant shareholder at the time of sale (or anytime in the 12 months preceding the sale), a 25% rate shall apply; and
- for gains from the sale of publicly traded bonds and commercial securities which are unlinked to the CPI or if not nominated in foreign currency, a 15% rate shall apply instead of the prior rate of 10% (which applied where publicly traded in Israel).

It should be noted that the Tax Reform rates apply for assets purchased on or after January 1, 2003. For real gains derived from the disposal of an *ordinary capital asset* purchased prior to this date, capital gains tax will be computed at a blended rate which takes into account that the ordinary individual tax rate (determined in accordance with the individual's marginal tax rate applicable for that year) will be applied to the gain amount that bears the same ratio to the total gain realized as the ratio the holding period commencing at the acquisition date and terminating on January 1, 2003 bears to the total holding period. For gains derived from *securities traded on the TASE or from certain Israeli securities traded on a foreign exchange*, the original cost of the securities may be redetermined in a manner that will take into account the capital gain exemption that applied for gains accrued prior to 2003. Other transitional rules apply.

Prior to the Tax Reform, capital losses realized by individuals [5] were classified according to specific baskets and were allowed to offset gains generally only within the same basket. A major change allowing for a broader use of capital losses will fully apply from January 1, 2007 with this basket limitation to be generally lifted thereby generally allowing capital losses to offset capital gains and interest and dividend income from securities, irrespective of whether the losses or gains were derived from publicly traded securities or not.

CORPORATE TAX RATES

Prior to the Tax Reform, corporate investors holding *publicly traded* securities (other than corporations owned only by individuals that did not deduct interest expenses) are generally subject to the provisions of the Income Tax (Inflationary Adjustments) Law, 1985 and are liable to tax at the regular corporate tax rate on the sale of listed securities. There is a comprehensive set of rules for determining the gains and losses from the sale of listed securities.

Under the Tax Reform, the calculation of the capital gain will now be determined under the Income Tax Ordinance and will continue to be subject to tax at the corporate tax rate applicable in the year of the gain.

Real capital gain from the sale of *non-publicly traded* securities and other capital assets will continue to be subject to a tax rate of 25% [6].

FOREIGN RESIDENTS

General

Capital gains tax is generally payable on capital gains by nonresidents on the sale of:

- assets located in Israel;
- assets located abroad that are essentially a direct or indirect right to an asset, or to inventory or that are an indirect right to a real estate right or to an asset in a real estate association located in Israel. Taxation will apply only in respect of that part of the consideration that stems from the above property located in Israel;
- assets that are a share or the right to a share in an Israeli entity;
- assets that are a right in a foreign resident entity, which is essentially a direct or indirect right to property located in Israel. Taxation will apply only with respect to that part of the consideration that stems from the property located in Israel.

Exemption for Capital Gains

Prior to the Tax Reform, under domestic law, non-residents (individual and corporations) are exempt from tax on capital gains derived from a sale of shares traded on the TASE or from shares issued in certain R&D companies [7] after December 31, 2002.

For other non-real estate assets, capital gains may qualify for a tax treaty exemption depending upon the particular circumstances and the provisions of the applicable tax treaty (e.g. in some tax treaties no capital gains exemption is allowed where the holding in the sold Israeli company exceeds a certain percentage).

The Tax Reform introduces a broader exemption under domestic law for non-residents regardless of their percentage holding in an Israeli company (not holding real estate rights) to include capital gains from the sale of securities (even where not traded in Israel) which were purchased between July 1, 2005 through December 31, 2008, provided:

- the capital gains was not derived by the seller's permanent establishment in Israel;
- for ten continuous years preceding the date of purchase of the security, the individual seller has been a resident of a country having a tax treaty with Israel. In the case of a sale by a foreign company, at least 75% of any of its "means of control" [8], directly or indirectly, have been held by individuals who were residents of a tax treaty country for 10 continuous years preceding the purchase of the security;
- the security was not purchased from a relative (as defined in the Income Tax Ordinance) or by means of a tax-free reorganization; and
- the nonresident complies with certain notice and tax filing requirements (including in the person's country of residency).

The Tax Reform makes no changes in the special tax exemptions and relief applicable to new Israeli residents or returning residents, with respect to capital gains (10 year exemption for assets owned prior to the date of new or returning residency).

REAL ESTATE GAINS

For capital gains arising from the sale of real estate, shares in a land association or real estate investment fund the following tax rates shall apply:

Individuals

Effective from 2007, subject to certain exceptions, the pre-Tax Reform tax rate will be reduced from 25% [9] to 20%.

For controlling shareholders a 25% tax rate will continue to apply.

Corporate

The pre-Tax Reform rate of 25% [9] shall continue to apply.

Non-residents

For nonresidents, there is no capital gain exemption for sale of real estate including shares in a real estate association or real estate fund. Generally most tax treaties also do not provide in such cases for a capital gain exemption.

III. PARTICIPATION EXEMPTION REGIME

The Tax Reform introduces a participation exemption regime following the recent trend of OECD countries, which is intended to encourage foreign investors to establish an Israeli company and to operate from Israel its overseas business holdings.

In order to qualify as an Israeli Holding Company (“Holding Company”) under this new regime, several conditions must be met including that its management and control must be operated only from Israel and the total investment in its held companies (“Held Companies”), including by way of loans, must be not less than NIS50 million (approximately US\$11 million). Certain conditions must be met for a company to qualify as a Held Company including that it must be resident in a country that has a tax treaty with Israel or the tax rate on its business activities in its foreign country of residence is not less than 15%. Additional detailed rules apply.

A Holding Company will be exempt from Israeli tax on (i) dividends received and capital gains from the sale of Held Companies in which it has a 10% shareholding interest; and (ii) interest, dividends and capital gains from securities publicly traded in Israel.

Dividends paid from the Holding Company to foreign shareholders will be subject to a 5% tax and a foreign shareholder will enjoy a capital gain exemption upon its sale of shares in the Holding Company.

It is apparent that the participation exemption introduced may be more restrictive in comparison to other jurisdictions. In addition, although Israel has an extensive treaty network, in most cases dividends paid from other treaty countries will be subject to withholding tax in the paying country. Therefore, the establishment of an Israeli Holding Company should be carefully examined.

IV. TRUST TAXATION

A. INTRODUCTION

The 2003 Tax Reform brought about a major transition for tax residents from a primarily territorial based tax system to a personal-based system, so that Israeli tax residents generally effective January 1, 2003 became subject to tax in Israel on their worldwide income. This created great interest in the trust concept as a device for potential tax savings opportunities.

In the 2003 Tax Reform there were included certain provisions regarding taxation of income accrued or derived outside of Israel, however, due to the absence of comprehensive tax rules for trusts, there still existed possibilities to avoid Israeli taxation through the means of trusts. In view of the lack of specific legislation, a special committee was requested to provide its recommendations on the issue of taxation of trusts. The Tax Reform, subject to certain exceptions, adopted the tax recommendations of the committee which are incorporated in new trust legislation in the Income Tax Ordinance.

The new legislation also applies to trusts created prior to January 1, 2006, but only with respect to trust income accrued or derived from January 1, 2006 and thereafter.

We set out below a high level overview of the new trust regime. We want to caution that careful consideration and examination is required of the detailed definitions of these trust terms and of the taxation implications which may arise under each specific trust arrangement.

B. TRUST TERMS

Under the Tax Reform, a “Trust” is generally an arrangement, whether made in Israel or outside of Israel, under which a person (“Grantor”) transfers to a person which may also include a company (“Trustee”), for no consideration, any asset or income from an asset whether located in Israel or outside of Israel, on condition that the trustee shall hold the asset for the benefit of a person who is entitled to enjoy the trust assets and its income, whether directly or indirectly (“Beneficiary”).

C. TYPES OF TRUSTS

There are four categories of trusts (further defined below):

- Israeli Resident Trust
- Non-Resident Grantor Trust
- Non-Resident Beneficiary Trust
- Testamentary Trust

Each of these trusts may be further classified as revocable or non-revocable (other than a non-resident beneficiary trust which by definition must be non-revocable).

A trust is generally defined as “revocable” where it is possible to cancel the trust or transfer or return its assets or its income to the grantor (or certain related parties of the grantor), where the grantor is a beneficiary of the trust or may become a beneficiary, or where there are certain defined relationships between the grantor and a beneficiary, or where the grantor has the ability to direct or influence the manner in which the trust is managed by the trustee or the protector.

A “non-revocable” trust is one that is not revocable. A confirmation of this status must be declared by the grantor and trustee and filed with the tax assessing office.

1. ISRAELI RESIDENT TRUST

An Israeli Resident Trust is defined as:

- A revocable or non-revocable trust which at the time of its creation had at least one grantor and one beneficiary who were both Israeli residents and during the applicable tax year at least one grantor or one beneficiary were Israeli resident; or
- A trust which does not qualify as a Non-Resident Grantor Trust, Non-Resident Beneficiary Trust or Testamentary Trust (as defined below).

2. NON-RESIDENT GRANTOR TRUST

- a revocable or non-revocable trust which at the time of its creation and during the applicable tax year all of its grantors are foreign residents; or
- a revocable or non-revocable trust which during the relevant tax year all of its grantors and beneficiaries are foreign resident.

3. NON-RESIDENT BENEFICIARY TRUST

A non-revocable trust is where there is an Israeli resident grantor but all beneficiaries are non-residents and the trust document expressly prohibits an Israeli resident as a beneficiary.

4. TESTAMENTARY TRUST

This is a trust established pursuant to the directives of a person’s will who immediately preceding death had been an Israeli tax resident.

D. TAXATION OF TRUSTS

Israeli Resident Trust

Income derived by an Israeli Resident Trust will generally be treated as derived by the grantor and subject to Israeli taxation at an individual's maximum marginal tax rate (currently 49%). When a reduced tax rate applies to an individual's particular source of income (e.g., capital gains, dividends, interest), such rate shall also apply to such income derived by the trust.

Where a trust is reclassified as an Israeli Resident Trust after a grantor [10] or beneficiary [11] have become a new Israeli tax resident or a returning Israeli resident (as defined in the Income Tax Ordinance), the trust's income shall also enjoy certain tax exemptions and concessions allowed for new and returning Israeli tax residents.

Certain deemed sale provisions occur on the reclassification of an Israeli Resident Trust to a Non-Resident Trust.

Non-Resident Trust

Income derived by a Non-Resident Trust will generally be viewed as attributed to an individual non-resident based on the foreign residency location of the grantor (where a non-resident grantor trust) or the beneficiary (where a non-resident beneficiary trust) [12].

Consequently, to the extent that the Trust has activities or investments not located in Israel, its non-Israeli source income would generally not be subject to tax in Israel. Likewise, it would be exempt from Israeli tax on Israeli source income for which a non-resident is exempt (e.g. capital gains from securities traded on TASE or income that may be subject to a tax treaty exemption).

Testamentary Trust

Where a Testator Trust has at least one Israeli resident beneficiary, the trust shall be treated as an Israeli Resident Trust and consequently the income shall be viewed as that of an Israeli resident.

Where there are no Israeli residency beneficiaries, the trust shall be viewed as Non-Israeli Resident Trust and the income shall be taxed as that derived by a non-resident (see Non-Resident Trust taxation above).

E. OTHER TAXATION ASPECTS

Additional detailed rules apply such as:

- The Trustee shall be the primary responsible party for the payment of any tax liability with the possibility of the tax authorities to collect tax from the grantor and beneficiaries in certain cases.
- Allowing for changes in the attribution and collection rules discussed above (e.g., income of an Israeli Resident Trust may be attributed to the beneficiaries rather than to the grantor in certain circumstances).
- Taxation aspects at the creation or termination of a Trust.
- For all trusts, the trustee shall be responsible for the filing of tax reports. A trustee of a Non-Resident Grantor Trust or Non-Resident Beneficiary Trust is only required to file reports of income from Israeli sources and not foreign source income.

V. OTHER MATTERS

REITs

The Tax Reform introduces legislation for a Real Estate Investment Trust (“REIT”) which has become an increasingly popular investment in many countries since they enable small investors to participate indirectly in major real estate projects. To be eligible for REIT status, the entity must be an Israeli company publicly traded on TASE whose activities are managed and controlled from Israel, which satisfies certain income and asset requirements. The new tax rules are designed primarily to provide an investor with the same tax results as if the investor had made a direct investment in real estate, but yet simplifying tax reporting for the investor.

TAX RULINGS

New legislation formalizes the process of obtaining tax rulings from the Income Tax Authorities, clarifies the binding effect of such tax rulings on all parties and allows for the Tax Authorities to publish the rulings in order to provide to other taxpayers guidance and uniformity as to the decisions of the Tax Authorities on certain issues.

STOCK OPTIONS

The required holding period for stock options issued on January 1, 2006 and thereafter under the trustee tax regime has been shortened to 12 months (under the ordinary income route) and 24 months (under the capital gains route). Transitional rules apply for options issued prior to January 1, 2006 under the capital gains route that allow for the minimum holding period to be shortened to 30 months from the grant date.

IMPROPER TAX PLANNING

New provisions have been added to the Income Tax Ordinance and VAT Law to assist the tax authorities in its dealing with aggressive tax planning which it feels is improperly exploiting local law interpretation or tax treaty protection. These provisions authorize the Finance Minister with the approval of the Parliament’s Finance Committee to determine a list of tax planning actions that are the subject matter of the Income Tax Ordinance, Land Appreciation Tax Law and the VAT Law for which a taxpayer will be required to disclose and report in its tax reports. Failure to comply with these disclosure and reporting rules will be a criminal matter subject to penalties and possible imprisonment. Severe monetary penalties will be imposed on tax deficiencies arising from an audit where a taxpayer’s transactions are deemed by the tax authorities to be artificial or intended to result in an improper reduction of tax.

Footnotes:

[1] For all references in this document to a “significant shareholder”, this term is defined in the Tax Reform as a person who holds directly or indirectly, alone or together with another related party, 10% or more in at least one of the “means of control” in the company (in terms of rights to profits, voting, the appointment of directors or a CEO and liquidation or exercise of such rights by instructing others). “Means of control” includes control through shares, rights to shares or other rights, or by any other manner including by means of voting agreements or trusts. There are detailed rules defining what is a “related party”.

[2] “Approved Enterprise” status, which provides for cash and tax benefits, may be granted to enterprises that increase the productive capacity of the economy, improve the balance of payments or provide new employment opportunities. The status is granted mainly to manufacturing and tourism enterprises under the Law for the Encouragement of Capital Investments

[3] As mentioned above, dividends distributed from AE source income generally attract a 15% tax rate. In addition, dividends received from an Israeli company which arise from foreign source income of the distributing company as well as dividends received by an Israeli company from a non-resident company are generally taxable to the receiving company at the rate of 25%. Under certain circumstances the receiving company may elect to be taxed on such dividends at its regular corporate tax in which case it would also be entitled to a foreign tax credit with respect to corporate taxes paid by the company distributing the dividend, i.e., an “underlying” tax credit.

[4] Provided that the seller did not claim interest and linkage differential expenses in respect of the security and other prescribed conditions.

[5] Including corporations that are not subject to Section 6 of The Income Tax (Inflationary Adjustments) Law, 1985.

[6] Transitional rules apply in calculating the capital gains tax applicable to assets purchased prior to January 1, 2003.

[7] As defined under the Income Tax Ordinance and tax regulations and which has received an approval from the tax authorities confirming that it satisfies such qualifying conditions.

[8] See footnote 1.

[9] The 25% tax rate applied for assets purchased on or after November 7, 2001. Regarding assets purchased prior to November 7, 2001, a blended tax rate applies taking into account the 25% tax rate for the portion of the gain accumulated on and after November 7, 2001 and the individual's marginal tax rate or the regular corporate tax rate for the portion of the gain attributed prior to November 7, 2001. The gain will be attributed to the period commencing on November 7, 2001 in accordance with the ratio of the holding period after this date to the entire holding period.

[10] In the case of a Non-Resident Grantor Trust.

[11] In the case of a Non-Resident Beneficiary Trust.

[12] Where there are multiple grantors, the income shall be attributed proportionally to the residency of the grantors based on their contribution of assets to the trusts. Where there are multiple beneficiaries, the income shall be attributed proportionally to the beneficiaries based on their portion of the distribution.

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