Impact of recent U.S. tax legislation on Israeli Companies

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Agenda

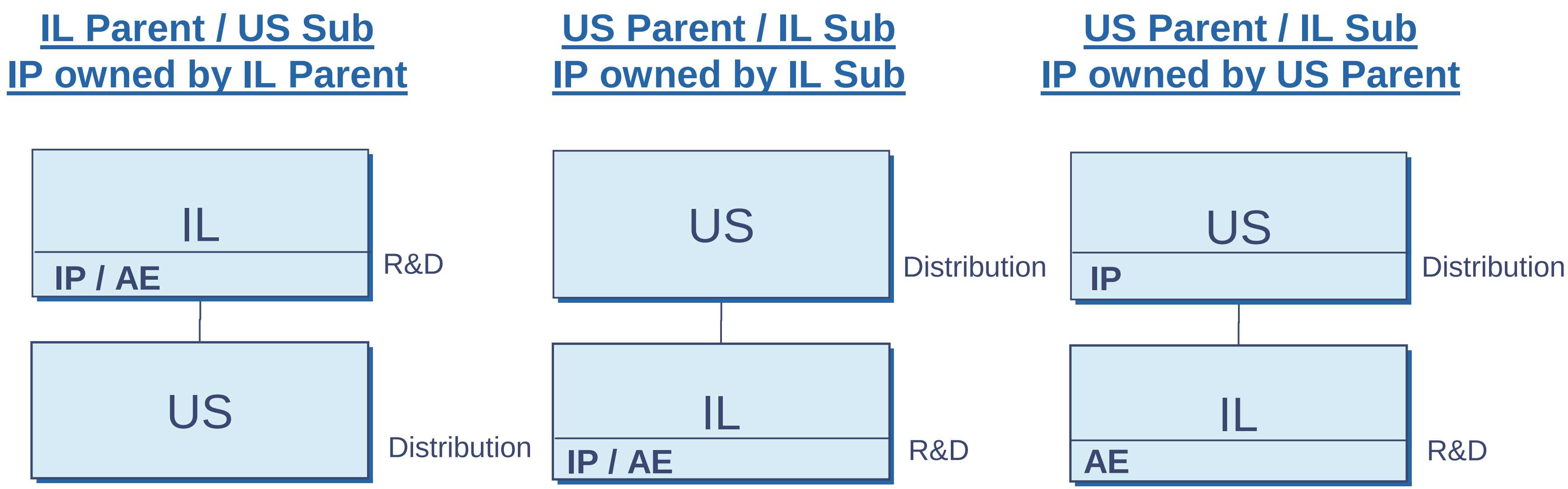
- Impact of Recent U.S. Tax Developments on Common Structures of Investment
- Deferred Compensation – § 409A Final Regulations
- Venture Capital Funds – Highlight of Tax Considerations

Impact of Recent U.S. Tax Developments on Common Structures of Investment

Common Structures of Investment – Main Issues for Consideration

- Contemplated mode of operation
- Location of IP
- Beneficial tax regimes (e.g., Approved Enterprise in Israel)
- Finance considerations
- Inter-company transactions – TP considerations
- Applicability of tax treaties
- Exit strategies

Common Structures of Investment



Common Structures of Investment – Israeli Parent

Tax Considerations

Israel

- **Approved Enterprise.**

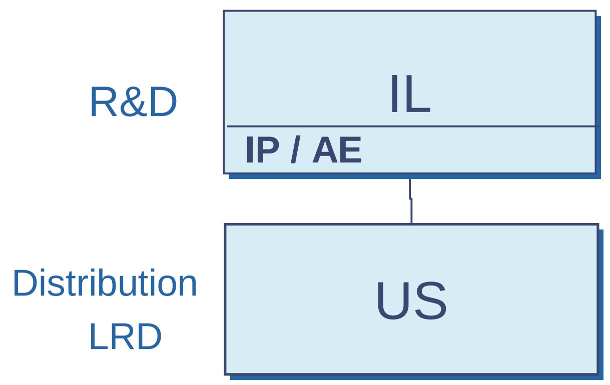
US

- Activity performed within the U.S. by IL Parent → **Permanent Establishment**.
- **TP** – US as a Low Risk Distributor.
- **Withholding Tax** – classification of transactions as sale, rent or license.

Summary

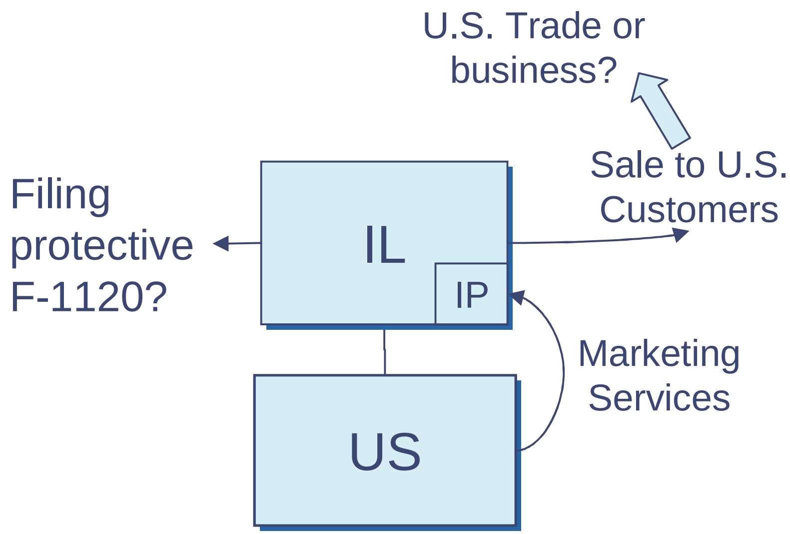
- Tax efficient.
- Small tax cost when group is in overall loss position.

IL Parent / US Sub – IP owned by IL parent



Common Structures of Investment – Israeli Parent PE Issues – Protective Return

- Foreign corporations that have a U.S. tax nexus (a U.S. trade or business or PE in case of a treaty) must file a U.S. tax return on annual basis to determine the foreign corporation's U.S. tax liability.
- Whenever there is a question whether the foreign corporation has such tax nexus, the foreign corporation may want to file a "***protective***" 1120-F. Such filing would generally:
  - Preserve the right to claim deductions in computing the taxable income for U.S. tax purposes.
  - Start statute of limitations for timely filing.
- In the case of Swallows Holding, the court determined that **no deduction would be allowed for a foreign corporation which failed to file a return within 18 months* of the due date.**



* A foreign corporation may generally file its tax return up until the 15th day of the sixth month following the close of its taxable year. Treasury Regulations state that for purposes of computing a foreign corporation's taxable income, deductions will be allowed only if a return is filed by the foreign corporation within 18 months following the due date of the return (i.e., 18 months after the 15th day of the sixth month after the close of the taxable year).

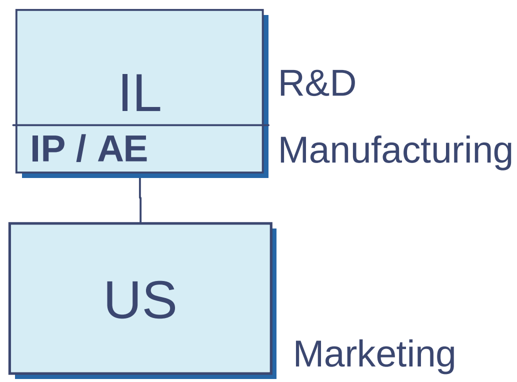
Common Structures of Investment – Israeli Parent Change of Ownership – Section 382 (when no LRD)

<u>Facts</u>

- Group operates for several years,
- IL performs R&D.
- No sales have been made by the group.
- Both IL and US have significant NOLs.
- A new investor intends to purchase more than 50% of the interests in the group.

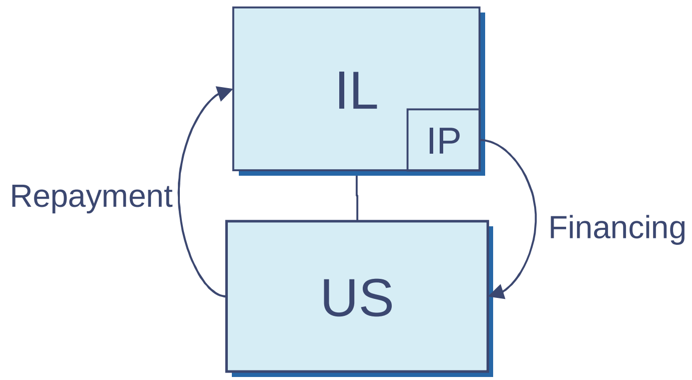
<u>Issue</u>

- Change in ownership – Section 382 – limitations on NOLs.



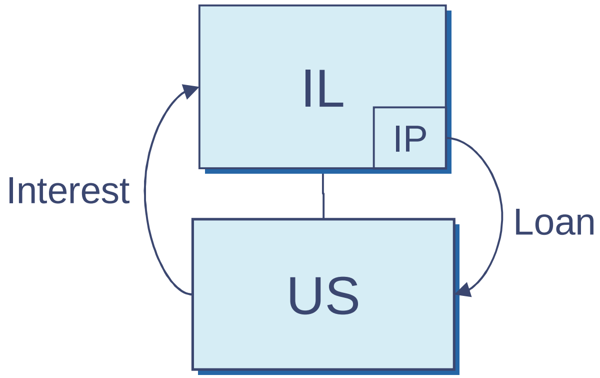
Common Structures of Investment Financing Issues (when no LRD)

- When no LRD is implemented (i.e., US incurs losses in first few years), there is a need to finance US.
- US can be financed in one of the following alternatives, each of which entails potential adverse tax consequences:
  - **Capital investment** (generally classified as equity for U.S. tax purposes).
  - **Interest bearing loan** (generally classified as debt for U.S. tax purposes).
  - **Hybrid instrument**, e.g., non interest bearing capital notes (may be classified as equity for U.S. tax purposes on the one hand and as debt for Israeli tax purposes on the other hand).
- Potential U.S. withholding tax issues.

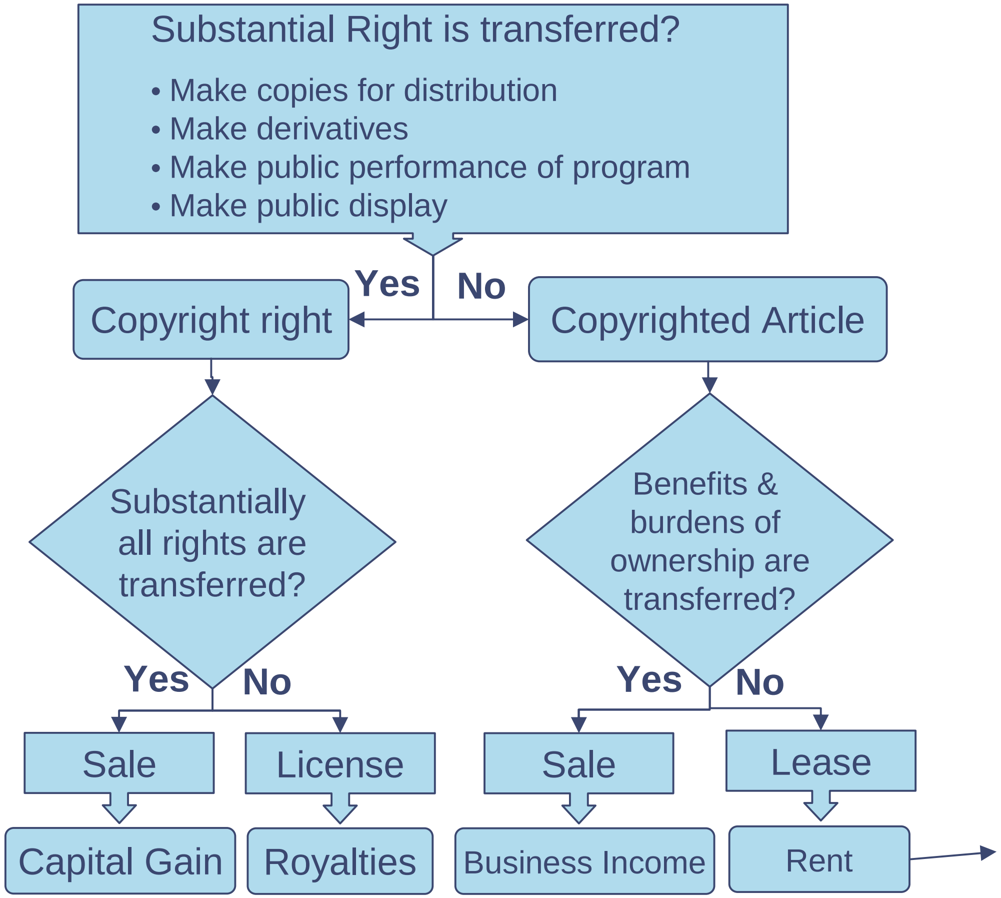


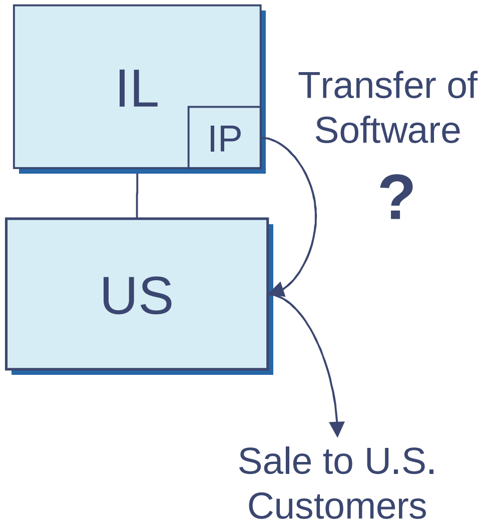
Common Structures of Investment Financing Issues – Israeli Perspective

- Until recently, if a loan granted by IL to US yielded interest which did not meet the ‘statutory measure’ (the increase in the CPI plus 4%; or, in certain cases, the difference in the NIS/USD plus 4%), the imputed interest on such loan would have been subject to Israeli tax at a flat rate of 40% with no right whatsoever to exemption, deduction or set off in respect of the tax (certain exceptions applied to certain hybrid instruments) in accordance with section 3(j) of the ITO.
- As a result of recent legislative changes in Section 3(j) of the ITO, **the section no longer applies to loans that are subject to section 85A** of the ITO (international transactions between related parties). On the other hand, such loan will be subject to the requirements stipulated under section 85A of the ITO (i.e., arm’s length standards).
- With respect to 2007 only, the ITA decided to interpret the law such that section 85A may not apply to certain hybrid instruments that have been classified as fixed assets in the hands of the lender.



Common Structures of Investment – Israeli Parent
Classification of Software Transactions – Withholding Tax Implications





Characterization of rental income as business income under the US/Israel treaty and possible exemption if no PE.

Common Structures of Investment – US Parent

Tax Considerations

Israel

- Approved Enterprise.
- Financing.
- OCS.

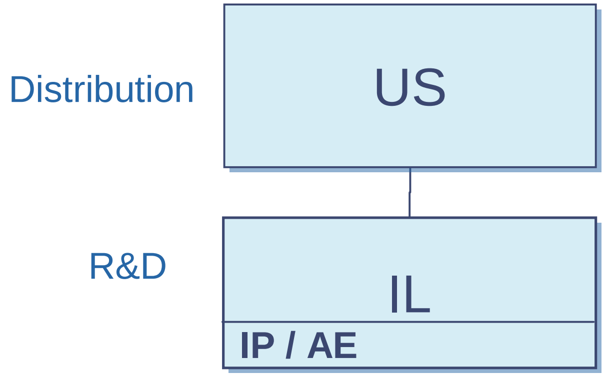
US

- U.S. **C**ontrolled **F**oreign **C**orporation ("CFC") issues.
- **Withholding Tax**
- Activity performed within the U.S. by IL sub → **Permanent Establishment**.
- **TP** – US also as a LRD.
- **Financing Issues**.

Summary

- Tax efficient, until distributions (or deemed distributions) are made to the U.S.
- Small tax cost when group is in overall loss position.

US Parent / IL Sub – IP owned by IL Sub



Common Structures of Investment – US Parent
Foreign Base Company Sales Income

- Under certain conditions a U.S. parent company is required to include in its taxable income, on a current basis, certain income generated as a result of its Controlled Foreign Corporation subsidiary's activity. One of such types of income is foreign base company sales income.
- **Foreign base company sales income** ("FBCSI") is defined as income arising from the purchase or sale of personal property where:
    1. The property is both produced outside the CFC's country of incorporation and sold for use, consumption or disposition outside such country*; and
    2. The property is either bought from a related person and sold to any person, bought from any person and sold to a related person, or purchased or sold on behalf of a related person.

FBCSI does not include income from the sale of personal property that is manufactured, produced or constructed by the CFC from personal property that it has purchased (the "**Manufacturing Exception**").

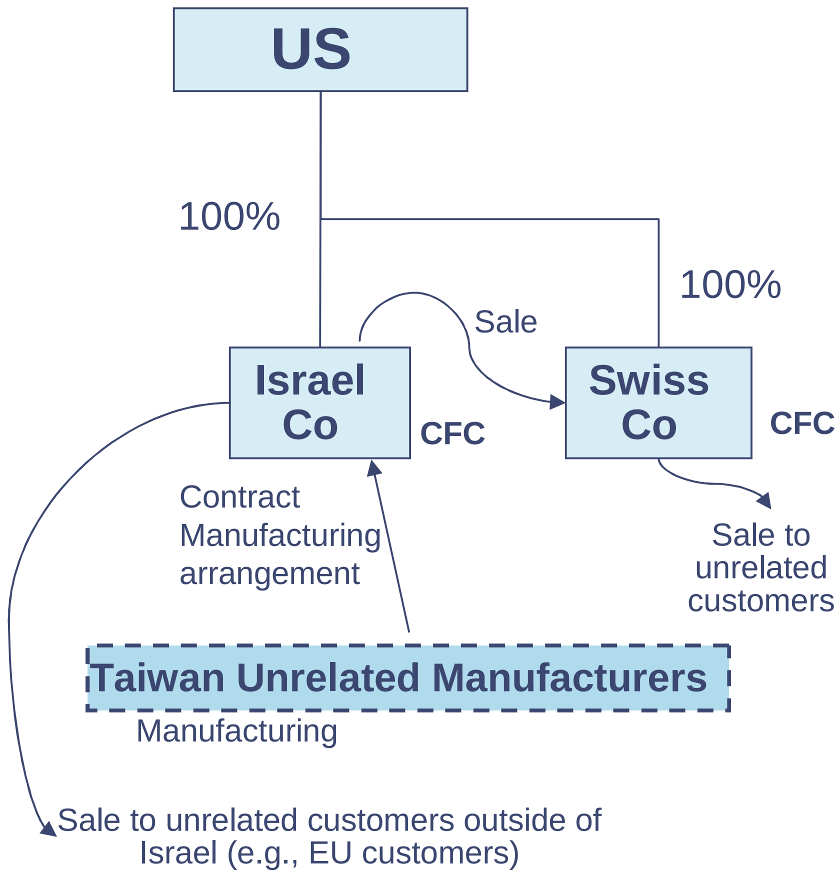
Common Structures of Investment – US Parent Contract Manufacturing Proposed Regulations: Example

Facts: At all times, Israel Co. retains control of the raw material, work-in-process, and finished goods, as well as the intangibles used in the conversion process. Israel Co. retains the right to oversee and direct the physical conversion of products by the Unrelated Manufacturers.

Under the Proposed Regulations:

If Israel Co. does not regularly exercise, through its employees, its powers of oversight or direction of Taiwan unrelated manufacturer – manufacturing exception does not apply.

If Israel Co. employees regularly exercise the right to oversee and direct the activities of Taiwan Unrelated Manufacturers in the manufacture of the products – manufacturing exception does apply.



Common Structures of Investment – US Parent

Tax Considerations

Israel

- Approved Enterprise.
- TP.

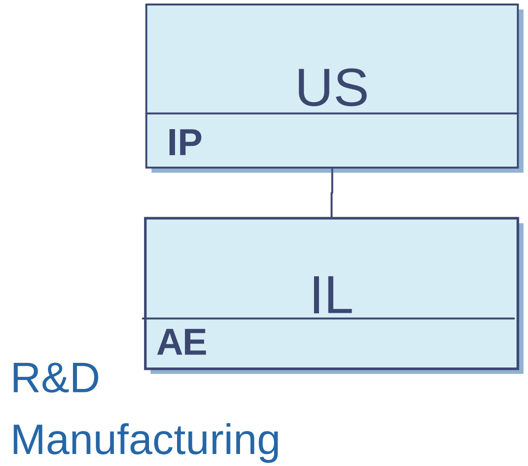
US

- NOLs.
- Financing – Intercompany balances – U.S. debt/equity issues; WHT implications.

Summary

- An inefficient tax structure.
- Small tax cost when group is in overall loss position.

US Parent / IL Sub – IP owned by US Parent



Deferred Compensation – § 409A Final Regulations
International Tax Aspects

General – Section 409A

- Section 409A generally applies to **nonqualified deferred compensation** that is **<u>earned and vested after December 31, 2004</u>**.
- Section 409A requires that nonqualified deferred compensation plans meet **<u>specific requirements</u>**.
- **If the plan's document fails the requirements of Section 409A, then <u>upon vesting</u>, all participants are subject to tax on the deferred compensation balance plus an additional 20% tax plus interest charges.**

Additional

20%

Tax

plus interest charges

What is Deferred Compensation?

- **Deferred compensation** is **compensation** that the **service provider** has a **legally binding right** to receive and that is **payable in a later tax year**
- **Compensation** – including certain stock options and Share Appreciation Rights.
- **Service provider** – including employees.
- **Legally binding right** – may exist even if the right is subject to a substantial risk of forfeiture.
- **Payable in a later tax year** – Arrangement that may provide for payment after short-term deferral period (2 ½ months following year of vesting) is deferred compensation.
- **Exclusion from being regarded as deferred compensation** – Certain qualified retirement plans, bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans as well as certain severance pay plans, **certain foreign plans**, certain payments under the short-term deferral rule, and **fair market value options and stock appreciation rights are excluded from being regarded as deferred compensation.**

Implications on International Employees

- Section 409A applies to any U.S. taxpayer, among others to
  - U.S. citizens and resident aliens working in the U.S. for either a U.S.– based or a foreign– based employer
  - U.S. citizens and resident aliens working abroad for either a U.S.– based or a foreign– based employer
  - Nonresident or resident aliens working in the U.S who participate in a plan maintained by current or former employer based in foreign country
- The final 409A regulations provide some relief and rights for participant of an Internationally sponsored plan and arrangements. However, they do <u>not</u> apply an overall exemption from Section 409A
- Employer, whether U.S.-based or foreign-based, whose employees are potentially subject to U.S. income tax should ,as good practice, analyze all of its deferred compensation plans for compliance with 409A or else possibly subject its employees to adverse tax consequences

§ 409A Regulations – Specific International Aspects

- The final regulations provide that compensation **vested** prior to becoming subject to U.S. taxation is not treated as deferred compensation under §409A even if such compensation is received at a time when the individual is subject to U.S. federal income taxation.
- This special provision does not mean that such compensation is exempt from U.S. income taxation when actually received.
- The final regulations provide for a de minimis exception for compensation deferred by a nonresident alien under a "foreign plan" for a given calendar year. Under the regulations, amounts deferred (within the de minimis limitation) are not treated as subject to §409A.

Applicability of § 409A – Matrix

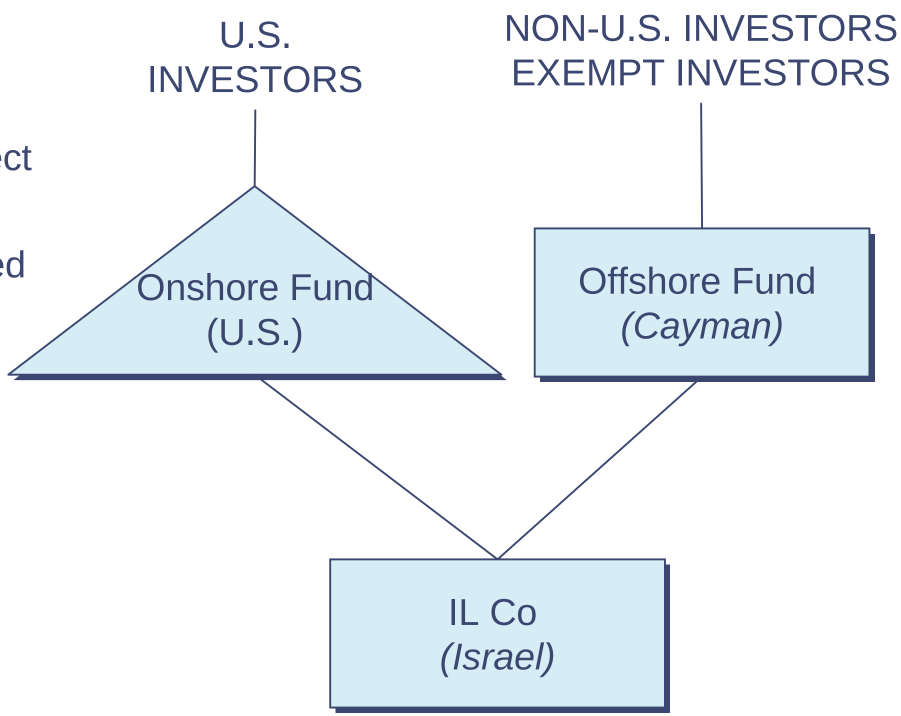
Residency of Employee	Place of Employment	Grantor of Deferred Compensation	Application of 409A
Employee is a U.S. citizen or a U.S. tax resident	Within the U.S.	U.S. Corporation	Section 409A applies
		Non-U.S. Corporation	
	Outside the U.S.	U.S. Corporation	
		Non-U.S. Corporation	
Employee is neither a U.S. citizen nor a U.S. tax resident	Within the U.S.	U.S. Corporation	In most cases, non-applicable
		Non-U.S. Corporation	
	Outside the U.S.	U.S. Corporation	
		Non-U.S. Corporation	N/A

Venture Capital Funds – Highlight of Tax Considerations

Israeli Domestic Taxation – Overview

- Under Israeli domestic law, a non-Israeli resident is only subject to Israeli tax on income accrued or derived in Israel (i.e., income from an Israeli source).
- Dividend income paid by Israeli corporations is generally considered Israeli source income and subject to a 20% - 25% tax rate*.
- Capital gains from non-traded Israeli securities derived by a non-Israeli resident <u>individual</u> are generally subject to a 20% tax rate unless reduced by a tax treaty.
- Where the person directly or indirectly holds at least 10% of the company's shares during the 12 months preceding the sale, a 25% tax rate would apply.
- Foreign residents are generally exempt from tax on capital gains from the sale of securities traded on an exchange in Israel, to the extent that such gain is not attributable to a permanent establishment in Israel.

Common Structure

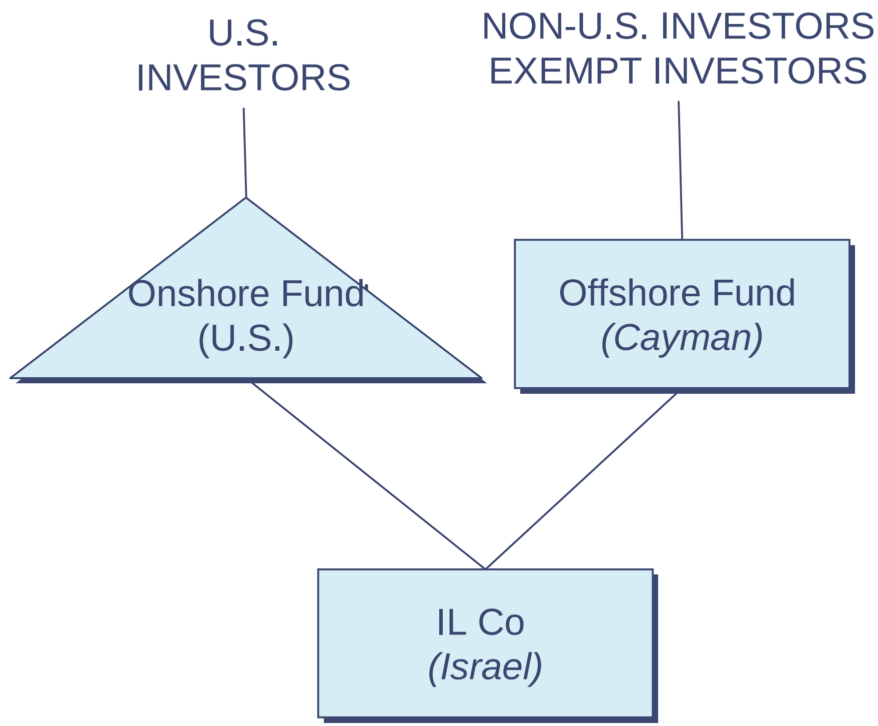


* The rate is mainly determined by the holding percentage of the interests in the company and may be reduced by an applicable treaty.

Israeli Domestic Taxation – Certain Exemptions / Relieves

- Certain exemptions or relief may be available under Israeli domestic law and double taxation treaties, as follows:
  - Section 16A ruling;
  - Section 97 (b3) – Exemption for Treaty Investors;
  - Section 97 (b1) – R&D Company;
  - Section 97 (b2) – Exemption for traded securities;
  - Tax treaties

Common Structure



Exemptions / Relieves

Section 16A – Main Aspects

- Section 16A rulings offer a measure of certainty for funds with regard to their tax positions, and facilitate the tax structuring of their activities in Israel.
- Generally, the ITA grants pre-rulings, according to which foreign investors in venture capital funds are exempt from tax in Israel and investors in private equity funds may enjoy reduced rates (15% for individuals, 25% for corporations, and exemption for tax exempt entities).
- The existence of a PE in Israel would not create adverse Israeli tax consequences for the fund.
- As such, the fund would be able have a local representative who would not be restricted with respect to the activities that they may perform in Israel.

Exemptions / Relieves – Cont'

Section 16A – Main Requirements

- There should be at least 10 investors in the Fund (foreign and Israeli) and each investor should hold no more than 20% of the fund's capital; and
- No more than 15% of the Fund's total investment in Israel should be invested in one entity. In other words, the Fund is required to hold at least seven Israeli portfolio companies;
- For VC Funds, at least 75% of the investment in each Israeli portfolio company should be performed by way of a capital contribution (i.e., not by way of a stock purchase).
- The ITA requires submission of certain generic investor information (e.g. entity type, name, residence).

Exemptions / Relieves – Cont'

Section 97(b3):

- Generally, Section 97(b3) of the Israeli Income Tax Ordinance ("ITO") provides an exemption for non-residents regardless of their holding percentage in an Israeli company with respect to capital gains from the sale of securities (even where not traded on a stock exchange in Israel) which were purchased between July 1, 2005 through December 31, 2008.
- The list of requirements outlined in Section 97(b3) include the requirement that the gain does not arise from a PE in Israel, and the requirement that the seller be a resident of a **treaty country**.* the receipt of the ruling under this section would generally not be available in case of conducting on going activities in Israel.
- Another disadvantage of this ruling is that in practice, the ITA typically requires a full disclosure of the investor information.

* Additionally, the security cannot have been purchased form a related party or by means of a tax-free reorganization, and the taxpayer must comply with certain tax filing requirements.

Exemptions / Relieves – Cont'

Section 97(b2):

- Generally, Section 97(b2) of the ITO provides an exemption for non-residents regardless of their holding percentage in the Israeli investment with respect to capital gains from the sale of traded securities. If the traded securities were purchased prior to their registration for trade, the portion of the capital gain which would have been generated if the stocks were sold immediately prior to the registration for trade is subject to tax (unless other exemptions apply).
- The requirements outlined in Section 97(b2) include the requirement that the gain did not arise from a PE in Israel.
- Further, the exemption does not apply to stock of a Real-Estate Investment Trust ("REIT").

Exemptions / Relieves – Cont'

Section 97(b1):

- An additional exemption from tax is available to foreign investors on gains arising from the disposition of shares in "Research and Development intensive company*."
- Under this section, an exemption is available, irrespective whether or not the foreign resident is a resident of a treaty country, where such interest was acquired through an allotment of shares.
- One of the main advantages of this provision is that it applies to the investee company, and there are no requirements with respect to the investors in such company.

* Israeli income tax regulations include a detailed definition of an R&D intensive company.

Exemptions / Relieves – Cont'

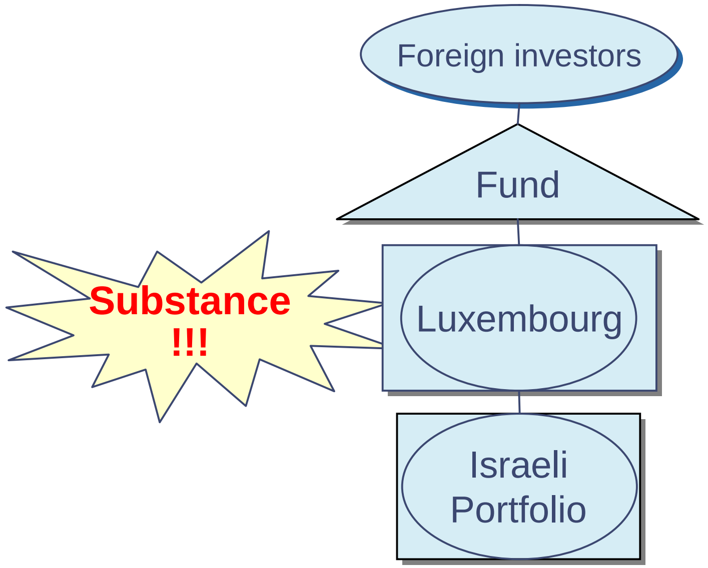
Utilization of an intermediate treaty country entity

- Due to the difficulties associated with the ability to enjoy the exemptions / relief mentioned above (i.e., the need to invest through an injection of capital; the differences in tax rates which lead to harsh disclosure requirements, and the applicability to treaty countries only, in some of the cases (mainly in private equity investments), it may be preferable to invest through an intermediate entity located in a treaty country, e.g., Luxembourg.
- The fact that many investment funds already have business presence in Luxembourg together with the fact that Luxembourg is the second most important investment fund domicile in the world after the U.S. may also contribute to the Decision to utilize a Luxembourg intermediate entity.

Exemptions / Relieves – Treaty Exemption – Examples

Luxembourg / Israel tax treaty:

- The use of a suitable offshore intermediate company structure, such as investment through a Luxembourg holding vehicle, for an Israeli investment may:
  - increase flexibility in terms of future exit options; and
  - offer tax treaty protection on future repatriations / capital gains from the investment.
- It is important to note that such intermediary company should generally meet certain substance requirements.
- Under the unique circumstances of a recent case, the Israeli court has determined that the **ITA may rely on domestic law** (specifically, section 86 of the ITO) in determining eligibility for treaty benefits even in a case of a treaty with no Limitation of Benefits clause.



Israel – Luxembourg Treaty Benefits		
	Dividends WHT	Capital Gain
Israel (non-treaty)	20% / 25%	20% / 25%
Treaty rate	5% - 15%	0%

Thank you

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