

Israel: New Opportunities under the Reform of the Encouragement of Capital Investment Law

Shlomi Zehavi, Vered Kirshner and Zeev Katz of PricewaterhouseCoopers discuss new opportunities under the reform of the Encouragement of Capital Investments Law. This is an extremely important amendment to a Law that provides very significant tax benefits for investments in production facilities in Israel and is well-known by foreign companies that have invested or are contemplating investment in Israel.

New Opportunities under the Reform of the Encouragement of Capital Investment Law

The Israeli Parliament approved on March 29, 2005 [1] a major reform amendment to the Encouragement of Capital Investment Law, 5719-1959 (hereinafter, "the Law") which is intended to provide expanded tax benefits to local and foreign investors and to simplify the bureaucratic process relating to approval of investments qualifying under the Law.

We would caution that this summary report is preliminary in nature and does not address all of the legislative changes. Further detailed rules apply and certain areas still await further legislation and clarifications as to the Israeli Income Tax Authorities' ("ITA") interpretive positions. [2]

APPROVED ENTERPRISE REGIME - OVERVIEW OF REGIME PRIOR TO REFORM

This Law generally provides that capital investments in new or expanded production facilities may, upon application to the Israel Investment Center, be designated as an Approved Enterprise ("AE"). Each certificate of approval for an AE relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, i.e., the equipment to be purchased and utilized pursuant to the program.

Under the Law prior to its amendment, a project would only qualify as an AE upon the submission of a detailed application to the Investment Center administration at the Ministry of Industry, Trade, and Employment ("IC") and upon receipt of the IC's issuance of the approval letter confirming AE status, subsequent certification by the IC of the AE's implementation report and meeting certain conditions set in the Law and by the IC.

Cash Grants

Approved enterprises located in development areas [3] A and B are eligible for cash investment grants, which vary according to the geographic location of the enterprise. Grant amounts and conditions are subject to governmental change from time to time.

Tax Incentives

An AE is also entitled to certain taxation benefits. The tax benefits derived from any such certificate of approval relate only to taxable profits attributable to the specific program, based upon criteria set in the certificate of approval.

Income derived from an AE is subject to a tax rate of 25%, rather than the usual rate in 2005 of 34% [4] for a period of seven years, commencing with the year in which the AE first generates taxable income.

A company that qualifies as a foreign investors company ("FIC") is entitled to enhanced tax benefits on AE income depending upon the percentage of foreign ownership (for example, a potential reduction in the company tax rate to 10% where the foreign ownership is 90% or more [5]). The period of such benefit is ten years [6], commencing with the year in which the AE first generates taxable income. In general, a FIC is a company having more than 25% of its share capital (in terms of rights to shares, profits, voting and the appointment of directors), and its combined share capital and investor loan capital owned by foreign residents. A company which is controlled by an Israeli resident shall not be considered as foreign resident.

Generally, this seven or ten year period of benefits cannot extend beyond twelve years from the year the enterprise commenced its operations or beyond fourteen years from the year in which the approval of its status as an AE was granted, whichever is earlier.

Alternative Benefits Track

Under an alternative benefit track of the Law, companies with new or expanding AEs may elect to forego all government cash grants and receive instead a total exemption (i.e. tax holiday) from company tax on undistributed profits of the AE enterprise for 10 years in Area A, for 6 years in Area B and for 2 years in Area C ("**Alternative Track**"). During the remainder of the benefits period, (until the expiration of seven or ten years as the case may be), the corporate tax rate applicable to that AE will apply (25% or a lower rate if the company is a FIC).

The tax holiday provides an Israeli tax exemption so long as the AE profits generated in the exemption period are retained within the company. Upon distribution of such exempt income, the distributing company will be subject to corporate tax at the rate ordinarily applicable to the AE's income (25% or a lower rate if the company is a FIC).

Dividends

Dividends of an Israeli company derived from the income of an AE if distributed either during the benefits period or during the twelve following years (or without limitation as to their distribution date where paid by a FIC out of its AE profits) shall be subject to a 15% dividend withholding tax (subject to a possible reduction under a tax treaty [7]).

If the dividend is attributable partly to income derived from an AE, and partly to other sources of income, the withholding rate will be a blended rate reflecting the relative portions of the two types of income. The withheld tax is generally considered the final tax in Israel on dividends paid to non-residents who do not conduct a business in Israel.

II. HIGHLIGHTS OF REFORM – AMENDMENTS TO THE ALTERNATIVE BENEFIT TRACK

We set forth below a summary of the principal tax and bureaucratic streamlining reforms provided for in the Amendments to the Law (“Amended Law”) for industrial activities. **[8]**

The following points should be specifically noted:

Many material changes in the Amended Law concern only the Alternative Benefit Track. There are certain changes in the Amended Law that also apply to the investment grant path available for an AE (see Section III).

The Amendments to the Law do not retroactively apply for investment programs having an AE approval certificate from the IC issued up to December 31, 2004 (even when investments under these programs are conducted after January 1, 2005). Consequently, the Amendments should not impact an existing AE which received an AE approval certificate. The new tax regime shall apply for a new AE and for an AE expansion for which the first year of benefits may be as early as 2004.

The Alternative Benefit Track discussed above which was in effect prior to the amendments continues to be available (“Regular Alternative Track”) with the Alternative Benefit Track being expanded to also now include a new “Ireland Track” and “Strategic Investment Track”, as will be discussed below. Additional amendments have been made to other provisions, as highlighted below.

A company that has received investment grants will apparently not be eligible to enjoy benefits under the Alternative Benefit Track before a certain prescribed period has elapsed.

“Ireland Track” - Special Reduced Company and Dividend Tax for Area A

A new opportunity has now been added to the Law for companies having an AE in Area A that seek to distribute dividends while maintaining a low company and dividend tax burden (“Ireland Track”). This new track is in contrast to the Standard Alternative Benefit Track which provides a tax holiday provided that profits remain undistributed.

Upon election, the Ireland Track provides for a 10-year term with a company tax rate of 11.5% and a tax rate of 4% upon the dividend distribution to foreign investors with no further company tax implications arising to the AE distributing the dividends. Consequently, in the case of foreign shareholders, the

aggregate company tax and withholding tax burden shall be 15% [9]. It should be noted that for Israeli shareholders, the regular 15% rate still applies for dividend distributions. Consequently, there would be an aggregate company tax and dividend liability of 24.78%. [10]

It should be noted that an election of the Ireland Track or of the Standard Alternative Benefit Track may not be altered during the entire period of the benefits. It is still uncertain whether such an election separately applies to each specific AE or AE expansion or alternatively to the entire company's investments in Area A.

“Strategic Investment Track” for Area A

A special alternative tax benefit track for strategic investments in Israel has been added to the Law (“Strategic Investment Track”). The Strategic Investment Track allows for an exemption during the benefit period from company tax and dividend withholding tax for a company having (depending on its location within Area A of the country):

qualifying levels of AE investments of at least NIS600 million or NIS900 million (US\$136 or US\$205 million) [11]; and

annual revenue levels measured for the company's consolidated group for the tax year prior to the year the new investment begins (or the annual average for the three years prior to the year of investment) which are at least NIS13 billion or NIS20 billion (US\$2.95 or US\$4.5 billion).

This means that during the benefits period, a company eligible for benefits from income accrued under this track will have no tax liability whatsoever for its productive activity and for the distribution of profits. The Israeli Government in specific cases may reduce these minimum requirements where it is deemed that the investments will produce material contributions to the Israeli economy.

Minimum Qualifying Investment Requirement and Time Restrictions

A new requirement for entitlement of tax benefits under the Alternative Benefit Track of the Amended Law is that there must be a certain minimal investment amount (“Minimum Qualifying Investment”) towards purchasing productive assets (e.g. machinery and equipment – but not buildings) within 3 years. In the case of a new factory, the minimum required investment is NIS300,000 (US\$136,000). For expansion of a factory, the amount of required investment shall be NIS300,000 or the amount based on the formula shown below, whichever is higher:

Value of Productive Assets In the Factory in the Tax Year Prior to the Year the Minimum Qualifying Investment Commences (in NIS million)	Amount of Investment Required expressed as percentage of the Value of the Productive Assets
Up to 140	12%
140-500	7%
Above 500	5%

Detailed rules apply in determining how to value the assets for purposes of these tests (including in regards to AEs operated by affiliated companies).

For investors wanting to expand their current AE, a new requirement has been added to the Law that demands at least a two-three year waiting period before an investor can obtain AE status for its new investments. Detailed rules apply and further clarifications are awaited from the ITA in regard to implementation of this new restriction.

Automatic Approval

A major feature of the Amended Law is the change regarding the administrative process in obtaining approval for qualification under the Alternative Track.

With a view to simplifying the bureaucratic process relating to approval of investments and reduce friction between entrepreneurs and government offices, where an investment project meets all of the eligibility criterion under one of the Alternative Tracks (Standard Alternative Track, Ireland Track or Strategic Investment Track) as set out in the Law and in regulations to be issued, a project will automatically qualify for the AE taxation benefits under the Law with no need for prior approval from the ITA (i.e., a "Green Lane" is created).

Another important procedural change to be noted is that the Amended Law provides that the criteria that confer tax benefits in the Alternative Track of the Law shall now be handled by the ITA and not by the IC.

It should be noted that a mechanism will be available which enables a company to apply for a pre-ruling from the ITA, where it desires to obtain certainty as to the investment taxation status of its investment under the Amended Law. The application to the ITA must be submitted no later than 6 months following the end of the investment's implementation year (first year of potential benefits for the AE).

III. CHANGES APPLYING FOR ALL BENEFITS (INVESTMENT GRANTS AND ALTERNATIVE BENEFIT TRACK)

Income Qualifying for AE tax benefits

The Amended Law now more specifically sets out what is considered as industrial income qualifying for AE tax benefits under all tracks:

Sales of products manufactured in the AE factory, including where components are produced in another factory;
Sales of semiconductors that are produced in an unrelated factory which uses technology developed by the AE;
license fees and royalties received for the use of the know-how or software developed in the AE; and
accompanying related services provided to the company's customers in connection with the above.

It would also seem that income derived from a foreign resident for R&D services would also qualify for these purposes. [12]

There are many aspects to this subject (e.g., eligibility of a contract manufacturer for an AE to the benefits under the Law) that should be carefully examined in light of additional anticipated legislation and clarification of ITA interpretive positions, as to whether anticipated income generated shall qualify for AE tax benefits.

Marketing and Economic Qualifying Factors

The establishment or expansion of an enterprise or part thereof shall be eligible for grants or tax benefits under the Law only if the enterprise contributes to Israel's economic independence and is globally competitive [13], and each year meets one of the following conditions:

- (a) its main activity is bio-technology or nano-technology [14]; or
- (b) its revenue during the tax year from sales in a specific country or separate customs duties territory does not exceed 75% from its total revenue for that tax year; or,
- (c) 25% or more of its revenue during the tax year is derived from sales in a specific country or in a separate customs duty territory which has a population of at least 12 million.

When dealing with an expansion of an already existing AE, the test of the conditions shall be conducted with respect to the expanded portion only. Detailed rules apply.

Qualifying for FIC status

As mentioned, a company that qualifies as a FIC is entitled to enhanced tax benefits on AE income. Prior to the Amended Law, the ITA had adopted the position that foreign ownership was to be included in the above measurement percentages only where the ownership was acquired by issuance of capital. This issue, however, is still a matter of controversy and there is no case law on the subject.

Under the Amended Law, effective retroactively from 2003, the percentage of the foreign investments shall also include investment made indirectly where the foreign investor purchases shares from another

shareholder, provided that the paid in capital of the invested company exceeds NIS5 million. The Amended Law also adds the requirement that there be foreign investment in the company of at least NIS5 million (US\$1,136,000).

There are many other detailed aspects to this subject.

Attributing taxable income between different programs of an AE

Similar to the prior situation, special rules govern the allocation of taxable income of "Mixed Enterprises". These are essentially entities that derive only part of their income from an AE or entities which operate under a number of approvals relating to separate investment projects. Prior to the Amendment, potentially different allocation methods were applied depending upon the circumstances [15]. The Amended Law generally sets forth specific rules requiring that the allocation of taxable income between several investment projects is to have regard to the increase in turnover resulting from the operation of each investment project ("the turnover ratio method") [16]. Detailed rules apply.

Regulations to be issued

The Minister of Industry, Trade, and Employment, in consultation with the Minister of Finance, shall be authorized to promulgate regulations for determining eligibility and determination of benefits under the Alternative Track and shall be authorized, in consultation with the Minister of Finance, to amend said regulations, all of which are in accordance with the provisions of this law.

Footnotes:

1 Published on April 11, 2005.

2 It is customary that such positions are published in ITA guidelines.

3 The Law differentiates between three geographical regions (A, B and C). Area A enjoys the most incentives, while Area C (generally the central area of the country) enjoys the least amount of incentives.

4 Further to a change in the Israeli tax legislation, enacted on June 28, 2004, the company tax rate was reduced from 36% to 35% (in 2004), to 34% (2005), and is scheduled to be further reduced to 32% (2006), and 30% (commencing 2007).

5 A FIC enjoys reduced company tax rates applicable to its AE income as follows 25% company rate where foreign ownership over 25% but less than 49%; 20% company rate where foreign ownership 49% or more but less than 74%; 15% company rate where foreign ownership 74% or more but less than 90%; and 10% company rate where foreign ownership is 90% or more.

6 An Intensive Foreign Investment Company, as defined under the Law, which satisfies certain conditions is entitled to an additional 5-year benefit period with the aggregate benefit period thereby being extended to 15 years.

7 It should be noted that dividends from non-approved enterprise profits that are paid to non-residents are subject to a 25% withholding tax rate that may be further reduced under the terms of a relevant tax treaty.

8 The special rules under the Law that relate specifically to the hotel industry (tourism projects) are not being addressed in this report.

9 11.5% company tax plus 3.54% liability on after-tax dividends. $[(100\% - 11.5\%) \times 4\% = 3.54\%]$.

- 10 11.5% company tax plus 13.275% liability on after-tax dividends $[(100\%-11.5\%) \times 15\% = 13.275\%]$.
- 11 An exchange rate of US\$1/NIS4.4 is applied throughout the document.
- 12 It should be noted that the R&D services activities should be authorized as such by the Chief of the Department of Industrial Research and Development.
- 13 It would seem that these conditions are primarily intended to set export goals for the AE.
- 14 An approval in this regard should be received from the Chief of the Department of Industrial Research and Development prior to approval of the AE.
- 15 In accordance to the previous legislation, the asset ratio allocation method has also been applied. The utilization of this method under the Amended Law, in essence, has been abolished in respect to allocation of income to AEs that are subject to the new provisions.
- 16 It should be noted that the allocation method applied under the turnover ration method has also been altered. Consequently, the previous system of income allocation shall apparently apply to the AEs already approved by the IC prior to December 31, 2004 and the new system of allocation shall apply to new AEs that are the subject matter of the new legislation.

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