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PRACTITIONERS' CORNER

Israel's Major Investment Incentives for 2011

by Henriette Fuchs-Grootscholten

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In January the Knesset (parliament) passed a substantial set of changes to the Law for the Encouragement of Capital Investments 1959[1] ("the law") as part of its approval of the 2011-2012 budget. In 2005, a major overhaul of the law was implemented allowing for various tracks that eligible companies could choose from. With the new changes to the law, the government is offering modernized tools for companies to compete through innovative initiatives, encouraging exports, and creating jobs. Because of investment incentives in place since the 1970s, Israel is well positioned among the top five world leaders in the high-tech industry.

Israel's corporate income tax rate in 2011 is 24 percent, which will be gradually reduced to 18 percent by 2016. To understand the changes to the law, one must understand the incentives in effect through the end of 2010.

I. Incentives Before 2011

Effective in 2004, corporate taxpayers were eligible for either grants or benefits for any industrial enterprise or hotel business established and managed in Israel[2] that:

- contributed to the independence of the Israeli economy;
- entailed a competitive business; and
- contributed to the Israeli gross domestic product (hereinafter, an "eligible enterprise").[3]

The law recognized three different types of potentially eligible enterprises:

- *Industrial enterprises.* An eligible enterprise wishing to qualify as an industrial business had to meet one of the following three conditions:[4]
  - — Its main activity is biotechnology or nanotechnology, and its research program must have received the prior approval of the chief scientist at the investment center of the Ministry of Trade and Industry.
  - — The sales of the enterprise in any particular market cannot exceed 75 percent of the total income derived from the sales of that enterprise during the tax year.
  - — In each tax year, 25 percent or more of the total income of the enterprise must be derived from sales in a market containing at least 12 million residents (that is, be for export outside Israel). "Market" for this purpose means a country or a specific customs area.

  The income of an industrial enterprise had to be derived from the sale of the production by an approved enterprise. The definition of

[1]Law for the Encouragement of Capital Investments, 5719-1959.

[2]Section 22 of the law.

[3]Section 18A(b) of the law.

[4]Section 18A(c)(1) of the law.

''production'' in Israel includes software products and their development. In the case of temporary noncompliance, once the conditions are again satisfied, the entitlement resumes. An industrial enterprise had to meet the criteria in each year of its entitlement period.[5]

The minimum investment allowing for beneficial qualification of a new enterprise or production line had been set at NIS 300,000 (approximately US $70,000) or had to amount to a percentage (varying from 5 to 12 percent) of the relative value of the expansion compared with the existing productive assets of the enterprise, which had to be made within a specific period after the day of the ''year of election.''[6]

- *Enterprises that manufacture components for industrial enterprises.* An enterprise that could not meet one of these three requirements but produces components — typically products of an enterprise that *does* meet one of the criteria — may nonetheless claim the benefit of the incentives[7] if additional criteria were met.
- *Enterprises in the tourist and hotel businesses.*[8] Income from the hotel business refers to all income from the operation of a hotel or from the provision of services to tourists.[9] Regarding an enterprise in the hotel business, at least 25 percent of the total nights of stay in any tax year, or on average over three tax years, must consist of stays by foreign guests.[10]

A. Tax Incentives From 2004 to 2011

1. Green Track

The ''green track'' would entitle an eligible enterprise to reduced tax rates on its qualifying income. The incentives and exemptions would enter into effect once the enterprise had become profitable.

Eligible enterprises operating a qualifying business in Zone A, the highest priority zone, had a choice. These enterprises could opt for the ''Ireland route,'' offering a choice between the full 10-year tax exemption and the payment of corporate income tax at a rate of 11.5 percent for the first 10 years together with a low rate of withholding tax of 4 percent on profits distributed to foreigners.

Qualifying investments would be entitled to an accelerated depreciation ranging from 200 percent (for machinery and equipment) to 400 percent (for buildings) of the standard depreciation rates applying to these assets. (Normal rates range from 5 to 20 percent for machinery and equipment, and from 8 to 20 percent for buildings.) The additional accelerated depreciation of 200 percent (for machinery and equipment) may be increased to 250 percent at the discretion of the assessing officer in some cases.

2. Foreign Investment Companies

High importance was attached to the involvement of foreign investment in the eligible enterprise and to the size of the investment. (See Table 3.)

A foreign investment company is a company in which foreign investors have invested at least NIS 5 million (approximately US $1.5 million) in an enterprise in which foreign investors hold more than:

- 25 percent of the rights to the profits of the enterprise;
- 25 percent of the votes regarding the appointment of management of the enterprise; and
- 25 percent of the capital of the enterprise.[11]

A company in which the foreign investor acquired his stake for at least NIS 5 million from another investor could also qualify as a foreign investors company.

3. Large Foreign Investment Companies

To claim a large foreign investment company (see Table 3), the enterprise must have at least 80 percent of its income in foreign currency and 17 years cannot have elapsed since it first elected to be treated as a large foreign investment company.

4. Large Investments

On any large investments (see Table 3) in a project in a qualifying zone, no corporate income tax or withholding tax on dividends would be payable for the period of the entitlement.

The law also addressed the issue of ''mixed enterprises.'' This is when an enterprise has undergone one or more expansions and parts of the enterprise are ''approved'' (under different rules applicable before 2004), ''eligible'' (under the new rules), did not benefit from any incentives, or any combination of these. The benefits would then be calculated on a pro rata basis.[12]

II. Tax Incentives After 2011

In the amendment to the law,[13] the various options as described above were canceled. Starting in 2011, fixed reduced tax rates are charged to all companies that run an industrial enterprise if they have minimum export quotas regarding income from production activities (hereinafter the ''preferred companies'' or ''preferred enterprises'').

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[5]Section 50A of the law.

[6]*Id.*

[7]Section 18A(c)(2) of the law.

[8]Section 18A(c) of the law.

[9]Section 51 of the law.

[10]Section 18A(c)(3) of the law.

[11]Section 53H of the law.

[12]Section 74 of the law.

[13]Israeli Law for Economic Policies 2011-2012 (Amendment of Laws) published in Sefer Hukim 2271 on January 6, 2011.

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Table 1. Tax Benefits for Primarily Domestic Investors

	Normal Investment — *Ineligible*			Approved Enterprise — *Eligible*	
	Corporate Income Tax	**Dividend Tax[b]**	**Tax Exemption**	**Continued Benefits**	**Dividend Tax**
Anywhere	30%-30%[a]	25%	N/A	N/A	N/A
Zone A	35%-30%[a]	25%	10 years *or* 11.5% for 10 years	N/A	15% [c]+ gross-up 4%/15%,[c] no gross-up
Zone B	35%-30%[a]	25%	6 years	1 year, 25%	15%[c]
Zone C	35%-30%[a]	25%	2 years	5 years, 25%	15%[c]

[a]It is intended that the standard rate of corporate income tax will be reduced from 35% to 30% (and based on pending proposals under consideration even to 25%) over the next few years.
[b]Distribution would trigger a liability to corporate income tax on the distributed profits.
[c]The 15% rate of dividend withholding tax may be reduced, depending on a tax treaty that is in effect.

Table 2. Tax Benefits for Foreign Investors

	Foreign Investments (More than 25%, but 74% or less			Large Foreign Investments (More than 74%)		
	Exemption	**Special Tax Rate 25%, 20% 15%, or 10%[a]**	**Dividend Tax[c]**	**Exemption**	**Special Rates**	**Dividend Tax[c]**
Zone A	10 years	N/A	15%[b]	15 years or 11.5%		15%[b] (4%)
Zone B	6 years + 6 years	+ 4 years, 25%-10%	15%	6 years + 11 years	9 years, 10%-15%	15%
Zone C	2 years + 2 years	+ 8 years, 25%	15%	2 years + 7 years	13 years, 10%-15%	15%

[a]The rate of corporate income tax decreased toward 10% as the foreign shareholders' stake increased (from 50% to 100%).
[b]The reduced rate of dividend withholding tax was unconditional, as opposed to dividends from normally approved enterprises. (See Table 1.) This results in the full restitution of the corporate income tax obligation on the premature distribution of profits.
[c]The relevant tax treaties may further reduce the effective rate of dividend withholding tax to 15%, 10%, 5%, or even to 0%.

Table 3. Very Large Investment — Full Tax Exemption

Zone	Qualifying Investment (NIS)	Turnover of Business (NIS)	Corporate Income Tax (%)	Dividend Tax (%)
Zone A	900 million	20 billion	0	0
North or South Israel[a]	600 million	13 billion	0	0

[a]The extreme northern and the southern regions of Israel.

The definition of ''foreign investment companies'' was abolished and the accompanying special benefits were canceled as of January 1, 2011. In the past, qualifying companies were referred to as ''benefitting'' enterprises; today they are referred to as ''preferred'' enterprises.

The revised tax benefits will no longer be limited in time, and will be applicable as long as the company follows the conditions prescribed in the law. Beginning in 2011, there is no longer a requirement for a minimum investment. The volume or length of tax benefits is no longer influenced by whether investors in the initiative are foreign residents. For eligible companies active in the business of tourism, the rules basically remain unchanged.

To be a preferred enterprise, a company must export a minimum of 25 percent of all sales of the preferred enterprise (direct export only). Preferred income is considered the income that was generated or accrued from activities in Israel.

A qualifying industrial enterprise[14] is a business that is competitive and contributes to the national product or an enterprise in renewable energy.

The benefits are also applicable to registered partnerships when the partners are companies incorporated in Israel.

The tax rates for industrial enterprises will be:

- 2011-2012 — 10 percent for enterprises in Zone A and 15 percent in all other regions;
- 2013-2014 — 7 percent in Zone A and 12.5 percent in all other regions; and
- from 2015 — 6 percent in Zone A and 12 percent in all other regions.

Research and development activities in Israel for the benefit of a foreign resident will also qualify as preferred income as long as certification was received from the chief scientist at the investment center of the Ministry of Trade and Industry. Starting in 2011, royalties will only be considered preferred income to the extent that an approval has been received from the tax authorities as ''accompanying income'' to activities that are producing activities of a preferred enterprise in Israel.

New personal income tax benefits regarding R&D and royalties also have been introduced for investors and scientists. An investor who invests between 2011 and 2015 in a domestic R&D company that is still in its seed stage, that has difficulty raising money, and that is considered high risk may recognize up to NIS 5 million (approximately US $1.3 million) of the investment as a deductible expense, against income from any source. This expense recognition will be against all other income sources subject to progressive marginal income tax rates, while the tax rate on any potential gain on the shares in the future is limited to 20 to 25 percent tax at the most. These specific deductible expenses may be used against other income over three years. To qualify, at least 75 percent of the R&D expenses of the company must have been put to use in Israel during the benefit period, while income in the year of investment or the year thereafter must not exceed 50 percent of its R&D expense and at least 75 percent of the investment is used for R&D work. Local companies investing in smaller R&D companies may now acknowledge 20 percent of their equity investment as deductible expenses.

Scientists who become new Israeli residents or who are returning Israeli residents are entitled to a tax exemption for royalty income flowing from abroad. The royalty must be for the use of know-how when they were still abroad. The tax exemption will apply for a 20-year period (five years for returning residents that stayed abroad less than 10 consecutive years) upon arrival in Israel. A foreign specialist who is invited to work at a recognized Israeli academic institution or hospital is entitled to a five-year exemption for certain, originally foreign-source royalty income paid to him by a ''research or development company'' of the same institution that employs him. The payment must be based on an agreement signed within two calendar years following the specialist's entry into Israel. The product for which the royalty is received should be derived from research and development according to an industrial R&D plan approved by the Office of the Chief Scientist.

Until the end of 2012, the map determining the two national priority zones for the entitlement to benefits and specific rates will remain unchanged. Zone B has been canceled, except for tourism enterprises (for which the rules remain unchanged). Zone A includes greater Jerusalem, which is included specifically for knowledge-intense enterprises and high-tech enterprises.

The definition of ''industrial enterprise'' does not include the business of mining, enterprises for the production of minerals, or businesses in search or production of oil. Income from the sale of components derived from mines, factories for the producing of minerals, and efforts for the search and production of oil and gas are excluded from ''preferred income.'' Government-owned companies will not be entitled to benefits under the law. Partnerships or companies partially owned by government companies may be eligible on a pro rata basis for benefits on the non-government part of holdings.

A special approach was chosen for ''specially preferred factories'' (giant producers). The following are considered giant producers:

- a business that generates preferred income of at least NIS 1.5 billion;
- a company that generates preferred income of NIS 20 billion;
- a case in which the tax authorities have determined that a program of a business will be a substantial contribution to the national economy and its business plan contains the following:

[14]Section 18A(b) and (c) of the law.

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— the volume of income-producing assets (not including buildings and land) amounts to at least NIS 400 million in Zone A, and NIS 800 million for any other priority zone within three years of when the tax benefits took hold;

— an investment in R&D of NIS 100 million in Zone A and NIS 150 million for an investment in any other priority zone, in each tax year; and

— employment of at least 250 new workers in Zone A and 500 new employees in any other priority zone, in every tax year.

Corporate income tax rates for giant producers will be 5 percent in Zone A and 8 percent in all other regions. A giant producer will also be entitled to accelerated depreciation.

The reduced tax rate and accelerated depreciation will be allowed for each tax year in which:

- the preferred income in a year is NIS 1.5 billion or more;
- the preferred income of a company is NIS 15 billion or more; and
- an annual approval from the tax authorities that its status as a giant producer has not been revoked.

The reduced tax rate and the accelerated depreciation will be allowed for a 10-year period.

Companies that have obtained approval from the tax authorities as ''industrial companies'' will be considered similarly by the investment center for the purpose of obtaining a special loan or grant.[15] The same applies for a company that obtained a loan or grant and for which the ministry[16] approved a program that is not less than 10 percent of the financing granted. This obligation for mutual acceptance of qualification will apply for a five-year period upon the issuance of the approval of the relevant government office, unless the relevant investment situation changed materially, or when the tax authority is convinced that it was not provided with substantive information or was provided with incorrect information.

Note that the provisions for the preservation of benefits that existed in the revised sections of the law do not explicitly apply to a preferred enterprise. This has created a loophole that might allow for the denial of the revised tax benefit to preferred enterprises.

All sales of the preferred plant and exports will be required to show a minimum of 25 percent of the sales of the preferred factory sales and will take into account direct exports in order to qualify as a preferred enterprise.

The tax commissioner is authorized to establish rules for attributing income to industrial enterprises that have operations both inside and outside Israel.

A preferred company will be entitled to accelerated depreciation rates set forth in article 42 of the productive assets used by the relevant qualifying business.

Dividend distributions from the profits of the preferred income of qualifying companies may be distributed to Israeli corporate shareholders without any withholding tax. The withholding tax rate payable on dividends to individuals will stand at 15 percent, whether the recipient is a resident of Israel or a foreign resident.

III. Grants After 2011

Effective in 2011, industrial enterprises are eligible for grants as well as tax benefits, since the amendment to the law removed the obstacle for obtaining double benefits from legislation. Both grants and loans are available. The grant may be up to 24 percent of the investment program — 20 percent for participation in the approved investment and 4 percent for administrative costs. The law allows the relevant ministers to increase the grants by another 10 percent for some investment programs.[17]

An investment program connected to a grant will be approved only for companies that are active in Zone A.

When a company does not meet the conditions of the export quota of its sales regarding the preferred enterprise, it will be entitled to grants only if it exports 25 percent of its additional turnover. For the purpose of receiving grants, therefore, it is sufficient that one of the two conditions regarding specified exports be met: either 25 percent of its entire turnover is from exports or the increase in turnover will be 25 percent from sales from exports.

Investment grants will be restricted to industrial enterprises located in Zone A only.

Ministerial approval of the Finance Committee of the Knesset is required to determine routes for additional assistance to factories located in Zone A (except the grants track for the establishment or expansion of factories), including additional benefits for the training and developing of employees and increasing the output of employees. This assistance can be given by a grant or a loan.

Tourist factory replacement benefits will not be entitled to a grant investment.

[15] Section 51(o) of the law.

[16] Office of the Chief Scientist at the Investment Center of the Ministry of Trade and Industry.

[17] Upon the approval of the Finance Committee of the Knesset.

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Table 4. Comparative Table

	Old Law Until and Including 2010		New Law — Starting 2011	
	Benefits Route	**Grants Route**	**Tax Benefits**	**Grants**
Development Area	A, B, and others	A and B	A, B, and others	A only
Key Benefits	Tax exemption deferrable (between two to 10 years, depending on the development area) on the turnover's growth.	Investment grants (inducing tax exemption deferrable for two years in development area A). Impossible to enjoy both deferred tax exemption and investment grants.	Fixed tax from the year 2015 — 6% in the periphery and 12% in the other areas on the income of the enterprise.	Investment grants (not limited to physical capital). Possible to enjoy both deferred tax exemption and investment grants.
Accelerated Depreciation	Entitled to accelerated depreciation for assets used in the production of income and for buildings.	Entitled to accelerated depreciation for assets used in the production of income and for buildings.	Entitled to accelerated depreciation for assets used in the production of income and for buildings.	Entitled to accelerated depreciation for assets used in the production of income and for buildings.
Exports for Factory Expansion	25% (examined in relation to the growth of turnover).	25% (examined in relation to the growth of turnover growth or the turnover in general).	25% (examined in relation to the turnover in general).	25% (examined in relation to the growth of turnover).
Special Route	''Interchangeable route,'' the ''green route,'' and ''strategic route.''		Special preferential enterprise (''giant enterprise'').	Other benefit routes will determine.
Exceptions	——	——	The law does not apply on wholly owned government companies, companies that generate their income from oil and mining. The law will apply to registered partnership of which all partners are companies incorporate in Israel.	
WHT Dividends for Israeli Company Enterprise Profits	15%	15%	0%	0%
Amount of Tax That Applies on Dividends Received	15% on profits from benefiting income (4% ''Ireland route,'' 0% ''strategic route'').	15% on profits from ''approved'' income.	15% on profits from preferred income (the turnover in general).	15% on profits from preferred income (the turnover in general).

IV. Comparison of Incentives

Table 4 compares the old arrangements and the new investment incentives.

V. Provisions for Transition

The revised tax benefits will apply to income generated from January 1, 2011, or later. Previous legislation will continue to apply to enterprises that began their investment before December 31, 2010.

Companies that were already subject to benefits under the laws before 2011 may choose to apply the new law, but must then forgo application of the provisions of the old law for the remaining benefit period governing them. The choice, once made, is final. Notice of this waiver will need to be given no later than the date for submission of annual reports, and the waiver will then apply beginning the tax year following the tax year for which the report, including the announcement, was submitted. Companies that do not give this notice will continue to be taxed under the old laws until the end of 2012 as long as the minimum required investment had been made by the end of 2010.

In order to encourage companies to work under the new law, companies that will have given notice of their waiver under the previous law until June 30, 2015, may distribute dividends from their previously gathered profits as benefiting or approved income without any further tax as long as dividend distribution is to an Israeli resident corporate shareholder, but only after any corporate income tax has been paid by the distributing body. Under the old law, this would effectively trigger an income tax rate of between 10 to 25 percent on Israeli resident companies from eligible income or beneficial income. Dividend payments before 2011 by approved or benefiting enterprises would trigger a withholding tax of 15 percent.

Regarding enterprises that choose to be in the grants program exclusively, before January 1, 2005, according

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to the then-applicable funding legislation, a cooling-off period will apply from the beginning of the year in which the grants program was activated. This cooling-off period will be three years for an enterprise that was approved before the change of Law No. 60[18] and five years for the plants approved after the change of Law No. 60. As long as proper notice is provided, it is likely that that the impact of the cooling-off period can be circumvented.

Conclusion

The changes in the law have widened the opportunities for initiatives in Israel for tax benefits that simultaneously allow for grants. Companies already active in Israel will need to decide in the next few years whether they would like to continue functioning under the old law or the new determinations. Tax-favored initiatives will focus on decisions regarding the intermediate dividend distribution as part of the transition, measuring the percentage of exports of actual sales, and how to offset any remaining losses. New investors will find that access to tax benefits and grants have been simplified and are relatively easy to take advantage of in Israel. ◆

[18]Amendment No. 60 (04-01-2005) to the law.

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