

# Redesigned Individual Income Tax Benefits of a “Start-Up Nation” on the Move

**The author, in this note, considers the tax benefits available for newly arriving and returning residents, which were re-designed in 2009 and are applicable retroactively to the 2007 tax year onwards.**

## 1. Introduction

On the occasion of Israel's 60th anniversary, in the spring of 2007, a project was undertaken to re-design a set of attractive tax benefits for new and returning residents to be implemented in the Income Tax Ordinance (ITO).<sup>1</sup>

In order to continue to attract intellectual and human capital to Israel, furthering its high tech and innovation success story,<sup>2</sup> Israel set out to encourage former and candidate new residents from all over the world to (re-)establish the centre of their lives in Israel. According to various official publications, the immediate loss of income to the country's treasury, as a result of these broad tax benefits, was expected to be outweighed by the anticipated contribution to the country's economic success in the long term. It should be noted that Israel's acceptance as an OECD Member country, just over a year ago, was mainly driven by its proven track record as a respected high tech and innovations player.

Although not enacted until the end of 2008,<sup>3</sup> the expanded tax benefits applicable to foreign source income for new arrivals and returning residents apply from 1 January 2007 to individuals who took up residency in Israel on or after 1 January 2007.

## 2. Transition to a “Personal Tax System” in 2003

As of January 2003, Israel taxes the worldwide income of its residents on the basis of tax residency as defined in the ITO.<sup>4</sup>

Before 1 January 2003, the taxable income of individuals in Israel was determined under a ‘territorial taxation system’ that only taxed income ‘generated, accumulated or received in Israel’. This approach dates back to the tax legislation that applied under the British mandate over the region.<sup>5</sup>

Commencing in 2003, persons that qualified as residents began to be subject to tax in Israel with respect to worldwide income and gains (individual income tax system); however, double taxation relief is provided for under domestic law<sup>6</sup> and in applicable tax treaties. A foreign resident may be liable for tax in Israel but only with respect to certain Israeli source income and gains. Israeli tax law defines the ‘place of production’ of the income and gains as the criteria for taxation in Israel for foreign residents.

Tax rates in Israel for individuals range from 10% to a top marginal tax rate of 45%. These rates have been slated to decrease annually by one percentage point, such that the top marginal rate will be 39% in 2016. Currently, a discussion is taking place regarding a freeze of these rate cuts for one year. Dividends, capital gains and interest are taxed at a flat rate of 20% provided that the owner of the security does not own a qualifying interest (at least 10% of the share capital of the company), in which case the rate would be 25%.

Tax residency of an individual is, in principle, determined pursuant to two rebuttable presumptions<sup>7</sup> based on the ‘number of days’ spent in Israel. An individual who stayed in Israel for 183 days or more during a certain tax year, or a person who spent at least 30 days during a certain tax year in Israel *and* spent a total of 425 days in Israel over the last two years, is deemed to be an Israeli resident for tax purposes, with the result that the individual will be taxed on worldwide income. The tax authorities take the position that travel days count as days spent in Israel. However, effectively, a ‘centre of life’ test applies,<sup>8</sup> which allows for the foregoing presumptions to be refuted. The centre of life test takes into account the overall facts and circumstances relating to the individual, including family, economic and social ties. Whether an individual holds Israeli citizenship or a visa, or has claimed the right to live in Israel<sup>9</sup> may be relevant in determining (or rejecting) ‘residency’, but such factors are not conclusive. To determine residency, as is the situation in most countries, a full examination of the circumstances is necessary. The tax authorities argue that the date of a person's arrival, as a resident, is the earliest of the following:

- the date listed on the Immigration & Absorption Ministry's residency certificate;
- the date from which there was a permanent home available for use;
- the date from which the family had a permanent home in Israel; or
- once the individual has been in Israel for a period of 183 days in the tax year.

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1. Income Tax Ordinance (New Version) 5721 – 1961 (ITO).  
 2. Dan Senor and Paul Singer, *Start Up Nation: The Story of Israel's Economic Miracle* (New York: Twelve, 2009).  
 3. Sec. 14 ITO.  
 4. Secs. 1 and 2 ITO.  
 5. British Mandate over Palestine of 26 September 1923.  
 6. Sec. 199 et seq. ITO.  
 7. Sec. 1 «Definitions» ITO on residency.  
 8. Sec. 1(a) ITO.  
 9. Law of Return 5710 – 1950.

In the past, a set of limited exemptions used to be available for newly arriving residents and returning residents in combination with import duty and purchase tax exemptions. This note focuses on the new income tax benefits.

### 3. Classification of “New Residents” and “Returning Residents”

A qualifying new or returning resident is entitled to substantial tax relief and benefits in regard to foreign source income.<sup>10</sup> In this respect, the ITO distinguishes between three classes of residents in terms of tax status and consequential special tax benefits:

- a new Israeli resident – an individual who has become an Israeli resident for the first time;
- a veteran/senior returning resident – an individual who, prior to arriving in Israel, was considered a foreign tax resident for a period of at least 10 consecutive years. In honour of Israel’s 60th anniversary, a temporary Decree provided that if one became an Israeli resident in 2007-2009, a shorter threshold period of five years spent abroad would be required (instead of the current 10 years) to be qualified as a veteran returner; and
- an ordinary returning resident – an individual who, prior to arriving in Israel, was considered a foreign tax resident for a period of at least six consecutive years. Nonetheless, in the event one left Israel prior to the end of 2009, a shorter foreign residency threshold period of three years applies (instead of six).

The tax status of a new Israeli resident and a veteran returning resident (together a “new resident”) is equivalent; both are eligible for the same tax reliefs and benefits.

The general position of the Israeli tax authorities is that the number of actual years spent abroad is determined based on national legislation and interpretation, i.e. the assessment of the criteria applicable in classifying one’s status is made solely based on national law and regulations without regard to any treaty or international taxation definitions as to residency.

### 4. Tax Benefits for Returning Residents and New Residents

A new resident is entitled, inter alia, to the following substantive tax reliefs and benefits, which modify the basic rules regarding the Israeli tax base:

- (1) A 10-year tax exemption for foreign source income.<sup>11</sup> New residents are exempt from tax in Israel, with respect to foreign-source income, for a period of 10 years commencing from the date of becoming such new residents (the “Benefit Period”). This exemption covers all income, active or passive, such as interest, dividends, pensions, royalties and rental of assets, whether produced outside of Israel or derived therefrom, as well as gains<sup>12</sup> from the sale of foreign assets (the “Exempt Income”);
- (2) A 20-year tax exemption for certain accrued interest.<sup>13</sup> A new immigrant is eligible for a 20-year tax exemption with respect to accrued interest on a for-

foreign currency account (“*Matach*”) held in a bank in Israel, commencing from the date of becoming a new immigrant, if the funds are deposited within 90 days of the transfer of the funds to Israel, for each time a deposit is made for a locked-in period of at least three months. The monies so deposited must have been sourced outside of Israel in the period of residency abroad and interest flowing from it must not be income belonging to a business of the taxpayer. A request must have been filed with the tax authorities within 14 days of the deposit. Returning residents may claim a similar exemption for a period of five years.<sup>14</sup> Interest on funds held outside of Israel is tax free for the duration of the 10-year period as indicated in (1).

- (3) Choice of an ‘Acclimatization Year’.<sup>15</sup> During the first year of stay in Israel, a person who qualifies as a new resident may elect to be considered a non-Israeli tax resident, thus allowing the individual to explore the possibility of residing permanently in Israel, without immediately being regarded as an Israeli tax resident and subject, accordingly, to Israeli taxation. If one elects to apply this status and, thereafter, stays in Israel permanently, the acclimation year will be counted as part of the 10-year Benefit Period, however, only nine years of benefits will remain. When the person leaves Israel during the acclimation year, there will be no Israeli tax ramifications in regard to his arrival or departure (for example, Israeli exit tax will not apply), as though he had never been an Israeli tax resident. This non-qualification as a resident will also be upheld when the individual does take up residency on another occasion. The request for the try-out year must be filed within 90 days of arrival;<sup>16</sup>
- (4) Additional credit points. New residents are entitled to additional credit points (personal credits to offset actual tax)<sup>17</sup> during the first three and a half years of residency in Israel. For 2011, each credit amounts to a monthly amount of NIS 209, which adds up to a tax reduction of NIS 2,508 annually per credit point. During the first 18 months, 3 extra credit points (effectively a tax reduction of NIS 7,524 annually) are given. During the subsequent 12 months, 2 additional credit points are offered and during the next 12 months, 1 additional credit point is available. Commencing in 2011, former residents who return to Israel between 16 May 2010 and 30 September 2012 and were abroad for at least six consecutive years shall be entitled to the same additional credit points effective the 2011 tax year;<sup>18</sup>

10. Sec. 14 ITO.

11. Sec. 14 (a) ITO.

12. Sec. 97 (b) (1) ITO.

13. Ministerial Decree «Exemption of Interest by a New Resident on Foreign Currency Deposits» of 2002.

14. Ministerial Decree «Exemption of Interest by a Returning Residents on Foreign Currency Deposits» of 2003.

15. Sec. 14 (b) (1) ITO.

16. Form 1130 for a «settling in year election», available at <http://www.finance.gov.il/taxes/docs/1130.pdf>.

17. Sec. 35 ITO.

18. Amendment 181 ITO.

- (5) Exemption or relief from certain reporting requirements<sup>19</sup> in regard to specific foreign income exempted for the duration of the Benefit Period;
- (6) Relief in regard to certain Controlled Foreign Entities. Similar to many other jurisdictions, Israeli tax law contains rules for bringing certain foreign entities that are related to Israeli residents within the scope of taxation (anti-abuse rules).<sup>20</sup> Certain exceptions have been provided with respect to new residents and any returning residents in connection with such entities under their control:

- (a) Management and Control of Foreign Companies. According to Israeli tax legislation, a company with its management and control in Israel, may be considered an Israeli resident, and thus would be liable to tax in Israel with respect to its worldwide income.<sup>21</sup>

Tax legislation applicable from 2007,<sup>22</sup> however, provides that if the ‘management and control’ is exercised by a person qualifying as a new resident, the above rule shall not apply to them or their companies during the 10-year Benefit Period. However, the company may generate income in Israel due to its specific activities and presence of management, which could trigger tax liability in Israel on Israeli-source income;

- (b) Controlled Foreign Corporation. Israeli law also contains certain CFC provisions,<sup>23</sup> according to which, in certain circumstances, a foreign corporation controlled by an Israeli resident may be deemed to have distributed its mainly passive income to its Israeli shareholder. A qualifying Israeli shareholder might, thus, be subject to tax in Israel on “deemed dividends” from a CFC.

The 2007 legislation limits the effect of this rule on new residents, in that they will not be considered Israeli residents for the purposes of this provision. In other words, the CFC rules will not apply to new residents during the 10-year Benefit Period;

- (c) Foreign Vocational Companies. According to Israeli tax law,<sup>24</sup> under certain circumstances, a foreign entity, provided a controlling interest (at least 75%) is held by Israeli residents and most of its income during a tax year is derived from certain activities provided by the company via the Israeli residents (for example, management, consultancy, accounting and legal services), may be subject, to a certain extent, to tax in Israel.

The new legislation provides that during the 10-year Benefit Period, holdings of new residents and returning veteran residents are not considered holdings by an Israeli resident; thus, de facto, such taxation does not, in general, apply to entities controlled by new residents and veteran returning residents;

- (7) Trusts and Foundations. According to Israeli tax law concerning the taxation of trusts and foundations,<sup>25</sup>

under certain circumstances, a trust or foundation may be considered an Israeli tax resident if one of its settlors or beneficiaries is or becomes an Israeli resident. An entity or arrangement shall not be characterized as an ‘Israeli resident trust’ – such that it would not become subject to worldwide tax and reporting requirements in Israel – merely when a settlor or beneficiary becomes a new resident or qualifies as a returning veteran.<sup>26</sup>

In the recently amended Law on Economic Arrangements<sup>27</sup> the Finance Minister was given the authority to double the 10-year Benefit Period to 20 years – by way of Regulations (that have not yet been issued), in circumstances where a “significant investment” was made in Israel by the eligible person. No definition of the required investment volume was provided.

Note that tax benefits are also awarded to ordinary returning residents, such as a 10-year tax exemption with respect to certain foreign capital gains and a 5-year tax exemption with respect to certain foreign “passive” income. These benefits are not addressed in detail in this article.

Any Israeli source income of a new resident shall be subject to regular taxation in Israel and will not benefit from any exemptions, although his additional personal income tax credits will indeed also apply to the calculation of tax on income from domestic sources. Income of a new immigrant or returning resident who physically works on Israeli soil, even if for a foreign employer or a foreign client, is considered Israeli source income and, therefore, taxable in Israel.<sup>28</sup>

## 5. Special Tax Breaks for “Privileged Residents” (Researchers)

In line with the desire of policy makers to attract brain capital to Israel, certain tax exemptions for ‘Privileged Residents’ have been created. Scientists who first become Israeli residents in 2011-2015, or who return to reside in Israel after having resided outside of Israel for six consecutive years, are entitled to a tax exemption for royalty income flowing from abroad. The royalty must be for the use of intangibles or know how, which arose or were generated by the scientist while still living abroad, in exchange for a license for the use of such property granted outside of Israel. The tax exemption will apply for a 10-year period, which is calculated from the date of arrival for new residents and veteran returning residents. This benefit period is reduced to five years for ordinary returning residents (less than 10 consecutive years abroad but at least six) upon arrival in Israel provided that the relevant

19. Secs. 134 and 135 ITO.

20. Secs. 5, 75B and 1 ITO.

21. Sec. 1 ITO.

22. Sec. 14 (b)(2) ITO.

23. Sec. 75 B(a)(15) ITO.

24. Sec. 5(e)(2) ITO.

25. Sec. 75 C ITO.

26. Secs. 75 P 1 (a1) and (c)(2)(a) ITO.

27. Law on Economic Arrangements for the Years 2011-2012 (Legislative Amendments), 2011.

28. Secs. 2 and 4 ITO.

foreign asset that triggers the royalty income was in his hands on the day he returned to Israel.

Lastly, for royalty income received from outside of Israel by a formerly foreign scientist who came to live in Israel for the first time – or who is considered a veteran returning resident – and who came to Israel on the basis of an invitation to work at a recognized Israeli academic institution or hospital, an exemption may be claimed for a period of five years for royalties paid to him from Israel by a ‘research or development company’ of the same institution that he was hired by, calculated from the year in which this income started to be paid. The payment of this royalty income must be based on an agreement signed by the individual within two calendar years after his actual entry into Israel to work with the relevant entity. The product, in relation to which the royalty is being paid to him from Israel, should be derived from R&D or product development or sales made according to an industrial R&D plan<sup>29</sup> approved by the Chief Scientist’s Office. Persons who take up residency prior to the end of 2015 may claim this benefit.

This exemption only applies to the portion of the royalties paid by the company that relates to the intangible out of amounts received by it from a foreign resident who does not have a permanent establishment in Israel (understood to be a fixed place of business).

## 6. Investment in a Seed Company

An investor, who invests between the beginning of 2011 and the end of 2015, in a domestic R&D company that is still in its seed stage, which has difficulty raising money and that is considered high risk, may recognize up to NIS 5 million (approx. USD 1.3 million) of the investment – also by close family members – as a deductible expense, against income from any source<sup>30</sup> spread over a period of three years. This expense may be deducted against all other income sources, including those subject to progressive marginal income tax rates (as high as 44%), while the effective tax rate on any potential gain on the shares in the future is limited to 20-25%. This deductible expense may be offset against other income over a three-year period. To qualify, at least 75% of the investment in the company, which must have been incorporated in and managed and controlled from Israel, must have been put to use for R&D of the company in Israel during the Benefit Period and the income of the company in the year of investment or the year thereafter may not exceed 50% of its R&D expense. For local companies wanting to invest in smaller R&D companies there is the possibility to acknowledge 20% of an equity investment as a deductible expense.

## 7. Circular regarding Benefits and Interpretation

In January 2011, the Israeli tax authorities issued a circular<sup>31</sup> outlining their interpretation and understanding of the various tax benefits and breaks based on experience with the incentives since 2007 and how they should be applied. At the beginning of July 2011 a second 15-page

Circular was issued<sup>32</sup> that addresses a series of additional matters that required clarification and interpretation.

## 8. Tax Benefits in the International Arena

A departure from one jurisdiction of residency, followed by immigration to Israel, may have significant tax consequences in the country of departure in respect of which tax treaties may not offer a partial or complete remedy. In addition, once a person arrives in Israel, income flowing from the former country of residency may not be protected from taxation in the former country for a number of reasons, including the relevant treaty definition of ‘residency’ and relevant tie-breaker rule, the division of rights to taxation of pension income or inheritance and gift tax. The Israeli tax authorities have indicated in an instruction that they will no longer allow former UK residents opting to pay (10%) tax on UK pensions in Israel, although exempt from tax in Israel, to obstruct the right of the United Kingdom to tax. It should be noted that Israel is a party to some 50 tax treaties that contain an exchange of information obligation for the authorities of the contracting states. Israel is, therefore, obliged to release information as to certain taxpayers under specific circumstances, which obligation it honours. In addition, as an OECD Member country, Israel fully subscribes to principles in regard to the fight against money laundering.<sup>33</sup>

## 9. Advance Agreements

The Israeli tax authorities have a tradition of issuing advance agreements regarding various tax issues, which includes the determination of the tax position and classification of an individual upon arrival in Israel, as well as the possibility to reach agreement, before actual immigration or tax reporting, as to the nature and classification of certain items of income (including income from foreign opaque entities that may, for tax reasons, be considered transparent, allowing any foreign taxes incurred to be offset).<sup>34</sup> Persons considering taking up residency in Israel may consider their potential tax position in Israel and discuss an acceptable outcome before actual arrival to avoid surprises; after all, immigration to a new country is challenging enough in itself.

## 10. Conclusions

Israel provides individuals, whether retired or still in the bloom of their careers, with a unique opportunity to transfer their wealth from foreign jurisdictions and financial centres to Israel, allowing them to employ their skills and make new investments under the encouragement of a favourable tax system and in a flourishing economy.

29. Sec. 22 of the Law on Economic Efficiency years 2011-2012 (Legislative Amendments), 2011.

30. Sec. 20 of the Law on Economic Efficiency years 2011-2012 (Legislative Amendments), 2011.

31. Israeli Tax Authorities, Circular 2011/1.

32. Israeli Tax Authorities, Circular 2011/9.

33. Law on Prohibition of Money Laundering, 2000.

34. Sec. 199 ITO and Circular 2002/3 on the Tax Treatment of LLCs & similar bodies.