ISRAEL

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Israeli tax authorities provide certainty on foreign fund investments

The stake of foreign investment in Israeli high-tech reached 77% of total capital raised in 2018, and 30 new venture funds were born in 2018, raising a record $2.6 billion compared to 'only' $1.6 billion in 2017. In 2019, the Israeli tax authorities are chipping in 'a share', by releasing the revised rules for tax-favourable arrangements regarding foreign equity and venture funds.

For more than two decades, a tax exemption for gains by non-resident investors on shares in Israeli companies has been in effect. The expansion of this exemption, in 2009, did not alter the requirement the shares sold should not belong to a 'permanent establishment' in Israel and that Israeli *situs* real estate does not form the larger part of the company's asset value. The first requirement would threaten the exemption on investments though funds supervised by local fund or investment management; local professional involvement would risk qualification of a 'permanent establishment'. Against this backdrop, and while aware of the importance of foreign risk capital as 'oxygen' for Israel's industrial advancement, the Israel tax authorities would regularly provide terms for relief to investment funds, on a case by case basis, in accordance with the intentions of Sec 16A of Israel's Tax Ordinance (no double taxation for foreign investors no matter whether resident in a treaty country or not). When in 2014 the State Comptroller pointed out that the tax authorities might be exceeding their authority by the 'foreign funds ruling policy' the process of introspection resulted in publication of two new circulars mid-2018.

In the guidelines for tax relief for 'venture capital funds' (2018/9 VCF) and for 'private equity funds' (2018/10 PEF), the Israeli tax authorities put in writing the terms for exemption from gains tax for foreign investments, relief from tax obligations on the fund itself and the tax position of the actual fund management, but in a new jacket.

A fund with an aggregate capital of $10 million, counting at least 10 unrelated limited partner investors (LPs), of whom none are connected to the general partner managing the fund (GP), each holding at the most 20% of the equity in the fund (one investor may hold up to 35%), while foreign investors must hold at least 30% of fund equity (and at least $5 million), can request for confirmation of the exemption from tax of its foreign LPs. The fund is managed by the GP and the limited partners do not participate in the management. Limited partners who hold more than 4% of the fund rights cannot have access to more than 10% of any rights in the GP. Note, a limited – anchor investor – partner who has rights in the GP of not more than 10% of control in the GP may claim tax exemption.

The funds eligible for a ruling must have at least $10 million 'qualifying investment'; ie. an Israeli company (or a foreign company of which most of the assets or activity, directly or indirectly, is situated in Israel) of which the main business contributed positively to Israel's trade balance, ranging from actual manufacturing to high tech. Of the amount of risk participation by the fund, at least $6 million must be tied up in Israeli R&D companies holding IP or a foreign parent company with an Israel subsidiary which holds IP being developed. Alternatively, at least 50% of the positions is in qualified investments and at least 30% thereof are in above described IP holding companies. The fund may have up to 25% of its aggregate capital commitments (after deduction of management charges) in one single portfolio company and not more than 20% of its Israeli investment may be in public companies.

The foreign investors and the GP in a private equity fund regarding investment gains (with respect to its foreign investors) are exempt from tax. Other income from qualified investments such as dividend income will be subject to a 15% tax rate for individuals while corporate investors may be charged 23% source (and reduced by any applicable tax treaty). When the LP is a foreign 'exempt' investor (public institutions, provident funds and pension funds) resident in a treaty country where they are exempt from taxation, Israel also exempts the proceeds of their investments. Interest income is subject to a tax rate of 15%, 20% or even 50% in limited cases for individuals, while corporates pay 23% (the corporate tax rate), again subject to further reduction under a tax treaty. Obviously, income from investments in non-Israel entities are not subject to taxation in Israel and foreign investors are exempt from filing any tax returns. Foreign owners of GP rights will be charged 15% on their stake in any carried interest in connection with the Israel investments and tax may be refunded if not creditable in the residency country.

The foreign investors and GP of a VCF are exempt from tax on capital gains, interest and dividends, provided 75% of investment is by way of issuance of shares or other convertible securities. Israeli and foreign, exempt investors may be exempt pending fulfilment of treaty and domestic tax law. Carried interest of the GP rights holders is as with the PEF.

A PEF and VCF with fewer than 10 investors must pay a 15% tax rate. In both cases, the Israeli fund manager will be subject to regular tax with respect to carried interest. Most active funds understand that the VAT authorities are also willing to support an -efficient arrangement and reduce the VAT cost of international fund constellations hosted by Israel.

Should a fund not exactly fit the requirements of the 2018 circulars, it may request that an appropriate relief or specific tax treatment relevant to the particular circumstances be determined.

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