Israel

Israel's tax outlook for 2019 eyes exponential R&D investment

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With spending on research and development (R&D) and venture capital investment as a percentage of GDP among the highest in the world, Israel has entered 2019 as a leading technology country.

Israel's growth in the tech sector has historically been underpinned by its progressive tax framework. Since the 1960s, corporate tax rates for new initiatives have been reduced repeatedly, while in 2003, Israel significantly improved beneficial tax arrangements for employee equity 'awards'. Israel, in addition, enacted tax perks and full exemptions for domestic and foreign equity investors.

The 2017 re-modernisation of Israel's 1959 'encouragement' legislation (pairing Israel's tax benefits to the OECD's instructions on fair tax competition) has further enhanced tax reliefs for income generated in high-tech and innovation industries. In 2019, corporate tax rates on industrial income may range from as low as 6% to 16% depending (but not exclusively) on the volume of activity and geographic location of the taxpayer.

Tax certainty for foreign funds and investors

Starting 2009, foreign investors have been able to claim full tax exemption on gains made in investments in Israeli companies. In light of the fact that foreign investor funds (both venture capital and private equity) are often managed by an Israeli general partner, permanent establishment issues would endanger the tax exemption for foreign investors in the fund.

To prevent uncertainty, the Israeli tax authorities developed and published the conditions under which exemption from tax for foreign investors in these funds would be safeguarded to include the size of total investments and minimum number of investors.

These venture fund rulings were put into a new jacket in April 2018 when Israel's tax authorities formally published revised rules (Circulars 9/2018 and 10/2018) for foreign investor funds to secure tax exemption and limited withholding tax. Funds are eligible even when a general partner is functional in Israel, as long as more than 10 limited (foreign) partners are present, 30% of investors are foreign, and investment commitments amount to $10 million. Non-Israeli investments held by the fund should not trigger taxation in Israel. The authorities have indicated that a slight deviation may be considered under certain circumstances.

Public and institutional investment in (young) R&D companies

Israel's tax authorities announced on December 21 2018 how they would implement a 2016 accepted measure to encourage investment in young R&D companies by public and financial institutions. The ultimate goal of this arrangement is the provision of 'oxygen' for riskier, younger companies by traditionally conservative investors: institutional investors and the public.

Under the new rules, an investor in a qualifying R&D company may recognise the amount of their equity investment (paid in cash for issuance of shares) as a tax relevant capital loss up to an amount of NIS 5 million ($1.4 million). This 'loss' may be offset over three tax years against taxable income (similar to Israel's Angels Law).

When shares in an R&D company are later sold, taxable results are determined after adding back the loss. For an R&D investment to qualify, the market value of the company should be between NIS 200 million ($55 million) and NIS 1 billion ($272 million). Each tax year, the company must have received confirmation from Israel's Innovation Authority that at least 70% of the company's expenses are R&D related.

Founders of an R&D company may claim the lower gains tax rate on the sale of shares they held prior to the company's listing, even though they are functioning in an employment relationship with the company.

An interesting detail is that the encouragement of participation and management by institutional investors in publicly traded technology funds (public tech fund) now allow tax exempt provident funds to control up to 75% of the fund, while their tax exemption on investments in 'regular' funds prohibits a control in the fund in excess of 50%.

The significant number of existing tax benefits available for R&D and IP-owning companies including low corporate tax rates, reduced withholding tax on dividends, together with a package of benefits for investors make for an encouraging beginning to an innovative 2019.

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