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Proposed Tax Relief for Foreign Investors in Israeli Companies

Client Updates

Recently, a memorandum to amend the Income Tax Ordinance (the "**Memorandum**" and the "**ITO**") was published as part of a series of amendments expected to be enacted in the Israeli state budget for 2025. The published Memorandum addresses, among other things, the provision of relief for foreign residents' investments in Israel and the activities of investment funds with foreign investors operating in Israel.

The background for this proposed amendment is based on the recognition of the significant contribution of the high-tech sector to the Israeli economy, alongside growing criticism from the business sector regarding the low level of tax certainty in Israel, which deters many foreign companies and investors. Therefore, the Memorandum aims to strengthen Israel's business environment by establishing an attractive, certain, and stable tax regime, with an emphasis on foreign residents' investments and investment funds operating in Israel.

Below are the main proposed amendments.

Exemptions and Reliefs for Foreign Investors in Securities of Israeli Companies (including through Investment Funds)

In general, a foreign resident is exempt from capital gains tax in Israel on investments in Israeli companies, unless the investment is considered part of a business activity in Israel or if such capital gain is attributed to a permanent establishment in Israel. However, if a foreign resident's investment is managed from or made by a representative in Israel, such as through investment funds with representation in Israel, the profit from realizing shares in Israeli companies might be classified as ordinary business income, or alternatively attributed to a permanent establishment in Israel. As a result, the capital gain tax exemption may not apply, even if the investor is a passive limited partner in the fund. Furthermore, income from dividends and interest received from such investments is subject to tax in Israel and may be classified as business income, subject to higher tax rates (compared to tax rates on passive income). Since foreign residents may be exempt from capital gains tax in their countries of residence and are typically subject to lower tax rates on passive income, the higher taxes that apply in Israel can create a barrier to investment.

Currently, eligible investment funds such as venture capital or private equity funds, may receive a tax ruling from the Israeli Tax Authority (the "**ITA**"). This ruling can regulate and reduce the tax liability in Israel for foreign resident investors in relation to capital gains, interest, and dividends derived from certain "qualified investments". However, the tax ruling mechanism creates uncertainty and may change according to the decisions of the administrative authority, making it insufficient to accommodate foreign investors.

Therefore, the Memorandum proposes to authorize the Minister of Finance, with the approval of the Finance Committee of the Knesset, to set regulations granting tax exemptions and reliefs for foreign residents under certain circumstances of investment in securities or other financial assets. Regarding capital gains, the proposal suggests amending the ITO to determine that capital gains derived from certain investments defined in the regulations will be exempt from tax, even if the gain is derived in connection to a permanent establishment in Israel, such as in the case of an investment fund with an office in Israel. Additionally, the amendment aims, among other things, to regulate in legislation tax benefits for foreign investors regarding interest and dividend income resulting from investments of the type specified in the regulations. In enacting such regulations, consideration will be given to promoting specific types of investments and the economic benefits they provide, considering the goals of encouraging capital investments and economic initiative, developing the production capacity of the economy, enhancing the business sector's competitiveness in international markets, and creating a sustainable employment infrastructure.

Regarding concerns of classifying passive income (including capital gains) as a business income, particularly in cases involving investment funds with Israeli managers, the proposal includes an amendment to the ITO concerning the taxation of partnerships. This amendment would ensure that income from securities or financial assets, including capital gains, received by a passive limited partner from investments in specified securities, will not be considered ordinary business income. This applies equally to both foreign and Israeli investors. These changes are also positive for Israeli resident investors, since the specific tax rulings issued to date for investment funds have only addressed income classification for foreign investors.

Taxation of Carried Interest

Currently, the position of the ITA is that income from carried interest in an eligible investment fund is considered ordinary business income. However, within the framework of the specific tax ruling, the ITA is willing to provide reduced tax rates on carried interest as follows: (i) for foreign managing partners, a flat tax rate of 15% (concerning carried interest derived from the disposition of Israeli companies); and (ii) for Israeli managing partners, the tax rate is calculated based on a formula that weighs the rates of foreign resident investors out of the total investors in the fund ("IVA Arrangement").

The Memorandum proposes amending the ITO to stipulate that carried interest income related to investments specified in the regulations, when attributed to Israeli managing partners, will be subject to a fixed tax rate of 32% (instead of the IVA Arrangement). This proposal serves as a compromise between the full ordinary income tax rate (up to 50%) and the capital gains tax rate (25% before surtax). The goal is to create certainty and uniformity, eliminating the need for special tax rulings or reliance on formulas that depend on the specific circumstances of each investment fund.

Regarding carried interest paid to a foreign resident managing partners, the tax relief is expected to be

provided as part of the amendment to the ITO within the new regulations.

VAT on Management Fees and Carried Interest

The Memorandum also proposes resolving the long-standing dispute between the ITA and the fund industry in Israel, regarding the applicability of VAT on management fees and carried interest in investment funds.

It is proposed that carried interest (which qualifies for benefits under the provisions of the ITO) will be exempt from value-added tax (rather than being subject to a 0% VAT rate). This implies that, under the VAT Law provisions, VAT outputs related to income from carried interest will not be deductible.

Regarding management fees, the proposal aims to provide certainty by stipulating that management fees attributed to the investment of foreign limited partners in funds meeting the criteria to be determined in the regulations, will be subject to a 0% VAT rate. This will be based on the portion of foreign investors in the fund (like the current arrangement regulated in specific tax rulings of the Israeli VAT Authority).

As indicated above, if and when the proposed legislation is adopted, it will significantly contribute to encouraging foreign resident investments in the Israeli economy, particularly through investment funds.

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