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ISRAEL COMBINES TAX AND ECONOMIC INCENTIVES TO LURE INVESTORS

Israel traditionally has been a high-tax country. Its current corporate tax rate is 40%. Dividends distributed from Israeli corporations are subject to 25% withholding tax. Nevertheless, a new effort to do away with red tape and recent developments in Israel have made it more attractive for a U.S. corporation engaged in a capital-intensive activity, such as manufacturing, to operate a plant or factory in Israel. These new incentives can result in minimal U.S. and Israeli taxes and allow corporations to receive cash grants of up to 38% of the amounts they invest in their Israeli operations.

In 1959, Israel enacted the Encouragement of Capital Investments Law (ECIL), which has been amended many times since. The ECIL, according to its preface, is designed to attract capital to Israel and to encourage economic initiative and investments. This was desired in order to increase productive capacity, improve the balance of payments, reduce imports, increase exports, and to absorb immigrants.

In 1990, the ECIL was amended to establish a system of government guarantees of loans to finance investment programs of "Approved Enterprises." Foreign investors who establish or expand an enterprise or part of an enterprise owned by a corporation (either incorporated in Israel or registered in Israel as a foreign corporation), or by specified partnerships and other entities, may be able to obtain from the Investment Center (the "Center") the status of Approved Enterprise, Approved Asset, Approved Investment, or Approved Loan, as the case may be.

The investor must submit an investment plan to the Center, and the plan must be authorized by the Center ("Approved Plan"). Where an Investor invests in foreign currency through an Approved Plan and earns profits on such an investment, these profits may be repatriated in foreign currency by the foreign investor.

The ECIL allows investment in either an entity incorporated in Israel or a foreign corporation registered in Israel. For a foreign corporation registered in Israel, there is a 15% "branch tax" on the income of foreign corporations that own an Approved Enterprise. The branch tax may not be imposed, however, if the tax authorities are satisfied that the income which would have been subject to tax is reinvested in the corporation's business in Israel.

The ECIL provides owners of Approved Enterprises with many different sets of benefits.

BENEFIT SYSTEM

The "Standard Set of Benefits" focuses primarily on extending government grants to the owner of an Approved Enterprise and in lowering its tax rate. A second set of benefits-the "Alternative Set of Benefits"--provides the investor with a complete tax holiday instead of government grants.

In addition, two new sets of benefits have been introduced since 1990: (1) "Government ***176** Guarantee" benefits providing guarantees to the investor on loans taken out by it, together with tax incentives, and (2) "Combined" benefits providing a combination of grants and guarantees, and certain tax incentives. Each of these benefits will be discussed below.

Obtaining Benefits

An application prepared by a potential investor is presented to the Center. The application must include physical and financial details of the projected investment; background information on the investors; sources of financing; forecasts of sales, operating results, cash flow, the “break-even point,” and projected manpower requirements, including full backgrounds of key personnel.

The Center examines the financial and other data in the application to determine the feasibility or possible hazards of the investment program. It can then issue a “Letter of Approval” stating that the program has conditionally received the status of Approved Enterprise. The Letter details conditions to be fulfilled, and the Center monitors the implementation of the investment program. It also issues final Approved Enterprise certification once the conditions have been met and the appropriate reports have been submitted to the Center.

Standard Set of Benefits

The Standard Set of Benefits consists of grants computed as a percentage of the total capital invested in the Approved Enterprise. The percentage differs depending on which “Development Zone” the enterprise is located in and the type of enterprise. In addition to the grants under the ECIL, the Center provides “Capital Grants” as a percentage of the investments made in the Approved Enterprise.

The following are the current grant rates under the ECIL and Capital Grants systems:[1]

	Industry	Hotels	Enterprises			
Development zone	**ECIL**	**Capital**	**ECIL**	**Capital**	**ECIL**	**Capital**
A	30%	8%	17%	12%	5%	17%
B	15	5	11	12	5	6
Others	0	0	4	12	5	0

Tax Benefits

In addition to the grants, an owner of an Approved Enterprise is entitled to tax benefits. The major tax benefit is a lower tax rate on the profits of the enterprise and on dividends paid out of such profits (if the owner is a corporation). The corporate tax rate on profits in Israel is ordinarily 40%. This rate is reduced to 25% in the case of profits from Approved Enterprises. The withholding tax on dividends distributed by a corporation to its shareholders is reduced from the ordinary 25% rate to a 15% rate.

Taxes can even be further reduced where foreign investors form a substantial portion of the owners of the corporation which in turn owns an Approved Enterprise. The tax rate on this type of corporation is gradually lowered as a function of the increase in foreign investor holdings in the enterprise. Furthermore, the period for which the tax benefits are granted is extended for corporations with substantial foreign ownership. The following tax rates are imposed on corporations with foreign ownership investors:

Foreign ownership	**Income tax rate**	**Dividend tax rate**

49%-74%	20%	15%
74%-90%	15	15
90% or more	10	15

All corporations taxed at reduced rates may continue to use accelerated depreciation.

Thus, assuming its income is not Subpart F income, a U.S. corporation is subject to a maximum tax of 10% in Israel. The shareholders of such a corporation are not taxed unless the corporation makes a distribution to them. The corporation is not taxed unless it repatriates funds to the U.S. This is a considerable benefit when coupled with the grants the government gives in the way of hard currency.

Benefit Periods

The time limits on benefits depend on the percentage of foreign ownership:

1. *More than 25% foreign owned*. The above-described grant benefits and reduced tax rates are available for ten consecutive years beginning with the first year taxable income is derived from the Approved Enterprise. The special tax rate on dividends paid of 15% has no time limit.

2. *Less than 25% foreign owned*. Where the approved enterprise does not meet foreign ownership requirements, the reduced tax benefits are available for seven years and dividends from income entitled to such benefits are taxed at the 15% rate for only 12 years.

Where the Approved Enterprise is more than 74% owned by foreign investors, under certain circumstances the duration of tax rate benefits can be extended an additional five years.

Alternative Set of Benefits

Approved Enterprises may forgo grants and tax benefits and instead elect a complete tax holiday for up to a maximum of ten years in Development Zone A, six years in Development Zone B, and two years in other Development Zones. After the tax holiday ***177** expires, the corporation is entitled to tax benefits under the Standard Set for the remainder of the term of the benefits granted by that Set.

Generally, only corporations that expect extremely high profits should elect the Alternative Set.

New Rules and Benefits

As indicated above, two additional sets of benefits were added recently to the ECIL:

1. *Government Guaranteed Set of Benefits*. Under this program, an Approved Enterprise may receive a government guarantee of the amount borrowed by the Approved Enterprise up to two-thirds of the Approved Investment Plan. Thus, the Approved Enterprise may have any loans that it takes guaranteed by the government of Israel. In addition, such an Approved Enterprise may elect the Standard or Alternative Set. The Enterprise must, however, be located in Development Zone A or B to receive these favorable tax benefits.

If the Alternative Set is elected and the Approved Enterprise is either not located in Development Zone A or B, or the

Approved Enterprise forgoes the government guarantees, then the period of tax holiday is extended from two to four years. Thus, an Approved Enterprise located outside of Zone A or B can effectively extend its Alternative Set benefits by qualifying for the Government Guarantee Set of Benefits and then waiving its rights to receive the guarantees.

2. *The Combined Set of Benefits*. The second set of new benefits enacted in 1990 is the Combined Set of Benefits. Under this program, an Approved Enterprise can elect to receive reduced grants, reduced government guarantees, or a combination of both grants and guarantees. The reduced rates are as follows:

1. For industries:

Development Zone	**Level of Grants**	**Government Guarantees**	
	ECIL	CAPITAL	
A	17%	8%	42%
B	5	5	57
Other	-	-	-

2. For hotels:

Development Zone	**Level of Grants**	**Government Guarantees**	
	ECIL	CAPITAL	
A	-	17%	50%
B	-	11	56
Other	-	4	63

3. For tourism enterprises:

Development Zone	**Level of Grants**	**Government Guarantees**	
	ECIL	CAPITAL	
A	-	17%	50%
B	-	6	61
Other	-	-	-

An Approved Enterprise that is receiving a combined rate of grants and guarantees may not receive a tax holiday but may receive the Standard Set--a reduction in the rate to as low as 10% and a reduction in the dividend withholding tax rate to 15% forever in terms of the portion of the investment program eligible for each type of benefit.

If the taxpayer fails to meet the requirements of the law, pertinent regulations, approval, etc., the Center may demand refund of the grants or consider that the terms of the agreement related to the government guaranteed loans have been violated.

PLANNING

Government grants in hard dollars and reduced income tax rates may encourage companies to consider investment in Israel. For example, a U.S. manufacturer of widgets wants the government grants and reduced tax benefits the ECIL offers. The shareholders agree to move manufacturing assets to Israel, or agree to construct in Israel the manufacturing assets necessary to manufacture there. If the U.S. manufacturer can show that it has two businesses--one being the design and manufacture and production of the widgets, and the other the marketing and sales function for the widgets, it might be possible to take the position that the corporation has two active trades or businesses.[2] The corporation then might be able to spin off the nonmanufacturing assets into a new sister corporation. Separating out the manufacturing assets from nonmanufacturing assets is desirable so that only the manufacturing portion would be subject to taxation and scrutiny by the Israeli authorities. It is, of course, advisable to obtain a private letter ruling from the IRS that the transaction under consideration is tax free for U.S. purposes.

The transferred assets should then be valued. Grants given by the Center are based on the current FMV of the equipment. If the equipment is constructed or purchased in Israel, valuation should not be a problem. If, however, the machinery or equipment consists of rare dyes or molds, these, while having a relatively low book value for U.S. tax and accounting purposes, may have a relatively high FMV in Israel, which value would enable the corporation to receive larger grants.

*178 DUTCH REGISTRATION.

The potential foreign investor should consider registering in Holland as a Dutch company rather than investing directly in Israel. The U.S. and Israel have no income tax treaty, though a new treaty has been signed (and will be the subject of a forthcoming article in this Journal). Israel and The Netherlands do have an income tax treaty, which can be used by a foreign company registered in Holland.[3]

The U.S. company can then form a partnership in Israel with Israeli ownership. This new entity can apply for Approved Enterprise status to receive a government grant. Because a U.S. corporation is used, Subpart F and Section 367-type problems are avoided.

The allocation of profits to the U.S. corporation can also be controlled through partnership allocations made by the Approved Enterprise. The Approved Enterprise should also follow the allocation rules of Section 704(b).

Conclusion

Israel currently favors the development of investments. No one can predict how long the government will maintain this pro-investment outlook, however. Accordingly, potential investors that want to avail themselves of the favorable grants offered by the Israeli government should consider applying for Approved Enterprise status at this time. This is especially true in light of President Clinton's call for a reduction in Section 936 benefits for investment in U.S. possessions.

Footnotes

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[1] Development Zone A includes the Negev, Judea, and Lake Kinneret. Development Zone B includes Jerusalem, Beit Shemesh, Kiryat-Malachi, and Nazareth.

[2] See Reg. 1.355-3(c), Example 10, noting that the spin-off may not work if there is a "related function device factor."

[3] Approximately 40 days after the U.S. and The Netherlands signed their new treaty, which, if ratified, may limit the utility of registration as a Dutch company, Israel and the U.S. signed a second protocol. Both of these treaties will likely be sent to the Senate this spring, and ratification of both is more likely than not.