

International Tax and Business Guide

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Israel





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Tax professionals of the member firms of Deloitte Touche Tohmatsu have created the Deloitte International Tax and Business Guides, an online series that provides information on investment conditions, tax regimes and regulatory requirements, along with information for executives working abroad. The Guides are supplemented by the Highlights series, an at-a-glance summary of basic information, including tax rates, for over 100 jurisdictions.

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1.0 The investment climate

Political background

Israel is a parliamentary democracy. The Knesset, the 120-seat unicameral parliament, is elected every four years under a proportional representation system. Ehud Olmert, the leader of the centre-right Kadima party, heads a five-party coalition government.

1.1 Economic structure

Israel enjoys a diversified economy. Services, particularly financial and business services, are the most important component of Israel's economy, comprising nearly 70% of total GDP in 2006. Industry accounts for 30.5% and agriculture for 2.6%.

Significant manufacturing activity occurs in electronics, communications and other high-tech industries. Medium- and lower-tech industries, such as chemicals, plastics and food, also are important. Israel holds a comparative advantage in research and development (R&D) stemming from high levels of education and the benefits of subsidies and massive investment in military R&D.

1.2 Banking and financing

The Israeli banking sector has long dominated the country's financial system and has a large role in the overall economy. A privatisation process in the banking sector is nearing completion.

Commercial banks offer a full range of retail and corporate banking services: brokerages in the local and foreign capital markets; mortgage, leasing and other forms of finance; underwriting and investment-banking services; mutual fund and other asset-management facilities; and numerous specialist services.

With few exceptions, all financial institutions are headquartered in Tel Aviv, the country's business and financial centre.

1.3 Foreign trade

Because Israel is weak in natural resources, it is necessary to import raw materials and many goods and services, and the country depends on exports to pay for such goods and services. Foreign trade is the mainstay of the economy, and there has been a steady liberalisation of Israel's trade regime.

Globalisation, combined with deregulation of capital flows, has brought about an increase in Israeli investment abroad, both foreign direct investment and portfolio, and a subsequent stream of earnings from interest and dividends.

Successive Israeli governments, irrespective of political-party composition, have been committed to free trade. Europe and the U.S. are Israel's largest trading partners, with the U.S. the largest source of imports and the most important export destination. Asia accounts for most of the remaining trade.

Israel's main imports are raw materials (excluding fuel and raw diamonds); investment goods (heavy machinery and vehicles); fuel; and diamonds. Leading exports are diamonds, electronics, software and chemicals. The electronics, software and telecoms equipment industries have emerged as the most important sectors, with high growth rates and far more added value than diamonds, but they too reflect fluctuations in world demand.

2.0 Business regulations

2.1 Registration and licensing

Because of the size and nature of the Israeli market, many firms use licensing to conduct business in the country.

Israeli companies generally do not need government approval for licensing agreements with foreign firms. However, agreements for the use of patents with security applications or those related to nuclear power do require approval. Similarly, patents or products developed from applications that carry contractual obligations to the Office of the Chief Scientist of the Ministry

of Industry, Trade and Labour may require clearance for licensing overseas. Once a company has produced statements from certified accountants, royalties may be freely transferred.

Israel participates in all activities of the World Intellectual Property Organisation and the United Nations Commission for Trade and Development and maintains ties with international organisations engaged in protecting industrial property rights.

2.2 Price controls

The government may impose price controls on goods and services supplied by a monopoly, or in the framework of restricted trade. Controls may also be imposed if there is a large concentration in the supply of a good, or if the goods and services are subsidised, or their producers receive support from the state budget. The government is entitled to impose price controls on goods and services deemed vital.

2.3 Monopolies and restraint of trade

The Israel Antitrust Authority (IAA) deems a monopoly to exist when more than one-half of the total supply or acquisition of an asset, or more than one-half of the total provision or acquisition of a service, is concentrated in the hands of a single entity. Because Israel's market is small and had been accustomed to many trade restrictions (although these are now largely abolished), barriers to entry and exit are relatively high and market dominance by major producers is common. The average level of concentration in the Israeli market is roughly double that in Europe. Although monopoly producers control a number of sectors (oil refining, steel, cement, glass, potash and certain foods), even more sectors are controlled by only two or three major competitors. The IAA frequently uses its power to direct monopolies to refrain from harming competition.

Once proclaimed a monopoly, a presumption is set on the definition of the market, the applicable market share and the existence of market power, thereby facilitating private actions and class actions against the monopoly for abuse of monopoly position. A firm that is defined as a monopoly by law, particularly if it has been proclaimed as such by the authority, is subject to legal restrictions similar to those defined in the Treaty of Rome (the basis for the EU). A monopoly may also be subject to price regulation, although not by the IAA, which does not regulate prices. In practice, however, this measure is rarely used.

2.4 Intellectual property

Patents, trademarks, copyrights and industrial designs are legally recognised in Israel, and there is adequate enforcement of property rights once secured. In extreme cases, criminal charges can be filed against violators of intellectual property laws. Infringement of patents, trademarks and designs usually meets with civil remedies, including an injunction and damages in Israel. For flagrant infringement, a company may sue for double damages. An exclusive licensee of a patent recorded in the patent registry may sue in its own name for an injunction to prevent continuing abuse.

2.5 Mergers and acquisitions

Under the Restrictive Trade Practices Law, notices of mergers and acquisitions must be filed with the director-general of the IAA in the following instances:

- If the transaction results in control of more than 50% of production, sale, marketing or purchase of a product or service, or group thereof;
- If the combined turnover in Israel of the entities involved exceeds NIS 150 million in the financial year before the proposed merger, and each company has turnover of at least NIS 10 million; or
- If one of the entities involved already operates a monopoly as defined in the law.

For these purposes, a merger is defined as the acquisition of the principal assets of one entity by another, or the acquisition of shares in such an entity involving control of more than 25% of issued share capital, voting rights, rights to appoint directors or participation in profits.

Acquisition can be direct or indirect, including via a voting agreement. These provisions generally apply to both companies and partnerships, and the review takes into account not only the direct parties to the transaction but also entities controlled, controlling or under common control.

Mergers may generally proceed after the expiry of a 30-day filing period. The IAA can issue a decision blocking the merger within that period if the merger creates a substantial likelihood that

competition and a relevant market will be significantly harmed. An unfavourable decision can be appealed, first to the Antitrust Tribunal and thereafter to the Israeli Supreme Court. The appeals process is usually lengthy.

Mergers of manufacturing, shipping and hotel companies are encouraged, with tax waived on the resulting capital gain if the merger contributes to the common good and the Ministry of Finance has approved the merger.

3.0 Foreign investment

3.1 Foreign investment incentives and restrictions

The U.S., Germany, Italy, France and the U.K. are the leading investors in Israel. The main focus of investment is high technology, which includes communications and Internet software, biotechnology and medical instrumentation. Other sectors that have been important foreign direct investment targets include both traditional industries and services (notably banking and insurance).

The system of incentives offered by the Law for Encouragement of Capital Investment features two types of benefits. The first is a package of grants and tax reductions, administered by the Investment Centre at the Ministry of Industry, Trade and Employment. The second is the Automatic Tax Benefits programme, overseen by the tax authorities.

To be eligible for grants or tax benefits for the establishment or expansion of a plant, the company must be registered in Israel, and prove that it is globally competitive and contributing to economic growth. In addition, an industrial company must show one of the following: its main field of activity is bio-technology or nano-technology; its sales income during the tax year from a specific country or separate customs duty territory does not exceed 75% of its total revenue for that tax year; at least 25% of its income during the tax year was generated by sales in a specific country or in a separate customs duty territory with a population of at least 12 million.

Incentives may be withdrawn or reduced if an enterprise does not comply with the conditions of approval. The scale of benefits depends on the location and size of the investment, in line with a map of priority zones. The mapping of these zones tends to change in line with political trends.

Approved companies that receive government grants are also eligible for various tax benefits. An investment project that is eligible for one of the automatic tax benefits tracks will automatically qualify for the tax reductions in the grants track without having to obtain the prior approval of the tax authorities.

Grants/reduced taxation track. Investors seeking cash incentives must file an application (including a plan for raising working capital) before investing in a project. Applications are filed on an official form with the Investment Centre (IC). For all projects in the grants track, a separate form must be provided to the Industrial Development Bank (IDB), which will evaluate the economic viability of the proposed project. Projects of up to USD 1 million are exempt from IDB evaluation. Once approved, the IC issues a Certificate of Approved Enterprise to the specific project.

To participate in the grants track, a company must finance at least 30% of the approved project with equity financing. In addition, an investment project must consist exclusively of fixed assets, such as new equipment and buildings. The project must be completed within three years of the grant's approval, and at least 25% of the work must be completed within one year.

Grants to investors in priority areas are as follows:

- Industrial and hotel projects of less than NIS 140 million are entitled to a 24% grant in priority zone A and 10% in priority zone B.
- Other tourist projects are entitled to a 15% grant in priority zone A.
- Industrial projects of more than NIS 140 million are entitled to a grant of 20% in zone A and 10% in zone B.
- An additional grant of up to 10% may be available for investment in certain industries, when the location is the Negev and southern region.

Earnings of industrial companies that qualify as approved enterprises are entitled to tax breaks. The earnings must stem from the sales of manufactured goods, even if the components are

produced in another plant. The tax breaks also apply to income derived from royalties and fees from licences if the latter are paid for the use of software or technology developed by the approved enterprise, or for services related to the use of the know-how or software. For an expansion of an existing approved enterprise, the test of the conditions applies only to the expanded portion.

The tax benefits for an approved enterprise are granted over seven consecutive years, starting with the first year the company earns taxable income (provided 14 years have not passed since the approval was granted and 12 years have not passed since the enterprise began operating). If at least 25% of a company's owners are foreign investors, the company is eligible for a ten-year tax benefit period.

Approved companies that receive government grants are eligible for a reduced corporate tax rate of 25% and a 15% dividend tax on the balance (in effect, a total rate of 36.25%). The minimum foreign investment required to qualify as a Foreign Investors Company (FIC) is NIS 5 million. If the company qualifies as an FIC, it can be eligible for further reduced rates, depending on the level of the foreign investor's holding in the company's capital and voting rights.

Automatic tax benefits tracks. These tracks include three different packages: the traditional or regular Alternative Track, the Priority-Area Track and the Strategic-Investment Track. Companies eligible are termed beneficiary enterprises. The law gives the tax authorities the power to determine criteria eligibility, although these are the same as the criteria required in the grants track, including eligibility for industrial enterprises and definition of covered income.

To qualify for tax breaks, the company must invest a minimum amount within the three years ending in the year of election, by purchasing "productive assets", such as machinery and equipment (but not buildings). For a new factory, the minimum required investment is NIS 300,000. For expansion of a plant, the minimum qualifying investment is NIS 300,000 or a level that varies in accordance with the value of productive assets in the factory, whichever is higher. The level stands at 12% of the value of productive assets if these assets are valued at no more than NIS 140 million, 7% for assets worth NIS 140 million–500 million and 5% for assets exceeding NIS 500 million.

Regular alternative track. Companies that waive their right to receive grants are entitled to a full exemption from corporate taxation for differing periods, depending on their location. The company must be a limited liability company, finance at least 30% of the approved project and execute the plan within three years of the approval date (25% of the plan within the first year).

For firms in priority area A, the tax exemption extends for ten years. For firms in priority area B, the tax exemption lasts six years, with an additional year of corporate tax at 25%. If the level of foreign investment amounts to at least 25% of the investee company's equity, the reduced rate applies for four years, rather than one year. If the company is outside these two areas (that is, area C), the total tax exemption runs for two years, with another five years at a reduced corporate tax (25%). Tax holidays run from the first profitable year (as long as 12 years have not passed since the beginning of operations or 14 years from the date of approval).

If the foreign ownership of a company exceeds 74% of its capital and it invests at least USD 20 million in a project with Beneficiary Enterprise status, it then qualifies as a "foreign investment intensive" company. Such projects are entitled to an extension of five years of tax benefits if 80% of their revenue in each of the five years is in foreign currency (averaged over a period of up to three years at the company's choice).

Priority-area track. This package is designed to suit the needs of companies that seek to distribute dividends while enjoying a low corporate tax burden. Upon election of this track, a company will enjoy a ten-year period of reduced corporate tax of 11.5% and a tax rate of 4% on dividends distributed to foreign investors, with no further company tax implications. In effect, the total tax burden on foreign shareholders is 15%. For Israeli shareholders, the regular tax rate of 15% still applies for dividend distributions.

Strategic-investment track. This package applies mainly to large multinational companies and confers a ten-year corporate and dividend tax exemption. To be eligible, the investor company must have an annual turnover of at least NIS 13 billion and the minimum investment in the project must be NIS 600 million. The project must be north of the Acre-Carmiel line, or south of the Beersheba–Arad Region. If the investment project exceeds NIS 900 million, these benefits are available throughout priority area A. For corporations with annual turnover exceeding NIS 20 billion, benefits accrue even if the project is in area B as long as the investment exceeds NIS 900 million.

Incentives for holding companies. A special tax regime applies to Israeli holding companies that invest in foreign corporations. Eligible corporations will be entitled to a participation exemption from tax on dividends received from foreign subsidiaries and on capital gains derived from the sale of shares in foreign subsidiaries, as well as to complete exemption from tax on financial income derived from investments in the Israeli capital market. In addition, dividends paid by the holding company to nonresident shareholders will be taxed at 5%, rather than the normal 25% rate.

Employment increase. In addition to the incentives offered by the grants and alternative tracks, there is a programme to increase employment in peripheral areas and regions with high unemployment. The government has allocated NIS 150 million per year in 2005–07, with the maximum support per worker set at NIS 120,000 per year. The incentives apply to the expansion of industrial plants, telephone call centres, computer-service support centres or logistic centres.

R&D incentives. The Office of the Chief Scientist (OCS) is responsible for promoting industrial research and development (R&D) that is likely to yield new export products. The criteria for approving a request include proven technological skill, implementation of the project in Israel (unless exempted by the Research Committee of the OCS) and a proven need for improvements in an existing product. To qualify for support from the OCS, applicants must submit a detailed proposal accompanied by an outline of the R&D programme and the required budget, including wages, direct costs and overheads amounting to 45% of the costs. The request must be submitted on special forms available from the OCS or from the Ministry of Industry, Trade and Labour.

There are various incentive schemes available through the OCS. Interested parties should contact the OCS for more details.

3.2 Exchange controls

There are no foreign currency restrictions. All activities and transactions in foreign currency are permissible, except for those explicitly restricted, such as money laundering.

Individuals are permitted to invest abroad in financial and real assets, including land and real property.

4.0 Choice of business entity

4.1 Principal forms of doing business

The two usual corporate forms are private and public limited companies. There is little distinction between the two forms; public companies are companies registered on the Tel Aviv Stock Exchange.

Requirements of a limited company in Israel

Capital. There is no official minimum capital requirement for setting up a company, but there is a filing fee for share capital. A company may provide capital in the form of goods or intangibles, valued under generally accepted accounting principles; the Investment Centre (IC) reviews the valuation of non-cash capital contributions to a company seeking investment incentives. There are no legal-reserve or profit set-aside requirements.

Founders, shareholders. Under the Companies Law, there are no minimum requirements for the number of founders or shareholders. There is no limitation on the nationality or residence of shareholders.

Directors. The law distinguishes between companies whose shares are registered for trading on a public stock exchange (public companies) and all others (private companies). For private companies, there is no minimum number of directors. Public companies must have at least two outside directors as well as a chairman, so that in practice there are at least three directors, and usually more to ensure a majority for shareholders. There are no nationality or residence requirements.

Management. There is no minimum number of managers for private companies, but public companies must have at least one, who serves as chief executive officer (CEO). The CEO may not serve as chairman of the board of directors. There are no nationality or residence requirements, but residence must be stated in founding documents and annual reports. Labour need not be represented in management or on the board.

Disclosure. Public companies must present the following to the Registrar of Companies: annual financial statements, inspected and confirmed by a certified auditor; a list of shareholders' names and addresses; and a copy of all decisions adopted at a general shareholders' meeting. Material corporate developments, such as the appointment or replacement of directors, must also be reported to the Registrar. Companies quoted on the Tel Aviv Stock Exchange must publish detailed quarterly income statements and balance sheets, including purchasing-power effects on profit-and-loss figures. They must issue statements disclosing any material developments in their affairs, as and when these occur.

Taxes and fees on incorporation include small registration and publication fees and a capitalisation fee of 1% of registered capital. Stamp duties are 1% on the allotment of shares, 2% on the issue of bearer certificates and 1% on the transfer of registered shares (private companies).

Types of shares. Shares with cumulative voting rights are allowed, but public companies registered on the Israeli stock exchange may not issue non-voting shares. The three most common types of shares issued are ordinary, preferred and deferred. Redeemable shares may be issued but must have preferred status. Companies may acquire their own ordinary shares, with certain conditions.

Control. A minority exceeding 25% may block major decisions. Election of board members usually requires a simple majority (more than 50%) of voters in attendance. It is mandatory for institutional investors (provident and unit trusts/mutual funds) holding more than 5% of a company to attend general assemblies and to vote.

4.2 Establishing a branch

Foreign companies may operate in Israel through a branch, but most prefer to establish a local subsidiary. Only companies registered in Israel are eligible for approved status (which qualifies a project for special incentives and assistance), and branch managers are personally liable for certain company obligations, such as money owed to workers.

To set up a branch, a foreign company must file a certified copy of its charter and statutes with the Registrar of Companies; submit a list of directors together with names and addresses of representatives authorised to act on behalf of the company in Israel; and indicate the country in which the parent is incorporated in any prospectus and on bills, invoices, letterheads, announcements and advertisements. After the branch is established, the parent company must present an annual financial statement to the Registrar of Companies. The registration fee is adjusted annually based on the cost-of-living index. There is no capitalisation fee.

4.3 Setting up a company

After complying with the formal requirements and paying capitalisation and registration fees, a firm must register with the Registrar of Companies for recognition as a legal entity. Registration documents are usually filed in Hebrew, with financial data expressed in shekels, although corporate documents in English are accepted. There are no restrictions or special requirements for registering a company's capital in foreign currency; in practice, however, this is rare.

Companies can participate in co-operative societies, limited partnerships and joint ventures. Co-operative societies exist mainly in agriculture, marketing, retailing, transport and freight services. A member's share may not exceed 20% of the society's capital, and shares may not be transferred. A joint venture is similar to a co-operative venture, but separate liability is attached to each party's obligations.

5.0 Business taxation

5.1 Overview

Israel operates a classical system of taxation, whereby corporate taxation is imposed at the level of the company and again when the income is distributed to shareholders. The amount of tax to be paid is calculated via a form of self-assessment, reviewed by the tax authorities.

The tax code uses a complex system of inflationary protection, instituted during the period of high inflation rates during the 1980s. The fall in inflation in recent years has led to a return to nominal accounting for the preparation of financial reports by companies, but the tax authorities continue to be bound by the system of inflationary accounting mandated in 1985.

Enterprises granted "approved" status (which qualifies a project for special incentives and assistance) pay company tax at 0%–25% (depending on the percentage of foreign investment, the location of the plant and the type of operations), with the tax exemption available until profits are distributed. This reduced rate is based on the lowest level of foreign investment during the tax year. Distributed after-tax income is subject to further withholding tax.

Among the investment routes available within the framework of Amendment No. 60 to the Encouragement Law is one designated only for enterprises whose plants are located in "National Priority Region A." An Approved Enterprise choosing this investment route will be subject to a flat corporate tax rate of 11.5% on its chargeable approved income. Distribution of income attributed to an Approved Enterprise, as a dividend, by the company to its foreign investors will be subject to a reduced withholding tax rate of 4%.

An additional incentive programme, termed the "Strategic Channel", is available for large foreign investments. Special rules apply to firms in banking, insurance, oil exploration and motion pictures.

Israel does not impose an excess-profits or alternative minimum tax. Taxable income calculations are based on annual financial reports, using generally accepted accounting principles, with necessary adjustments—including for inflation.

There is a special tax regime for Israeli holding companies investing in foreign corporations. These benefits are offered to private corporations incorporated and managed in Israel provided, *inter alia*, the company has a minimum investment of NIS 50 million in shares and loans of foreign subsidiaries that are resident in countries that have concluded a tax treaty with Israel.

5.2 Taxable income and rates

Israeli income tax is imposed on the worldwide income of Israeli residents and on the income of non-Israeli residents that was accrued in or derived from Israel.

A corporation will be deemed to be resident in Israel if its activities are managed and controlled from Israel or if it is organised under the laws of the State of Israel.

There are no basic differences in the tax regime applied to different forms of business organisation. The basic rate of company tax on net taxable income is 29% in 2007 (gradually reducing to 25% as follows: 27% in 2008, 26% in 2009 and 25% from 2010).

In general, income may be classified as ordinary income, capital gains or passive income, such as dividends.

Ordinary income. Generally, income from business operations is treated as ordinary income, which is subject to a flat corporate tax rate.

Capital gains. See below at section 5.3.

Dividends. The tax rate on dividends distributed by an Israeli resident company to another Israeli company is 0%, provided the dividends arise from income produced or accrued in Israel. The tax rate on dividends from income produced or accrued abroad and from dividends derived from abroad is 25%, with a credit granted for tax withheld. Alternatively, the gross dividend would be subject to the regular corporate tax rate with both a direct and indirect foreign tax credit if the Israeli company qualifies for the indirect tax credit mechanism. Dividends distributed by an "approved enterprise" are taxed at a rate of 15% if the distribution is made out of profits attributable to the approved enterprise.

Interest. Interest is subject to the regular corporate tax rate.

Taxable income defined

Corporate tax applies to all income irrespective of where the income arises. Adjustments for inflation or currency appreciation are treated as ordinary income or expenditure. A foreign company operating through a branch (rather than a subsidiary) is generally subject to tax only on income derived from local operations of the branch. A branch is subject to tax at the standard corporate rate on Israel-source income and capital gains. There is no branch tax in Israel.

Israeli resident companies are liable for capital gains tax on their worldwide capital gains.

Deductions

Current revenue expenses incurred in producing income are deductible; capital and private expenses are not. This applies to royalties and interest. Dividends are not deductible from income (corporate taxes are paid on income before distribution of dividends).

Depreciation

Fixed assets may be depreciated at the rates prescribed by statute and deducted in computing taxable profits. The rates and amounts used in tax computations may differ from those used in compiling the company's financial reports. Allowances are not available for expenditure on land and residential homes. Depreciation for tax purposes is calculated on a straight-line basis. Industrial companies purchasing new equipment may elect to use a modified declining-balance method on an asset-by-asset basis, with the election irrevocable for the life of the asset. Higher depreciation rates apply to industrial equipment used for more than one shift. Assets may not be revalued for tax purposes.

Approved enterprises that have been qualified by the Investment Centre or by the tax authorities are entitled to accelerated depreciation on certain assets in certain circumstances.

Patents held by industrial companies are depreciable over eight years. Capital expenditure for research and development (R&D) may be written off in three equal annual instalments. With the special approval of the Chief Scientist Office, R&D expenditure used to finance R&D projects may be written off in one year.

Losses

Trading or business losses may be offset against income from any source in the same year. Losses may be carried forward indefinitely from one income year to another, linked to the consumer price index, to be offset against income from trade or business capital gains. Losses may not be carried back.

5.3 Capital gains taxation

The capital gains tax rate depends on the nature of the seller, purchase date and the nature of the asset. The general capital gains tax rate is 25%.

Corporations are taxed at a 25% rate on gains realised from the disposal of shares (with respect to gains accumulated from 1 January 2003). However, if the seller is a corporate entity subject to the Inflationary Adjustments Law, it will continue to be subject to the corporate tax rate on gains derived from the disposal of traded securities. The inflationary component of gains is exempt from tax for both individuals and corporations (10% tax rate applies upon inflationary gain accrued up to the end of 1993).

An Israeli resident is subject to capital gains tax in Israel on the disposal of all of its assets regardless of whether the assets are located in Israel.

Capital gains on the sale, exchange, transfer or other disposition of most types of tangible and intangible capital assets located in Israel or constituting a direct or indirect ownership interest of assets in Israel are treated as Israeli-source income and subject to Israeli capital gains tax, regardless of whether the seller is a resident of Israel for Israeli tax purposes. Shares and other securities of Israeli companies, or shares and other securities of non-Israeli companies holding significant assets in Israel, may be treated as Israeli assets.

However, persons who are not resident of Israel for tax purposes are exempt from Israeli capital gains tax on gains from the sale of shares traded on the Tel Aviv Stock Exchange and on capital gains on the sale of shares of Israeli companies traded on stock exchanges overseas acquired after listing, unless the gain is attributable to a permanent establishment that the seller maintains in Israel.

Additional tax relief offers an exemption from capital gains tax on the sale of Israeli securities acquired between 1 July 2005 and 31 December 2008 by residents of countries that have concluded a tax treaty with Israel, provided the gains are not attributable to a permanent establishment of the seller in Israel.

In addition, foreign residents are exempt from Israeli capital gains tax on capital gains derived from the sale of shares allocated to them (in tax year 2003 onwards) by an Israeli resident company in consideration for their capital investment. The exemption is granted if the allocating company was qualified, at the time of the allocation, as a "Research and Development (R&D) Intensive Company."

Capital losses are first set off against real capital gains and then against inflationary amounts due to tax in the ratio of 1:3.5. Unrelieved capital losses may be carried forward to be set off against future capital gains, for an unrestricted period.

5.4 Withholding tax

Dividends

A 20% withholding tax is levied on dividend payments to a non-controlling foreign resident (that is, one that holds less than 10% of the Israeli company payer's shares); otherwise, the rate is 25%. These rates may be reduced under an applicable tax treaty. Dividends from profits of approved enterprises are subject to a 4% or 15% withholding tax, depending on the type of the investment (provided a treaty does not already reduce the tax rate below either 4% or 15%).

Interest

Most interest payments made by Israeli corporations to nonresidents are subject to withholding tax at the rates of 15%, 20% or 25%, depending, *inter alia*, on the type of loan (whether or not linked to the index) and whether the recipient of the interest income is deemed to be an individual or "body of persons". These rates may be reduced under an applicable tax treaty.

Royalties and fees

Royalty payments are subject to a 25% withholding tax, unless reduced under an applicable tax treaty.

5.5 Foreign income and tax treaties

Israel grants a direct foreign tax credit for any foreign taxes paid on non-Israeli source income.

Israel has tax treaties in force with over 40 countries. The withholding tax rates on remittances of dividends, interest and royalties are shown in the table below. Domestic rates apply if they are lower (a "D" indicates that the domestic rate applies).

Withholding tax rates under Israel's tax treaties			
Treaty Partner	Dividends	Interest	Royalties
Austria	25	15	0/10
Belarus	10	5/10	5/10
Belgium	15	15	0/10
Brazil	10/15	15	10/15
Bulgaria	7.5/10/12.5	5/10	7.5/12.5
Canada	15	15	0/15
China	10	7/10	10
Czech Republic	5/15	10	5
Denmark	25	25	10
Finland	5/10/15	10	10
France	5/10/15	5/10	0/10
Germany	25	15	0/5
Greece	D	10	10
Hungary	5/15	0	0
India	10	10	10
Ireland	10	5/10	10
Italy	10/15	10	0/10
Jamaica	15/22.5	15	10
Japan	5/15	10	10
Korea	5/10/15	7.5/10	2/5

Withholding tax rates under Israel's tax treaties			
Treaty Partner	Dividends	Interest	Royalties
(R.O.K)			
Latvia	5/10/15	5/10	5
Lithuania	5/10/15	10	5/10
Luxembourg	5/10/15	5/10	5
Mexico	5/10	10	10
Netherlands	5/10/15	10/15	5/10
Norway	25	25	10
Philippines	10/15	10	15
Poland	5/10	5	5/10
Romania	15	10	10
Russia	10	10	10
Singapore	5/10	7	5
Slovakia	5/10	2/5/10	5
South Africa	25	25	15
Spain	10	5/10	5/7
Sweden	0/D	25	0
Switzerland	5/10/15	5/10	5
Thailand	10/15	10/15	5/15
Turkey	10	10	10
Ukraine	5/10/15	5/10	10
United Kingdom	15	15	0/15
United States	12.5/15/25	10/17.5	10/15
Uzbekistan	10	10	5/10

5.6 Transactions between related parties

Transfer pricing

The Israeli transfer pricing rules, which are based on the OECD guidelines, apply to transactions between an Israeli resident and its related nonresident. A hierarchy of transfer pricing methodologies applies, with preference given to transaction-based methods over profit-based methods. Documentation requirements mandate that the taxpayer attach a statement to the annual tax return, and the taxpayer must provide a detailed transfer pricing study upon the request of the tax authorities. Advance pricing agreements may be obtained.

Controlled foreign companies

Under the Israeli CFC regime, if a foreign company is "controlled" by Israeli shareholders (more than 50% of its "means of control" are held by Israeli shareholders) and has accumulated undistributed passive profits taxed at a rate lower than 20%, it will be considered a CFC. In such a case, the Israeli controlling member will be treated as if it had received its proportionate share of those profits as dividend income (deemed dividend), even though not actually distributed. The deemed dividend will be taxed in the hands of the Israeli resident at a rate of 25%. Simultaneously, a tax credit (a deemed credit) will be granted to the Israeli controlling shareholder in the amount of the foreign tax that would have been paid if the undistributed passive profits had been distributed as a dividend.

Thin capitalisation

Israel does not have thin capitalisation rules.

Consolidated returns

The filing of a consolidated return is generally not permitted in Israel. Each company in a group is required to file its own return. However, provided certain conditions are satisfied, qualified "industrial companies" are entitled to file a consolidated return for tax purposes.

5.7 Turnover and other indirect taxes and duties

Value added tax (VAT) applies to most goods and services, including imported goods and services. The VAT rate is 15.5%, but a number of categories are zero-rated. These include exported goods, intangible goods and the provision of certain services to nonresidents, tourism services, the transport of cargo to and from Israel, the sale of goods and services to the Eilat free-trade zone, and the sale of fresh fruit and vegetables. VAT-exempt goods and services include certain leases, transactions of very small businesses (defined as "exempt Dealers") except for real estate transactions and sales of goods where the input VAT was not deductible.

The value of imported goods for VAT purposes includes customs duty, purchase tax and other levies. Each supplier (vendor) of goods and services collects VAT on the total costs to that stage of production or distribution.

Financial institutions pay a tax on wages and profits instead of VAT, at the same rates. A similar wages tax applies to non-profit organisations, at a reduced rate of 7.5%. Excise taxes apply to fuel and tobacco.

5.8 Other taxes

Stamp duty on signed documents was abolished in 2006. Municipalities levy various property and business taxes.

The property betterment tax is applicable to the sale of real estate. The principles of the property betterment tax are basically similar to those of the capital gains tax:

- The betterment, in real terms, derived from the purchase date up to 11 November 2001 will be subject to the corporate tax rate (for companies) or the marginal individual tax rate (for individuals). The balance of the betterment, in real terms, will be taxed at the rate of 25% (for companies) and at marginal individual tax rates up to 20% (in 2007 and thereafter) (for individuals).
- The inflationary betterment will be exempt from tax, except for tax at a rate of 10% that would be imposed on the inflationary betterment arising from the purchase date until 31 December 1993.

For real estate sales other than land sale for residential property, land sales tax is levied at a rate of 2.5% for assets purchased before 7 November 2001; assets purchased after that date are not liable for the sales tax. In response to an approved draft bill that would abolish the land sales tax retroactively on all real estate assets as from 1 August 2007, the Israeli tax authorities created a mechanism for freezing debts relating to the land sale tax until the Knesset (parliament) has approved the draft bill.

Purchase tax is levied on certain imports or local industrial production and is collected from local manufacturers 30 days after the month in which goods are sold and from the importer when goods are released from customs. Customs duties are levied on several imports.

5.9 Tax compliance and administration

The tax year begins in January, but this may be changed for special circumstances by application. Companies must file an annual tax return no later than five months after the end of the tax year (an extension to file may be obtained in certain circumstances). The tax authorities determine advance tax payments, with some taxpayers required to pay according to monthly turnover.

Most firms make 12 monthly advance payments at a fixed ratio of the company's turnover. Alternatively, a company may be required to make ten monthly payments, beginning in the second month of the tax year, with each payment a fixed percentage of the previous year's tax assessment.

Penalties apply if advance payments are overdue or if tax returns are filed late. The balance of any taxes due is payable from the beginning of the following tax year and is linked to the consumer price index. Any overdue tax balance attracts interest at an additional 4% until paid in full.

6.0 Personal taxation

6.1 Residency

Israeli residents are subject to individual income tax, social security tax and capital gains tax on a worldwide basis. Nonresidents are taxed on income sourced in Israel. The Israeli tax system moved from a territorial to a worldwide system in 2003.

An individual is resident in Israel if that person's "centre of vital interest" is in Israel. (The definition is a combination of criteria as defined in case law and as used in practice.) The number of days an individual spends in Israel and overseas also affects residence status: an individual will be deemed to be resident if that person spent 183 days or more in Israel or if in the current tax year spends 30 or more days in Israel, and the total period of the stay in Israel in the tax year and in the two preceding tax years on a cumulative basis amounts to 425 days or more.

Withholding taxes are generally final for nonresidents, who need not file an income tax declaration.

6.2 Taxable income and rates

As noted above, Israeli resident individuals are taxed on worldwide income.

Furthermore, foreign residents are exempt from tax on capital gains arising from investments on Tel Aviv Stock Exchange-listed securities. They are also exempt (subject to meeting several criteria) from capital gains on profits deriving from the disposal of Israeli company securities made between 1 July 2005 and the end of 2008, irrespective of when these profits are realised, unless the investee company's main assets are real property.

A medium-term tax-reduction programme provides for the decline of the top marginal rate of personal income tax, which will fall to 44% in 2010; a reduction in marginal rates for lower income bands will be larger. The 2007 personal marginal tax rates for "earned income" for the year 2007 are as follows: 10% for income up to NIS 51,240; 21% from NIS 51,241 to NIS 91,200; 29% from NIS 91,201 to NIS 136,920; 35% from NIS 136,921 to NIS 196,560; 36% from NIS 196,561 to NIS 423,240; and 48% for income above NIS 423,241.

The rates of tax on unearned income are 15% on nominal interest payments, 20% on interest payments that are index-linked and 20% on dividends. Individuals classified as "significant shareholders" will pay 25% tax on dividends and the consumer price index-linked interest payments and 20% on unlinked payments. Amendments have established 20% as the sole rate of capital gains tax for households on all investments, and 25% for significant shareholders (that is, holders of more than 10% of the company).

Determination of taxable income

All income from employment and business is taxable, including the value of fringe benefits and cost-of-living allowances. From January 2003, passive income from bank deposits and savings, both in Israel and overseas, is taxable. Expenses that attract tax benefits include social welfare contributions for the self-employed, life insurance premiums, and payments to pension and provident funds.

Tax liabilities are partly offset by tax credits, which are based on a point system and deducted from the income tax liability. Each credit point is worth NIS 178 per month, or NIS 2,136 per year. Married or unmarried resident taxpayers are granted 2.25 credit points. In addition, working women—married or unmarried—receive an additional 0.5 credit point, and working women are entitled to an additional point for every child. Point values are fully linked to the cost-of-living index.

A mandatory health tax is withheld at source at a rate of 3.1% for monthly income up to NIS 4,522 and 5% for income exceeding that amount, up to a ceiling of NIS 35,760.

The employee funds social security taxes at 0.4% on the first NIS 4,522 of income per month and 7% on income exceeding that amount up to a ceiling of NIS 35,760. Employers' contributions are 4.14% on the first NIS 4,522 of income per month and 5.68% on income exceeding that amount up to a ceiling of NIS 35,760. Foreign expatriates are subject to lower tax brackets. The deduction from the employee is 0.04% for the first NIS 4,522, and 0.87% thereafter, up to the ceiling. The employer pays 0.80% up to the same ceiling. Foreign expatriates are not covered by the national health insurance scheme.

6.3 Special expatriate tax regime

Expatriate experts (i.e. “approved specialists” or nonresidents approved by the Investment Centre) are taxed at a maximum rate of 25% up to a ceiling. Other expatriates are subject to ordinary tax rates, but foreign residents do not receive tax credits. Double-taxation agreements generally restrict the taxation of short-term assignees who receive their salaries from abroad to the country of residence.

6.4 Capital Taxes

Local taxes are levied on property. There is no wealth tax, inheritance tax or estate duty in Israel, although capital gains tax may arise on assets received through an inheritance or on the sale of the asset.

7.0 Labour environment

7.1 Employees’ rights and remuneration

Major statutes affecting labour are as follows:

- Hours of Work and Rest Law established that a workday may not exceed eight hours (seven hours in night-work), and a working week may not exceed 47 hours.
- Male and Female Workers (Equal Pay) Law requires employers to pay female workers equal wages for similar work.
- Severance Pay Law requires payment of one month of wages for every year of employment to a person who has been employed continuously for one year, by the same employer or at the same place of employment, and has been dismissed.
- Minimum Wage Law (updated in April 1997) establishes that any full-time employee is entitled to pay of at least 47.5% of the average wage.
- Work Safety Ordinance and the Labour Inspection (Organisation) Law are designed to ensure worker safety.
- Settlement of Labour Disputes Law provides for arbitration of disputes that have not been settled within a certain period.

Working hours

The normal working week is five days, beginning on Sunday and ending on Thursday (or Friday midday, for those businesses still working Fridays). Overall working hours have been reduced to 43 hours per week. Factories normally work an eight- to nine-hour day.

7.2 Wages and benefits

The minimum wage is NIS 3,585 per month and applies to all workers in the economy, both local and foreign.

Wages in foreign-owned firms are generally much higher than the minimum wage, because foreign ownership is concentrated in high-wage industries, notably electronics.

Fringe benefits in manufacturing in Israel vary under different collective agreements, but they generally amount to 40%-60% of base pay, or 20%-35% of gross wages—depending on the industry and status of the employee. Office workers receive slightly higher fringe benefits, often including annual bonuses equal to one month’s or two months’ salary.

Pensions

A 2003 pension-reform package raised the retirement age to 67 for both men and women, up from 60 years for women and 65 for men. This change will be implemented over a period of six years for men and 21 years for women.

Social insurance

National insurance is required by law (covering allowances and stipends for pensioners, widow/ers, disability, maternity, children’s allowances, industrial accidents, military-service pay and unemployment). Some employers pay part or all of workers’ compulsory contributions to the national insurance scheme.

Other benefits

Paid annual holiday leave is required to be at least 10-12 working days after one year of employment, up to a maximum of 22-24 days. Other benefits that must be provided are paid public holidays; health insurance and sick pay; paid recreation; vocational training funds; and travel to and from work.

Voluntary benefits often supplement mandatory ones. Many employers provide work clothes, canteens and holiday bonuses and maintain nurseries for children of working mothers. A number of large concerns have introduced profit-sharing plans for both blue-collar and white-collar workers.

7.3 Termination of employment

Manufacturers are legally entitled to dismiss workers at will. The Employment Service must be notified about dismissals of more than ten workers. Collective agreements ordinarily provide that, after 6-12 months on the job, a worker, even when paid on a daily basis, may be fired only for special reasons and after consultation with the union. In unionised companies, the employer generally conducts advance negotiations with the unions.

Business requirements are increasingly accepted as the first consideration for dismissals, but seniority and workers' needs are taken into account. Disagreements are settled by "parity" grievance committees and, if required, arbitration boards. The law requires severance pay upon dismissal, upon retirement at the legal retirement age and in other specified circumstances. Severance is paid at the rate of one month of basic salary for every year of service or, for daily workers and for employment prior to 1993, 12 days' basic pay for every year of service. In practice, much higher amounts are often granted, especially in state-owned firms. Collective and some individual agreements provide for severance pay even when employees leave voluntarily. Severance pay for managers and professional workers is usually spelled out in their employment contracts.

7.4 Labour-management relations

In the past, trade-union membership covered about 80% of Israel's labour force, but this ratio has shrunk steadily. However, many more workers are signatories to collective employment agreements, which may include affiliation with unions. Nearly all unions are affiliated or co-operate closely with the Histadrut, the trade-union federation.

Public-sector unions still have considerable influence. Indeed, strikes staged by public-sector workers have affected many state-controlled companies, such as the telephone and electricity services, airports and hospitals.

In general, good working relations exist between firms and unions. Clauses stipulate that workers in the same company must belong to the union of that sector, if one exists. Thus workers tend to obey the decisions reached by their trade union, which, in turn, helps prevent wildcat strikes. Collective agreements usually cover a two-year period.

Co-operation between employees and employers is a fundamental element in the Israeli work system. Negotiations in the private sector are not usually prolonged or accompanied by crises. The salary conditions fixed in the national agreement serve as minimum levels, with separate negotiations held subsequently for each industrial sector, between the employers and the trade unions. When a strike does occur, companies may apply to a labour tribunal for an injunction against the strike.

Collective wage bargaining has been shifting steadily from the national level to industry and factory negotiations and from flat-rate wage hikes to those based on productivity gains. Other agreements (such as for pensions) tend to be on the national level. Collective agreements normally run for a two-year period starting 1 April (to coincide with the public-sector pacts).

When bargaining continues past the deadline, the new terms are usually made retroactive to 1 April. The agreement between labour and employers also includes measures to reduce absenteeism and determine dismissal arrangements, procedures to deduct union fees and set up joint-production councils, and methods to determine incentives pay and update output norms.

Arbitration may be imposed if it is specified in collective agreements, if either party to a dispute requests it or if the government thinks it advisable. There is usually a 15-day cooling-off period. Special labour courts deal with cases concerning interpretation of labour laws and existing collective agreements. The government has the right to appeal to labour courts for back-to-work orders for public services deemed "essential". Although the courts have traditionally been

reluctant to issue such orders, they have been instrumental in bringing the sides back to the negotiating table.

Relations are amicable between the Histadrut and the Manufacturers' Association (which includes state-controlled companies). The association's public position is that the Histadrut should be involved in any major economic discussions.

7.5 Employment of foreigners

Passports of travellers to Israel must be valid for at least six months after the period of intended stay and visitors must hold onward or return tickets and sufficient funds to cover the intended period of stay in Israel. No visas are required for visits of up to three months.

Foreign workers are only partially covered by labour rights. They are not allowed to join the Histadrut, but they are covered by the terms of collective agreements. Non-documented foreign workers are not entitled to the full benefits granted by the National Insurance Institution, including maternity leave. The National Health Insurance does not cover foreign workers; employers must cover their health insurance.

To reduce the number of foreign workers, the government introduced a series of measures. There is a NIS 500 fee per worker, which the employer pays when submitting a request for an employment licence, as well as a NIS 4,000 annual fee per employed foreign worker, or NIS 1,000 per employed worker in agriculture. In addition, the maximum fine for employing workers without employment permits is NIS 104,400. Officially, Israel imposes no limits on foreign managerial or technical personnel, but nonresidents need work permits from the Employment Service. Work permits, which ordinarily take several weeks to obtain, are not normally issued for more than one year but can be renewed. Residents of the Palestinian Authority and of the Occupied Territories working in Israel must have permits from the Employment Service.

8.0 Office locations

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