

PRIVATE INVESTMENT FUNDS IN ISRAEL

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Tags

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Encouragement of
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INTRODUCTION

The State of Israel has encouraged foreign investments in Israel for many years. One of its primary tools is the special tax regime applicable to private investment funds. Over the years, the Israeli Tax Authority (“I.T.A.”) has issued substantial guidance and numerous private rulings under Section 16A of the Income Tax Ordinance [New Version], 5721-1961 (the “Ordinance”) to private investment funds operating in Israel. In general, these rulings provide significant tax benefits to foreign investors and funds if certain conditions are met.

This article outlines various income tax arrangements that are applicable to private investment funds operating in Israel.¹ It is based predominantly on I.T.A. Income Tax Circulars 9/2018 and 10/2018 (the “Circulars”), which govern the taxation of venture capital funds and private equity funds operating in Israel. Note that limited partners holding more than 4% of the interests in a fund cannot control the entities managing the fund and cannot hold more than 10% of the general partner if they wish to enjoy the tax benefits described below.

At present, the special tax regime applicable to private investment funds is currently under review by the I.T.A. and the Israeli Ministry of Finance. Consequently, tax benefits that are available under the existing regime may be adjusted, and additional conditions may be added. It is generally understood that any changes to the regime likely will not affect existing tax arrangements for non-Israeli limited partners.

CONDITIONS FOR BENEFICIAL TAX ARRANGEMENT

A private equity fund or a venture capital fund must comply with the following conditions in order for a non-Israeli investor to be entitled to beneficial tax treatment:

- The fund must have at least 10 investors, each of whom is unrelated to the others, as of the closing of fund raising and throughout the lifespan of the fund.
- Investors in the fund may not hold more than 20% of the capital of the fund. However, the anchor investor may hold up to 35% of the capital of the fund.
- At least 30% of the investors in the fund must be non-Israeli investors.

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¹ This article does not address the application of value added tax to the fee charged for management services provided by the general partner.

- Throughout the duration of the fund, the total investment commitments must be at least U.S.\$10 million, of which at least U.S.\$5 million comes from non-Israeli investors.
- The fund may not invest in excess of 25% of the fund's total commitments (net of management fees) in any single company.
- The fund may not invest more than 20% of its total funds raised (after deduction of management fees) in companies whose securities are publicly traded.
- The fund may not hold short-term cash deposits or publicly traded securities, except if they originate from monies which investors transferred in accordance with their investment commitments in the fund, or if they originate from the realization of profits prior to their distribution or reinvestment.
- The fund must invest in "Qualifying Investments" in Israel equal to the lesser of the following amounts:
 - U.S.\$10 million in Qualifying Investments, of which at least U.S.\$6 million must be invested, directly or indirectly, in Israeli resident companies owning intellectual property that was developed in-house, or the non-Israeli parents of those companies.
 - At least 50% of the fund's total commitments is in Qualifying Investments, of which at least 30% of the fund's total commitments must be invested, directly or indirectly, in Israeli resident companies owning intellectual property developed in-house, or the non-Israeli parents of those companies.
- The fund must be managed by the general partner or by a person on its behalf. The limited partners may not take any role in identifying target companies or managing the portfolio companies, or in the day-to-day management of the fund, and shall not have any voting rights in the investment committee of the fund.
- The fund may be required to provide certain financial information to the I.T.A.
- Investors in the fund may be required to provide certain information to the fund or the I.T.A. in order to establish their right to enjoy the benefits of an I.T.A. ruling issued with respect to the fund.

The terms used in the above requirements have specific meaning.

- An investment is a Qualifying Investment if it relates to shares of an Israeli resident company or in the shares of an Israel affiliated company whose principal activity is a Qualifying Activity. Qualifying investments include venture capital investments. Investments in securities traded on a stock exchange will not be considered to be a Qualifying Investment unless the fund has held the shares for at least one year.
- An activity is a Qualifying Activity when it relates to the establishment or expansion of enterprises that are engaged in designated activities in Israel, such as (i) industry, (ii) agriculture, (iii) tourism, (iv) transportation, (v) construction other than real estate, (vi) water, (vii) energy, (viii) technology, (ix) communications, (x) computing, (xi) security, (xii) medicine, (xiii) biotechnology, (xiv)

nanotechnology, and (xiv) research and development related to the foregoing activities in Israel.

- A foreign company is an Israel Affiliated Company where its principal assets or activities are directly or indirectly located in Israel.
- Shares include stock options or warrants, convertible notes, and convertible bridge loans that are not secured by assets other than the technology or other assets of the target company.
- Venture capital investments are Qualifying Investments in the hi-tech sector, where at least 75% of the total investment relates to an initial issuance of shares.

THE BENEFICIAL TAX ARRANGEMENT

If all of the conditions listed above are met, the following will apply to the non-Israeli investors in the fund and in the general partner:

Tax Arrangement for Non-Israeli Limited Partners

- Any income derived from non-Israeli investments (*i.e.*, non-Israeli companies or non-Israeli Affiliated Companies) will be exempt from tax in Israel.
- Income derived from venture capital investments (*i.e.*, capital gains, dividends, and interest) will be exempt from tax in Israel.
- Income derived from Qualified Investments that are not venture capital investments will benefit from the following favorable tax-related provisions.
 - Income from the realization of Qualified Investments will be exempt.
 - Dividend income derived by individual investors directly or through an entity that is tax transparent in the home country of the individual will be subject to tax at the rate of 15%, unless a treaty applies.
 - Dividend income derived by corporate investors will be subject to tax at the corporate income tax rate (currently 23%) unless a treaty applies.
 - Dividend income derived by investors from a treaty jurisdiction are entitled to the tax rates set forth under the applicable treaty, subject to confirmation by the I.T.A. of tax residence and beneficial ownership by the investor.
 - Interest income will be subject to tax at the regular tax rates set forth in the Ordinance. Individual tax rates range between 15% and 50% depending on the nature of the interest. Corporations are taxed at a flat 23%.
 - Non-Israeli investors resident in a treaty jurisdiction are entitled to the tax rates set forth under the applicable treaty, subject to confirmation by the I.T.A. of tax residence and beneficial ownership by the investor.



- Any other income that is not covered above, including income from management fees received from portfolio companies, will be subject to the regular tax rates set forth in the Ordinance, which have been described above.
- Foreign investors in the fund will not be considered as tax residents of Israel and will not have filing obligations in Israel as a result of their investments in the fund.

Tax Arrangement for Non-Israeli Fund Managers

Once the fund qualifies for tax benefits, the general partner and the managers of the fund may be entitled to certain tax benefits. Again, the special tax regime applicable to private investment funds is currently under review by the I.T.A. and the Israeli Ministry of Finance. It is possible that tax benefits may be adjusted and additional conditions may be added.

Taxation of Carried Interests Held by Fund Managers

Carried interest income attributable to Israeli Investments will be subject to tax at the rate of 15% in the hands of non-Israeli fund managers. Carried interest income attributable to investments in foreign entities will not be subject to tax in Israel.

Non-Israeli general partners and fund managers resident in a treaty jurisdiction may be eligible for tax rates set forth under the applicable treaty, subject to confirmation of the recipient's tax residence and beneficial ownership by the I.T.A.

Taxation of Management Fees

Income derived from management fees will generally be subject to the regular tax rates as set forth in the Ordinance, which have been described above.

ALTERNATIVE TAX ARRANGEMENTS IF CONDITIONS ARE NOT MET

Over the years, the I.T.A. has also issued alternative tax arrangements for funds that do not meet the conditions listed above. Included are funds that have fewer than 10 unrelated investors, funds with commitments of less than U.S.\$10 million, funds in which the limited partners are involved in the management of the fund, and funds in which the general partner is a substantial investor.

Funds That Have Fewer Than 10 Investors

Here, the tax rules are as follows:

- Income from realizations of Qualifying Investments will be subject to 15% income tax in Israel.
- Income from interest and dividend payments that are derived from Qualifying Investments will be subject to tax at a rate of 15%, or a lower rate that applies under a tax treaty.

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- Other income that is not derived or accrued from Qualified Investments will be subject to the tax rates established in the Ordinance. As mentioned above, the rates for individuals range between 15% and 50%. The rate for corporations is 23%.
- Income derived from non-Israeli companies and non-Israel Affiliated Companies will be exempt.

Funds With Less Than U.S.\$10 million in Commitments

- A beneficial tax arrangement will be available to funds that are focused on making venture capital investments.
- Income from the realization of venture capital investments will be exempt from tax in Israel.
- Income from interest and dividend payments will be subject to the tax at the lesser of (i) the tax rates established in the Ordinance or (ii) a lower rate that applies under a tax treaty.

Non-Israeli Fund Investing in Israel Without Representation in Israel

- Generally, such a fund will enjoy the same tax benefits as enjoyed by non-Israeli limited partners, discussed above.
- Non-Israeli managers of the fund will be entitled to exemption from Israeli tax with regard to their carried interest and management fees.



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