

Things to consider when starting a business in Israel

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Starting a business in Israel is like riding a bicycle - you get used to it.

Moreover, the bureaucracy has decreased. The World Bank's web site has a comparison of various aspects of doing business in 175 countries in 2006. Israel scores quite well - 5th for protecting investors, 7th for getting credit, 13th for trading across borders and 15th for starting a business.

So what are the main factors to plan when starting a business in Israel? You should check this out with professional advisors in each country, but the items on your agenda will probably include the following:

- * Do you need a company in Israel?
- * If so, should it be a subsidiary or a branch of a non-Israeli company?
- * How to incorporate in Israel and register for tax purposes?
- * What monthly and annual tax filings are needed?
- * How much tax will there be on profits?
- * How to repatriate income?
- * What about any future exit?

Do you need a company in Israel? For most businesses, a company is the preferred way of doing business. A company generally has limited liability, which means the company can be sued to the extent of its capital and resources, but its shareholders generally cannot lose more than their investment in the company if they acted in good faith. Other possibilities include being self-employed, forming a partnership or even a limited partnership under Israeli or foreign law. Limited partnerships tend to be used mainly as passive investment fund vehicles to enable a group of foreign individual investors to credit Israeli taxes (or utilize any Israeli losses) for tax purposes in their home country.

If you decide on a company, should it be a subsidiary of a non-Israeli company? In the past, many Israeli hi-tech companies were formed as subsidiaries of a US (or other foreign) parent corporation. This was done mainly to avoid Israeli capital gains tax upon any exit at rates of up to 50% - around double the tax rate then prevailing in countries like the US, UK and Canada. All this has now changed and Israel offers passive foreign investors exemption from capital gains tax in most cases upon exit - see below.

Furthermore, the use of a US parent corporation is particularly problematic as the US may tax undistributed profits under complex provisions in Subpart F of the US Internal Revenue Code. To sum up, an Israeli parent company is usually fine from the tax perspective and can readily be taken public on stock exchanges in the US, London, Toronto, Frankfurt and elsewhere after meeting their normal listing requirements. And an Israeli company may enjoy tax breaks on its profits - see below.

It is possible to operate a business operation in Israel as a branch of a foreign corporation. In this way, it may be possible to avoid dividend withholding tax (up to 25%) in most cases, but company tax (see below) will still be payable on Israeli source profits. In practice, the Israeli Tax Authority may request to see the overseas accounting records of the foreign corporation to check how much income and expenses are allocable to its Israeli branch for company tax purposes. And a foreign company is not exempt from the Israeli statutory audit requirement. US investors occasionally use US LLCs with no other activity to conduct Israeli operations that do not qualify for Israeli tax breaks. In practice, most Israeli businesses tend to be conducted by an Israeli company as this is usually easier when dealing with Israeli suppliers, customers and banks.

How to incorporate in Israel and register for tax purposes? An Israeli lawyer is needed to help incorporate a company in Israel. The Israeli Companies Law, 1999, largely follows UK and US principles. Companies may be public or private. A private company must have at least one shareholder and one director. The issued share capital can be as little as one shekel (23 US cents). A public company is a company whose shares are traded on a stock exchange (in Israel or abroad) or have been offered to the public pursuant to a prospectus under the Securities Law and are held by the public. It

usually takes a day or two to incorporate an Israeli company. A foreign company must be registered at the Israeli Companies Registry as a foreign company if it has a place of business or an office for share transfers in Israel.

Separate registrations of a new business in Israel are needed for the purposes of (1) income tax (2) Value Added Tax (3) payroll and other withholding taxes (4) national insurance (social security). Such registrations are should be done at the local offices of the respective authorities or before starting the business - an old rule registration allowing three months after starting up was repealed in 2003.

Non-residents are required to appoint an Israeli tax representative and VAT representative if any part of their activities is conducted in Israel. The VAT representative is deemed to be the tax representative if no other tax representative is appointed. The tax representative is empowered to pay Israeli tax out of the foreign resident's assets.

What monthly and annual tax filings are needed? The Israeli tax year is normally the calendar year. However, subsidiaries of foreign publicly traded companies may sometimes be allowed to use a different fiscal year.

Companies are generally required to file audited annual tax returns and financial statements within five months after the end of their fiscal year, but extensions may be obtained. Israeli certified public accountants are usually allowed to spread the filing of the tax returns of their clientele over a period of up to 13 months after the tax year-end. COMPANIES ALSO must file monthly returns on account (bimonthly sometimes if the business is small) accompanied by tax payments. This applies to the following taxes:

- * Company tax installments, which are typically computed as a percentage of a company's monthly sales revenues.

- * Supplementary company tax installments with respect to certain non-deductible expenses (odfot).

- * Tax withheld from salaries and remittances to certain suppliers.
- * National insurance.
- * Value-added tax (VAT).

These filings and payments are made by the 15th day after the month end at a local post office or bank. If you are a few days late, a computer-generated penalty is usually issued. Detailed bookkeeping and invoice requirements are contained in the income tax and VAT regulations. In practice, most taxpayers use bookkeeping software packages approved by the Israeli Tax Authority. The books and returns should be in one of the official languages - Hebrew or Arabic. In practice, though, English is usually tolerated by most tax offices. The accounting records should be available for inspection in Israel by tax officials. Multinational groups wishing to use international online systems in English may do so if they obtain approval from their tax office.

What about payments for expenses? In the case of most domestic Israeli expenses, withholding tax rates of up to 50% are prescribed unless the recipient holds confirmation from the Israeli Tax Authority allowing a lower rate. In the case of remittances from Israel, the Israeli banks must withhold tax, generally at a rates of 25%-31%, unless the remittances relate to imported goods. A withholding tax exemption or a reduced withholding rate may be obtained from the payor's tax office in certain other cases, such as when a treaty applies or when the payments are for services that are rendered entirely abroad. Failure to withhold will result in a denial of the relevant expense and possible penalties.

How much Israeli tax will there be on profits? Self employed individuals pay income tax on taxable income at rates ranging from 10% to 49%, plus national insurance. National insurance rates range up to 16.23% on the first NIS 35,760 (\$8,300 approximately) of monthly income, but 52% of these national insurance payments are deductible for income tax purposes in the year they are paid, resulting in an effective combined maximum of 57.3%, decreasing to 49% beyond NIS 35,760 per month.

For companies, the regular rate of company tax is scheduled to decrease from 31% in 2006 to 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter. Subject to any tax treaty, the standard rate of dividend withholding tax in 2006 is 20% for shareholders who hold under 10% of the company and 25% for 10%-or-more "material shareholders." Consequently, in 2007, distributed profits will generally be taxable at 43.2%-46.75%.

Incentives in a nutshell: Lower tax rates apply to "Privileged Enterprises" and "Approved Enterprises" in the industrial, technology and hotel sectors, pursuant to the Law for The Encouragement of Capital Investments, 1959. A privileged enterprise owned by an Israeli company may elect a tax holiday package without obtaining approval if certain conditions are met. These conditions include the requirement that a minimum qualifying investment be made in fixed assets in industry or in a hotel in Israel within a three-year period. The tax holiday applies to undistributed profits for two to 15 years, depending on the location and foreign ownership. Low company tax rates of 10% to 25% apply to distributed and subsequent profits. The combined total benefit period for the tax holiday and low rates can range from seven to 15 years.

Approved enterprises in a development area may receive fixed asset grants of 20% to 32%. In addition, approved enterprises may benefit from low company tax rates of 10% to 25% for a period of seven to 15 years. Enterprises may be granted approval by the Investment Center until the end of 2007, unless this deadline is extended.

Dividend withholding tax is imposed at a reduced rate of 4% or 15%, depending on the package selected. As a result, the combined company and dividend tax rate ranges from 15.04% to 36.25%.

Large investments (NIS 600 million to NIS 900m. - approximately \$140m. to \$209m.) in privileged enterprises by large groups in certain areas of Israel may qualify for exemption from company tax for both retained and distributed profits, as well as for exemption from dividend withholding tax. To qualify as a large group, the groups must generate annual revenues exceeding NIS 13 billion to NIS 20b. (approximately \$3b. to \$4.6b.).

Research & development grants are available from the Office of the Chief Scientist at rates ranging from 20%-85%. R&D grants of 50%, usually, are alternatively available from a number of bilateral funds Israel has entered into - with the US, the UK, Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain, Sweden, Canada, Hong Kong, India, Korea (Rep.), China (People's Rep.), Australia, Singapore and Taiwan.

What about any future exit? With regard to capital gains, subject to any tax treaty, foreign residents are taxable on Israeli source "real" (inflation adjusted) capital gains at varying rates (individuals: 20%-49%; companies: 25%-31%).

NEVERTHELESS, FOREIGN residents not doing business in Israel may enjoy an exemption from Israeli capital gains tax (tax only in the investor's home country) in the case of:

- * Investments in Israeli securities made between July 2005 and December 2008 if the investors reside in a country that had a tax treaty with Israel during the 10 years before their investment and report it within 30 days to the Israeli Tax Authority.
- * Shares in a research-intensive company that were issued to the foreign resident investor on or after January 1, 2003.
- * Venture capital funds that obtained an advance tax ruling from the Israeli tax authorities.
- * Securities traded on the Tel Aviv Stock Exchange.
- * Securities of Israeli companies traded on a recognized foreign stock exchange.
- * Exemption under any applicable tax treaty (restricted to under-10% shareholders in the US-Israel tax treaty).

Exchange control - none since 1998! So, to sum up, Israel offers a reasonable tax climate but appropriate advice should be obtained in each country in specific cases.

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