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Israel

Israel Offers Tax Breaks on Venture, Private Equity Investments

By Matthew Kalman

The Israel Tax Authority published two circulars clarifying its policy on granting tax relief for venture capital and private equity investments in young technology companies, particularly for foreign investors.

The authority was criticized last year by the state comptroller, legislators, and the ministry of justice for a lack of consistency and transparency in handling tax exemption requests from investment funds.

Snapshot

- Circulars confirm exemptions for foreigners investing in young tech companies
- Question of whether tax authority overreached on mandate

“The Israeli high-tech industry has made a significant contribution to the growth, productivity and prosperity of the Israeli economy,” the authority said in Circular 9/2018 on venture capital funds, published March 14. “The ‘oxygen’ of the high-tech industry and especially of companies in the initial stages of their founding and development, comes mainly from venture capital funds through which large numbers of foreign investors are invested in Israeli industry.”

Investments through venture capital and private equity funds that qualify for the special status set out in the Encouragement of Capital Investments Law can claim exemption under the provisions of Section 16A of the Income Tax Ordinance, which until now has been granted on a case-by-case basis after discussion with the tax authority.

In November, Israel's state comptroller said that a series of exemptions granted by the Israel Tax Authority were illegal—including a one billion shekel ($287.5 million) tax exemption granted to Apax Partners LLP when it bought and sold Tnuva, Israel's largest dairy and former state monopoly.

After criticism from legislators, the deputy attorney general agreed, writing in December that “there was room for a clear regulation of the criteria and conditions for granting a refund or tax exemption.”

Benefits for Investors, Fund Managers

The venture fund circular and Circular 10/2018 on private equity funds confirm the authority's policy to grant a full tax exemption to foreigners investing through local venture or private equity funds in young high-tech companies as specified in the Encouragement of Capital Investments Law.

The circulars provide that the local managers don't constitute a “permanent establishment” in Israel and that gains on investments are therefore not taxable, said Henriette Fuchs, partner and chair of the international tax group at Pearl Cohen Zedek Latzer Baratz in Tel Aviv.

The circulars also explain the significant benefits for the Israeli fund managers, setting out the terms under which the carried interest they derive from an exit can be treated as a capital gain instead of part of their progressively taxed income. In addition, the circulars confirm the tax-exempt status in these investments by Israeli pension funds, provident funds and other special investors classified under Section 9 of the Income Tax Ordinance.

“It's wonderful,” said Fuchs told Bloomberg Tax March 19. “It's great that they are also thinking with the marketplace. The circular is looking to take a load and a tax risk off foreign investors who go into a fund that might be deemed as locally present and locally managed, and saying they are still going to get the exemption.”

“Israel wants to encourage these funds,” said Daniel Paserman, partner and head of tax at Gornitzky and Co. law firm in Tel Aviv. “They bring money from abroad. They contribute to all the startups and companies. For the Israeli economy, it's positive.”

Did Authority Exceed Mandate?

“I welcome them clarifying the policy. It's important that the policy will be clear and equal for all funds,” Paserman said by phone March 20. Transparency is better than the uncertainty and conflicting rulings based on whichever lawyer or tax official is handling the case, he said. “The main point is the foreign investors. If you want to encourage foreign investors, it's important to have clarity, that things are known.”

But the circulars may not have settled the matter, he said, because the tax authority could have overstepped its mandate by granting reduced tax rates under certain conditions of 15 percent on dividends, which are not tax-exempt, even for foreign investors.

“If you look at the Israeli tax ordinance, I'm not sure you have this tax rate. It's an issue whether the tax authority can give such a reduced tax rate or not. I'm not sure they have the authority. It's quite a challenge from the constitutional perspective, from the legal perspective. It's not so straightforward,” Paserman said.

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