ISRAEL – COUNTRY REPORT

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I. Introduction

The modern State of Israel is a small country, about the size of Belgium or the state of New Jersey. On the eve of the country's 57th Independence Day, Israel's population was 6.9 million, eight and a half times the country's population on the eve of the Declaration of Independence in 1948. Located on the eastern shore of the Mediterranean Sea, Israel is at the crossroads of Europe, Asia and Africa, and maintains important political and economic ties with North America. Although located in the Middle East, Israel is culturally a European country with a secular democratic government and a legal system based on Anglo-American traditions. Israel leads the Middle East region in gross domestic product, per-capita income, high-tech industry, technology transfer, and telecommunications.

The Israeli business scene is heavily based on international commercial activity. While Israel is not a 'tax shelter' in the same manner as the Cayman Islands, the Israeli government makes a strong effort to encourage foreign investment and trade. While locals face a heavy tax burden, Israel provides generous tax exemptions for new immigrants and foreign investors.

II. Banking

Israel maintains a modern computerized banking system. Most banks provide private banking services and keep special centers for tourists and foreign investors. The five large Israeli banks have branches and subsidiaries in Europe and the United States and representative offices in various other countries.

III. Law of Inheritance

Israeli inheritance law is generally governed by the Succession Law of 1965. It is the intent of this Law that matters of succession be governed, as far as possible, by the deceased's last will and testament. There is no limitation upon the right to bequeath and the Law does not mandate a specific portion to family members. It does, however, protect the surviving spouse (as long as he or she remains single), children and dependent parents, by providing for maintenance payments from the estate. Israeli courts have jurisdiction over people who, at the time of death, were domiciled or left assets in Israel. A person can inherit either under a will or by law where no valid will exist.

IV. Law of Trust

The trust institution has been recognized under the Israeli legal system since the 1920s. The enactment in 1923 of the Charitable Trusts Ordinance set the rules for a public trust. The private trust, on the other hand, was not regulated by statute until 1979, when the Trust Law was enacted. Nevertheless, the Supreme Court held that the concept of trust existed in Israel even prior to that date. After the enactment of the Trust Law, the courts no longer needed to rely on foreign laws, which formed the basis for the recognition of the trust before 1979. However, there remains a strong connection between the Israeli and Anglo-American systems in this field and a great resemblance between the trust institutions of these legal systems.

An Israeli trust has several specific features. The trustee is endowed with control over the assets, although there are no particular conditions as to the manner of control. A common means of control is acquired through title to the trust assets passing to the trustee. The trustee may, however, be vested with control over the assets by being empowered to deal with them, whether as an agent or otherwise. A trustee is deemed to have control if he can, by his acts, affect the way in which the trust assets will be dealt, whether they are distributed, invested, or exchanged for other assets. The trustee must exercise his control over the assets for the attainment of the purpose of the trust. A trust will be valid and enforceable where there is a definite beneficiary. It will also be valid where there is no definite beneficiary, as long as there is some purpose to the trust.

One peculiar feature of the Trust law is that it does not permit skipping generations, i.e. one cannot create a trust that will survive the life beneficiary for the benefit of his successor and a valid will and probate will be required.

V. Taxation

The subject of taxation in Israel is very complex. The following describes a few aspects of taxation which are relevant to foreign investors.

Tax System

Israel, in general, imposes tax on Israel source income, that is, income accruing in or derived from Israel, (the “territorial basis”). This general principle is applicable to both resident and non-resident persons. Residents are also subject to tax on their world wide income
Companies in Israel are generally subject to company tax on their profits, at the rate of 34% on taxable income (to be reduced to 31% in 2006, 29% in 2007, 27% in 2008, 26% in 2009 until it will reach 25% in 2010). Distributed profits after company tax are subject to dividend withholding tax at rates of up to 25% in the case of individual and non-resident shareholders Interest and royalties are also generally liable to

withholding tax of 25% unless reduced by a tax treaty (starting January 1st 2006 the rates will be 20% for a share holder who is not considered a "substantial shares holder"). Lower tax rates and other benefits are applicable under Israel's investment incentive legislation.

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Israeli Tax Reforms

On July 24th 2002, the Israeli Knesset (Parliament) passed the Law for the Amendment of the Income Tax Ordinance. Until the end of 2002 the Israeli tax system was based on the territorial principle, i.e., income liable for tax in Israel was income that was "accrued" or "received" in Israel. The new legislation set the principle of personal global taxation which determines tax liability for an Israeli resident, whether the income is accrued or received in Israel or abroad. The new Tax rules became effective on January 1st 2003. In August 10th 2004 another "minireform" was legislated. It will become effective in January 1st 2006. This minireform deals with taxation of trusts, Underlying companies, pre ruling, participation exemptions, exemption for foreign residents from tax on capital gains from the sell of shares, establishment of Real Estate Investment Trusts in Israel, and more. The minireform also decreases the tax rates on individuals and companies on various types of incomes.

Foreign Residents

Foreign residents enjoy a range of tax benefits such as the law for encouragement of capital investment, exemptions for trusts, participation exemption and more, all aimed to attract foreign investors. Foreign residents who are not resident in Israel or are not doing business in Israel, will in principle, continue to enjoy a range of exemptions which cover income from passive investments in Israeli banks. However, foreign residents will be subject to tax on capital gains derived from Israeli assets, except for gains in stock market equities and sale of shares of private Israeli company and provided other conditions are fulfilled.

Israeli Residents

In principle, the purpose of the 2002 reform was to reduce the personal tax rates, including social security payments, from a maximum rate of about 60% to a lower rate of 49% including social security payments.

Israeli residents, on the other hand, will pay tax on worldwide income, even if the income is received from assets located abroad, and even if the funds received overseas are not transferred to Israel.

The change to personal taxation in Israel includes stock exchange taxation, which was previously exempt.

Other taxes

Value Added Tax (VAT) is generally imposed on transactions conducted in Israel, as well as on transactions relating to assets or activities in Israel and imports. The standard rate of VAT in Israel is currently 16.5%, but exports are generally zero-rated. Special provisions apply to financial institutions and non-profit bodies.

Israel has no inheritance or gift tax.

Double Taxation Relief

Israel is a party to almost 40 double taxation treaties. The foreign investor who takes advantage of double taxation treaties can often withdraw profits earned in Israel under favorable tax treatment. Where a taxpayer is taxable both in Israel and abroad in respect of the same income, double taxation relief may be available either in accordance with a bilateral tax treaty (convention) or, in certain cases, unilaterally. In general, double taxation relief may take the form of a credit for overseas taxes (the credit method). Many of Israel's tax treaties allow investors to take a full foreign tax credit, even if the rate has been reduced in Israel, as an investment incentive under the Encouragement of Capital Investments Law. This is known as "tax sparing" relief.

Alternatively, double tax relief may take the form of an exemption in the source country where income or gains arise, or in the taxpayer's country of fiscal residency (the "exemption method" of double tax relief). In all cases, reference should be made to individual treaties (where applicable) and to local legislation to ascertain the exact details of the double taxation relief afforded and the conditions attaching thereto.

VII. Conclusion

Israel is a small and young country yet it has a strong economy, a modern banking system, an educated population and laws aimed at attracting foreign investors. The Israeli tax system has undergone a complete overhaul in the past few years, most recently, the taxation of trusts. This taxation of trusts law is intended to close certain lacunas with respect to Israeli residents but to maintain Israel's policy of providing certain benefits to foreign residents. Further, the underlying company may be advantageous to certain foreign residents as an investment vehicle for income derived from sources outside Israel. Israel may be the right venue for certain foreign residents to form their financial planning center. It is important for each prospective investor to consult with Israeli professionals prior to commencing any activities in Israel as each set of facts should be reviewed separately. This article provides a general overview only, is not intended to provide legal advice to any party and therefore should not be relied upon without independent professional advice.

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