This book was prepared by Kost, Forer & Gabbay, the Israeli member firm of Ernst & Young International. The book was written to give the busy executive an overview of the investment incentives, taxation, and business practices in Israel. Making decisions about foreign operations is a complex process. It requires an intimate knowledge of a country's commercial climate, laws and regulations. Companies doing business in Israel - or planning to do so - are well advised to obtain current and detailed information from experienced professionals. In particular, readers should note that a proposed tax reform package is expected to emerge soon. For details of the reform proposals, please see the chapter "Proposed Tax Reform in Israel." This book reflects information current at December 1, 2000.

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Foreword

The years 1999 and early 2000 were characterized by increasing efforts to push forward the Middle East peace process. The Israeli government has made a continuous effort to obtain an overall settlement with the Palestinians, and to narrow the gap between the parties' opposing positions. As for Syria, a series of high-level meetings between the two countries took place during the winter of 1999/2000 and though unfruitful, they leave room for hope that an Israeli-Syrian peace treaty may be concluded in the future. Meanwhile, Israel has withdrawn its forces in a unilateral action from the "security zone" in the South of Lebanon, resulting in a somewhat tense but steady and ongoing tranquility in the country's Northern border.

Although these difficulties are expected to continue in the future, support from the international community reinforces the impression that the Middle-East Peace Process will continue.

Israel continues to experience substantially increased interest on part of foreign investors, including multinational business concerns, in various fields in the economy. Investors from Europe, the USA and Asia, continue to express their faith, and actively pursue the possibility of investing for profit in the Israeli economy.

Venture Capital Funds have become an increasingly important participant in Israeli economy in the past few years. Some 60 Israeli VC Funds and some 20 representatives of foreign VC Funds have operated in Israel in the past few years. However, most of the investors in the Israeli VC Funds are, in fact, also foreign, and thus, they constitute another, significant vehicle through which foreign investors participate in the Israeli economy.

Due to the advanced level of research and development in many areas of technology and the incentives offered by the government in this area, a growing number of large concerns continue to acquire or merge with Israeli hi-tech companies. The unprecedented prices paid by large concerns in recent acquisitions of hi-tech companies established by Israeli entrepreneurs have stimulated the entire hi-tech industry in Israel, encouraging many new enterprises and boosting salaries in the hi-tech sector of the Israeli work force.

The advanced level of research and development is also reflected by a growing interest by Japanese and other Asia-Pacific region concerns who are now exploring the possibility of investing in the Israeli economy, following the U.S concerns that have been particularly prominent in maintaining Israeli research centers.

In respect to other aspects of the economy, the consumer price index (CPI) rose 1.3% in 1999, which is the lowest inflation rate in three decades, while the growth rate in that year was a modest 2%. However, the growth rate is expected to continue the trend it started in the second part of 1999 and reach an annual growth rate of 4.5% in the year 2000.

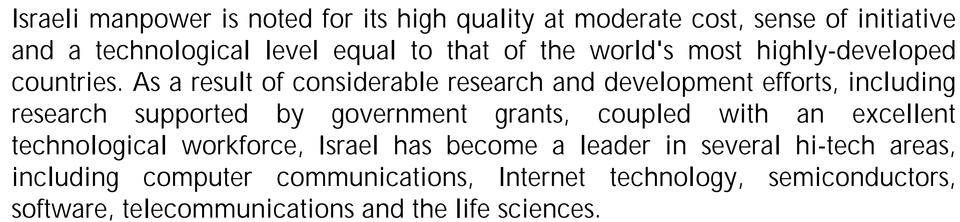
During 1999, exports rose by 9.4%, while software exports increased by 30% in dollar terms, which reflects Israel's increasing technological comparative advantage. On the other hand, imports, excluding imports of ships, planes and diamonds, increased by 4.5%, most of which derived from the import of capital goods.

One of the most noticeable expressions of faith in Israeli economy was the improvement in the credit rank of the State of Israel defined by Moody's analysts based on the improvement in the economic scenario and the ongoing peace process. A corresponding improvement in the analysis of risk factors in Israel was published in Standard & Poor's recent analysis. The credit rate of Moody's has improved from an "A-" to an "A", and the Standard & Poor's rank was reconfirmed as an "A-".

In addition, international agreements concluded in recent years continue to yield benefits for the Israeli economy. Among others, these agreements include:

- Agreements with the European Union, the United States, Canada and the European EFTA group of countries put the State of Israel in the unique position of being a Free-Trade Area Partner with world's main economic powers.
- Treaties for the prevention of foreign taxation with most leading nations in the global economy, including the United States, Canada, Mexico, Japan, China, India, South Africa, The United Kingdom, Italy, France, other Western and Eastern European countries, and other significant Southeast Asian countries. More tax treaties are under negotiations. In addition, Israel broadened its trade relations with countries in the Asia-Pacific region, especially with Japan, Korea, and India.

The Israeli economy is characterized by modern industry, based on local research and development at the highest scientific levels, intensive activity in all areas of foreign trade, and a well-developed money market.



Israeli manpower is noted for its high quality at moderate cost, sense of initiative and a technological level equal to that of the world's most highly-developed countries. As a result of considerable research and development efforts, including research supported by government grants, coupled with an excellent technological workforce, Israel has become a leader in several hi-tech areas, including computer communications, Internet technology, semiconductors, software, telecommunications and the life sciences.

Government policy includes incentives for investment. In particular, there are substantial grants for research and development projects, as well as participation in training factory employees, and grants to finance overseas marketing efforts. Accordingly, zero or low rates of corporate tax (10%-25%) are possible in the case of Approved Enterprises and Approved Properties as discussed later in this publication.

The combination of the above benefits, as well as a possible exemption for foreign investors from capital gains tax in excess of the rate imposed on them in their home countries, represents an attractive "basket" of benefits for foreign investors.
Indeed, under certain circumstances, the overall tax burden (both in Israel and in the United States) on an individual American investor who invests in an enterprise in Israel, can be less than the tax burden on investments within the U.S. In addition, the broad range of possibilities offered by tax treaties between Israel and European countries, especially through exemption and tax sparing clauses, can also produce a substantial reduction in the overall tax burden for European investors in projects qualifying for Israeli tax incentives.

In summary, Israel's free trade agreements and advanced technological base, together with the broad range of incentives in the form of tax benefits, grants, and other incentives represent a combination which is both beneficial and attractive to the foreign investor.

Israeli Tax Reform

On May 4, 2000, the Public Commission published extensive proposals in Israel for the Reform of Income Tax, known as the Ben-Basat Commission. A draft bill reflecting the Commission's proposals was published on July 26, 2000.

In principal the proposals deal with the taxation of capital markets, real estate and international transactions and investment.

If passed, the measures will take effect in phases starting on May 4, 2000, but principally on January 1, 2001.

Proposed measures include a uniform rate of capital gains tax for individuals, an estate and gift tax of 10%, and a move to taxation of all worldwide income for Israeli residents. In addition, incentives and stock option tax rules will be amended.

The tax reform Bill is currently undergoing a process of public debate and review by the Israeli tax authorities. Therefore, readers are strongly advised to monitor the progress of the of tax reform process in Israel.

For further details regarding the proposed tax reform, please see the chapter entitled "Proposed Tax Reform in Israel".

The Israeli Economy

General

The years 1999-2000 are characterized by a number of major developments:

- The economy grew modestly at an annual rate of 2%. Following a decrease in the annualized rate of 4.1% during the first quarter of 1999, the following 15 months to June 2000 saw an annualized growth rate of 5.6%.

- The turnaround in the economy, indicating a sharp cyclical change from a recession in the years 1996-1998 that was reflected by a more rapid growth in exports, non-housing investment and private consumption.

- While the government's inflation target for 1999 was 4%, actual inflation was only 1.3%, partly as a result of an appreciation of the shekel since the end of 1998. In the 12 months to August 2000, the inflation rate stood at 1.0%.

- Exports rose by 9.4% in 1999. while imports, excluding ships, planes and diamonds, increased by 4.5%, most of which derived from the import of capital goods. The balance-of-payments current account deficit totaled USD$1.7 billion (or 1.7% of GDP), in 1999 and USD$ 1.5 billion in the 12 months to June 2000.

- Exports by the communications and scientific medical equipment industries that account for a quarter of non-diamond industrial exports rose by 13% in dollar terms in 1999, compared with 1998. Software exports increased by 30% in dollar terms, which reflects Israel's increasing technological comparative advantage. This trend continued in 2000.

- Despite the economic recovery in the second half of the year, the rate of unemployment increased from 8.5% in 1998 to around 9% in 1999.

This chapter briefly reviews the Israeli economy in 1999, and developments in 2000.

Inflation and Exchange Rate

The inflation rate in 1999 was the lowest since 1967 and amounted to only 1.3%. The dominant contributing factor was the appreciation of the shekel, principally in the first quarter of 1999. Another major factor was the recession and the rise in the rate of unemployment, which had the effect of restraining demand. The exposure of the economy to Third World countries, which reduced the costs of imports and a continued decrease in raw material prices, were additional factors.

During the first quarter of 1999 the shekel appreciated by 3% against the dollar and by 5.5% against the basket of currencies, consisting of the Deutsche Mark, Swiss franc, British pound, U.S. dollar and Japanese yen. During the second and third quarters the appreciation of the shekel ceased, only to be followed by a 2.9% appreciation against the dollar and 4.1% against the basket of currencies, as a result of the resumption of peace negotiations with Syria. During the whole of 1999, the shekel appreciated by 0.2% against the dollar and by 3.2 against the basket of currencies.

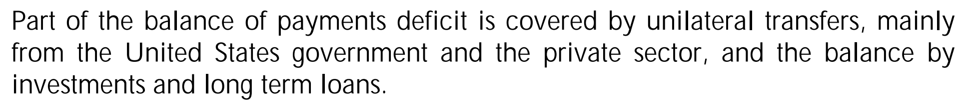
Although the rise in the Consumer Price Index during 1999 was similar to that in Western European countries and half that of the United States, it is still too early to establish that the level of inflation in Israel is consistent with the level in those counties. The high rate of depreciation in 1998 affected the growth of inflation in 1999 - if, as a result, we take the years 1998-1999 as a single unit we obtain an average inflation rate of 5%. Nevertheless the year-on-year inflation rate stood at 1.0% in August 2000, growing grounds for cautions optimism.

Balance of Payments

The recovery in worldwide economic activity during 1999 was also reflected in the balance of payments. The balance-of-payments current account deficit totaled USD$1.7 billion or 1.7% of GDP.

Israel's net external debt amounted to USD$10.9 billion at the end of the third quarter of 1999, compared with USD$13.1 billion the prior year. The debt has been falling since 1985, from 80% of GDP to the 1999 level of approximately 12%.

The primary reasons for the decrease in debt are budgetary discipline, a real decline in the dollar exchange rate relative to the Shekel and the impressive increase in direct foreign investment in Israel. In 1999, this investment totaled USD$2.3 billion compared with USD$1.8 billion in the whole of 1998.



Part of the balance of payments deficit is covered by unilateral transfers, mainly from the United States government and the private sector, and the balance by investments and long term loans.

Israel's foreign reserves stood at US$ 22 billion as of July 2000, virtually unchanged since a year prior to then.

Foreign Trade

Israel's dealings in foreign trade represent a significant part of the country's economic activities. Exports from Israel mainly comprise of communication equipment, electronics, chemicals, machines, diamonds, textiles and clothing, plastics, and processed and agricultural foodstuffs. Exports of goods during 1999 grew by 9.4% compared with the same period in 1996.

Exports by the high tech sector of the economy are continuing to grow, led by software exports, which increased by 30%. The growth in exports in this sector has in recent years benefited from the appreciation of the shekel as well as periodically reduced or frozen level of export prices.

In the area of service exports, exports of tourism services rose by 7.5% in 1999 reflecting an improvement in the geopolitical climate, and millenium events.

Imports of goods and services grew by 14.3% in 1999. However, excluding ships, planes and diamonds, the increase amounted to only 4.5%, the majority of which was derived from imports of capital goods.

Industry in Israel

The Government's strategy for Israel's economic development is based upon continuous industrial development, particularly in those sectors which are both sophisticated and export-oriented.

In the year to June 2000, Israeli gross domestic product grew by 5.6% and industrial production grew successfully by 10.6%.

Among the various sectors of Israeli industry, the ones which are particularly outstanding are those based on advanced technological know-how, such as electronics, communications, software, chemicals and pharmaceuticals. Indeed, the focus of Israel's industrial development is on the sectors that are characterized by high levels of investment in Research & Development and have all the inherent advantages of a workforce with highly advanced technological capabilities.

The industrial development, which has taken place over the last decade, is largely based on original research and development, and this has begun to play an increasingly important role in modern Israeli industrial practice. Israel is reportedly the fourth most creative country technically after the United States, Finland and Singapore (the latter being a successful importer of technology).

In 1999 the Israeli venture capital industry showed a remarkable increase committing a record of USD$1.5 billion to venture capital, marking a 69% increase over 1998 levels. The total investment of Israeli venture capitalists reached USD$439 million, an increase of 32% from the previous year's figures.

The capital raised by these funds was in tandem to the emergence of hundreds of high-tech companies, which were backed by the Office of the Chief Scientist at the Ministry of Industry and Trade during the past few years, from the seed stage through the final stage of technological development.

Construction and Infrastructure

Housing construction activity continued to decline in 1999 for the third consecutive year. The slowdown is attributable to the adjustment of investment to demand. During the first half of the 1990s investment in housing construction doubled in response to the upsurge in demand created by the wave of mass immigration.

The lower level of immigration during the last couple of years has reduced the demand alongside a high price level. The number of housing starts in 1999 is estimated at 38,000 units compared with 71,000 in 1995. The number of housing units under construction fell from 103,000 in 1996 to 76,000 in 1999.

Investment in fixed assets increased by 1.5% in 1999, following two years of an average annual decrease of 3%.

Employment in Israel

During the early 1990s, Israel succeeded in absorbing a substantial wave of new immigrants and integrating them into the economy, without creating significant unemployment. The high proportion of academic, technical and professional personnel among the immigrants who arrived in recent years, has resulted in the Israeli workforce becoming one of the world's most highly educated, with the proportion of academically trained personnel representing around 14% - 15% of the entire population. However, the signs of a slowdown in the economy have been plainly evident in the labor market in the past year, from the unchanged

number of employees, the rise in the number of unemployed persons and the increase in the rate of unemployment.

Despite the recovery in economic activity that was recorded in the second half of 1999 and into 2000, the annual rate of unemployment has hovered around 9% in comparison with 8.5% in 1998. The number of job seekers registered at the Employment Service Offices rose by over 10,000 in 1999 and totaled in 158,000 job seekers in 1999. During 1999 the average number of job seekers increased by 2.2% in comparison with 1998. In the first quarter of 2000 there were 163,000 job seekers.

The unemployment rate among new immigrants, who account for 17% of the civilian labor force, is higher than the rate among veteran residents in Israel. During the first nine months of 1999, the average rate of unemployment among immigrants amounted to 11.5%, the same as in 1998. The percentage of unemployed immigrants is inversely proportional to the number of years they have lived in Israel. Within Israel itself, there is a trend amongst immigrants towards migration to the center of the country, whereas employment opportunities are greater in the peripheral areas.

The Capital and Money Markets

Developments in the capital and money markets during 1999 were affected by the more austere policy of restraint adopted by the Bank of Israel.

The interest rate on the monetary tender was cut from 13.5% in January 1999 to 11.2% in December. Inflation expectations for the coming year fell from 6% at the beginning of the 1999 to 2% at the end of the year. Actual inflation amounted to only 1.3%, with the result that the effective retroactive real interest rate exceeded 11%.

The high degree of volatility in the inflation rate is complicating the Bank of Israel's management of monetary policy. A fine-tuning of the interest rate is very difficult to achieve under the prevailing conditions in the Israeli economy. It is also necessary to maintain some degree of difference between the shekel interest rate and the interest rate abroad. The potential for cutting the interest rate is limited by this difficulty. The current interest rate differential of 5.5% against the dollar is likely to contract when the expectations of an interest rate hike in the US and an interest cut in Israel are realized.

Between 1995-98, the proportion of foreign currency credit to total credit increased from 18% to 30%. This trend ceased in 1999 due to the large depreciation of the shekel at the end of 1998, and the business sector's internalization of the risk inherent in foreign currency credit.

Credit in the economy climbed by 10.3% in 1999. The rate of increase was similar in all linkage segments (unlinked, CPI-indexed and foreign currency).

The Tel Aviv 100 Index experienced gains of 60.4% during 1999, whilst the Yeter Index of shares and convertibles went up by 70.9%. Daily turnover in the equity market rose to an average of NIS 296.3 million in 1999 from 192.1 million in 1998.

Unlinked bonds rose by a nominal rate of 13.8% in 1999. Fixed-rate bonds benefited from a fall in yields and rose by 14.4%.The average yield-to-maturity on CPI-linked bonds in 1999 reached its highest level since 1985 with 6% for the short term of a year and 5.1% for the long term of ten years. Dollar-linked bonds also rose marginally by 4% due to the unchanged level of the shekel-dollar exchange rate and the increase in yields-to-maturity.

Government Economic Policy

No major changes have taken place over the past few years in the general economic policy of the Israeli government, and the underlying policy principles - detailed below - remain the same. These policy principles include:

- Decreasing the inflation rate;
- Exposing industrial products to competition from abroad;
- Liberalizing the capital and foreign currency markets;
- Encouraging inward foreign investment;
- Providing incentives for investment;
- Supporting export development through research grants and grants for expanding overseas marketing networks;
- Privatizing government-owned companies.

Economic Forecast for 2000

The main parameters published by economists as a forecast for 2000 are as follows:

- The growth trend will continue with an expected annual growth rate of 5%;
- Private consumption will grow by about 5%, retained by a relatively high level of unemployment;
- Exports are expected to grow by 8% in real term compared with 7.4% in 1999;

- The rate of growth in imports is expected to fall to 6% in 2000;
- Investment in fixed assets is expected to grow by 2.5% in 2000 compared with 1.5% in 1999 due to a stabilization in construction activities;
- The deficit will be similar to that of USD$1.6 billion in 1999;
- Direct foreign investment is expected to remain at its current high level of USD$3 billion;
- The inflation rate is expected to be at 3.5% in 2000, and the government's inflation target for 2000 and 2001 has been set at 3-4% ;
- Monetary interest rate is expected to fall by 9-9.5% at the end of 2000;
- The shekel will depreciate by 4% against the currency basket by the end of 2000, but is not expected to depreciate against the dollar.

Future Outlook

The factors that caused the shekel to strengthen during 1999 are continuing to exert an influence in 2000. The balance of payments situation is good: the current account deficit is low and direct foreign investments are increasing from year to year, and now actually exceed the level of the current account deficit. Although they are declining, the interest rate differentials between Israel and abroad are still strengthening the shekel, leading to stability in the shekel-dollar exchange rate.

The year 2000 budget's main objective is an increased level of economic activity. The need to adhere to a GDP deficit target of 2.5% will not present a problem, since government revenues are expected to increase due to the economic recovery and enhanced enforcement . The rate of unemployment is also expected to be steady in 2000 in view of the 5% growth rate forecast. Increased government investment in infrastructure could contribute to more rapid growth and to an improvement in the allocation of resources within the economy. Although the total expenditure framework is expected to be rigid, changes may stem from a peace agreement with the Palestinians, as was the case with the recent withdrawal from Lebanon.

Exports of goods and services will experience a continued positive effect from the resumption of worldwide growth as a result of a cyclical turnaround, which will accelerate the trade volume growth.

Israeli monetary policy has been highly restrictive for a number of years with the aim of reaching low inflation levels close to European levels by cooling the economy and preventing a depreciation of the shekel. In order to achieve the government's inflation target for 2000 of 3-4%, a measured reduction in the interest rate will be necessary. Nonetheless, in view of the Bank of Israel's natural tendency to pursue a conservative course, the interest rate may actually be cut gradually and marginally. This would result in inflation remaining lower than its targeted level.

The Public Committee for Income Tax Reform, the so called Ben-Basat committee, made recommendations in May 2000 intended to reduce the tax burden for middle-income groups which included provisions for the taxation of corporate and individual capital market income. Due to the fact that the Committee's recommendations have not received parliamentary approval so far in the Knesset, it is unlikely that they will exert any influence in the near future.

Investment Incentives under the Law for the Encouragement of Capital Investments

General

Introduction

The Law for the Encouragement of Capital Investments, 1959, aims to assist in the development of Israel's manufacturing base, in the efficient exploitation of Israel's resources and in the realization of the country's full economic potential through the encouragement of economic enterprise and the attraction of local and international capital investors to the Israeli market.

The Law additionally contributes to improving the nation's balance of payments through the reduction of imports and expanded exports. It also assists in the absorption of immigration, the efficient regional dispersion of the population and the creation of new sources of employment. For the purpose of realizing these objectives, the Law offers benefits to both companies and their investors in the form of various tax incentives, and grants.

The principal eligibility criteria for receiving the said benefits are: international demand, high local added value, marketing capability, technological innovation and the creation of new sources of employment.

The Investment Center at the Ministry of Industry and Trade is supervised by a Director and a Board, who possess discretionary powers to grant approvals to proposed enterprises, handle appeals and advise the government. Such powers are subject to periodic renewal.

Types of "approved programs"

Once the program is approved in part or entirely, it will be categorized and dealt with according to one of the following classifications:

a. Approved Enterprise(or "approved equipment leasing enterprise")- for a new enterprise or an expansion program for an existing enterprise or part thereof;

b. "Approved property" - for an investment in all or part of an approved real property by a foreign resident with foreign currency;

c. "Approved investment" or "approved loan" - for investments in the equity of a company or loans given for a period of at least seven years - see later section.

Approval of approved enterprise program

In order to apply for approved enterprise status for the purpose of enjoying the benefits offered by the Law, a proposed investment program must be submitted to the Investment Center for approval. The program should provide details regarding the investment, sources of finance, the financial and marketing capability of the company, and so forth.

After analyzing the application, the Board of the Investment Center reviews the data and the investment having regard to broader considerations. These may include the overall utility to the economy, creation of new sources of employment and the contribution to the development of national priority regions. It should be noted that these particular considerations are sometimes subject to change in accordance with government policy and national budget constraints. It is, therefore, advisable to inquire about the relevant considerations prior to submitting the application.

If the investment program is approved in principle by the Board of the Investment Center it becomes an "approved program" and the investor receives a "letter of approval". The Board of the Investment Center may place certain conditions on the validity of the approval; any such preconditions will be specified in the letter of approval.

Only investments that are made subsequent to the date of receipt of an application to the Investment Center may constitute a part of the approved program (if approved).

Thereafter, the approved program is implemented i.e., the investment in plant proceeds.

Therefore, the Investment Center approval process consists of two distinct stages:

Stage one:

Approval in principle of the proposed program as outlined above. This is set forth in the letter of approval, citing details of the proposed undertaking and the initial preconditions of the Board.

Stage two:

Approval of the subsequent implementation of the proposal and related investments. This occurs after a thorough review of the implementation by the Investment Center. The approval of the second stage may conceivably entail restrictions and conditions.

Supplements and expansions

Supplements to the letter of approval constitute an expansion of the amount of the originally-approved investment and are treated as part of the existing letter of approval.

There are several supplement possibilities:

1. Supplements following price increases - These do not alter the content of the program's assets but rather reflect the increase in market prices of the assets included in the approved program, over time. Supplements following price increases may originate from fluctuations in the exchange rate or the Consumer Price Index, as well as from an increase in real terms in asset prices.

2. Supplements not originating from price increases - These reflect an additional investment in assets and serve to increase the total assets within the framework of the approved program.

Approval criteria for supplements: The following are the Board's principal approval criteria in deciding whether to approve supplements to an existing letter of approval, rather than require an application for an expansion program, as detailed below:

1. The total amount of the supplement is inconsequential in relation to the letter of approval.

2. The application concerns a supplement that is complementary to the existing program in terms of the product and/or technology, etc.

3. A short time has elapsed since the approval of the original program.

4. The new application concerns a plant that will be created within the grounds of the approved enterprise or in proximity to it.

Expansions

An expansion of the plant will be considered as a separate and independent approved program. The application process is similar to the process when setting up a new plant.

Expansion Program Criteria: The following are the Board's principal approval criteria for approved enterprise expansion programs:

1. The investment will result in a considerable increase in output, both in financial and in quantitative terms (an increase of at least 20% in real terms is normally required).
2. An investment in the production line of a new product will be recognized as an expansion program, provided that it is expected to result in a growth in output of at least 10% in real terms.
3. The new application concerns production lines for new products, a new area of investment or a new technology.
4. A final date of operation has already been set with respect to the existing program, or a final implementation report has been submitted.
5. A long time has elapsed since the approval of the original program.
6. The new application concerns a plant in a new location.

Ownership of an "approved enterprise"

An Approved Enterprisemust be owned by one of the following:

a. An Israeli company;
b. A foreign incorporated company registered at the Israeli Companies Registry under the Companies Ordinance;
c. An Israeli partnership;
d. A partnership registered as a foreign limited partnership, in which all the Israeli partners are entities;
e. A partnership in which all partners are entities, as set out in a. - d. above;
f. Anyone else approved by the Board of the Investment Center.

An approved enterprise must be at least 30% equity - financed, as discussed below in the section on Criteria and Procedures for Receiving Approval.

National Priority (Development) Regions

Boundaries of the National Priority Regions (also known as Development Regions) are determined by the Ministers, with the authorization of the Knesset Finance Committee. In exceptional circumstances a more beneficial priority region status may be granted to a project in a region of lower classification.

National Priority Regions, as determined for the purpose of encouraging investments in industry, are separate from those regions designated for the encouragement of investments in the tourism industry.

Region A:

Upper Galilee, the Golan Heights, the Jordan Valley, the Bet Shean Valley, and the Southern Negev, and also a number of Industrial Regions in Lower Galilee, Yoqneam, Carmiel, Afula and Atarot (near Jerusalem). It should be taken into account, that some of the above mentioned towns and geographical regions, are defined as "temporary" national priority regions, a status which is extended periodically.

In addition, Jerusalem will be considered as Region A with respect to science and technology-based or skill intensive enterprises.

Region B:

Lower Galilee and the Northern Negev, as well as Or Akiva and Ashkelon.

See attached map below. Please note the National Priority Regions are indicative only as revisions occur periodically.

National Priority Regions in Israel

Miscellaneous general aspects

a. Unless otherwise stated, the program must be implemented within two years after the date of the "letter of approval" Usually, if the company invests at least 40% of the overall program by the end of these two years, an extension will be granted for an additional year, subject to the approval of the Investment Center.

b. Investments made after the application for approved enterprise status is submitted, but before approval is granted, will generally be included within the scope of the approved program.

c. Any material change in the contents of a program exceeding 10% of the "approved program" will require the approval of the Investment Center.

d. Equity investment is to be effected during the implementation of the project as needed, and not at the end.

e. The "approved program" will generally relate to investments in new equipment and buildings, only. However, in special cases the Investment Center may also approve investment in used equipment e.g., essential existing equipment imported from abroad.

f. The conditions and obligations of the enterprise as set forth in the "letter of approval" will remain valid for a period of at least five years.

g. A sale of assets included in the "approved program", for which benefits have been received, will be permitted only with prior approval as long as seven years have not elapsed since the assets were first put into operation. Yet, according to a new procedure that has yet to be approved by the Investment Center, a plant will be permitted to shorten this period regarding assets that were donated to an educational institution, subject to the approval of the Investment Center.

h. It is advisable to specify the types of income that will be generated by the enterprise, especially where "royalties" or "license fees" are the norm in a particular sector (e.g. software). Nevertheless, it is also advisable to specify all potential types of income, that may be derived in the future. This is in order to avoid subsequent claims by the Israeli Tax Authorities that the company's income was not derived from the approved enterprise.

i. As to the company's business model, it should be noted that there are some models, eg., revenues deriving from services, that have not yet been approved by the Investment Center. Thus, when preparing the application it is advisable to structure the revenue model in compliance with the policy of the Investment Center, while considering alternative tax models.

A change in the ownership structure of an approved enterprise, or a change in the location of the enterprise or a change deriving from a corporate merger or division of an approved enterprise requires the prior approval of the Investment Center.

Three months after actual implementation of the approved program or the deadline fixed for implementation, whichever is earliest, the enterprise is required to submit a final implementation report relating to the approved program. The report should be audited by an accountant.

Criteria and Procedures for Receiving Approval

A. "Approved enterprises"

1. Industrial approved enterprises receiving approval

The Board of the Investment Center may approve an application for approved enterprise status after considering a number of criteria:

a. **International market**

The Investment Center does not currently make approval conditional upon the achievement of a certain level of export sales but takes into account the ratio of potential export sales to total sales based on the following:

Nation Priority Region "A": 30% - 35% of sales should be direct exports.

National Priority Region "B": 45% of sales should be direct exports.

Elsewhere, i.e. the Central Region: 50% - 60% of sales should be direct exports.

Since "letters of approval" no longer contain an export sales condition, attention is given, during the review stage of an application, to the possibilities of setting up an overseas distribution network and implementing foreign marketing operations.

In cases where there is a doubt as to the export capability of the enterprise, the Investment Center may require the implementation of a marketing plan which includes details concerning the scope of the local and export sales markets. Non-adherence to the marketing plan could result in cancellation of the approved enterprise status and the refund of benefits received. However, there is usually a degree of flexibility in implementing the marketing plans as they span several years.

Moreover, there is a high degree of flexibility regarding the above export ratios, particularly in National Priority Region "A" and areas of high unemployment.

b. **Production of goods for indirect export, and subcontracting:**

In general, such enterprises will be approved only in National Priority Region "A", subject to certain exceptions.

c. **Employment:**

As mentioned above, the employment criterion is one of the essential components considered by the Investment Center. Enterprises located in National Priority Region "A", development towns and areas of high unemployment will receive preference.

d. High added value:

There is no firm rule regarding the level of added value required of a company for it to qualify for approval from the Investment Center.

e. Size of project:

There is currently a tendency towards granting approved enterprise status to smaller firms that are able to maximize the use of equipment and increase productivity, particularly in the high-tech and software industries.

f. Innovative technologies:

Innovative technologies will receive consideration, especially in the following sectors: industrial chemicals,
bio-technology, electronics, software and communications.

g. Intensifying competition:

Approved enterprise status may be given to enterprises in sectors where there is a monopoly which influences price levels in the economy.

h. Increase in output:

An application for approval of a plant expansion project may be required to show an increase in output of 20% or more.

i. Capitalization requirements:

The minimum proportion of paid-up capital required is 30% of fixed assets. The capital must be invested as assets are acquired, but the company's capital will fulfil the requirements, if repayed within 18 months prior to issuance of the Letter of Approval.

2. *Equipment leasing companies*

Companies whose business consists of leasing equipment to "approved enterprises", and which have substantial revenues, are eligible for the status of a "leasing-equipment company".

If awarded this status, such a company will be entitled to receive the grants that would have been obtainable by an approved enterprise had it purchased the equipment itself.

Nevertheless, this status does not entitle the lessor to the tax benefits available to an Approved Enterprise (the lessee receives the tax benefits and the lessor receives the right to the grant).

3. *Tourism*

The encouragement of tourism in Israel is handled by the Ministry of Tourism. The Ministry encourages the development of the hotel sector and of tourism projects in areas it wants to designate as tourism focal points. The principal encouragement is given to hotels (including renovations of existing hotels). For these, the Ministry of Tourism may grant Approved Enterprise status in areas where, in its opinion, room capacity may be increased.

The status of Approved Enterprise may be also given to holiday villages, camping sites and investments in refurbishing old hotels. Approved status may also be given to apartment hotels, on condition that at least half the total room space and none of the public areas are sold, but are operated as a hotel. Up to 50% of the room space may be sold to foreigners, for foreign currency, subject to certain conditions.

Approved Enterprise status is also granted to non-hotel tourism projects including sports centers, tourist attractions and camping sites, but not restaurants, shopping malls, stores or night clubs.

4. *Leasing of factory buildings*

The criteria for an investment in factory buildings for rental are the same as those for investment in an approved industrial enterprise, except that the buildings must be rented out, wholly or substantially, to approved industrial enterprises for a period of at least seven years. The rental portion of the building will be as determined by the Investment Center in the "letter of approval".

In such a case, the owners of a factory building for rental will receive the grants, and tax benefits available to an approved industrial enterprise, depending on the National Priority Region in which the building is located.

The main conditions to be met are:

a. The factory building must be owned by a company.

b. There is a demand for such buildings in the region.

c. In Priority Region A at least 70% of the floor space should be rented to approved enterprises. In Priority Region B at least 90% of the floor space should be rented to approved enterprises. In the central region 100% of the building should be rented to approved enterprises. There is generally no requirement regarding a minimum floor space for receiving the approval.

d. Thirty percent of the investment must be financed by paid-up share capital.

Detailed procedures for examining the building, its quality and compliance with the requirements of the Investment Center have been laid down.

5. *Software houses*

The size of investment required by the Investment Center is minimal; software houses whose owners have invested only $100,000 have received approval. Two - of several - requirements are, the employment of at least five additional professional employees, and, generally, for at least 50% of revenues to come from export.

6. *Export companies*

These act as sales agents for export manufacturers. See the Chapter "Incentives for export companies".

7. *Motion pictures*

A cinema film may receive Approved Enterprise status if the foreign currency income expected from its overseas distribution is more than 30% of its total earnings, or if the percentage of foreign currency invested in the film is at least 70% of the total investment.

8. *Export of planning or contracting services*

Approved Enterprise status may be awarded to entities engaged in the export of planning or contracting services, for purposes of tax benefits only and not for grant eligibility. The conditions for awarding the above status include a minimum paid-up share capital equivalent to $50,000, and meeting additional terms.

B. "Approved property"

Investment in real-estate (buildings and land) for rental purposes, may receive "Approved Property" status. Benefits emanating from Approved Property status are only reduced tax and accelerated depreciation.

The principal conditions are follows:

a. The entire approved property investment should be paid in cash in foreign currency.

b. The investment should be for the purchase or construction of a building for rental for industrial, tourist, commercial or residential purposes.

c. The investor must be a foreign resident or an Israeli entity wholly owned by a foreign residents or a foreign owned and incorporated company registered in Israel. An entity jointly owned by foreigners and Israelis will enjoy benefits in proportion on to the foreign holdings.

d. The property did not previously enjoy any benefits according to the law.

e. The Approved Property investment should be financed by way of private equity (for individuals and partnerships) or paid-up share capital (for companies).

C. "International trading companies"

See the chapter on "Incentives for International Trading Companies".

D. "Approved investment"

An investment in foreign currency by a foreign resident in the share capital of a local Israeli company may be granted the status of an "approved investment".

Generally, the "approved investment" status does not confer, any advantages except for the promise that tax rates will not be changed during the approved period.

E. "Approved loan"

A foreign resident (including a foreign company) that grants a loan to a local corporation may be granted "approved loan" status for the amount of the loan.

Generally, the "approved loan" status does not confer any advantage other than an undertaking that tax rates will not be changed during the approval period.

Incentives Overview

A number of alternative sets of investment incentives are available for approved enterprises, as summarized in Appendix 4. In brief, investors may choose between various combinations of financial and tax incentives taken from the following list:

1. Grants

According to the law, grants are given in order to finance up to 20% of tangible fixed assets of approved enterprises in Priority Region "A" (still, it is important to note that in certain circumstances, Approved Enterprises may enjoy financing of up to 24%), and up to 10% in Priority Region "B". There are no grants given in the Central Region. Tax benefits are available in Priority Region "A" only (see below).

2. Tax benefits

Complete exemption ("tax holiday") is available for undistributed profits for 2-10 years, depending on geographical location. This period is followed by a period of 1-8 years during which company tax rates are reduced to between 10%-25%, depending on the level of foreign investment in the company. Dividend withholding tax or branch tax of only 15% also apply, as do optional accelerated depreciation rates.

Approved enterprises in Priority Region A may receive both grants at regular rates and a 2 year exemption from company tax followed by the abovementioned beneficial tax rates for 5 - 8 years possible. The 2 year exemption will only apply to retained profits; distributed profits earned in that period will nevertheless qualify for the beneficial tax rates.

These different incentives are discussed further below. Investors must state which overall package of financial and tax benefits is desired when applying for approved enterprise status. Therefore, investors should evaluate, in present value terms, which package appears most beneficial to them. Inquiries should also be made in specific proposed instances as to availability and conditions. Approved enterprises and other businesses are also potentially eligible for a range of general incentives for Israeli businesses in qualifying instances, as outlined in this publication. Duplicate financial support for the same expenditure is not permissible, but the benefits may be optimized. Prospective foreign investors should, of course, also review the overall tax burden in all countries concerned.

Grants

Grant eligibility and conditions

The Law provides that an investment grant may be given to a company, a cooperative society, an Israeli partnership or a foreign partnership in which the Israeli partners are any of the abovementioned entities. In special circumstances, a grant may be given, if authorized by the Board, to a partnership of individuals, where such partnership is the owner of an Approved Enterprise. The aforesaid Approved Enterprise must be an industrial enterprise, an Equipment Leasing Enterprise, a rental factory building (including investments in renovations), or a Tourism Enterprise, as prescribed by Law.

The grants are given only with respect to buildings, investments in industrial building renovation, new equipment and commercial vehicles. Machinery and equipment costs eligible for grants include installation and other related expenses. The amount of the investment grant, as detailed below, cannot exceed the paid-up share capital or the paid-up capital in the case of a partnership.

The amount of the grant is calculated as a percentage of the original cost of land development expenses and the cost of investment in buildings (including investment in industrial building renovation and planning expenses), machinery and equipment (excluding private automobiles).

The grants are paid when investments are actually incurred by the enterprise and are not given for items acquired on suppliers' credit until payment is made. No grants will be paid if 18 months have elapsed since the due date for effecting the investment.

For the purposes of the asset cost calculations that serve as the basis for payment of the grant, no account is taken of financing, administrative and general expenses, travel expenses and running-in costs, even if it is customary to capitalize them as part of the assets, according to generally accepted accounting principles. The only investments to be considered as investments in buildings or improvements are those made in buildings owned by the investor or leased by him for a period exceeding ten years.

For self-built or self-created assets, a reasonable profit (as determined under the law) may be added to the costs incurred for the purposes of computing the grant.

Under the law, the Investment Center will pay advances on account of the investment grant, based on progress reports submitted prior to completion of the project.

The investment grant reduces the original cost of an asset for the purposes of calculating tax depreciation and the capital gain when the assets are sold.

If the conditions of the approval are not fulfilled, or if there is a reduction of capital not resulting from losses, the Investment Center can demand the return of the grant or part thereof, with the addition of interest and linkage.

Grants for productive (non-tourism) "approved enterprises"

Productive (non-tourism) Approved Enterprises are essentially, industrial companies or companies which own industrial buildings. The rate of grant available to productive enterprises varies according to the location of the "approved enterprise".

Currently the grant rates (as percentages of the recognized assets tangible fixed cost) are as follows:

	National Priority Region		Elsewhere i.e. Central Region
	"A" %	"B" %	%
Industry and Industrial buildings	20	10	-

As mentioned by government decision the grant rate in Priority Region "A" was frozen at up to 24% in certain circumstances.

High-tech and skill-intensive enterprises in Jerusalem, which receive special approval as such, are eligible for grants at a rate calculated as if the enterprise was located in National Priority Region "A".

Grants for tourism Approved Enterprises

Tourism Approved Enterprises are essentially, hotels, sites and companies engaged in other tourism projects.

The Investment Center may grant the status of Approved Enterprise to tourism enterprises such as hotels, holiday villages, hotel renovations and other tourism projects recognized by the Ministry of Tourism as assisting in the promotion of Israeli tourism.

Approved tourist enterprises are eligible for investment and capital grants fixed according to their locations. The criteria for determining the National Priority Regions applicable to a tourism enterprise are different from those for other approved enterprises.

Currently, the above grants are as follows:

National Priority Region		Elsewhere i.e. Central Region %
"A" %	"B" %	
20	10	-
15	-	-

The aforesaid grant rates are calculated on the basis of the actual cost or from standards that have been set, whichever are lower.

Apartment hotels

Apartment hotels are treated in accordance with the usual procedures applicable to hotels; however, grants will be given only with respect to those units which are not for sale and for an attributable proportion of public areas.

Tax Benefits

Regular "approved enterprises" benefits

A company which owns an Approved Enterprise is generally liable to a reduced rate of company tax, during "the period of benefits". This is a period of seven to ten years (depending upon the chosen option (grant option or alternate option) and the national priority region in which the approved enterprise is located. This

period begins in the year during which the Approved Enterprise first earned taxable income, on condition that twelve years have not passed from the year in which the enterprise commenced operations or fourteen years since the year the approval was granted, whichever is earlier.

Dividends paid to the shareholders from the profits of an Approved Enterprise earned during "the period of benefits" are liable to income tax at a rate of 15%, if paid within the period of benefits.

The same rule and 15% rate apply to a dividend which is passed along any chain of intermediate companies until the dividend reaches an individual or a foreign resident.

Generally, the year in which an enterprise is deemed for tax purposes to begin operations will be the year in which at least 60%-80% of the Approved Program has been implemented.

The following table compares the total Approved Enterprise tax burden on a company and an investor during "the period of benefits" with that of an ordinary company.

		Company which owns an "approved enterprise"		Ordinary company	
		(1)	(2)	(1)	(2)
	Profit	100	100	100	100
i	Company Tax (X)	25	25	36	36
	Dividend	-	75	-	64
ii	Income tax on dividend 15% or 25% (Y)	-	11.25	-	16
	Net income to the individual shareholder	-	63.75	-	48
	Total Israeli tax burden on company and individual shareholder (X + Y)	25	36.25	36	52

Notes:

(1) No profit distribution.

(2) Profit distribution - the Israeli dividend withholding tax rate for shareholders receiving a dividend is the same for Israeli and foreign resident individuals and foreign resident companies.

Taxation of a foreign-invested Approved Enterprise

A Foreign Investors' Company is entitled to additional tax benefits as set out below.
See also Appendix 3.

A Foreign Investors' Company is a company in which the percentage of foreign investment in share capital and shareholders' loans (taken together) is over 25%, with the additional condition that the proportion in share capital alone must be over 25% including the rights vesting in the shares regarding profits, voting power and the appointment of directors.

For these purposes, a shareholder's loan is a loan given by a shareholder, the repayment term of which is not less than three years.

In the opinion of the Income Tax Commission, the acquisition of shares by a foreign resident from an Israeli resident shareholder (rather than shares allotted by the company) is not considered a foreign investment.

A Foreign Investors' Company is entitled to incentives for a period of ten years (rather than seven), beginning in the first year in which the Approved Enterprise earned taxable income. "The period of benefits" is limited to twelve years from the first year that the enterprise commenced operations, or fourteen years from the year in which approval was granted, whichever is earlier.

A view exists that because each tax year is separate, a company which becomes a Foreign Investors' Company before the end of the seven year period of benefits becomes entitled to benefits for up to ten years, on condition that it continues to be a Foreign Investors' Company during the remaining years.

During its 10 - year period of benefits, a Foreign Investors' Company will be liable to Company Tax at the following rates:

% Foreign investment	Company Tax rate	Dividend Tax rate
0%-49%	25%	15%
49%-74%	20%	15%
74%-90%	15%	15%
90%- 100%	10%	15%

A dividend paid by a Foreign Investors' Company from profits of the Approved Enterprise, earned during the period of benefits, is liable to tax at a rate of 25% and the company shall be entitled to a refund for the company tax it paid on the dividend paid.

"Alternative Benefits" (Tax Holiday)

The owners of an Approved Enterprise (either a new enterprise or an expanded existing enterprise) may choose the "Alternative System of Benefits" (the "Alternate Package" or "Tax Holiday"). The benefits accruing under the Tax Holiday are only given to an Approved Enterprise owned by an ordinary company, and not by an individual, kibbutz, family company, etc. This restriction is imposed since the benefits of the Tax Holiday are only given in regard to undistributed profits.

An approved enterprise choosing the Tax Holiday package is entitled to an exemption from Company Tax on undistributed profits generated over a period of two to ten years, depending on the plant location, as follows:

	National Priority					
	Region "A"		Region "B"		Central Region	
	Tax Holiday	25% tax	Tax Holiday	25% tax	Tax Holiday	25% tax
0%-25% Foreign Investment	10 years	-	6 years	1 year	2 years	5 years
Over 25% Foreign Investment	10 years	-	6 years	4 years	2 years	8 years

According to the language of the law, the period of tax exemption (tax holiday) must begin within twelve years from the time the enterprise commenced operations, or fourteen years from the date of its approval.

If a dividend is distributed out of tax-exempt profits of the approved enterprise, the company will then become liable to Company Tax on distributed profits at the rate applicable had it not chosen the Tax Holiday. The dividend itself will be liable to income tax at a rate of 15%.

Therefore, at the time of the dividend distribution the total tax on the company and the individual shareholder will be the same as the tax on an approved enterprise, as described above. Nevertheless, companies will find useful the ability under the Tax Holiday to defer taxation until profits are distributed.

A "mixed enterprise"

A "mixed enterprise" is one in which only part of it is an "approved enterprise"; this situation may result from a number of factors:

- An existing enterprise that was not approved now expands, and the expansion is approved;
- An enterprise whose program was only partly approved;
- An Approved Enterprise which expanded, but the expansion did not receive approval;
- An Approved Enterprise that was set up in stages, and the "benefit period" regarding some of the stages has ended;
- An Approved Enterprise that received a number of "letters of approval", a part of which received the alternative package of benefits (Tax Holiday);
- An enterprise which began to produce products not included in the approved investment program.

A "mixed enterprise" is only entitled to tax benefits arising from the approved part(s). In accordance with the law, the Board of the Investment Center shall determine how to calculate the taxable income derived from each approved part. A sales increase basis is typical.

At the time the company decides to distribute a dividend from the "mixed enterprise", the law states that the distributed dividend relates to the different parts of the enterprise, weighted according to their respective amounts of taxable income. However, a company's directors may choose to distribute a dividend out of taxed profits rather than exempt retained profits generated during a Tax Holiday.

Accelerated depreciation

An Approved Enterprise is eligible for accelerated depreciation on buildings and equipment included in an approved project at rates that range from 200% (for machinery and equipment) to 400% (buildings) of the standard straight-line depreciation rates of those assets. This applies during the first five years of the asset's operation, except that the rate of depreciation for buildings cannot exceed 20% per annum.

Government grants are deducted from the costs of the fixed assets for which they were received, and the depreciation is calculated on the reduced cost.

An "approved investment" and "approved loan"

A loan or equity investment in an enterprise may be awarded the status of an "approved loan" or "approved investment".

The taxable income on an "approved investment" during the "benefit period" is taxed at a rate not exceeding 25%. Approved loans are treated similarly.

The income distributed by a company out of income from an "approved investment", is also considered income from an "approved investment" and taxed at a rate not exceeding 25%.

An "approved property"

As mentioned, an investment made in foreign currency in real estate projects, by a foreign resident, may be granted the status of "approved property". The tax benefits applying to an "approved property" are generally identical to those of an "approved enterprise".

Accordingly, when calculating the taxable income of an "approved property" accelerated depreciation is granted, and the tax rates applied to the income from the property range between 10% and 35% depending on the form of ownership and the percentage of foreign ownership. For further details, refer to the sections above on Taxation of a Foreign Invested Approved Enterprise and "Individual - Approved Enterprise". The "period of benefits" is seven years (ten years for a "foreign investors' company").

"Approved rental buildings"

An approved rental building is an approved property which qualifies for additional benefits. The granting of benefits is conditional upon at least half the floor space of the building being rented for residential purposes for an average period of at least five years out of the seven years following completion of construction.

The approved part of a building must contain at least six apartments, or at least eight apartments in larger buildings.

The benefits granted to an approved rental building are as follows:

1. Real (inflation adjusted) depreciation of 20% per year for those apartments first rented as residential accommodation (excluding the land upon which the apartments have been built).
2. If the depreciation (and the inflationary adjustment for depreciation allowed under the Adjustments for Inflation Law) exceed taxable income before deduction of other expenses related to that income, the loss created by the depreciation and the inflationary adjustment may be offset only against income deriving from the rental or sale of buildings to which this law is applicable.
3. The rates of tax imposed on an Approved Rental Building will apply both to the rental income (rental of apartments and any other rental income) and to gains generated by the sale of the part of the building designated for sale. These rates also apply to gains from the sale, at the end of the prescribed rental period, of the apartments designated for rental.

   Accordingly, in the case of an Israeli company, the rate of Company Tax will be 25% if the investors are mainly local, 20% if the foreign investment is 49% to 73%, 15% if the foreign investment is 74% to 89% and 10% if the foreign investment is over 90%. A withholding tax of only 15% will be applicable to dividends distributed from the aforementioned income.

   A foreign-incorporated company will be subject to Company Tax at a rate of 10%-25% depending on the level of foreign investment therein. In addition, it will be taxed at the rate of 15% ("branch tax") on the aforementioned income after Company Tax subject to the provisions of any applicable tax treaty. Some of Israel's tax treaties contain "branch tax" override provisions.

   The alternative package of benefits ("Tax Holiday") is not available in the case of an approved rental building.

   The income tax rate applicable to an individual is 35%.

   The foregoing benefits apply to items of income subject to income tax, Company Tax and Land Appreciation Tax.

   These tax benefits for approved rental buildings apply without any time limit, unlike other approved projects under the Law for the Encouragement of Capital Investments.

Capital gains

The tax incentives that have been explained above do not apply to capital gains attributable to an approved enterprise nor to an approved property.

Taxation of U.S. Investors

General

With the enactment of the Revenue Reconciliation Act of 1993 in the U.S., several changes were made in the basic tax system of the U.S. including an increase in the tax burden on individuals and companies.

The maximum tax rate for individuals was increased from 31% to 39.6% and the maximum rate for corporations was increased from 34% to 35%.

Despite this increased tax burden, there are sometimes substantial tax related reasons for U.S. residents to invest in their own country rather than overseas. Nevertheless, a direct investment in an Israeli operation may, in fact, be beneficial as explained below. This assumes that the investor's objective is to focus on ongoing income rather than capital gains.

U.S.- Israel Tax Treaty

The U.S.-Israel Tax Treaty became effective in 1995. Attached in Appendix 6 is an overview of the Treaty's provisions.

Under the Treaty, there is no change in the 15% withholding tax on dividends paid by an Israeli company from the profits of an approved enterprise, and the U.S. continues to give U.S. citizens a foreign tax credit in relation to such dividends received. However, the Treaty reduces the rate of Israeli "branch tax" payable by U.S. corporations that have an Approved Enterprisebranch operation in Israel from 15% to 12.5%. Other withholding tax rates also decrease under the Treaty.

Perhaps the most significant feature of the Treaty concerns capital gains taxation when selling shares of an Israeli company. Under the Treaty, U.S. residents who held less than 10% of the Israeli company's voting power throughout the 12 months preceding the sale will be exempt from Israeli capital gains tax; while other U.S. residents may now credit any Israeli tax against U.S. tax on that capital gain. Prior to the Treaty, conflicting "source rules" sometimes led to double taxation of such gains.

There is no "tax sparing" clause in the treaty allowing a U.S. investor to credit regular rather than reduced Israeli taxes so as to preserve Israeli incentive benefits. Consequently, Israeli tax benefits may be partly eroded by the effects of U.S. taxation.

Operations

In evaluating the operational stage of an Israeli enterprise, it is important to review the overall tax burden imposed on U.S. corporate and individual investors in Israel and the U.S. This review will show why the tax incentives given in Israel to U.S. investors in "approved enterprises" are still attractive, despite the taxes imposed in the U.S.

Comparative Calculations

In the following tables, the calculations are grouped for comparative purposes as follows:

Appendix A:	Calculation of net income from an investment in a U.S. corporation:	
		by a U.S. individual.
		by a U.S. corporate investor which, in turn, has U.S. individual shareholders.
Appendix B:	Calculations of net income from an investment in a regular Israeli company, and in an Israeli company owning an approved enterprise, as follows:	
	i.	Direct investment by a U.S. individual.
	ii.	Investment via a U.S. corporation holding less than 10% of the Israeli company.
	iii.	Investment via a U.S. corporation holding over 10% of the Israeli company, using a deemed paid tax credit (i.e. a credit in the U.S. for underlying Israeli company tax as well as dividend withholding tax).

The tax calculations do not distinguish between a company which is a taxable Approved Enterprise and one which has chosen the alternative benefits package, ("Tax Holiday") because at the time of a dividend distribution, Israeli taxes will be the same. The tax calculations also do not illustrate the option of taking a U.S. tax deduction for foreign taxes withheld.

Conclusions

From a pure tax viewpoint, based on the assumptions listed below, the tables indicate that an investment in a U.S. corporation is preferable for a U.S. investor rather than an investment in a regular Israeli company.

However, a U.S. individual investor may prefer to invest in an Israeli company that has an Approved Enterprise, (regular or foreign-investors' company), rather than an investment in a U.S. corporation.

A U.S. corporation whose shareholding in another company does not exceed 10%, may prefer an investment in another U.S. corporation rather than an investment in any form of Israeli company, except for an Approved Enterprise which has foreign investment over 90%.

A U.S. corporation whose shareholding in another company is between 11% and 80%, may prefer an investment in a U.S. corporation rather than a regular Israeli company, but an investment in an Israeli company that has an Approved Enterprise may be more advantageous.

A U.S. corporation whose shareholding in another company is 80% or more may prefer an investment in a U.S. corporation rather than a regular Israeli company, or an Approved Enterprise with foreign investment up to 49%. However, when the rate of foreign investment in an approved enterprise is greater than 49%, the tax results are identical.

U.S. investors should, of course, consult advisors in each country regarding any proposed investment.

Assumptions used in the calculations

a. Investor's goal is to optimize ongoing ordinary income.

b. Maximum marginal tax rates for ordinary income are used.

c. Calculations use regular federal income tax rates and not the rate determined for the purposes of the Alternative Minimum Tax (A.M.T.).

d. It is assumed that the taxable income subject to tax in Israel is identical to the taxable income calculated under U.S. tax law.

e. The Israeli company's income results from an active manufacturing business and not from passive sources. The Israeli company does not have income or assets that are taxable under subpart F or related rules in the U.S.

f. There is no substantial time lag between the generation of income and the distribution of dividends.

g. The levels of shareholding shown relate to all controlling rights.

h. The foreign investment in the Israeli company is the only foreign investment of the U.S. investors and the U.S. investors can claim foreign tax credit relief to the extent that their Israeli tax liability is less than or equal to their U.S. tax liability. But they cannot set off excess Israeli taxes paid against their U.S. tax liabilities.

i. The calculations do not consider the impact of U.S. state or local taxes (if any).

j. Each U.S. corporation is a "C-Corporation".

Summary table comparing net income to U.S. investors

	U.S. Investor (shareholder)				
	U.S.				
	individual	Corporation			
	% shareholding				
	0-100%	0-10%	11-19%	20-79%	80% or more
Net income from investment in U.S.Corp. (see Appendix A)	39.26	58.18	58.18	60.45	65
Net income from direct investment in Israeli co. (see Appendix B):					
Regular Israeli Co.	38.66	41.60	56	56	56
Israeli Approved Enterprise (foreign ownership 0-48%)	45.30	48.75	63.75	63.75	63.75
Israeli "foreign investors" company owning an approved enterprise 49-73%	48.32	52.0	65	65	65
74-89%	51.34	55.25	65	65	65
90% or more	54.36	58.5	65	65	65
90% or more - net income upon distribution to ultimate individual U.S. investor	54.36	35.33	39.26	39.26	39.26

Appendix A:

Calculation of net income from an investment in a U.S. corporation

	U.S. individual	U.S. Corporate investor		
	% shareholding			
	0-100%	Under 20%	20-79%	80% or more[1]
Profit of U.S. corporation Income tax on above	100 35	100 35	100 35	100 35
Available for distribution	65	65	65	65
Dividend received deduction	N/A	45.5(2)	52(3)	65
Income taxable in the hands of recipient	65	19.50	13	0
Tax rate	39.6%	35%	35%	35%
Tax on dividend	25.74	6.82	4.55	0
Net income to direct shareholder				
U.S. individual	39.26			
U.S. corporate investor		58.18	60.45	65
Taxes on dividend distribution to U.S. individual shareholder (39.6%)	N/A	23.04	23.94	25.74
Net income to U.S. individual	39.26	35.14	36.51	39.26

Notes:

(1) On the assumption that the other corporation is a member of the same U.S. affiliated group.

(2) A 70% deduction for a dividend received from another U.S. corporation, where less than 20% of such other corporation is owned by the recipient.

(3) An 80% deduction for a dividend received from another U.S. corporation where 20% of such other corporation is owned by the recipient.

Appendix B:

Calculation of net income from an investment in an Israeli company

(i) Direct investment by U.S. individual

	Regular Israeli company	Israeli Company owning "approved enterprise" (Note)	"Foreign Investors' Company" owning "approved enterprise"		
			% foreign investment		
			49-73%	74-89%	90% or more
Profit	100	100	100	100	100
Israeli Company Tax	36	25	20	15	10
Gross dividend	64	75	80	85	90
Israeli withholding. tax (25% or 15%)	16.00	11.25	12	12.75	13.5
U.S. individual Net div. recd. in U.S.	48.00	63.75	68	72.25	76.5
U.S. tax for the individual (39.6%)	25.34	29.70	31.68	33.66	35.64
Foreign tax credit	(16.00)	(11.25)	(12.00)	(12.75)	(13.50)
Net income to U.S. individual	**38.66**	**45.30**	**48**	**51.34**	**54.36**

Note: Foreign ownership 0 - 48.99%.

(ii) Investment in Israeli company via U.S. Corporation holding less than 10%

	Regular Israeli company	Israeli Company owning "approved enterprise" (Note 1)	"Foreign Investors' Company" owning "approved enterprise"		
			% foreign investment		
			49-73%	74-89%	90% or more
Profit	100	100	100	100	100
Israeli Company	36	25	20	15	10
Gross dividend	64	75	80	85	90
Israeli withholding tax					
(25% or 15%)	16	11.25	12	12.75	13.5
Net div. received in U.S.	48	63.75	68	72.25	76.5
U.S. tax on gross dividend (35%)	22.4	26.25	28	29.75	31.5
Foreign tax credit	(16.00)	(11.25)	(12)	(12.75)	(13.5)
Net income to U.S. corp.	**41.60**	**48.75**	**52.00**	**55.25**	**58.5**
U.S. taxes on dividend distribution to U.S. individual shareholder (39.6%)	(16.47)	(19.31)	(20.59)	(21.88)	(23.17)
Net income to U.S. individual	**25.13**	**29.44**	**31.41**	**33.37**	**35.33**

(iii) Investment in Israeli company via U.S. Corporation holding over 10% using a deemed-paid tax credit

	Regular Israeli company	Israeli Company owning "approved enterprise" (Note 1)	"Foreign Investors' Company" owning "approved enterprise"		
			% foreign investment		
			49-73%	74-89%	90% or more
Profit	100	100	100	100	100
Israeli Company	36	25	20	15	10
Gross dividend	64	75	80	85	90
Israeli withholding tax (25% or 15%)	8	11.25	12	12.75	13.5
Net div. received. in U.S. per (i)	56	63.75	68	72.25	76.5
Taxable in U.S.	100	100	100	100	100
U.S. tax on corporation (35%)	35	35	35	35	35
Credit for foreign tax (Israeli company and withholding taxes)	(44)	(36.25)	(32)	(27.75)	(23.5)
Excess foreign tax credit available for set off against other foreign income (Note 2)	(9)	(1.25)	-	-	-
Net income to U.S. corporation	56	63.75	65	65	65
U.S. taxes on dividend distribution to U.S. individual shareholder (39.6%)	22.18	25.25	25.74	25.74	25.74
Net income to U.S. individual	**33.82**	**38.50**	**39.26**	**39.26**	**39.26**

Notes:

(1) Foreign ownership 0 - 48.99%.

(2) Only if the U.S. corporation owns more than 50% of the Israeli company and certain other conditions are fulfilled.

Taxation of U.K. Investors

General

The tax treaty between the United Kingdom and Israel allows scope for a low level of taxation to apply to investments by UK investors in companies located in Israel. This is because the UK/Israel treaty provides "tax sparing" relief whereby a UK investor is given a credit (so far as it can be utilized) for the tax saving achieved in Israel through Approved Enterprise status.

U.K tax aspects - corporate

If a UK corporate investor holds at least 10% of the voting power of an Israeli company it is entitled to take into account a credit for the underlying Israeli Company Tax as well as dividend withholding tax in computing its UK corporation tax liability. This credit will include spared Company Tax. No additional UK tax should arise in the UK company as the UK corporate tax rate is lower than the standard rate for Israel.

It should be noted that new rules introduced by the UK's Finance Act 2000 can restrict the ability to utilize credits for underlying tax but these only have limited effect in the situation where the UK investing company invests directly in an Israeli subsidiary. UK investors should, of course, consult advisors in each country regarding any proposed investment.

Example

Suppose a UK corporate investor holds 100% of the shares in an Israeli company owning an "approved enterprise". For simplicity, it is assumed throughout that the book profits shown by the Israeli enterprise are equal to the profits on which corporate tax is levied. It is also assumed that the UK individual pays tax at the higher rate. The following is an illustrative tax computation (assuming the UK standard rate of corporate tax applies):

	£	£	£
Israel			
Pre-tax profit of Israeli "approved enterprise"		100,000	
Company Tax - beneficial rate 10%		10,000	
Company Tax - regular rate 36%			36,000
Net available for distribution		90,000	
Less: Dividend withholding tax 15%		13,500	
Dividend remitted to UK		76,500	
UK			
Israeli profit		100,000	
UK corporation tax	30,000		
Less: Israeli company and withholding taxes paid or spared (limited to amount of UK liability)	30,000		
UK corporation tax payable		NIL	
Net income of UK company from Israel		76,500	
Dividend to UK individual		76,500	
Grossed up dividend (100/90)		85,000	
Personal Income Tax 32.5%	27,625		
Tax Credit (85,000-76,500)	8,500		
Personal Income Tax - net due		19,125	
Net income of UK individual		**57,375**	

U.K tax aspects - individual

A UK individual will not enjoy tax sparing relief, as he or she cannot credit the underlying Israeli company tax. (The 15% dividend withholding tax for approved enterprises is also the general rate for UK investors under the UK/Israel tax treaty, so tax sparing relief does not apply to the dividend withholding tax).

Nevertheless, if the UK individual is a 100% direct shareholder in an Israeli company with an approved enterprise, the overall liability will be as follows:

	£	£
Israel		
Pre-tax profits of Israeli "approved enterprise"		100,000
Company Tax - beneficial rate 10%		10,000
Net available for distribution		90,000
Less: withholding tax		13,500
Dividend received in UK, net		76,500
UK		
Deemed gross dividend		90,000
UK income tax 32.5%	29,250	
Less: Israeli withholding tax credit	13,500	
UK tax payable		15,750
Net income of individual		**60,750**

Other Tax Reliefs Reserved for Foreign Investors

Unilateral relief for capital gains tax

The Finance Minister has discretionary authority to order partial or full tax refunds to a foreign resident, if the amount of tax paid in Israel is greater than the tax credit granted in the foreign resident's home country on income originating in Israel.

The Finance Minister sometimes uses this authority to lower the rate of tax imposed upon capital gains resulting from the realization of an investment, but the resulting Israeli tax rate will usually be at least 25%.

Foreign based venture capital funds

In the case of foreign based venture capital funds dedicated to investing in Israeli companies a 20% tax rate is sometimes obtainable for foreign resident in investors in such funds. No further tax is payable at the fund level. In addition, an exemption has sometimes been granted to investors in such funds if they are tax exempt institutions in their home country (e.g. pension funds, etc) provided the home country has a tax treaty with Israel.

Unilateral relief for tax on interest on certain loans

Interest on loans from a recognized financial institution abroad that finance projects in Israel's macroeconomic interest may be granted a withholding tax rate of 15% on interest exceeding the LIBOR rate on the date of payment.

In other cases, lenders who can prove that they received financing abroad for purposes of granting the loan, may request (or be required) to pay tax only on the interest profit margin at the regular Company Tax rate of 36%, i.e., on the difference between loan interest received and the cost of financing the loan.

Unilateral tax relief on income or dividends from negotiable securities

Income received by a foreign resident from dividends or interest on debentures (with a 12 year term or more) or on securities traded on the Tel-Aviv stock exchange, will be exempt from taxation if the foreign resident receives no tax credit in his home country for taxes paid in Israel.

Tax exemption on bank interest

Interest received by foreign residents on non-residents' foreign currency bank deposits at a bank in Israel is tax exempt, if the foreign resident does not have a business in Israel.

Other

Information on other tax benefits for foreign residents is included in the relevant chapters herein.

Benefits for Investors in Eilat

General

The city of Eilat and neighboring area has been designated a "free trade area" in accordance with the Eilat Free Trade Areas Law. Similarly, certain areas around the Eilat port have been declared "free port areas" in accordance with the Free Port Areas Law. Authorized enterprises in the Eilat free port receive wide ranging tax benefits.

Furthermore, an industrial free zone has been specified in the regulations pertaining to the Eilat Free Trade Areas Law; its boundaries are specified in the regulations. Special benefits, detailed below, will be granted to "authorized enterprises" established in this industrial free zone.

General benefits not specifically concerned with the encouragement of capital investments, are also granted in Eilat in accordance with the Eilat Free Trade Areas Law. These benefits are available to businesses in and residents of the Eilat free trade area, and allow significant concessions relating to both direct and indirect taxes.

The key benefits in Eilat are described below:

Indirect taxes

An exemption from indirect taxes is given on the import of goods to the Eilat free trade area for the purpose of selling them for foreign currency to tourists in the area.

Merchandise produced in Israel and sold to tourists as above will be considered as goods exported from Israel, and will therefore be exempt from indirect taxes.

A major portion of the goods and services consumed in the Eilat area is exempt from Value Added Tax (VAT). Sales of such goods and services to dealers in the area by dealers elsewhere in Israel are generally zero-rated for VAT purposes.

Direct taxes

Residents of Eilat are eligible for a tax credit at a rate of 10% of taxable income earned in Eilat. In addition to the foregoing, residents of Eilat may receive a tax credit of 7% on income earned outside Eilat, up to certain limits fixed by the regulations. An employer who pays wages in the Eilat area is entitled to a rebate of 20% on labor costs out of tax withheld at source from salaries.

Tax concessions in the Eilat Free Port Area

Ventures approved by the Council of the Eilat Free Port Area are designated "authorized enterprises". In accordance with the Free Port Areas Law and its regulations, "authorized enterprises" will be eligible for direct taxation benefits as follows:

1. Complete exemption from Company Tax for the first seven years from the year in which the "authorized enterprise" first earns taxable income. After this period, the Company Tax rate is limited to 30%.

2. On dividends paid from such income, withholding tax is payable at the rate of 15%, with no time limit.

3. Inflationary capital gains generated by an "authorized enterprise" are tax-exempt. (For other taxpayers, inflationary capital gains that accrued up to the end of 1993 are taxed at 10%, and are exempt to the extent they accrued thereafter).

4. Capital gains from the sale of shares in a company that operates an "authorized enterprise", by a foreign resident who acquired the shares with foreign currency, are fully exempt from capital gains tax and land appreciation tax.

5. Furthermore, a supplementary depreciation allowance is claimable on assets operated in the Eilat area.

6. The Minister of Finance or the Minister of Trade and Industry is authorized to designate an "authorized enterprise" as an "approved enterprise", also, pursuant to the Law for the Encouragement of Capital Investments. In such a case, the enterprise will enjoy the benefits provided by that law, particularly grants, in addition to the benefits provided by the Free Port Areas Law and the Eilat Free Trade Areas Law.

Tax benefits to an Approved Enterprise located within the Eilat industrial zone

Under the Eilat Free Trade Areas Law and regulations thereto, "approved enterprises" (pursuant to the Law for the Encouragement of Capital Investments) located in the Eilat industrial zone, specified in the regulations are eligible for tax benefits applicable to Eilat "authorized enterprises". These benefits include a complete exemption from company tax for the first seven years from the year in which the enterprise first earns taxable income.

After this period, the company tax rate is limited to 30%. On dividends paid from such income, withholding tax is payable at a rate of 15%, with no time limit.

Benefits for Investors in Free Port Areas

General

In accordance with the Free Port Areas Law, designated areas in the ports of Haifa, Ashdod and Eilat have been proclaimed as "free port areas".

The objective of the law is to create a framework through which investors may enjoy special privileges and a large measure of independence, particularly concerning the holding and exchange of foreign currency, relief from taxes, and freedom from administrative limitations.

Enterprises in "free port areas" are eligible to enjoy all the benefits provided by the Law for the Encouragement of Capital Investments, provided they have obtained Approved Enterprise status in accordance with that law. Such benefits are in addition to those provided by the Free Port Areas Law.

The authority designated to grant approvals and administer the law is the Free Port Areas Council. The Port Authority is responsible for carrying out the decisions of the Council.

Direct tax benefits

"Authorized enterprises" of companies according to the above law are only liable for Company Tax and capital gains tax, and are exempt from income tax. (The exemption from corporate income tax has no significance, since the tax has been repealed).

Enterprises also approved under the Law for the Encouragement of Capital Investments may be granted full exemption from Company Tax or will be taxable at a low rate of 10% to 25% for 7-10 years. Dividends will be liable to 15% withholding tax. Assets of authorized enterprises will be exempt from property tax. With regard to Eilat enterprises, see the chapter on "Benefits to investors in Eilat".

Indirect taxes and foreign currency

No indirect taxes will be imposed on imported goods used for establishing an authorized enterprise, for its use, or for export. Exemption from all licensing requirements is granted for imports and exports of goods.

Authorized enterprises will also be entitled to unrestricted use of foreign currency as far as required for operating the enterprise, as long as the Minister of Finance does not restrict that use.

Free Processing Zone

Plan exist to construct and operate a free processing zone near Beer Sheva, towards the South of Israel. Qualifying businesses, as well as the zone concessionaire, would enjoy substantial operating freedom and tax exemptions in Israel.

Research and Development

Introduction

Israel accords high priority to the promotion of research and development and the expansion of the Israeli high tech manufacturing sector. This follows from the shortage of mineral resources in Israel and the high level of expertise of the Israeli labor force. The recent inflow of immigrants from the C.I.S. republics further enhanced the per capita ratio of skilled personnel available to among the highest in the world.

Government R&D grants - general

Pursuant to the Law for the Encouragement of Research and Development in Industry, 1984, cash grants of up to 66% (see below) of approved expenditures are provided to support R&D projects of all types by the Office of the Chief Scientist (OCS) at the Ministry of Industry and Trade.

Government R&D grants are given with a view to developing skill-intensive industries, by utilizing Israel's technological base and human resources. The grants also aim to increase job opportunities in industry and stimulate the development of products with export potential.

Government grant conditions

Basic conditions of eligibility for R&D grants from the OCS include the following:

1. Each grant will be based on an R&D program approved by the OCS Research Committee.

2. Program applications must detail technical, commercial and financial aspects in a required format. Technological innovations and export potential should be emphasized.

3. Expenditure requires approval on an itemized basis. Currently, monthly salaries of up to $4,000 are generally recognized. Employment benefits of up to 30% of salaries are recognized. General overheads of up to 45% of

salaries are also recognized. Equipment depreciation may also be requested.

4. Expenditure supported under other incentive programs is ineligible for OCS support.

5. If the R&D is successful and results in commercial products, a sales royalty becomes due to the OCS.

   The sales royalty rates are currently 3% in years 1-3 after commercial sales begin, 4% in years 4-6 and 5% in year 7 onwards (prospective changes are expected as follows: replacing the 4% level in years 4-6, a 3.5% royalty rate will apply, and replacing the 5% rate, will be a 4.5% rate. Once these changes enter into force, they shall apply in retrospect according to the above). In special cases higher rates may apply. Small companies enjoy a grace period of two years prior to the repayment of royalties, but in all cases the payback is limited to 100% of the dollar value of the grant received plus LIBOR interest of 12 months regarding programs approved on or after January 1, 2000. Royalties are also payable on revenues from services derived or related to the product that was developed under an OCS - approved program or any rights therein.

6. In principle, a program may not be approved unless firm arrangements have been made to ensure that the manufacturing will take place in Israel. In cases where the research is conducted pursuant to an international R&D cooperation agreement to which Israel is a party - that includes provisions pertaining to the transfer of know-how and manufacturing rights between the participating countries - the program shall be approved in accordance with the agreement, even if some manufacturing is done outside Israel.

   In other exceptional cases, manufacturing abroad may be permitted by the OCS Research Committee, subject to payment of increased royalties from the research party up to a maximum of 300% of the grant at an accelerated rate (almost immediately in some cases). However the Research Committee possesses the authority to consider foreign manufacturing only with respect to research that was previously approved by the OCS. A new research project application will not be accepted if it contemplates overseas manufacturing outside the scope of an international R & D cooperation agreement.

Regarding the transfer of the developed know-how, the Law specifically states that the Intellectual Property developed within the framework of the program will not be transferred to another party, without prior consent of the Research Committee (transferring the information without the Committee's approval constitutes a criminal offense). The Committee usually approves knowhow transfers within Israel, subject to assignment of all the obligations and liabilities to the recipient. Knowhow transfers outside Israel are approved only in special and rare cases, and are subject to payment of increased royalties.

The OCS Research Committee may approve a program that is partially financed by a non-governmental entity, provided the entity's participation does not give it ownership or rights over the developed knowhow or product. In such a case, the financing received from the third party shall be deducted from the cost of the program.

Government R&D grant packages

The Israeli government, through the OCS, offers an extremely broad range of alternative grant packages, as summarized below. Each package has detailed conditions and royalty payment rules.

1. Regular grant program

Grants of 50% of approved expenditure are available for single and multi-year R&D programs expected to result in know-how, processes or methods for manufacturing a new product or significantly improving an existing product or process.

2. Start-up businesses

Grants equal to 66% of the approved budget, up to an annual maximum of $250,000, are available to start-up enterprises for a period of two years. A start-up enterprise is defined as one whose said R&D program constitutes its first and only activity and that possesses no additional sources of finance, except for shareholders' equity.

3. National Priority Region "A"

Grants of 60% of approved expenditure are available for R&D projects conducted in a location in National Priority Region "A".

4. *Product improvement*

Grants of 30% of approved expenditure may be given for developing improved versions of existing products.

5. *R&D with third party support*

Grants of 5% of approved expenditure are available for projects which are also supported by a third party participant. This is generally only relevant to third parties who are not shareholders in the company that deduct their participation as an expense for Israeli tax purposes under Section 20A of the Income Tax Ordinance.

6. *The GTRD Program (Generic Technological R&D)*

A. General:

The GTRD program (Generic Technological R&D) is an innovative assistance program for Israeli industry that is administered by the Office of the Chief Scientist (OCS) at the Ministry of Trade and Industry.

The plan is unique in promoting cooperation among various industrial firms and between these firms and academic research institutes. This is done through the establishment of a consortium and joint work groups to deal in the development of pre-competitive technologies and their assimilation.

For this purpose generic technology is defined as knowhow that serves as a factor in the development, design or manufacturing of a variety of products.

B. Incentives:

In order to encourage the participation of industrial firms in this program, whose relative inherent risk is high, greater-than-normal incentives are offered, including a 66% development grant, a wider recognition of expenses entitled for the grant, as well as a full exemption from the payment of royalties to the OCS.

C. **Criteria for qualifying programs:**

A program that merits assistance will be assessed according to several main criteria, including: the likely extent of future exploitation of program products; the inherent international commercial potential; technological, scientific, logistic and financial capabilities of the applicants; and whether there are civilian (rather than military) applications for the products.

D. **Sale of Generic Know-how to International Entities:**

Any sale of generic know-how to foreign or international entities will require advanced authorization from the GTRD Committee.

7. *"Beta-site" grants*

Once a research project has identified and developed a potentially viable project, grants are available to finance the critical phase of making production prototypes, testing them at client "beta-sites", and implementing pre-production modifications based on resulting feedback. These grants may also be used to finance chemical pilot plants, related technical support, patent fees, foreign licensing expenses, and marketing consultancy fees. Grant applications should be filed within two years after the completion of the original research project.

Grants are available at the rate of 50% of approved expenditure if the company's sales revenues did not exceed $6 million in the three preceding years, or 30% if sales revenues in the latest year did not exceed $30 million. Maximum approved expenditure is $600,000.

8. *Projects within Technology Incubators*

An incubator is a specialized location for housing immigrant scientists and others who develop new products or processes for commercial purposes.

While the incubator itself may receive annual grants of up to $120,000 (approximately), the individual projects may receive an annual grant of up to $100,000 (approximately), for a period not longer than two years, to finance 85% of the approved budget.

9. *"Industrial incubators"*

"Industrial incubators" are based on similar general principles to "technological incubators". However, "industrial incubators" are administered by established Israeli industrial companies with R&D experience and annual revenues of $5 million, or by other business concerns with proven R&D experience and at least $7 million invested in other companies.

In an "industrial incubator", grants of up to 66% are available for approved R&D expenditure of up to $300,000 per year for up to two years. Thereafter, other grants may be requested from the OCS. In the event that the company concerned performs a feasibility study, it will be eligible for a grant equal to 50% of the cost of the feasibility study, up to a maximum of $7,500.

10. *Defense products*

Grants of 30% - 40% of approved expenditure are available.

11. *Market feasibility studies*

Prior to embarking on an R&D project, grants are available for market feasibility studies, at a rate of 50% of approved expenditure, of up to $25,000 (for studies on one continent) or $30,000 (for studies on more than one continent).

Bilateral Academic R&D Cooperation

The Joint Commission for Science and Technology

General:

In 1994, a memorandum of understanding was signed between Israel and the United States regarding the establishment of a Joint Commission for Science and Technology. Each country allocated $15 million for financing the activities of the Commission.

The purpose of the Commission is to advance and encourage joint operations in the following scientific and technological fields:

1. Creation of joint projects in the Israeli high-technology industry.

2. Promoting cooperation between academic and research institutes in both countries, in areas that may potentially lead to joint commercial activity.

3. Promotion of technological development in defined fields such as: Medicine and biotechnology, telecommunications, electronics, microelectronics and data processing, environment/ecology, energy and agriculture, as well as the promotion of research for the conversion of military technology into civilian applications.

Support Criteria:

The Commission strives to locate projects in two principal categories:

1. Projects of $10-12 million for a period of up to four years, with financial participation by the developing partners in both countries at a rate of 50%.

2. Technologically-innovative, breakthrough projects in a smaller financial amount, that will contribute and influence new developments in both countries and will assist in promoting and creating new businesses and new places of employment. These projects are also for a period of up to four years.

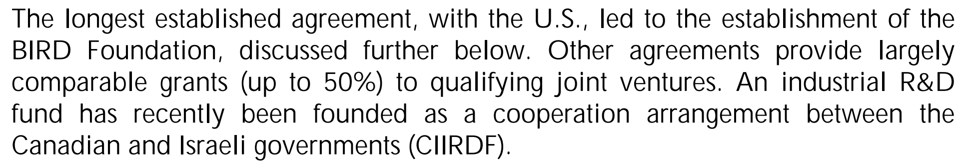
Submitting the Application

The application is to be submitted by at least two companies - one from each country that are parties to a cooperation agreement. The projects must comply with the technological areas and the timeframes defined in the memorandum of understanding.

The Commission will not intrude into the areas of activity of the BIRD Foundation and the Commission should therefore not be approached with projects that are eligible for the full support of this foundation.

Bilateral Commercial R&D Agreements

In recent years, the Israeli government has signed a number of bilateral R&D cooperation agreements with foreign governments in order to encourage technological joint ventures between Israeli and foreign companies. The ventures typically lead to joint R&D, manufacturing and marketing. Such agreements exist with the U.S., Canada the European Union, France, Germany, India, the Netherlands, Spain, Austria, Portugal and Singapore.



The longest established agreement, with the U.S., led to the establishment of the BIRD Foundation, discussed further below. Other agreements provide largely comparable grants (up to 50%) to qualifying joint ventures. An industrial R&D fund has recently been founded as a cooperation arrangement between the Canadian and Israeli governments (CIIRDF).

Such agreements provide Israeli companies with marketing outlets, R&D cooperation and access to new technologies they may otherwise not achieve.

The foreign company benefits, too. It gains access to new technology and is also likely to derive commercial advantages from Israel's free trade agreements with the U.S., the European Union, EFTA, Canada and other countries

Some bilateral agreements result in the creation of an autonomous funded R&D foundation. Other bilateral agreements are really parallel support arrangements whereby each government finances the entity in its country according to certain rules.

BIRD Foundation

Background

The Israel-United States Binational Industrial Research and Development Foundation (known as BIRD or BIRD-F) was established in 1977, under a treaty signed between the governments of Israel and the United States of America. The goal of this foundation is to encourage and support industrial cooperation between Israeli and American companies.

The foundation has an independent status and its own funds. Its head office is situated in Israel. The foundation has a board of directors consisting of Israeli and American government representatives.

BIRD-funded projects must be jointly proposed and implemented by a partnership - temporary, conditional or permanent - between an Israeli company and a U.S. company. The joint venture agreement should outline each partner's share in the financing of the project, in the actual research, in the ownership over the developed product, product manufacturing, marketing matters, etc. About 50% of new projects initiated in the last few years have been between companies introduced to each other by BIRD. A typical Israeli company may be a new or existing manufacturing company in the high-tech industry. On the U.S. side, a typical company will have complementary abilities and be of medium size ($20 - $500 million annual sales and growing). The U.S. company may, for example, develop, manufacture, market and support high-tech products. Resulting BIRD-supported products may be sold anywhere in the world, taking advantage

of Israel's free trade agreements with the U.S.A., the E.U., EFTA, Canada and other countries. However, the actual manufacturing of the developed product must be performed either in Israel or in the United States.

Grant availability

BIRD participates on a cost-sharing basis with Israeli company-U.S. company teams in the development, to the point of commercial readiness, of innovative (non-defense) technology-based products or processes which have reasonable potential for generating revenues and profits commensurate with the investment and the risks. BIRD's participation takes the form of "conditional grants" of up to 50% of the approved project expenditure.

Cost-sharing conditional grants awarded by BIRD fall into a number of categories, as follows:

(a) Full-scale projects:
Total project expenditure ranges from $200,000 to $2,500,000 over one to three years. BIRD may finance up to 50% thereof.

(b) Mini-projects:
Total project expenditure ranges up to $200,000. BIRD finances 50%. BIRD has quicker approval procedures for such projects.

(c) Feasibility test awards:
BIRD may award up to $30,000 as its 50% share for conducting market feasibility studies.

(d) Proposal preparation awards:
On an occasional basis, grant awards of up to $10,000 are available towards the preparation of a promising proposal for a full-scale project.

Recognized expenditure

Project proposals submitted to BIRD should conform to a standard format giving prescribed details. Recognized expenditure may include: direct labor salaries of up to $80,000 per annum for Israeli companies or $100,000 per annum for U.S. companies, employment benefits except company cars, overheads at the rate of 25% of direct labor salaries and benefits, equipment depreciation or leasing outlays, materials, travel, subcontractors, consultants, other approved expenses, and a general and administrative overhead allowance of 5% of the foregoing expenses.

Repayments

As with royalties paid to the Office of the Chief Scientist, conditional grants received from the BIRD Foundation must also be repaid out of the sales revenues of products developed, according to special terms determined by the foundation. Only in cases in which the project fails and there are no sales, the companies are exempt from repaying the grant sum.

Repayments are typically at negotiated rates ranging from 2.5% to 5% of product sales revenues. Such repayments continue until a prescribed percentage of the conditional grants have been repaid. If the prescribed percentage is not attained in a given year, the percentage generally rises, as shown in the following table.

Years following first commercial transaction	Maximum percentage of condition grant and other sums to be repaid
1	116%
2	124%
3	132%
4	141%
5	148%
6 and more	150%

These percentages refer to the dollar value of the BIRD conditional grant, plus adjustment for inflation as measured by the U.S. Consumer Price Index. In the event that resulting patented technology is licensed to a third party, 30% of the resulting revenues must be remitted to BIRD. If such technology is sold outright (with appropriate permission), 50% of the consideration must be remitted to BIRD. Such remittances to BIRD count towards the conditional grant repayment requirements shown in the above table.

Approval of Application

The Foundation's Board of Directors assembles twice annually for discussing and approving full-scale projects. A maximum of eight full-scale projects possessing special urgency or outstanding business potential may be approved annually, with the recommendation of the Foundation's General Manager, during the periods between the semi-annual assemblies.

Up to 20% of the Foundation's annual budget is designated for small-scale projects. The analysis and approval process of these smaller projects in simpler and does not require the approval of the Foundation's Board of Directors.

The Canada Israel Industrial Research and Development Fund (CIIRDF)

The governments of Israel and Canada resolved to contribute Can $ 1 million annually during the years 1995-1997 as finance for conditional R&D grants that will be approved by the Fund's management for Israeli and Canadian companies. The Canadian Fund is headquartered in Ottawa and consists of three representatives from each country.

Project Approval Conditions

The projects must involve the development or the realization and transfer of new and advanced technology. The Israeli and Canadian companies must jointly submit their application, which is to include details regarding both companies, the R&D subject, objectives, a technological description of the project, timetables, means of finance and the R&D's commercial implementation program. The Fund must also be presented with the agreement between the two companies, regulating their relationship with respect to ownership over the know-how, technology, division of manufacturing, marketing, etc.

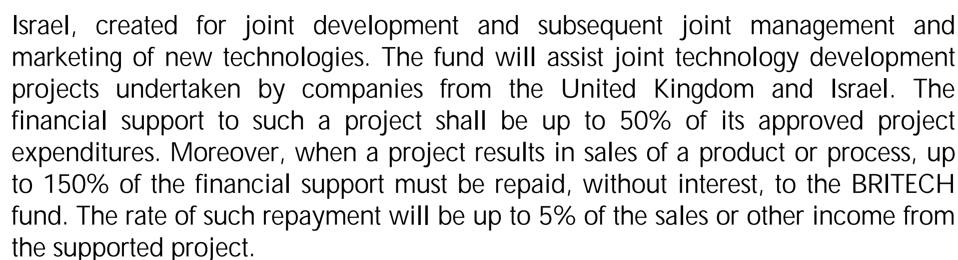
Grants and Repayments

The project will be granted support at a level equal to 50% of the approved expenditures. These expenditures normally include participation in labor wages, materials, sub-contractors, consulting and in special cases - travel expenses. The maximum volume of support will be Can$ 900,000 distributed over a three-year period (maximum support of Can$ 300,000 per annum). Royalties will be paid until the full repayment of the grant.

Israel- United Kingdom Bilateral Cooperation Agreement

On May 4, 1999, the Bilateral Cooperation Agreement between the government of Israel and the government of the United Kingdom was signed. The agreement became effective on September 3, 1999. Its main purpose is to promote activities of the private sectors of the countries to intensify bilateral industrial research and development cooperation.

For the above purpose, the countries have established the BRITECH Fund. This joint fund has as objective, the strengthening of the United Kingdom-Israel science and technology, business to business and overall economic and trade relations. The BRITECH fund will support alliances between businesses in the United Kingdom and



Israel, created for joint development and subsequent joint management and marketing of new technologies. The fund will assist joint technology development projects undertaken by companies from the United Kingdom and Israel. The financial support to such a project shall be up to 50% of its approved project expenditures. Moreover, when a project results in sales of a product or process, up to 150% of the financial support must be repaid, without interest, to the BRITECH fund. The rate of such repayment will be up to 5% of the sales or other income from the supported project.

Bilateral Parallel Support Agreements

Background

The activity related to these agreements is conducted by the national ministries that are responsible for industrial R&D projects in each country. The budgets and working procedures are identical to the accepted national procedures. A director is appointed in each country and the two directors (from the two countries) coordinate the activities related to the search for partners, approval, bilateral financing, etc.

Project Approval Conditions

The projects must involve cooperation between at least one company from each country. The projects must present technological innovation and global marketing potential. In the event that the project is approved by both nations it will receive bilateral support. The Israeli company will be supported in accordance with OCS regulations and the foreign company in accordance with the accepted regulations in its own country. In Israel this support is equal to 50%-60% (66% for a start-up enterprise). Royalties are also payable in each country according to regulations.

There are bilateral support agreements with: Belgium, India, the Netherlands, Spain, France, Austria, Portugal and Singapore.

Information for Foreign Investors in R&D Projects

General

The Ministry of Trade and Industry operates a computerized database, containing information regarding hundreds of Israeli technological projects that are offered for cooperation both in Israel and abroad.

Obtaining Information

1. "Advanced Technologies from Israel" is a bi-monthly magazine in English that is distributed to some 6,000 industrial companies, investment firms, venture capital funds and consulting firms, worldwide.

2. Selective exposure of Israeli projects at international fairs.

3. Dissemination of information on Israeli projects via an Internet site containing information regarding:

    (1) Israeli projects seeking international cooperation.

    (2) Profiles of Israeli companies that are interested in technologically cooperating with international corporations.

Operational Incentives

Overseas Marketing Grants

Grants for participation in export marketing programs are awarded by the Overseas Marketing Encouragement Fund. This fund is administered by the Ministry of Trade and Industry.

The Fund generally classifies goods and services exporters as follows:

Start-Ups(*)	**I.** Develops products belonging to one or more of the following industries: software, electronics, computers, communication equipment, control & development, medical equipment, electricity equipment and bio-technology; and **II.** The company has performed preliminary inquiries regarding the technology's feasibility, or has received support from the Chief Scientist and/or raised funds from private sources or from the public; and **III.** The company has incorporated as a legal entity; and **IV.** Time elapsed since incorporation is no longer than 5 years; and **V.** The company is capable of presenting its product for sale within 1 year; and **VI.** All regulations pertaining to Small Exporters as set forth hereunder.
Small Exporters	Exports of up to $2 million in the year before the application for support and annual revenues not exceeding $4 million.
Small Intermediate Exporters	**I.** Exports of $ 2-7 million in the year preceding the application for support and annual revenues not exceeding $15 million. **II.** Exports of more than $2 million, and investment of $ 250,000 pursuant to a marketing plan, in the year preceding the application for support.
Intermediate Exporters	Exports of $7 -15 million in the year preceding the application for support and annual revenues not exceeding $30 million.

(*) The "Start-ups" class was introduced for a test period in 1999, as a variation of the "small exporters" class. It is therefore our estimation that continuation of this class will be subject to budget availability.

Grants or loans from the Fund are given to an exporter who is a small intermediate or an intermediate exporter for maximum of two years.

Grants or loans are given initially for one year and the Fund's Board may consider a grant or a loan for one more year. However, an exporter who does not accomplish at least 50% of its marketing plan in any one year will not receive Fund support in the following year. An exporter who does not accomplish at least 33% of its marketing plan in any given year must pay back the grant or loan received from the Fund.

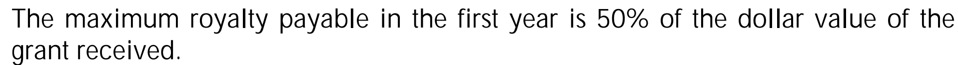
The marketing support grants available are as follows:

For Start-Ups	A grant at the rate of 30% of the approved budget, up to a maximum grant of $55,000.
For Small Exporters	A loan the rate of 30% of the approved budget, up to a maximum loan of $45,000.
For Small Intermediate Exporters	A loan at the rate of 30% of the approved budget. The maximum loan amount $ 180,000.
For Intermediate Exporters	A loan at the rate of 30% of the approved budget up to a maximum loan of $300,000.

The Fund operates according to a budget predetermined on a yearly basis. In previous years, the Fund terminated its yearly operation prior to the end of the calendar year, due to lack of funds. It is therefore recommended that prospective applicants contact the Fund as early as possible during any given year.

A broad range of export marketing activities may be supported including participation in exhibitions and fairs in Israel or abroad, demonstration campaigns, market surveys, maintaining offices and warehouses during their first 24 months of activity, catalogs, advertising, registering patents and trade names or symbols, standards testing, marketing-related legal advice, packaging to export standards, marketing trips to other countries, overseas project exploratory surveys, overseas professional workshops, invitations to overseas buyers, and obtaining ISO 9000 status in Israel.

If the marketing program is successful, small intermediate and intermediate exporters repay the dollar value of the grant received via royalties at the rate of LIBOR plus 4% of the resulting growth in exports. Payment of royalties generally begins 12 months following the end of the year of the marketing program.



The maximum royalty payable in the first year is 50% of the dollar value of the grant received.

The Fund also provide grant or loans to manufacturers in the textile, jewelry, motion picture and additional industries.

Employment and training grants

With regard to grants to export agents and distributors see the chapter "Incentives for export companies".

Job creation grants are paid by the Ministry of Immigration to employers who engage new immigrants aged 45 or more. The Ministry of Labor and Welfare may participate in the cost of on-site training of workers.

There is an assistance program for the absorption of immigrant scientists engaged in Research & Development. There are also assistance programs for adjustment and personal training for immigrants 45 years of age and older, and assistance programs for adjustment and personal training for academics.

The Israel Foreign Trade Risks Insurance Corporation Ltd. (IFTRIC)

It provides Israeli exporters with insurance and guarantee services. These services are designed to reduce the risk associated with implementing export transactions and to assist in financing exports. IFTRIC deals with two main types of insurance: insurance of export transactions implemented on the basis of short-term credit and insurance for export transactions implemented on the basis of medium and long-term credit.

The insurance services covered by IFTRIC cover a wide variety of areas such as agriculture, engineering pharmaceuticals, high-tech and telecommunications. In recent years, the scope of export insurance for technology-led industries such as electronics and telecommunications has been increasing.

Supply of land

In certain cases, the Israel Land Authority allocates land to investors in enterprises, without a tender, for a reduced price.

Small business loan fund

Certain Israeli banks are authorized to provide loans of up to NIS 500,000 for 5 - 6 years on controlled terms to finance investment programs of businesses that will have up to 70 employees upon completion of the program and whose annual turnover is less than $5 million. The business must not be eligible for other Israeli government benefits (e.g. Approved Enterprise status) and all shareholders must be Israeli resident individuals. Certain fields of activity are excluded such as real estate, diamonds and electronics. The loans may be applied towards equipment, working capital and leasehold improvements but not for other construction or real estate expenditure, nor the repayment of existing debts. The government will issue a loan guarantee as partial collateral in addition to a lien over the assets, and the proprietor(s) must invest equity of 25%.

World Bank MIGA Guarantees

Israel is a member country of the Multinational Investment Guarantee Agency of the World Bank. Consequently, investors from approximately 153 other member countries may purchase insurance cover against political and other non-commercial risks on recognized investments in Israel. Israeli investors may buy similar insurance covering investments in specified developing member countries of MIGA. The arrangement is administered in Israel by the Bank of Israel.

Operating Benefits for Industry and Commerce

Various other operating benefits of an ongoing nature are available to industrial and commercial concerns, including:

- Exemption from, or recovery of, customs duties, purchase tax and port dues on raw materials used to manufacture exported products;
- VAT loan fund to enable a certain rate of the VAT on imports to be deferred by exporters pursuant to certain conditions until recovery of the tax as input VAT on the next VAT return (limited for one year).
- Purchase and sales of stocks are not liable to VAT.

In addition, note that according to Israeli law, services for foreign resident (as consultants) are taxable at a rate of 17%, whereas consulting which relates to an asset which is in Israel, or to making an agreement to which an Israeli citizen is a party, is taxable at a rate of 0%.

Incentives for Other Sectors

Agriculture

Approved agricultural enterprises enjoy tax and financial benefits broadly similar to approved industrial and tourism enterprises. However, the benefits tend to be more limited as the Law aims mainly to assist smaller farming concerns.

Oil Exploration

Oil exploration pursuant to a government license is subject to a special tax regime. At the exploration stage, publicly traded limited partnerships are fiscally transparent so that investors may deduct their share of oil exploration expenses and losses up to the amount of their investment (the at-risk concept).

If any oil is discovered, a 12.5% oil production royalty will be payable to the government, but generous deductions are available for land amortization and depletion allowances as well as the royalty. Tax may be payable at reduced rates if approved enterprise status is granted. Exemption from import taxes on essential equipment may also be granted.

Film Production

Film productions in Israel may qualify for government film grants in certain cases and may pay tax at reduced rates if approved enterprise status is granted. Moreover, if a public or private limited partnership vehicle is used, production expenditure (net of any grants) will be allocated to the investors as a deduction against income up to the amount of their investment, but not exceeding 45% of their taxable income. Partnership "pre-sales" will not be taxable until consideration is received until the tax year commencing after 18 months following completion of the production, whichever is earlier.

Exemption may also be granted from import taxes on consumables and on equipment that is later re-exported.

Incentives for Export Companies

Income tax benefits

Commercial export companies, which meet the criteria outlined below, may be awarded the status of "approved enterprise". This status may also be awarded to companies exporting expertise or involved with overseas projects.

An export company for these purposes is one, which represents at least five unrelated Israeli manufacturing enterprises and exports their products. The condition for receiving Approved Enterprise status is that the company generate at least $1,000,000 per annum in export sales (F.O.B) and represent at least five manufacturers, each with a minimum export turnover of $70,000 per year.

The receipt of Approved Enterprise status entitles a company with a foreign investment to reduced company tax rates for a period of up to 10 years from the year the company first earns taxable profits, as follows:

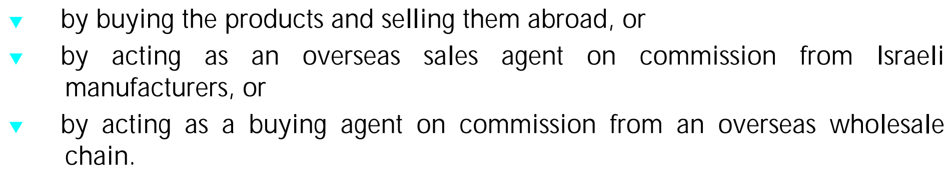
% foreign investment	Company tax rate
25.01 - 48.99%	25%
49.00 - 73.99%	20%
74.00 - 89.99%	15%
90% or more	10%

If the company is no more than 25% foreign owned, it may enjoy a 25% company tax rate for up to 7 years (instead of 10 years).

Dividends paid from profits of the Approved Enterprise are liable to withholding tax at the rate of 15%.

Other incentives

Commercial export companies may, as an alternative, receive a grant or loan. Another incentive is offered by the Industry and Trade Ministry's Overseas Encouragement Marketing Fund (see the chapter "Operational Incentives"). For these purposes, an "export company" is a non-manufacturing company (or individual) whose principal activity relates to the export of products of Israeli manufacturers:



- by buying the products and selling them abroad, or
- by acting as an overseas sales agent on commission from Israeli manufacturers, or
- by acting as a buying agent on commission from an overseas wholesale chain.

Various conditions apply to such grants including the following:

- The export company must have a registered office for its use only, as well as employees, equipment and facilities necessary for its activities.
- In an agreed base year, the export company facilitated exports of at least 5 Israeli manufacturers, in an amount of at least $50,000 each; and its name and identity number were recorded in boxes 15 and 16 of the Israeli Customs export documents.
- The export company undertakes in its marketing plan to continue to facilitate exports for at least 5 small Israeli manufacturers (among others) whose exports totaled under $5 million each in the base year. Marketing activities should be comprehensive and cost over $20,000.
- The export company must be unrelated to the manufacturers and to other export companies, in accordance with detailed rules.

Incentives for International Trading Companies

The Law for the Encouragement of Capital Investments allows the Minister of Finance to grant total tax exemption (as detailed below) for a period of ten years to a foreign company registered in Israel that is engaged in international trade.

Israel is not normally considered a haven, and it has a well-developed array of services and personnel dedicated to international trade. Therefore, a rationale exists for companies involved in international commerce to use Israel for entrepot trade.

The following criteria are normally used to define an international trading company:

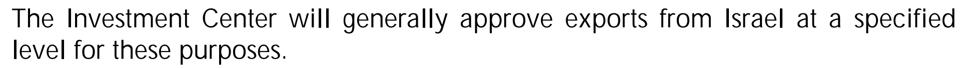
a. Its shareholders are residents of a foreign country.

b. The company is registered in Israel as a foreign company operating in Israel, dealing exclusively in international trade, with the exception of permitted ancillary dealings.

c. The company is involved with exports from Israel as part of the permitted ancillary dealings mentioned in c. above.

d. The company must have branches in at least three countries.

International trade is defined as trade which is carried on entirely outside of Israel, other than exports from Israel or imports thereto as stated in c. and d. above. Other activities which are approved in advance by the Board of the Investment Center may also be regarded as international trading activities on condition that their value is insignificant in comparison with the overall international trade revenues.



The Investment Center will generally approve exports from Israel at a specified level for these purposes.

Tax concessions for an approved international trading company and its shareholders are as follows:

a. Exemption from Israeli company tax for a period of ten years, beginning with the year in which taxable income is first derived from international trade.

b. Exemption for the company from capital gains tax on overseas assets for a period of ten years.

c. Dividends paid to a foreign resident shareholder out of tax-exempt profits are themselves exempt from taxes for the aforementioned ten year period and the next ten year period (a total of 20 years).

d. Capital gains derived by the shareholder from the sale of shares in the company during the aforementioned 20 year period are also tax-exempt.

International Trade Agreements

Background

In view of the vital importance of industrial and agricultural exports to Israel, a comprehensive set of international trade agreements has been signed.

Israel's main trade agreements are:

- The GATT agreement, within the framework of which most international trade is regulated. Israel became a signatory to this agreement in 1959.
- Israel is a founder member of the World Trade Organization formed in 1995.
- Agreement concerning a Free Trade Area with the European Union (formerly the European Community), which Israel signed in 1975. This was replaced by an expanded agreement in 1996.
- Agreement of 1985 concerning a Free Trade Area with the United States.
- Agreement of 1992 concerning a Free Trade Area with other Western European countries (EFTA).
- Israel - Jordan peace accord.
- Israel - PLO autonomy accords.
- Israel - Canada Free Trade Agreement.
- Israel - Czech Republic Free Trade Agreement.
- Israel - Slovakia Free Trade Agreement.
- Israel - Turkey Free Trade Agreement.
- Israel - Poland Free Trade Agreement
- Israel - Hungary Free Trade Agreement
- Israel - Mexico Free Trade Agreement
- Israel - Slovania Free Trade Agreement

Israel-E.U. free trade agreement

In 1975, Israel signed an agreement for the establishment of a Free Trade Area with the EU. Under the terms of this agreement, Israel now enjoys complete exemption from EU import duties on most of its exports. In return for this exemption, Israel agreed to expose local industry to competition from the EU Countries through a phased reduction of import duties, which is now complete. Certain "rules of origin" relating to goods traded must be complied with to enjoy the FTA benefits. These rules ensure a minimum local added value in Israel and the EU countries, respectively.

The Israel-EU Free Trade Area agreement facilitates the expansion of industrial trade with the Common Market countries, and indeed, exports to the EU account for around 40% of Israel's total export sales.

In October 1995 Israel and the EU signed in principle a replacement free trade agreement, also referred to as an Association Agreement. The new agreement was implemented during 1996.

The new agreement introduced enhanced benefits various relaxations including the following:

- An invoice declaration by an "approved exporter" regarding the origin of goods may replace the present EUR1 certificate of origin.

- Alternative percentage rules to compute local content in certain cases, such as goods that result from R&D or undergo testing.

- Up to 10% of the price of goods may be derived from interim processing in a third country prior to export from the exporting country.

- Allowance of raw materials from the EU (for Israeli products) or Israel (for EU products) in computing the local content.

- Admission of Israel to EU research programs as an observer without voting rights.

During July 1997 additional accords were signed between Israel and the EU concerning governmental procurement. According to these accords limitations will be relaxed on such commerce.

Israel-U.S. free trade agreement

In 1985, Israel and the United States entered into the FTA (Free Trade Area) agreement.

Under a previous arrangement - the GSP - (general system of preferences) Israel enjoyed certain preferences in its exports to the American market on an ad hoc basis. The FTA, however, provides Israel with fixed terms of access to the U.S. market on a long-term basis.

Within the framework of the FTA, Israel enjoys additional preferences in a number of areas, e.g., textiles, clothing, fresh and processed foods, and others, in order to broaden its export potential.

The agreement provides that American exports to Israel will enjoy similar conditions and customs and excise tax rates as that of EU countries. However, product "rules of origin" are different.

Further more, inputs originating in the Palestinian autonomous areas or the Irbid industrial zone in Jordan will be treated as Israeli-origin inputs in certain circumstances.

Israel - EFTA free trade agreement

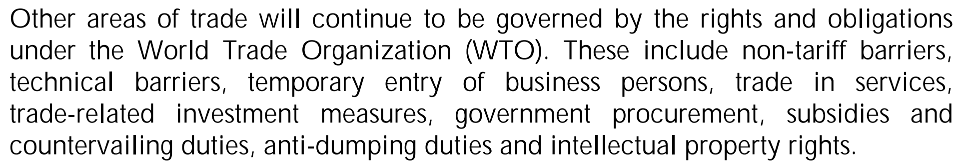
In 1993, a Free Trade Agreement became effective between Israel and the European EFTA countries regarding industrial and agricultural products originating in countries, which are parties to the agreement.

Tariffs on industrial products were immediately repealed. Tariffs on certain agricultural and processed food products were reduced or abolished.

Israel - Canada free trade agreement

The Free Trade Agreement between Israel and Canada became effective as from January 1, 1997.

The key feature of the Agreement was the extensive elimination of tariffs on Canadian and Israeli goods. Virtually all tariffs of industrial products were eliminated immediately upon implementation of the Agreement. The package of tariff concessions for the agriculture and fish sectors covers a wide range of products of export interest to both countries, involving about 80 per cent of agri-food trade between the two Parties.



Other areas of trade will continue to be governed by the rights and obligations under the World Trade Organization (WTO). These include non-tariff barriers, technical barriers, temporary entry of business persons, trade in services, trade-related investment measures, government procurement, subsidies and countervailing duties, anti-dumping duties and intellectual property rights.

Cultural industries are exempted from the provisions of the Agreement.

The Rules of Origin in the Israel Canada FTA are based on changes in tariff classification of products under the Harmonized System for tariff classification. The rules of origin are, on the whole, less restrictive than those under the North American Free Trade Agreement and reflect the structure and openness of the Canadian and Israeli economies.

Since both Canada and Israel have free trade agreements with the United States, U.S. - made materials will, under specific circumstances, be treated as originating inputs when used to produce goods in Canada for export to Israel and vice versa.

The FTA will also allow some minor processing of otherwise originating goods while they are in transit in the United States. This will be limited to processes which are incidental to the production of goods, such as minor decorative, packaging or cleaning processes and will be subject to certain verification procedures.

The Rules of Origin are to be reviewed after two years to see if they can be improved.

Israel- Jordan Peace accord

On October 26, 1994, Prime Minister Yitzhak Rabin and Prime Minister Abdul-Salam Majali signed the Treaty of Peace between the State of Israel and the Hashemite Kingdom of Jordan, the second peace treaty Israel has signed since its independence.

Economic cooperation is seen as one of the essential ingredients of the peace agreement. As a result of ongoing negotiations since 1994, bilateral agreements have been signed between Israel and Jordan, primarily in the areas of tourism, environmental cooperation, trade, police cooperation and agriculture.

As mentioned above, inputs originating in the Irbid industrial zone will be treated as originating in Israel for the purposes of the Israel - U.S FTA, in certain circumstances. Such inputs must result from substantial cooperation between an Israeli manufacturer and a Jordanian manufacturer.

Israel-PLO autonomy accords

In the period 1993-1998, Israel and the PLO signed a series of autonomy accords, including in the "Interim Agreement on the West Bank and the Gaza strip" of September 28, 1995. This Interim Agreement contains detailed legal, commercial, economic and tax provisions.

In particular, the Interim Agreement states that there is to be free movement of industrial goods, i.e., free of restrictions including customs and import taxes, between Israel and the autonomous areas, subject to each side's legislation.

Similar principles of free movement between the two sides will also apply to agricultural products. However, veterinary and plant protection procedures must be observed, and temporary quantity limits apply to certain items.

The Palestinian Council has certain powers and responsibilities in the sphere of import and customs policy and procedures, as well the collection of import taxes.
Payments for goods sold by Israelis to Palestinians, or by Palestinians to Israelis, may not be subject to deduction of tax at source, except on such income as is attributable to a permanent establishment in the areas under the tax responsibility of the other side. Withholding tax certificates will be issued by the taxpayer's own tax office on special paper to assure authenticity.

Tax will not be deducted at source on income from transportation by an Israeli (or Palestinian) if the point of departure or final destination is in the areas under Israeli (or Palestinian) tax responsibility.

Implications

Israel is unique in that it is the only country which enjoys Free Trade Area agreements with the U.S, Canada, the EU and EFTA, and various Eastern European countries, as well as preference arrangements with Japan. Furthermore, proposed free trade agreements with other countries are under negotiation.

These developments assume special importance in light of the unification of the European Common Market. This market, which is likely to become the largest in the world, includes within its member nations approximately 380 million of the world's more affluent consumers. The U.S. market, of course, encompasses a further 250 million active consumers.

Israel's trade agreements with the EU represent an important incentive for investors from the United States the Asia-Pacific region and elsewhere, due to the preferential access available to these enormous markets.

Moreover, these free trade agreements enable manufacturers in Israel to achieve substantial import tax cost savings on import and export transactions with these countries.

Tax Treaty Benefits

Israel currently has treaties for the avoidance of double taxation with thirty one countries including the U.S.A. and most European countries (including Sweden, the U.K, France, Finland, Germany, Norway, Austria, the Netherlands, Belgium, Denmark, Ireland and Italy), as well as China, Japan, Korea, Singapore, Canada, South Africa, and India.

For details of the U.S.-Israel treaty, see Appendix 6.

Under Israeli law, the provisions of a tax treaty override internal Israeli legislation. Proposals exist to allow the tax authorities to disregard transactions that substantially reduce Israeli taxes by means of treaty abuse.

Treaties do not impose new taxes, they merely distribute the tax revenue "cake" between the signatory countries. This distribution is effected by the use of exemptions, reductions in tax rates, and the granting of tax credit. Where the tax rate or treatment under the domestic laws in one country is less than that provided for by an applicable treaty, the more advantageous domestic rate or treatment, from the taxpayer's perspective, will generally be applied.

Most tax treaties signed by Israel have not been subject to any change over the years. Investors may, therefore, view them as a body of law with a low probability of being amended.

Foreign investors, particularly those with multinational operations, should make their investment plans in conformity with the provisions of any applicable tax treaty. They must decide from which country to invest, and how to structure the operation and the investment (i.e. whether with equity, shareholders' loans, royalty, licensing agreements, leasing, or a combination of these). Additional thought must be given to any capital gains taxes that might be imposed and the way in which any relevant treaty relates to them (if at all).

An investor planning his investment strategy must also ascertain whether any local laws or treaty provisions operate to prevent treaty shopping, i.e. the using of third party countries through which to route an investment purely for reason of a tax gain.

In many of Israel's tax treaties, there is a clause giving "tax sparing relief", which grants certain advantages to investors in Israeli operations. As a general rule, a "tax sparing clause" ensures that certain tax rate reductions granted under Israel's incentive legislation "flow through", to the investor. Accordingly, in the investor's country of residence the investor may receive a credit as if full Israeli taxes had been paid on the income concerned, rather than the reduced Israeli taxes, actually paid. In this way a foreign investor is assured of retaining the full benefit of tax incentives granted with respect to his investment in Israel.

The following examples will illustrate how the above relief operates.

Combination of the use of an "indirect" tax credit for Israeli company taxes paid and "spared", may result in a total tax charge of only 23.5% in Israel and Britain on distributed corporate profits of an Israeli company. This applies where a British company has invested in an Approved Enterprise via an Israeli company in which it owns 90% or more of the shares and other rights.

It would seem that for Austrian, French, German and Dutch companies which invest in Israeli "approved enterprises", the total foreign and Israeli tax burden will not exceed 23.5% under certain circumstances due to domestic and treaty exemption provisions in those countries.

Some of the treaties also grant tax savings in relation to interest or royalty income (e.g. The Netherlands and Singapore).

A combination of Dutch internal law and the Netherlands-Israel treaty, where a substantial equity participation exists, may sometimes result in exemption from capital gains taxes in both countries.

Treaty Withholding Tax Rates (September 2000)

The following table provides Israeli withholding tax rates for payments of dividends, interest and royalties to residents of various countries. Exemptions or conditions may apply, depending on the terms of the particular treaty.

	Dividends	Interest	Royalties (a)
	%		
Austria	25	15	10
Belgium	15	15	10
Canada	15	15	15
China	10	7/10 (b)	7/10 (c)
Czech Republic	5/15 (d)	10	5
Denmark	25	25	10
Finland	5/10/15(e)	10	10(f)
France	5/10/15(e)	5/10(f)(g)	10
Germany	25	15	5
Greece	25(h)	10	10
Hungary	5/15(d)	0	0
India	10	10	10
Ireland	10	5/10(g)	10
Italy	10/15(i)	10	10
Jamaica	15/22.5(j)	15	10
Japan	5/15(k)	10	10
Korea	5/10/15(e)	7.5/10	(l)2/5(m)
Mexico(ee)	5/10(n)	10(o)	10
Netherlands	5/10/15(e)	10/15(p)	5
Norway	25	25	10
Philippines	10/15(q)	10	10/15(r)
Poland	5/10(d)	5	5/10(s)
Romania	15	5/10(t)	10
Singapore	0(u)	15	0(v)
South Africa	25	25	0
Sweden	0(u)	25	0
Thailand	10/15(w)	10/15(x)	5/15(y)
Turkey	10	10(z)	10
United Kingdom	15	15	0
United States	12.5/15/25(aa)	10/17.5(bb)	10/15(cc)
Uzbekistan	10	10	5/10(dd)
Nontreaty countries	25(ff)	25	25(ff)

(a) Different rates may apply to cultural royalties.

(b) The 7% rate applies to interest paid to banks or financial institutions.

(c) Under a protocol to the treaty, the 7% rate is the effective withholding rate for amounts paid for the use of industrial, commercial or scientific equipment.

(d) The 5% rate applies if the recipient holds directly at least 10% of the capital of the payer (Hungary) or at least 15% of the capital of the payer (Poland), or if the recipient is a company that holds at least 15% of the capital of the payer (Czech Republic).

(e) The 5% rate applies if the dividends are paid out of profits that were subject to the regular company tax rate (currently, 36%) and if they are paid to a corporation holding at least 10% (Finland, France, Korea) or 25% (Netherlands) of the payer's capital. The 10% rate applies to dividends paid to such a corporation out of profits that were taxed at a reduced rate of company tax. The 15% rate applies to other dividends.

(f) Alternatively, an interest recipient may elect to pay regular tax (currently, the company tax rate is 36%) on the lending profit margin.

(g) The 5% rate applies to interest on a bank loan as well as to interest in connection with sales on credit of merchandise between enterprises or sales of industrial, commercial or scientific equipment.

(h) Dividends are subject to tax at the rate provided under domestic law, which is currently25% in Israel.

(i) The 10% rate applies if the recipient holds at least25% of the capital of the payer.

(j) The 15% rate applies if the recipient is a company that holds directly at least 10% of the voting power of the payer.

(k) The 5% rate applies to corporate recipients that beneficially own at least 25% of the voting shares of the payer during the six months before the end of the accounting period for which the distribution is made.

(l) Interest on certain government loans is exempt. The 7.5% rate applies to interest on loans from banks or financial institutions. The 10% rate applies to other interest payments.

(m) The 2% rate applies to royalties for use of industrial, commercial or scientific equipment.

(n) The 5% rate applies if the recipient is a company that holds at least 10% of the payer, provided the payer is not an Israeli resident company that pays dividends out of profits that were taxed at a reduced rate of company tax. The 10% rate applies in all other cases.

(o) Interest on certain government loans are exempt.

(p) The 10% rate applies to a Dutch bank or financial institution.

(q) The 10% rate applies if the recipient holds at least 10% of the capital of the payer.

(r) The 15% rate applies unless a lesser rate may be imposed by the Philippines on royalties derived by a resident of a third country in similar circumstances. The Philippines-Germany treaty specifies a 10% withholding tax rate on industrial and commercial royalties. Consequently, a 10% rate is likely to apply to these royalties under the Israel-Philippines treaty.

(s) The 5% rate applies to royalties for the use of industrial, commercial or scientific equipment.

(t) The 5% rate applies to interest on bank loans as well as to interest in connection with sales on credit of merchandise between enterprises or sales of industrial, commercial or scientific equipment. Interest on certain government loans are exempt.

(u) Under a disputed interpretation of the treaty, a 15% rate may apply to dividends paid out of the profits of an approved enterprise or property.

(v) The tax rate on the royalties in the recipient's country is limited to 15%.

(w) The 10% rate applies if the recipient is an Israeli resident or if the recipient is a Thai resident holding at least 15% of the capital of the payer.

(x) The 10% rate applies to interest paid to banks or financial institutions, including insurance companies.

(y) The 5% rate applies to royalties paid for the use of literary, artistic or scientific works, excluding radio or television broadcasting works.

(z) Interest on certain government loans is exempt. The 10% rate applies to all other interest payments.

(aa) The 12.5% rate applies to dividends paid by a company that does not have an approved enterprise or approved property in Israel to U.S. corporations that own at least 10% of the voting shares of the payer, subject to certain conditions. The 15% rate applies to dividends paid out of the profits of an approved enterprise or property. The 25% rate applies to other dividends.

(bb) The 10% rate applies to interest on a loan from a bank, savings institution, insurance company or similar company. The 17.5% rate applies to other interest. Alternatively, an interest recipient may elect to pay regular tax (the company tax rate is currently 36%) on the lending profit margin.

(cc) The 10% rate applies to copyright and film royalties. The 15% rate applies to industrial and other royalties.

(dd) The 5% rate applies to royalties paid for the use of literary, artistic or scientific works, excluding cinematographic films. The 10% rate applies to other royalties.

(ee) Implementation Order effective in Israel from January 1,200.

(ff) See Sections A and B.

Israel has also initialed draft treaties with the Russian Federation, the Slovak Republic and Spain.

Raising Capital from the Public in Israel

General

An important factor to be considered by entrepreneurs is the possibility of raising additional capital by issuing securities to the public after a successful business start-up.

Israel has a sophisticated capital market, centered in the Tel-Aviv Stock Exchange ("TASE").

Trading in securities and raising capital from the public are regulated by the Securities Law and its regulations, and those of the Stock Exchange.

The Securities Law

Under the Israeli Securities Law, a Securities Authority has been established to protect the interests of investors and to administer the law and its regulations.

The Israeli Securities Authority operates on the basis of the principles of the U.S. Securities legislation, which is among the strictest in the world. The requirements relating to financial statements of Israeli listed companies have been set along progressive lines laid down by the Israeli Certified Public Accountants Institute, generally in accordance with United States generally accepted accounting principles.

The law requires that any offer of securities to the public be made through the issuance of a prospectus. The law establishes criteria for the prospectus, the financial reports and the details included therein, and so forth.

The law also establishes the obligations of the company in reporting to the Securities Authority after issuing securities to the public, concerning both financial reports and changes occurring in the company, its business, its management and its ownership. Similar reports are required by the Stock Exchange.
In 2000, a dual listing amendment to Israel's Securities Law was made and it is expected to take effect during the third quarter of the year 2000. The amendment enables U.S. - listed Israeli companies to easily dual-list on the Tel-Aviv stock exchange (TASE), based on the U.S. SEC's disclosure and filing requirements and financial statements prepared according to U.S. GAAP. Some 80 Israeli companies, most of them in the high tech field are currently listed exclusively on U.S. markets.

The Tel-Aviv Stock Exchange

Following a bull market that began in 1989, the Israeli stock market hit a depression in 1994 that continued well into 1996. Share prices eventually stopped falling and since November 1996, a rebound has occurred. Trading in 1998-99 was characterized by lively activity and high turnover of stocks, which reached record levels in 2000, together with rising rates and large fluctuations, and an increase in capital fund raising.

The increasing activity of foreign investors on the stock market, a slowdown of inflation and the improved profitability of publicly-traded companies, were among the factors that contributed to the positive atmosphere and to the market rebound. It is important to notice that the difficulties encountered in implementing the Middle East peace process did not prevent this recovery. An improvement in the political sphere should further boost Israel's stock market.

Equities trading is the main business of the Tel-Aviv Stock Exchange (TASE). This market offers around 1,000 securities, including shares, warrants and convertible bonds. The TASE has for some years sought to equalize the status of all listed shares since 1990. All new companies can issue shares only according to the one share one vote principle. Only a few companies still have classes of shares with different voting rights.

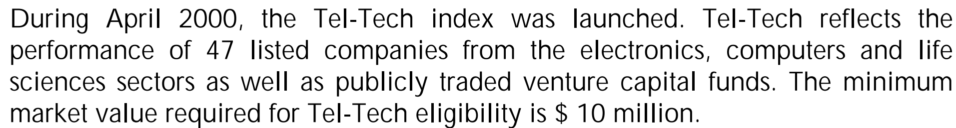
In August 1997, the Tel-Aviv Stock Exchange introduced the fully-automated Tel-Aviv Continuous Trading (TACT) system. By the end of 1998 all shares, bonds and T-bills had been transferred to the new system and in October 1999, derivatives trading migrated to TACT as well.

TACT gives investors state-of-the-art tools for trading, while providing the exchange with convenient and efficient monitoring channels.

The system has already boosted the TASE's derivatives volumes and the exchange expects further increases as international investors become more familiar with, and recognize the advantages of, investing in TASE-listed companies.

The MAOF (derivatives) market grew to capture a respectable share of the total capital market, is characterized by elevated activity, especially in the trade of TV 25 index options (the index of the 25 heaviest shares on the stock exchange).

During January 2000, the TA 75 index launched. This index includes the 75 shares that follow the exchange's 25 largest shares by market capitalization.



During April 2000, the Tel-Tech index was launched. Tel-Tech reflects the performance of 47 listed companies from the electronics, computers and life sciences sectors as well as publicly traded venture capital funds. The minimum market value required for Tel-Tech eligibility is $ 10 million.

In June 2000, the TA Banking Index was launched, which reflects the performance of the TASE's five largest commercial banks. The banks make up one of the most active sectors on the exchange, accounting for 12% of the market's total trading turnover in the first half of 2000.

In the first half of 2000, the present round of privatization of government companies was successfully completed, a process which led to an increase of some 12% in the holdings of shares by the public over 1998-7.

In 1996 a wave of acquisition bids began which continues today and bears witness to the increasing numbers of company mergers, which itself reflects the desire of controlling shareholders to reorganize in a more efficient manner. During 1999, 50 acquisition bids were published.

The number of companies whose shares are traded on the Tel-Aviv Stock Exchange was 661 at June 2000, and the market value of shares, options and convertible bonds traded amounted to $74 billion. More then 20 TASE-listed companies are also listed in other countries, mostly on NASDAQ and the New York Stock Exchange. Dual listing raises the international profile of Israeli companies, helping widen their investor bases and boost trading volumes.

Daily trading volumes reached an average of $86 million in 1999. In June 2000, average daily turnover was about $141 million, despite the setback in the second quarter in line with turbulence on other world markets.

During the first half of 2000, over $1.6 billion in capital has been raised on the TASE - more than the total amount raised during 1999.

The number of public issues and sale offers in 1999 reached 47 by the end of the year, including 13 initial public offerings (IPOs).

Principal share market activity indices 1993-2000				
Year	**No. of companies (1)**	**No. of offerings (2)**	**Average daily dealings ($ millions)**	**Capital raised ($ billions)**
1993	558	285	123	3.1
1994	638	176	104	1.8
1995	654	79	37	0.7
1996	655	53	33	0.8
1997	659	131	59	2.2
1998	662	90	62	2.1
1999	654	97	86	1.5
2000 (3)	661	111	141	1.6

(1) Year-end data.

(2) Includes issues abroad, sale offers, private placements and options realized. Also included since 1994 are private allotments of redeemable bond stocks.

(3) First half of 2000.

Rates of holdings by the public and other parties having an interest in 1993-2000

	December							June
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Israeli parties having an interest	-	-	42.4	44.1	47.1	49.2	52.5	50.8
Foreign interested parties	-	-	7.2	7.1	8.5	8.5	6.1	6.1
Israeli government	16.2	14.5	16.5	16.5	11.3	9.1	7.8	6.0
Total related parties	66.1	66.2	66.1	67.7	66.9	66.8	66.4	62.9
Israeli and foreign public	33.9	33.8	33.9	32.3	33.1	33.2	33.6	37.1
(of which: foreign public)*			(3.0)	(3.0)	(4.0)	(4.6)	(5.0)	(4.8)
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

* Estimate according to Bank of Israel data.

An examination of the percentage of the publics holdings of shares traded on the Tel-Aviv Stock Exchange indicates that there are 60 companies in which the public holds more than 50% of the shares as opposed to only 50 companies at the end of 1999.

Similarly, there are currently 25 stocks in which the public owns less than 7.5% - the limits set by stock exchange registration guidelines. The rate of foreign interest holders in stocks on the TASE declined during 1999 due to the sale of shares to Israeli investors but since than has remained stable at around 6%, currently valued at about $4.4 billion.

Principal listing criteria of the Stock Exchange for shares

As an additional step to modernize the stock exchange, the principal listing criteria for companies requesting to issue shares on the TASE were altered in mid-1997 and updated during 1999. The purpose of the new regulation is to lower equity requirements before the offering and to increase the public's share in the listed company. The new criteria also make it easier for new high-tech companies to list on the TASE.

Following is an outline of the major listing criteria.

Criteria	Alternative			
	A	B (big companies)	C	R&D company
Seniority (years)	1	1	-	1
Equity before the public offering registration ($ millions)	1	1	-	-
Equity after the public offering ($ millions)	4	9	-	2
Value of the public's holdings	2	6	20	1.25
Added value during year preceding the public offering ($ millions)	1	-	-	-
The Capital raised from the public at the offering ($ million)	-	-	20	-
Value of the company's stock ($ million)	-	-	50	-

A company requesting to issue shares must comply with one of the following alternatives as well.

Criteria	Alternative						
	A	B	C	D	E	F	G
When equity held by the public is ($ millions)	1.25[1]	2	4	6	8	12	50
The public shareholders' level must be at least (%) (not including R&D companies)	-	40	30	20	15	10	7.5
The public shareholder's level in R&D companies must be at least (%)	25	25	20	13.3	10	7.5	7.5

There are separate criteria for limited partnerships for oil exploration and film production, and venture capital funds.

Listing criteria for bonds

In the case of bonds, shareholders' equity of the issuing company shall not be less than $6 million, and the minimum issue not less than $6 million.

Underwriting timetable and expenses of the offering

The Stock Exchange ordinarily requires an underwriter for securities, although this is not required by law.

There is no objection to the underwriter having an interest in the issuing body.

The required period of time for implementing a normal issue is about five months, as follows:

- Deliberations within the company including preparation of a business plan, negotiations with the underwriter, and preliminary preparations (1 month).
- Preparation of the prospectus and financial statements (1 month).
- Examination of the reports by the Securities Authority and negotiations with the Stock Exchange and authorities (2-3 months).

The expenses associated with a share issue of about $5 million may amount to around 10%.

[1] Only valid for R&D companies.

The Regular Income Tax System in Israel

(For details of the proposed tax reform, see the chapter "Proposed Tax Reform in Israel").

Liability to tax - companies

Subject to any applicable tax treaty, Israeli and foreign resident companies are generally subject to Israeli taxation on income from Israeli sources, being income which is accrued, derived or received in Israel.

Israeli resident companies are generally also taxable on: (1) income from an overseas business which is controlled and managed in Israel, and (2) worldwide capital gains.

A company is generally resident for Israeli tax purposes if: (a) the company is incorporated in Israel and its principal activity is in Israel, or (b) it is a foreign company that elects residency and is registered in Israel as a foreign company, or (c) its business is controlled and managed in Israel.

Interest, rental and royalty payments by an Israeli resident to a foreign resident are specifically deemed to be derived from sources in Israel.

The tax is calculated separately for each tax year. A consolidated tax return is not permitted in Israel, except for certain industrial companies and industrial holding companies.

The tax year is the calendar year ending December 31.

Although the Income Tax Commissioner has the authority to permit a different tax year in certain circumstances, this authority is rarely exercised, except for companies owned by publicly traded foreign concerns.

Tax treaty relief or unilateral relief is given to Israeli residents regarding income derived from overseas which is taxable both abroad and in Israel. Relief is also available for other income (usually passive in nature) which is subject to Israeli tax upon receipt in Israel.

Israel's tax treaties mostly follow the OECD model treaties. Business profits of a treaty country resident should only be taxable in Israel if they are derived from a permanent establishment or a fixed base in Israel. A permanent establishment is generally defined as a fixed place of business in which the activities of an enterprise are wholly or partly carried on. However certain auxiliary activities

may be excluded from taxation such as warehousing, display, advertising, procurement or information gathering.

The above treaty criteria are also typically used as a guideline for the operations of foreign residents from countries which do not have a tax treaty with Israel.

Income for tax purposes is usually reported on the accrual basis. However, the income of professionals, may be reported on a cash basis

There are special provisions set forth in the law regarding the timing and allocation of income from long-term construction and other projects (lasting over one year) and prepaid rental income.

Tax advances

Tax advances are on account of the current year's tax paid throughout the year usually in 10 or 12 monthly payments. These advances are generally based on prior year's taxable income or a percentage of the current year's sales revenues. For a new business, tax advances are based upon estimates for the economic sector concerned. Any balance of tax due will incur interest and indexation (which are not deductible for tax purposes), from the end of the tax year until the date of payment.

If it should become evident that the tax liability, according to the self-assessment is higher than the tax advances which were paid, it is possible to pay the difference in the period between January and March following the end of the tax year, with certain reliefs with respect to the linkage differences and interest on that difference.
Monthly tax advances are also payable at a rate of 45% of certain non-deductible expenses incurred - see the section below on "Deductible Expenses".

Taxation under inflationary conditions

The Income Tax Law (Adjustments for Inflation), 1985, specifies a number of adjustments to taxable income, computed in historical cost terms, of business concerns in Israel. The aim is to protect proprietors' equity while neutralizing unintended benefits that may otherwise result from inflation, as measured by the Israeli Consumer Price Index (CPI).

In brief, the main adjustments are essentially as follows:

- An excess of equity over depreciated fixed assets, multiplied by the rate of inflation, is deductible from taxable income. (The excess represents proprietors' equity tied up in the business that needs protection from inflationary erosion). The deduction is not to exceed 70% of taxable income in the year it arose. Any balance is index-linked and carried forward to future years without limit.

- An excess of depreciated fixed assets over equity, multiplied by the rate of inflation, must be added to taxable income. (This excess represents fixed assets financed by liabilities which generate inflated financial expenses upon year-end or periodic revaluation).

- Indexation of tax depreciation.

- Indexation of any tax losses carried forward to future years.

- Special provisions for taxing holdings of marketable securities.

The provisions of the Income Tax Law (Adjustments for Inflation) do not apply, if so elected, to taxpayers who derive no business income or to a company which is held by up to 5 shareholders which is obligated to maintain books and records pursuant to the Bookkeeping directives regarding liberal vocations. In both cases, the taxpayers or companies (which ever the case may be) must not own securities during the tax year and should report their income in historical cost terms and may not deduct interest expenses.

Companies in which the level of foreign investment exceeds 25% are permitted to maintain books and records in U.S. dollars (in addition to Shekels) and to report on this basis, subject to certain rules specified in the tax regulations. Alternatively, such companies are currently allowed to compute the above adjustments applying movements in the shekel/dollar exchange rate instead of the CPI.

Dollar reporting may be allowed by the tax authorities with respect to partnerships if all the partners are non-residents, and all the partners' equity and loans were in foreign currency.

Deductible expenses

The law permits the deduction of expenses which are incurred wholly and exclusively in the production of taxable income.

Certain types of employment benefits and payments made to major shareholders in private companies are allowable as deductions on a cash basis. With regard to employment benefits, the law prescribes certain limits.

If a taxpayer derives several types of income which are taxable at different rates, the law requires that expenses be apportioned to each type of income in accordance with certain rules.

Expenses paid by Israeli residents to foreign residents that are subject to a withholding tax obligation are only deductible if the requisite withholding tax is paid during the tax year or within 3 months thereafter (with interest and indexation accruing from the year-end). Subject to any applicable tax treaty, a withholding tax obligation of 25% is generally applicable to overseas remittances relating to interest, royalties, rent, and services performed in Israel, among others. Foreign residents who receive interest may request (or be required) to pay Israeli tax at regular rates on their lending profit margin after deducting proven costs.

Certain types of expenses, such as: motor vehicle expenses and depreciation, entertainment, overseas travel, etc., are allowable, subject to limits set forth in the law. Expenses incurred in excess of the allowable amounts fixed by the law, create an obligation to pay a tax advance of 45% (generally) of this excess in the following month.

These advances may be credited against the current year's Company Tax liability, then against future liabilities. The advances are not refundable, even if the taxpayer is in a loss position. These advances will be adjusted according to the rate of the increase for the CPI, from the end of the tax year in which they were paid until the end of the tax year in which they were offset.

Capital expenditure and personal outlays that are not incurred wholly and exclusively for the purpose of producing taxable income, capital expenditure, etc., are not allowable deductions.

Depreciation

Depreciation of tangible assets (excluding land) is allowable at various prescribed rates, if the assets are used for the production of income. Also, an industrial

company may amortize the costs of purchasing know-how, patents and rights to make use of a patent at the rate of 12.5% per year, applying a straight line basis.

Accelerated depreciation is granted for buildings and equipment (excluding private vehicles) used in industry and hotels. The accelerated rates below are renewed annually - a renewal for 2000 has been passed.

The accelerated depreciation rates, applying a straight line basis, are 5% for buildings and 20%-40% for equipment in industry, depending on the number of shifts the equipment is operated.

Alternatively, industrial enterprises may elect to depreciate equipment on a declining balance basis. The rates of depreciation on equipment for the first 3-5 years are 30% - 50%, depending on the number of shifts worked.

For equipment used in the construction sector, accelerated straight-line depreciation of 20% is deductible.
For more details of depreciation rates - see Appendix 5.

Losses

In general, business losses may be set off against income from any source in the same tax year. Unutilized business losses may be carried forward and offset against subsequent business income or business capital gains or land appreciation in subsequent years without time limit. Proposals exist to discourage loss utilization by companies which undergo ownership changes within a year after the loss was incurred.

In general, losses from renting out a building as a passive activity may only be set off against future income from the same building.

Research and Development Costs

R&D costs incurred on a project approved by the Chief Scientist of the Ministry for Trade and Industry or by the Ministries responsible for agriculture, transportation, or energy, may be deducted by an industrial company in the year that the work is carried out. R&D expenses of an industrial company, which are not allowable in this way, may be deducted in equal installments over three years.

Participation by any taxpayer in the financing of R & D for a project in which the Chief Scientist also participates through a grant, is allowable for deduction in the current tax year and the following year, subject to certain limitations.

Corporate tax rates

The regular rate of Company Tax is currently 36%.

Reduced Company Tax rates of 0% - 25% and other benefits are available for, among others, approved industrial or tourism enterprises, approved properties, and authorized Eilat enterprises. Details of these tax and other incentives are set forth earlier in this publication.

"Family companies" controlled by one family may elect to treat a family member with the largest (or joint largest) entitlement to profits as the taxpayer, rather than the company. In such cases, the assessed shareholders will pay tax at regular personal rates ranging up to 50%.

The income of a company controlled by up to five persons, whose entire assets are buildings and entire business is building maintenance, will be considered as its shareholders' income subject to several conditions.

Lower tax rates (usually 35%) apply to preferred income, such as interest on Israeli government securities.

Resident companies are exempt from Company Tax on dividends received from the ordinary profits of other regular resident companies. Dividends derived from the income of an approved enterprise or an approved property are liable to a 15% withholding tax, which is passed along any chain of intermediate companies until the dividend reaches an individual or foreign resident.

Subject to any applicable tax treaty, the standard rate of withholding tax on dividends, interest and royalties paid to foreign residents is 25%, or 15% on dividends derived from an approved enterprise or approved property.

The total effective tax rate on regular profits of the company and the shareholder on the assumption that all profits are distributed as dividend, is 52%.

The following table illustrates the above principles:

	Distributed profits			Undistributed profits	
	Tax rate	Amount	Tax liability	Amount	Tax liability
Regular profit		100		100	
Company tax	36%	36	36	36	36
Distributable		64		64	
Dividend to non-resident or Israeli resident individual		64			
Withholding tax	25%	16	16		
Net income after tax & dividend distribution		48	-		
Total Israeli taxes			52		36

Different withholding tax rates apply to dividends paid to shareholders that are resident in certain countries which have a tax treaty with Israel.

Industrial companies

For Israeli tax purposes, an industrial company is an Israeli resident company, which derives 90% or more of its annual income (excluding capital gains, gains on publicly traded securities, interest and dividends) from an industrial enterprise whose main activity is productive. Industrial companies enjoy the following tax reliefs:

- Group tax returns and group loss relief are permissible in certain circumstances.
- Public share issue costs may be written off in three equal annual installments in certain circumstances.
- Purchased patents and rights to make use of a patent and know-how may be depreciated at a rate of 12.5% per annum on a straight line basis.
- Accelerated depreciation is available for equipment and buildings - see above and Appendix 5.

Liability to tax - individuals

Residents and non-resident individuals are taxable on income from Israeli sources, being income which is accrued, derived or received in Israel. Resident individuals are also taxable on:

- Overseas income from a business controlled and managed in Israel.
- Overseas income from a profession or vocation generally conducted in Israel. This is the case even if the individual works as an employee in Israel and on a self employed basis abroad, or vice versa.
- Other overseas income (e.g. passive income) remitted to Israel.
- Worldwide capital gains.

Income which originates outside of Israel and is received in Israel by a foreign resident individual who is present in Israel on a temporary basis for less than 6 months in the tax year is generally not taxed in Israel.

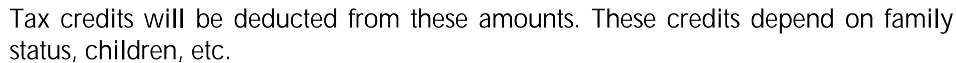
In general, residency is determined by reference to an individual's overall personal and family circumstances over several years. This is similar to the "center of vital interests" test found in most of Israel's tax treaties for allocating residence to one country to avoid situations of dual residence.

In practice, visitors who come to Israel for a limited period as tourists or on a B-1 work permit visa will generally be treated as non-residents.

Individual tax rates

In principle, an Israeli personal tax liability is computed annually. Nevertheless, tax is typically withheld from salaries and reported each month. The Israeli tax year is the calendar year. Monthly tax brackets used during a year for payroll and other purposes are periodically updated for inflation and totaled to produce the annual tax brackets. Following are anticipated the annual tax brackets for 2000.

Tax rate	Anticipated annual income brackets - 2000		
%	NIS		
10	0	-	23,280
20	23,281		46,680
30	46,681		122,880
45	122,881		222,720
50	222,721 and above		



Tax credits will be deducted from these amounts. These credits depend on family status, children, etc.

The tax rates of 10% and 20% are restricted to:

(1) Income earned from employment and self employment,
(2) Income derived by persons aged over 60, and
(3) Rental income derived by persons who previously used the rental property for at least 10 years in employment or a business or profession.

In September, 2000 the average exchange rate of the U.S. dollar to the new Israeli shekel approximated US 1 = NIS 4.05.

An Israeli resident may claim personal tax credits and deductions, relating to various types of approved pensions, savings, life insurance and other social payments, within specific limits.

A taxpayer who derives income, up to certain limits, from the rental of residential accommodation is exempt from tax.

Indexation differentials on certain bank deposits are exempt from tax.

Interest income from certain bank deposits, in foreign or local currency, is fully exempted from tax or liable to taxation at a reduced rate.

Indexation differentials on investments in Israeli government bonds, or other bonds authorized for this purpose, are exempt from tax. Interest income from these bonds is taxed at reduced rates, typically 35%.

Dividend income received from Israeli companies by Israeli resident individuals and foreign residents (companies and individuals) is taxed at a rate of 25%, generally, or 15% to the extent the dividends were derived from an Approved Enterprise or an "approved property".
The foregoing is subject to any applicable tax treaty.

National Insurance

National insurance is payable on employment income up to certain income limits. Following are the rates for 2000.

Israeli resident employees	
Employee pays	5.76% - 9.70%
Employer pays	4.93%
Foreign resident employees	
Employee pays	0.33% - 0.60%
Employer pays	0.7%

Notes:

(1) The lower rates currently apply to the first NIS 3,174 ($770 approx.) of monthly earnings. The higher rates apply to monthly earnings in the range NIS 3,175 - NIS 31,785 with regard to employee payments and in the range NIS 3,175 - NIS 25,388 with regard to employer payments.

National insurance does not apply to monthly earnings exceeding these amounts.

(2) The above rates for Israeli resident employees incorporate a health levy of 3.1% - 4.8%. Foreign residents are exempted from the health levy and are therefore not covered by the governmental health care system. Foreign residents are advised to obtain private health care cover for themselves and their families.

(3) In addition to the above, Israeli resident employees pay an Organization Levy of up to 0.7% on the first NIS 9,521 ($ 2,318 approx) of monthly earnings, if they are members of the Histadrut Labor Federation or affiliated bodies, or if they work in a unionized work place. Plans to extend the levy to other Israeli residents have not been implemented.

Expatriates

In principle, expatriate individuals are liable to Israeli tax at regular rates on income from personal services performed in Israel, irrespective of how or where they are paid. Israel's tax treaties usually provide an exemption from Israeli tax for employees resident in the treaty country who are present in Israel less than 183 days in the tax year, if their employer is non-resident and does not deduct their remuneration from the profits of any permanent establishment in Israel. Where no treaty exemption applies, expatriates are not eligible for most of the personal tax deductions and credits available to residents. Instead, expatriates may receive:

- Deductions for documented accommodation as well as a per diem allowance of up to NIS 250 ($61 approx.) per day for expatriates invited by Israeli residents. The deductions are available for the first 12 months after the expatriate's arrival in Israel and are conditional on obtaining "foreign expert" status from the Employment Service, as part of the work permit process.

- A maximum tax rate of 25% for up to 8 years if an Israeli resident invites the expatriate and applies to the Investment Center for "approved specialist" status for the expatriate before his/her arrival in Israel. This status is granted on a discretionary basis only, primarily for skilled industrial or tourism specialists, in respect of the first $6,250 per month of salary, usually.

Israel has social security totalization agreements with Austria, Belgium, Denmark, France, Finland, Germany, Italy, the Netherlands, Poland, Sweden, Switzerland, the U.K. and Uruguay (but none with the U.S). At the moment an agreement is being negotiated with Spain. Hungary and Turkey. Negotiations with the Czeck Republic, Chile and Canada have been concluded although agreements have not yet been signed. Where no totalization agreement exemption applies, minimal national insurance contributions totaling up to 1.3% apply to expatriate employees as outlined in the above section on National Insurance. However, comprehensive private coverage is advisable.

New immigrants

New immigrants may request, in the first 7 years of Israeli residence, to be taxed at a reduced or
zero rate on income from foreign sources which would otherwise be liable to Israeli taxation on a remittance basis. Currently the policy of the tax authorities is to accept tax at a reduced rate of, say, 10%, in certain cases.

Interest earned on non-business foreign currency deposits of 3 months or more with Israeli banks, is exempt from tax for 20 years from the date of immigration to Israel.

In addition to the above, new immigrants are eligible for extra tax credits during their first 42 months of residence in Israel. These amounts are not too material.

New immigrants also enjoy the following benefits:

- Continued exemption for interest on certain Israeli bond holdings, where such interest is exempt for non-residents.
- Various indirect tax concessions to facilitate the import of personal possessions and a motor vehicle or the purchase of such items in Israel.
- Acquisition tax (transfer fees) of 0.5% (instead of up to 5%) up to certain limits on the purchase of a home and business premises in the period from one year before to seven years after their entry into Israel.

Regarding a new immigrant's entitlement to exemption from capital gains tax in certain cases, see the chapter: "Taxation of Capital Gains".

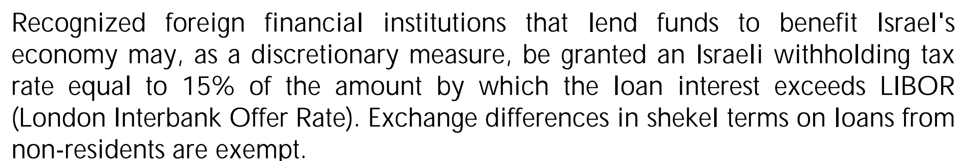
Employers may also receive financial support if they hire new immigrants - see the section on "Employment and Training Grants" in the chapter "Operational Incentives".

Income tax calculations

For specimen personal income tax calculations for Israeli residents and expatriates, see Appendix 7.

Withholding taxes

Israeli banks are obliged to withhold tax, usually at a rate of 25%, from most overseas remittances unless they relate to imported goods (other than software). This tax is not necessarily the final tax payable, but the tax authorities do not always pursue matters further with regard to foreign residents with no presence in Israel. Payments, such as salaries, that fall within the scope of specific withholding tax rules, will be taxed at relevant rates under those rules. Consent for a reduced withholding rate or exemption may be obtained from the tax authorities e.g. pursuant to a tax treaty, or where services are rendered entirely abroad. Lenders may request to pay regular Israeli tax rates on their proven lending profit margin, only.



Recognized foreign financial institutions that lend funds to benefit Israel's economy may, as a discretionary measure, be granted an Israeli withholding tax rate equal to 15% of the amount by which the loan interest exceeds LIBOR (London Interbank Offer Rate). Exchange differences in shekel terms on loans from non-residents are exempt.

Interest paid on a non-residents' foreign currency deposit at an Israeli bank by a foreign resident not doing business in Israel, is exempt from Israeli tax.

Arm's length principles should be observed in transactions between related parties.

Tax returns from foreign residents

A foreign resident who has income that is derived or accrued in Israel is exempt from submitting a tax return to the Tax Authorities for the following sources of income, if the requisite tax was withheld at source, it the foreign resident has no other income from taxable sources in Israel:

a. A business or vocation carried on in Israel in a tax year for cumulative periods not exceeding 180 days.
b. Salaries.
c. Interest, dividends or royalties.

Taxation of Capital Gains

(See also the chapter "Proposed Tax Reform in Israel").

General

The rules for taxation of capital gains are set forth in the Income Tax Ordinance and the Land Appreciation Tax Law.

The Land Appreciation Tax Law deals with capital gains from the sale of rights relating to immovable property in Israel or from transactions by a company or partnership whose principal assets, directly or indirectly, are rights in immovable property. For the latter purpose, assets not used by the entity to produce income are not taken into account.

The Income Tax Ordinance taxes capital gains not covered by the Land Appreciation Tax Law.

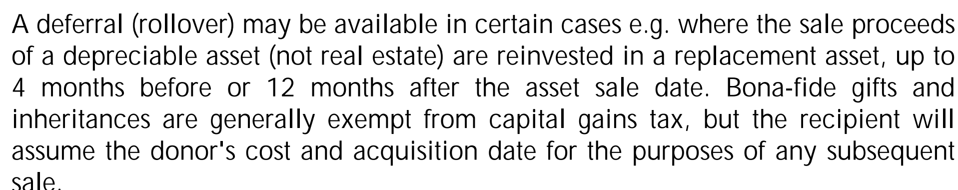
Taxation of capital gains under the Income Tax Ordinance

Capital gains relating directly or indirectly to assets in Israel, or rights thereto, are generally subject to Israeli Capital Gains Tax. This includes gains from Israeli securities. Special rules apply to publicly traded securities - see below. Israeli residents are also taxable on overseas capital gains.

Capital gains are split into their real and inflationary elements. The real gain is taxed at the regular corporate rate (36%) or personal rates (30% to 50%). The inflationary amount is exempt to the extent it accrued since January 1, 1994 and is taxable at the rate of 10% if it accrued before then.

Foreign residents who invested with foreign currency may elect to apply the relevant exchange rate vis-a-vis the Shekel rather than the rate of inflation to compute the inflationary amount.

As a further benefit, a shareholder pays tax of 10% instead of regular rates on a proportion of the real gain attributable relating to retained corporate profits, in historical Shekel terms, that accrued over the seven preceding tax years, (unless the company is a real estate entity - see below). Proposals exist to raise this 10% tax rate regarding retained profits to 25%.



A deferral (rollover) may be available in certain cases e.g. where the sale proceeds of a depreciable asset (not real estate) are reinvested in a replacement asset, up to 4 months before or 12 months after the asset sale date. Bona-fide gifts and inheritances are generally exempt from capital gains tax, but the recipient will assume the donor's cost and acquisition date for the purposes of any subsequent sale.

A resident taxpayer may request that the tax on real capital gains be calculated as having arisen in equal annual amounts over a period not exceeding four years up to the end of the year in which the profit was realized.

These annual amounts are added to taxable income in the relevant tax years and tax is recalculated accordingly.

Stock exchange gains

With regard to securities traded on the Tel-Aviv Stock Exchange and approved foreign stock exchanges, business concerns in Israel pay tax at regular rates on certain realized gains. In principle securities dealers are taxed under the normal rules applicable to business income.

No Israeli tax is currently imposed on capital gains from securities traded on the Tel-Aviv stock exchange that are derived by persons or entities not conducting business in Israel.

Likewise, no Israeli tax is currently collected from persons and entities not doing business in Israel on capital gains from the sale of securities traded in designated overseas countries that are issued by Israeli industrial or industrial holding companies. However, capital gains derived by individuals from a sale of foreign securities traded abroad are taxable at a rate of 35% of the real gain in foreign currency terms.

The listing of existing securities on a stock exchange may be a taxable event for the holder. However, it is generally possible to defer any tax liability until the first actual sale, whereupon normal capital gains tax rates (companies 36%, individuals 30% - 50%) apply, computed according to detailed rules.

Reorganizations

Special provisions facilitate tax-deferred reorganizations that are carried out for bona-fide commercial reasons. Types of reorganization include: court-approved mergers; corporate divisions approved by the Tax Commissioner, and asset/share

exchanges notified to the tax authorities within 30 days (consent is needed if a non-resident company receives the asset).

Various conditions apply, particularly in the two tax years after such a reorganization. These conditions aim to preserve an element of continuity regarding activities, asset ownership, share ownership (limits apply to new issues) and tax attributes. The utilization of losses incurred before a reorganization will usually be spread over at least five years, with certain exceptions. VAT on the transaction and a 0.5% transfer fee on real estate interests remain chargeable (instead of transfer fees ranging up to 5%).

Tax concessions for foreign residents

a. As mentioned above, a foreign resident may choose to calculate the inflationary gain based upon the currency in which the investment was made. This inflationary capital gain is fully exempt from tax in the case of shares in an Israeli company, unless it is a real estate entity.

b. A foreign resident who received little or no relief for Israeli tax in his home country may sometimes be granted a reduced Israeli tax rate by the Minister of Finance. This is a discretionary relief - in practice the Israeli tax rate will usually less then the regular rate and applicable only to capital gains.

   In addition, an exemption may sometimes be granted with respect to foreign investors in such a fund that are tax exempt institutions in their home country e.g. pension funds etc.

c. According to the provisions of some of Israel's tax treaties, capital gains are tax exempt in Israel, unless they relate to real estate interests or the assets of a permanent establishment. Additional conditions apply under some treaties. For instance, sales of shares in an Israeli company may be exempt from Israeli tax under the U.S.-Israel treaty if the U.S. investor held less than 10% of the voting power of the Israeli company concerned throughout the 12 months preceding the share sale.

Double tax relief

Foreign capital gains tax on dispositions of overseas assets may be credited by Israeli residents against Israeli capital gains tax thereon, pursuant to any applicable treaty or under Israeli unilateral regulations.

New immigrants

During the first seven years of Israeli residency, an Israeli resident is exempt from capital gains tax on the sale of assets that were owned and held outside of Israel, prior to becoming a resident.

Capital loss relief

- A capital loss may be set off only against capital gains, in the same tax year or in the seven years after the year in which the loss occurred. For this purpose, gains or losses from the sale of immovable property are treated as capital gains or losses.

- Alternatively, capital losses from business plant and equipment may be deducted as a revenue expense to the extent that the sale proceeds were reinvested in replacement assets in the same tax year.

- Capital gains arising in a business may be set off against ordinary losses, in the same year. Capital gains on the sale of an asset used in the business may also be offset against ordinary losses brought forward from previous years.

Land Appreciation Tax

Capital gains from the sale of immovable property in Israel, or rights thereto, are taxable under the Land Appreciation Tax Law. The system and rates of tax, which are not materially different from the capital gains tax provisions mentioned above, include the segregation of real from inflationary gains.

A major difference of principle relates to a "real estate association", which is a company or other entity whose principal assets consist of Israeli real estate rights. A sale of shares (or other interest) in such an "association" is assessable to land appreciation tax, taking into account the value of the underlying real estate assets.

The Land Appreciation Tax Law allows a resident seller to elect to spread the real capital gain over the period of ownership, but no more than 4 years ending on the last day of the tax year in which the property was sold.

The sale of a residential home owned by an individual, including a foreign resident which was primarily used for residential purposes, is exempt from tax if, at the time of sale and in the four preceding years, the seller did not sell at an exemption from Land Appreciation Tax another apartment, or that this is his sole apartment and that he did not sell, during the 18 months prior to the sale another apartment at an exemption from Land Appreciation Tax, and that he did not own more than one apartment during the four years prior to the sale. Certain other relief's also exist.

Specific inquiry is advisable in proposed instances.

Sellers of real estate will be taxed at the rate of 2.5% of the selling value price.

It is also important to note that a residential home that is exempt from Land Appreciation Tax, will also be exempt from sales tax.

Proposed Tax Reform in Israel

Background

On May 4, 2000, extensive proposals were published in Israel by the Public Commission For The Reform Of Income Tax, generally known as the Ben-Basat Commission.

These proposals have been accepted in principle by the Israeli government and the process of enactment has begun. A draft bill reflecting the Commission's proposals was published on July 26, 2000. The bill is presently undergoing further refinement and may be presented to the Knesset for debate and possible enactment soon.

If passed, the measures will take effect in phases starting on May 4, 2000, but principally on January 1, 2001.

The Commission pointed out that tax and national insurance rates currently range up to 59.7% on salaries as low as NIS 222,720 (US$ 55,000 approximately) per year. By contrast, broad exemptions exist including those for private sales of stock exchange investments and the rental and sale of residential homes.

Previous reform efforts came to nothing but the Ben Basat Commission consisted of non-political specialists claiming to propose moderate fiscal measures comparable to those found in OECD countries.

Proposals of interest at the international level are outlined below. It should be noted that these measures will be subject to the provisions of any applicable tax treaty between Israel and the taxpayer's country of residence.

Proposals relating to private investors

Under the proposed bill, there will be a maximum tax rate of 25% of inflation-adjusted capital gains for resident and nonresident individuals - instead of 30% to 50% at present.

In particular, the 25% tax rate will apply to capital gains from securities traded on a stock exchange or similar "orderly market" in Israel or abroad for resident and non-resident individuals, subject to tax treaties. This compares with the current exemption or 35% rate.

Different rules and tax rates will continue to apply to capital gains derived by businesses and companies in Israel.. Advisory and custody fees will be deductible, but NOT finance expenses.

In the case of homes, resident individuals will receive a life-time cumulative deduction of NIS 500,000 (US$125,000 approximately) but mortgage interest will not be deductible and transitional rules will apply to property acquired before the reform.

To discourage dividend stripping investors have historically been taxed under on gains from share sales at a fixed rate of 10% on gains equaling the last 7 years' retained profits of the company concerned. It is proposed to apply instead the rates that apply to dividends. Currently, subject to any treaty, the applicable rates are:

- 25% for dividends from regular profits to resident individuals and foreign resident shareholders
- 0% for dividends from regular profits to resident corporate shareholders
- 15% for dividends from approved enterprise profits to any shareholder (it is not clear whether company tax of 10% - 25% will also be deemed payable on "tax holiday" profits under the "alternative system of benefits for approved enterprises).

The exemption for founders of industrial companies taken public before 1996 will be abolished.

The monthly limit on exempt home rental income will decrease from NIS 7,000 approx. (US$1,750 approx.) to NIS 3,000 (US$ 750). Where tax applies, landlords may choose between paying full tax after deducting expenses including depreciation or tax at a rate of 10% without deductions.

The Ministry Of Finance is expected to publish its criteria for granting discretionary relief to foreign residents under Sections 14A and 16A of the Income Tax Ordinance. This will be relevant to foreign venture capital funds among others - who are typically granted a 20% tax rate for gains derived by funds for their investors subject to certain conditions.

There will be a maximum tax rate of 25% on inflation-adjusted interest for resident individuals - instead of various rates at present.

Tax of 25% for dividends received by individuals from Israeli and foreign companies, withheld at source - unchanged.

Proposals relating to business

The regular rate of company tax will continue to be 36%.

Changes are proposed for approved enterprise projects that receive their certificate of approval on or after the new legislation is enacted and becomes effective.

Tax holidays elected for 2 - 10 years under the alternative system of benefits by "approved enterprises" in industry and tourism would be modified and result in company tax at a rate of 0% in Development Area A for 10 years, at a rate of 5% in Development Area B for 6 years and at a rate of 10% for 2 years elsewhere in Israel.

The company tax rate will be 25% for all approved enterprises that do not elect the alternative system of benefits (as they chose to receive government fixed asset grants) or that remain within their overall period of benefits (7 - 10 years) after enjoying the alternative package of benefits. Currently, company tax rates of 10% - 20% apply to approved enterprises of companies in which foreign investors hold at least 49% control.

International Tax Proposals

Israeli residents will be taxed on their worldwide income under the "personal" or "residency" basis of taxation. This will replace a mainly "territorial" basis at present.

Foreign residents will remain taxable on Israeli source income and gains, subject to tax treaties.

Residency rules will be clarified. Subject to any tax treaty, individuals will be presumed resident if they are present in Israel:

- At least 183 days in year, or
- At least 30 days in a year plus 350 days in the previous 2 years, or
- They return to Israel within 3 years after the end of the year in which they left Israel to reside abroad (they will remain resident throughout the period of absence from Israel).

Companies will generally be resident if they are:

- Incorporated in Israel, or
- Their principal activity is in Israel, or
- Their business is controlled and managed from Israel - especially if their place of effective management is in Israel having regard to their ongoing daily management.

There will be rules for determining the geographical source of income. Dividends paid by an Israeli resident entity will be Israeli source unless more than 75% of the profits distributed are derived from foreign sources - this perhaps raises the prospect of Israeli holding companies. Interest paid by Israeli residents will be Israeli source. Royalties will be sourced where intangible property is used. Capital gains will be sourced where the relevant asset is located directly or pursuant to a right or option.

Foreign tax paid within 11 months after the year-end may be credited against Israeli tax on the same type (basket) of income from all foreign countries. Excess foreign taxes may be carried back 3 years and carried forward 5 years.

It is proposed to allow foreign business losses to be offset against foreign source business income. An offset would also be allowed against Israeli source income but restricted to the extent of: (1) foreign source income reported and taxed in Israel in the 3 previous years - but no more than a 50% restriction in the case of individuals, and by (2) the percentage of foreign tax credit that would be available if the foreign loss had been foreign income.

There will be a regime for taxing 10%-or-more Israeli resident shareholders in a "controlled foreign corporation" ("CFC") controlled directly or indirectly by Israeli residents if the CFC mainly derives passive income, namely capital gains and non-business income. Such shareholders will be treated as receiving their proportionate share of the profits of the company as a dividend in the year the income was derived if Israeli residents control more than 75% of the foreign company, or in the third year thereafter if Israeli residents control 50.1% to 75% of the foreign company. The treatment of royalties (common in high-tech) and intermediate holding companies in an active group is not yet clear.

It is proposed to empower the Tax Commissioner or his delegate to deny tax treaty benefits in cases of treaty abuse that substantially reduces an Israeli tax liability or tax payment "according to a treaty".

Currently, Israel has a general requirement that transactions between related parties be conducted on arm's length terms. It is proposed to strengthen this by specifically permitting the tax authorities to tax transactions applying market (arm's length) terms if they believe that due to special relations between parties

(25% control connection), the price of an asset, right, service or credit or other terms were terms of an international transaction were determined so as to yield less or more profit than unrelated parties would have derived. In addition, the Tax Commissioner will be authorized to issue rules relating to the allocation of income, expenses, deductions, credits and exemptions between related parties. No further details are yet available

Under the proposals, tax exemptions for international trading companies and their shareholders will be repealed. In addition, special expenditure deductions will no longer be allowed before income is generated for partners in oil and film partnerships.

Proposals relating mainly to employees

The maximum rate of income tax will continue to be 50% for income exceeding NIS 18,560 per month and the lower personal tax brackets will be enlarged.

It is proposed to repeal the 25% maximum income tax rate for foreign "approved specialists" in the Israeli industrial and tourism sectors.

Significantly, the taxation of employee share option and share purchase plans will be overhauled. In principle, a tax liability will apply upon a deemed or actual "realization". Consequently, if an approved trustee holds the options or shares, the taxable realization may not occur until sale or withdrawal from trust. Without a trustee, the taxable realization will generally occur upon vesting of options, allotment of shares; or exercise or sale of an option if the underlying shares are not publicly traded. Nevertheless, cessation of employment or migration abroad of the employee will trigger a taxable "realization" for Israeli tax purposes. Rules will be prescribed regarding foreign residents in Israel.

Detailed rules are proposed to split the overall share option or purchase benefit upon "realization" between salary income (tax up to 50%) and capital gain (tax up to 25% proposed).

If an approved trustee is used and the underlying shares are publicly traded shares, the salary element will essentially be the market price when the options vest in the employee (or when the employee migrates abroad) less any cost paid by the employee up to the vesting date (adjusted for inflation up to the realization date), and any remaining benefit will be taxable as capital gain.

If an approved trustee is used and the underlying shares are not publicly traded, the total taxable benefit will be split between salary and capital gain on a 50:50 basis.

If no trustee is used and the underling shares are publicly traded, then the salary portion of the benefit will be the gain that accrued up to the time the options vested in the employee (if no vesting applies - up to the time the shares are allotted following exercise of the option).

If no trustee is used and the underlying shares are not publicly traded, then the salary portion of the benefit will be the gain upon conversion (i.e. exercise) of the option to shares or upon sale of the option.

Any gain accruing after the "realization" will be taxable as capital gain. Numerous other detailed rules and exceptions are proposed with regard to share options and purchase plans. The above is only a brief summary of the proposals and it remains to be seen what will be enacted. Clarification is also awaited regarding the ability or otherwise for employers to enjoy an expense deduction on amounts taxed to employees. Israeli and foreign expatriates will need to review the interaction between Israeli and foreign taxes.

Proposals relating to immigrants to Israel

Under the proposals, immigrants to Israel may enjoy an exemption from Israeli tax on income and capital gains derived from assets which they possessed abroad before they immigrated - for 10 years after immigrating compared with 7 years at present. However, capital gains would be taxable if they relate directly or indirectly to assets situated in Israel.

The Minister of Finance, in conjunction with the Knesset Finance Committee, would be authorized to issue regulations extending the 10 year exemption in the case of pensions, social security or similar payments made by a foreign government or other foreign resident pursuant to obligations that arose partly or wholly before the individual immigrated.

Estates, gifts and trusts

The Bill contains proposals relating to estates, gifts and, in passing, to trusts, as summarized below.

It is proposed to impose estate tax on the estates of Israeli residents that pass away on or after January 1, 2001 at a rate of 10%. Personal chattels worth up to NIS 500,000 would be exempt. (Currently, the exchange rate approximates USD 1 = NIS 4.1). Liens and debts would be deductible.

Israeli residents include anyone that was resident for income tax purposes in at least three years during the 10 years preceding death.

It is also proposed to impose a gifts tax on a gifts made by Israeli residents at a rate of 10%, once reportable gifts made on or after May 4, 2000 exceed in total NIS 2 million. Any unused portion may be offset against the taxable estate for estate tax purposes. (A "resident" would be as defined above - so the gift tax might apparently be avoidable if the taxpayer has lived abroad for over 3 years before making the gift and lives more than 10 years abroad after making the gift)

Gifts to individuals of up to NIS 2,000 per year per recipient would be exempt. Gifts would be exempt in an unlimited amount if they are given to a spouse, or upon a family occasion (engagement, wedding, bar mitzvah, bat mitzvah, birth of offspring, etc.) or to finance studies or heath treatment of living expenses of offspring aged up to 25.

Gifts will be reportable by residents (not necessarily taxable - see above) to the Israeli tax authorities if the gifts exceed NIS 100,000 or in the period from May 14, 2000 to the end of 2000, if (1) the donor is aged 55 or more at the end of the year, or (2) if the donor's total gifts to date exceeds NIS 2 million. Otherwise, resident individuals must report gifts if they exceed NIS 150,000 in any year or in the period from May 4, 2000 to the end of 2000.

Foreign gifts and estate taxes may be creditable against Israeli gifts and estate taxes.

Estate and gifts taxes paid may be added to the cost basis of assets for Israeli capital gains tax and land appreciation tax in the future. It is presently unclear whether this will also apply to foreign estate and gifts taxes credited.

A taxable estate would include lifetime transfers made by the deceased into a trust, and the fruits thereof (presumably income and gains) during the deceased person's lifetime, unless the transfer was treated as a gift i.e. the trust might effectively be disregarded for Israeli estate tax purposes unless included in lifetime gifts for gifts tax purposes.

Gifts include the grant of an asset, directly or indirectly, including by way of a trust that a party created directly by that party or by another on their behalf or under their control for less than full consideration.

Life insurance payouts upon death would be includable in the deceased person's taxable estate, as would any other payment in consequence of the death (with limited exceptions for employment pension policy payouts).

Transitional provisions

Detailed provisions and alternative elections aim to help taxpayers allocate income and gains between pre and post reform rules with most reform measures planned to take effect on January 1, 2001 if the proposals are enacted.

Future Outlook

The tax reform Bill is currently undergoing a process of public debate and review by the Israeli tax authorities. The political situation may also impact the acceptance and timing of the proposed legislation.

The estate and gifts tax proposals have aroused opposition within Israel and may or may not be adopted.

It remains to be seen whether and in what form the proposed tax reform Bill will be enacted.

Readers are advised to monitor developments and obtain professional advice in Israel in specific proposed situation.

Value Added Tax and Other Taxes

VAT - Definition

Value Added Tax (VAT) is an indirect tax borne ultimately by the end consumer, and is based on the consumption of goods and services in Israel. The tax is levied on imports and on local products and services at each stage of the production and distribution chain, on the basis of the value added to them at that stage.

Output VAT is collected on each sale of goods and services. The VAT collected is paid monthly (or bi-monthly for certain small businesses) to the Customs and Excise Division of the Ministry of Finance, after deducting any input VAT paid on purchases from previous suppliers in the chain. The final consumer will bear the VAT charged by his supplier, which is in effect the total cumulative VAT in the chain.

Generally, VAT payments on imports are recoverable by authorized VAT dealers. Apart from certain exemptions and zero-rated items, all businesses are subject to the payment of VAT at a uniform rate of 17% on their transactions.

Foreign residents who commence an activity in Israel must appoint a local VAT representative within 30 days.

VAT - Zero-rating

Zero-rated supplies are technically taxable, but at a tax rate of zero. Suppliers of zero-rated goods and services do not charge VAT to customers but they are normally required to register and file VAT returns. Such registered suppliers can claim repayment of VAT input taxes on their expenditure, subject to various rules.

A partial list of zero-rated items includes:

- Exported goods;
- The sale of intangible property to non-residents (with exceptions);
- Services to non-residents that do not relate to assets in Israel and are not rendered to Israel residents nor foreign residents in Israel; Zero rate VAT does not apply to services relating to the making of an agreement to which an Israeli resident is a party.
- Fresh fruit and vegetables.

Other Taxes

Property Sales tax

Effective January 1, 2000, the real estate tax law was amended. The annual property tax on land was reduced to 0% (effectively abolished) and a sales tax was imposed on a sale of real estate in addition to land appreciation tax - see the chapter on Taxation Of Capital Gains. Upon any sale of rights to real estate or effecting a transaction in a real estate corporation, the sales tax will be at a rate of 2.5% of the "Sale Value" irrespective of whether the property is classified as fixed asset or business inventory. However, upon a sale of a residential apartment which constitutes business inventory of the seller (for instance a contractor or a real estate broker) the rate of tax will be 0.8%. A sale of a residential apartment, which conforms to the definition of "eligible residential home", will be exempt from the sales tax.

Inheritance tax

No inheritance tax is levied in Israel, but inherited assets are transferred with the acquisition cost and date of the testator or donor, if a capital asset is subsequently sold, for the purposes of computing capital gains tax.

Payroll taxes

No payroll tax is levied on private sector business employers in Israel. Financial institutions pay a 17.5% wage and profit tax in lieu of value added tax. Not-for-profit bodies pay an 8.5% wage tax in lieu of VAT and they pay a 4% payroll tax.

Municipal taxes

Municipal taxes are imposed annually on real property owned or occupied.

Acquisition tax (transfer fees)

Purchasers of real estate interests in Israel pay acquisition tax (transfer fees) at various rates ranging up to 5%. Rates of 0.5% to 4.5% apply to residential homes. New immigrants may pay 0.5% acquisition tax (up to certain limits) on one home and one place of business acquired in the period from one year before to seven years after their entry into Israel. Real estate interests that are transferred pursuant to a corporate reorganization (under sections 103-105 of the Income Tax Ordinance) are also liable to acquisition tax of 0.5%.

Stamp duties

Stamp duty or registration fees are payable on a wide range of contracts and documents at rates ranging from 0.1% to 2% or more in certain cases.

In the cases where, at the time an agreement is signed, the final consideration is unknown (for example, a tender) it is necessary to pay NIS 5 and, and subsequently to pay the balance of stamp duty, once the final consideration emerges.

Foreign Currency Regulations

a. Introduction

On May 14, 1998, Israel lifted currency control restrictions as part a policy of economic liberalization.

In the past few years, the process of liberalization of foreign currency has been based on the principle of a changeover from regulation to reporting, in other words, on the development of an information system for obtaining ongoing statistical data on activities in foreign currency and foreign residents. The aim is to monitor the factors influencing the foreign currency market and the management of monetary policy.

b. Obligation to furnish information to a financial broker

An Israeli resident who carries out a transaction with a foreign resident either in foreign currency or in new Israeli shekels ("NIS"), must notify the Israeli bank or financial intermediary (bank, broker or moneychanger) carrying out the transaction and provide details of the nature of the transaction for the purpose of its classification.

A foreign resident carrying out a transaction through a foreign resident's account is required to furnish the Israeli bank or intermediary (if any) with information with respect to the nature of the transaction, in addition to the notification requirement which applies to any Israeli resident that is a party to the transaction.

c. Reporting to the Controller of Foreign Currency

The rules for reporting to the Controller of Foreign Currency at the Bank of Israel distinguish between reports obtained through a financial intermediary, who is reporting on the activities of his or his customers activities with parties residing abroad in the framework of the receipts and payments system, and the direct reports obtained from the party carrying out the transaction.

The direct reports concerning transactions in foreign currency by financial intermediaries, the private non-banking sector, institutional investors, credit card companies and Israel (not foreign) residents, are summarized in the table appearing below.

Trust funds and severance pay funds are required to report on the composition of the balance and breakdown of their assets.

An insurer is required to report on the balance of his financial investments in or linked to foreign currency.

d. Definitions

For exchange control purposes:
(1) An Israeli resident defined as:

- An Israeli citizen or someone present in Israel or an administered territory on an immigrant visa or certificate or permanent resident's visa, except for someone who, in the 12 months preceding any act, transaction or fulfillment of an obligation, was not present in Israel or an administered territory more than 60 days, whether consecutively or not.
- An entity registered or required to register in a statutory registry in Israel or administered territory.
- Anyone designated a resident for exchange control purposes by the Minister of Finance.

(2) A foreign entity is a foreign resident entity in which an Israeli resident holds paid-up capital, except for a publicly traded company if the Israeli resident holds under 5% of the paid-up capital.

(3) A controlled entity is an entity in which a foreigner resident entity holds directly or indirectly 50% or more of the paid-up capital.

e. Confidentiality of the information

It is forbidden to disclose currency information provided to the Bank of Israel or reveal a document submitted pursuant to that law unless the Governor of the Bank of Israel so instructs him for the purpose of a criminal suit.

The information will be kept at the Bank of Israel accessible to a limited number of the employees in the foreign-exchange control department. It will only be used for the purpose of macro-economic analysis.

Summary of the direct reporting requirements to the Controller of Foreign Exchange by Israel residents

a.	**Reporting by companies**				
1.	**Type of transaction** **Direct investment**	**Applicability**	**Date**	**Form**	**Comments**
1.1	Establishment or purchase of a foreign entity; controlled entity; foreign real estate	Amount of accumulated cash transfers of the Israeli entity in purchasing the foreign entities, controlled entities and real estate or any of these is equal to or exceeds $ 5 million. The balance of the holdings in foreign investments is $ 5 million or more.	Within 15 days from the date of the establishment or purchase or after having initially reached the $5 threshold.	**Form 1**	Following the receipt of the report by the foreign exchange control, the reporter will be sent a document in which an identifying number will be issued regarding the foreign entity to be used for reporting additional cash transfers.
1.2	Cash transfers for a direct investment in a foreign entity; controlled entity or foreign real estate.	Accumulated transfers of **$ 5 million** or more for investments in foreign entities, controlled entities or foreign real estate or all of the above.	Within 15 days from the date of the establishment or purchase or after having initially reached the $ 5 threshold.	**Form 2**	Reporting is required whether the investment is carried out from Israel or directly abroad.
1.3	Cash receipts from the sale of a foreign entity; controlled entity; foreign real estate.	Cash receipts which are related to the total or partial realization of an investment in a foreign entity; controlled entity; foreign real estate, or all of the above in a cumulative amount of **$ 5 million** or more.	Within 15 days from the date of the realization.	**Form 3**	**Realization of investment -**sale of shares (including a reduction in the percentage of ownership deriving from a share issue, repayment of shareholders loans, and the sale of an asset. Reporting is required irrespective of whether the proceeds arrived in Israel or if they were deposited in a foreign account or were used in other transactions.

1.	Type of transaction Direct investment	Applicability	Date	Form	Comments
1.4	Acquisition of foreign entity through a securities swap.	Acquisition of a foreign resident entity by an Israeli entity through a securities swap in an amount equal to **$ 5 million** or more.	Within 15 days from the date on which the transaction was effected.	**Form 4**	**A securities swap** - A transaction in the context of which an Israel resident entity acquires the securities of a foreign entity and, in exchange, allots securities in the Israel resident entity to the owners of the acquired entity, or a transaction wherein a foreign entity acquires the securities of an Israel resident entity and, in exchange, allots securities in the foreign entity to the owners of the Israeli entity. The value of the investment in a foreign entity will be according to the value of the swapped securities around the date of the transaction in the agreed swap ratio.
1.5	The balance of direct investments in foreign entities; controlled entities or foreign real estate.	The cumulative balance of the direct investment with respect to each of the investments or all of them jointly equal to **$ 5 million** or more.	Within 90 days from the end of the year to which the report refers.	**Form 5**	**The balance of direct foreign investments** - The cumulative balance according to the share of the reporting party: At the market value of the marketable securities in the foreign entity, or according to proprietors' equity of the foreign entity whose shares are non-marketable, and loans in the cumulative direct investments transferred in order to acquire foreign real estate.

2.	Type of transaction **Financial assets**	**Applicability**	**Date**	**Form**	**Comments**
	Balance of investments in foreign financial assets.	A company for which the balance of financial assets located abroad or in its possession, as of the reporting date, is equal to **$ 5 million** or more.	Quarterly and not later than 15 from the end of the quarter.	**Form 7a**	**Financial investments -** shareholdings lower than 5% of the shares issued by an Israel resident company and which are traded abroad, and shares of foreign resident companies, as well as the debentures that are marketed abroad and deposits in foreign accounts of the reporting company.
3.	**Issuances**				
3.1	Foreign issuance of securities.	An entity which effects a public or private issuance abroad, or whose securities are offered abroad in a public offering by Israel residents who are interested parties therein, for which the amount of the issuance or the offering or both amounts jointly are equal to **$ 5 million** or more.	Within 15 days from the date of the issuance or the offering.	**Form 6**	
3.2	Report of an Israel resident entity that is listed for trade abroad regarding its securities and its interested parties.	An Israel resident entity whose securities are listed for trade abroad and the cumulative amounts of the issuance of the securities issued abroad through a public offering, or a private placement or a foreign offering, or all of them jointly are worth **$ 5 million** or more.	Quarterly and not later than 15 from the end of the quarter.	**Form 7**	

4.	Loans				
4.1	Receipt of loans from a foreign resident.	An Israel resident entity which received a loan from a foreign resident in the amount of at least **$ 100 thousand** or at least **NIS 400 thousand.**	Within 15 days from the date on which the loan was received.	**Form 8**	Reporting is required whether the proceeds are deposited in Israel or in a foreign account and/or the proceeds were used for other purposes.
4.2	Granting a loan to a foreign resident.	Israel resident entity which granted a loan to a foreign resident in an amount of at least **$ 100 thousand** or at least **NIS 400 thousand.**	Within 15 days from the date on which the loan was granted.	**Form 9**	

b.	Reporting by a large company				
	Type of transaction	**Applicability**	**Date**	**Form**	**Comments**
	Monthly report of the movements on a cash basis in foreign accounts and quarterly reports of the balances of assets and liabilities in foreign currency in Israel and abroad.	Reporting applies to Israel resident companies with a consolidated sales turnover exceeding **$ 50 million** if the Controller of Foreign Exchange has addressed a request for specific reporting.	The monthly reports and the quarterly reports will be submitted within 30 days from the end of the period to which the report applies.	**Form 11**	A large company is exempt from reporting pursuant to paragraph 2 above (Report on Foreign Financial Assets)
c.	**Reporting by a non-profit organization**				
1.	Foreign contributions and income and the balances for domestic and foreign financial assets.	An Israeli resident not for profit organization for which the scope of the contributions it receives annually are worth $ 0.5 million or more, or for which the balance of its holdings, at the end of the quarter, in assets outside of Israel (direct investments and financial investments) are equal to or exceed that amount.	Quarterly and not later than 15 from the end of the quarter.	**Form 12**	
2.	Direct investment.	An Israeli resident not-for-profit organization to which the conditions in paragraph 1 apply with respect to the reports by companies on direct investments.			The report on the direct investment will be according to the format in paragraph 1.1 to 1.5, similar to reports by companies.

d.	Reporting by individuals				
1.	Balance of direct foreign investment by individuals.	An individual Israeli resident with respect to whom the conditions in paragraph 1.5 apply regarding the reports by companies on direct investments.	Within 30 days.	**Form 13**	
2.	Balance of foreign financial assets.	An individual Israeli resident with respect to whom the conditions in paragraph 2 apply regarding the reports by companies on financial investments.	Within 30 days.	**Form 14**	Only includes reports on the balance of foreign financial assets.
3.	Loans - Receipt of loans by foreign residents Granting of loans to foreign residents.	An individual Israeli resident with respect to whom the conditions in paragraph 4 apply regarding reports by companies on loans to foreign residents.			The reports will be made according to the format in paragraphs 4.1 to 4.2, above, as detailed in the Reporting by companies.

Appendix 1

Useful Addresses and Telephone Numbers

When dialing from an international location, the international access number for Israel, 972, must be used as a prefix, and the 0 of the area code should be omitted.

GOVERNMENT AGENCIES:	
Income Tax Commission **www.mof.Gov.il**	5 Kanfei Nesharim St. Jerusalem Tel: 02-6559559 Fax: 02-6525327
Ministry of Industry and Trade **www.Tamas.Gov.il**	30 Agron St. Jerusalem 91002 Tel: 02-6220220 Fax: 02-6231468
Investment Center **Tamas.Gov.il**	30 Agron St., Jerusalem 94196 Tel: 02-6220373 Fax: 02-6250442
Bank of Israel **www.Bankisrael.Gov.il**	P.O. Box 780, Kiryat Ben Gurion Jerusalem 91007 Tel: 02-6552211 Fax: 02-6535516
Ministry of the Environment **www.environment.Gov.il**	2 Kaplan St. Tel-Aviv Tel: 03-6952494 Fax: 03-6951303
The Customs & VAT Authority **www.mos.Gov.il.Slash.customs**	32 Agron St. Jerusalem 91002 Tel: 02-6703333 Fax: 02-6258602

GOVERNMENT AGENCIES:	
Ministry of Agriculture **www.agri.gov.il**	Volcani Center Beit Dagan - 50250 Tel: 03-9683111 Fax: 03-9665327
Ministry of Labor and Social Affairs	2 Kaplan St. Jerusalem Tel: 02-6752311 Fax: 02-6752540
The Employment Service	16. Mesilat Yesharim St. Jerusalem Tel: 02-6249281 Fax: 02-6231965
Ministry of Justice **www.justice.gov.il**	29 Tsalach Adin St. Jerusalem Tel: 02-6466666 Fax: 02-6288065
Patents Registry	11 Beit HaDfus St. P.O.B. 354 Givat Shaul Jerusalem 91002 Tel: 02-5316666 Fax: 02-5316696
Tel-Aviv Stock Exchange **www.tase.co.il**	54 Ahad HaAm St., Tel-Aviv Tel: 03-5677411 Fax: 03-5105379

BUSINESS ORGANIZATIONS:	
Institute of Certified Public Accountants (Israel) www.icpas.org.il	20 sheffer St. Tel-Aviv Tel: 03-5161114 Fax: 03-5103105
Manufacturers Association of Israel www.industry.org.il	29 Hamered St., Tel-Aviv 61500 Tel: 03-5198787 Fax: 03-5162026
Israel Export Institute www.export.gov.il	29 Hamered St., Tel-Aviv 68125 Tel: 03-5142830 Fax: 03-5142902
Israel Bar Association www.israelbar.org.il	10 Daniel Frisch St. Tel-Aviv 67132 Tel: 03-6918691 Fax: 03-6918696
Federation of Israeli Chambers of Commerce www.tlv-chamber.org.il	84 Hachashmonaim St., Tel-Aviv Tel: 03-5631010 Fax: 03-5619025
Bank Hapoalim B.M. www.bankhapoalim.co.il	50 Rothschild Blvd. Tel-Aviv 61000 Tel: 03-5673333 Fax: 03-5673695/0
Bank Leumi LeIsrael Ltd. www.bankleumi.co.il	32 Yehuda Halevi St., Tel-Aviv 61000 Tel: 03-5148111 Fax: 03-5148360
Israel Discount Bank Ltd. www.discount-bank.co.il	27 Yehuda Halevi St., Tel-Aviv 65546 Tel: 03-5145555 Fax: 03-5145155

BUSINESS ORGANIZATIONS:	
United Mizrahi Bank **www.mizrahi.co.il**	13 Rothschild Blvd. Tel-Aviv 66881 Tel: 03-5679211 Fax: 03-5679913
The First International Bank **www.fibi.co.il**	9 Ahad HaAm St., Tel-Aviv 65251 Tel: 03-5196111 Fax: 03-5100316
The Organization of the Agricultural Cooperatives in Israel	The Agricultural Center House 8 Shaul Hamelekh Blvd. P.O.Box 4010 Tel-Aviv Tel: 03-6929988 Fax: 03-6929936

Appendix 2

Comparison of results between using a branch and using a company

	Regular operation		Approved enterprise or property (1)	
	Branch	Israeli Company	Branch	Israeli Company
Profit in Israel	100	100	100	100
Company Tax	36	36	(2)10	(2)10
Distributable	64	64	90	90
Branch Tax - Nil or 15%	Nil		(3) 13.5	
Dividend withholding				
tax - 25% or 15%		(3)16		(3)13.5
Remittance from Israel	64	48	76.5	76.5

Notes:

(1) Pursuant to the Law for the Encouragement of Capital Investments, 1959.

(2) Assuming the company is 90% or more foreign owned.

(3) Subject to any applicable tax treaty.

Appendix 3

Company Tax Rates

(See text for details)

	Company Tax rate	Maximum period of benefits	Dividend withholdin g tax rate
Regular operations	36%	N/A	25%
Approved enterprise or approved property with foreign ownership of: Up to 25%	(1) 25%	7 years (2)	15%
Over 25% but under 49%	(1) 25%	10 years (2)	15%
49% or more but under 74%	(1) 20%	10 years (2)	15%
74% or more but under 90%	(1) 15%	10 years (2)	15%
90% or more	(1) 10%	10 years (2)	15%
Authorized Eilat enterprise: Initially Thereafter	 Exempt 30%	 7 years Indefinite	 15% 15%
International Trading Company	Exempt	10 years	Exempt

Notes:

(1) A total tax exemption ("Tax Holiday") may be selected for retained profits generated in the first 2 - 10 years, depending on location. The beneficial approved enterprise company and dividend withholding tax rates shown will generally apply if such profits are distributed, and to profits generated after the tax holiday in any remaining part of the 7-10 year period of benefits shown above. Government grants must be forgone in most cases. See Appendix 4 for further details.

(2) No time limit on benefits applies to Approved Rental Buildings.

Appendix 4

Approved Enterprise Incentives

		National Priority Region		
	Benefit	**"A"**	**"B"**	**"central"**
Grants Package	Grant*	20%	10%	-
	Tax Holiday	2 years	-	-
	25% Company Tax **	5 years	7 years	-
Alternate Package of benefits	Grant	-	-	-
	Tax Holiday	10 years	6 years	2 years
	25% Company Tax **		1 year***	5 years ***

* Different grant rates apply to approved tourism enterprises.

** Companies with foreign ownership of more than 49%, are eligible for lower tax rates of 10%-20% - see Appendix 3.

*** Companies with foreign ownership of more than 25%, may enjoy 3 more years of benefits.

Appendix 5

Tax Depreciation Rates

The following is an illustrative sample of annual depreciation rates applicable in 2000 for Israeli tax purposes. These rates are renewed annually.

Circumstance	Straight line basis	Declining balance basis (1)	
	%	%	Final Year
Industrial company (accelerated rates):			
- Equipment - 1 daily shift	20	5	3
- 2 daily shifts	30	4	4
- 3 daily shifts	40	3	5
- Buildings used by the industrial enterprise	5 - 16	-	-
		-	-
- Purchased patents and know-how	12.5	-	-
- R&D expenditure (net of grants received)	33.3 - 100	-	-
- Public share offer expenses	33.3		
Hotels (accelerated rates):			
Buildings	5 - 8	-	-
Equipment	20	-	-
Most other businesses (standard rates): (2)			
- Mechanical equipment	7 - 10	-	-
- Electronic equipment	15	-	-
- Buildings (depending on grade)	1.5 - 4	-	-
- Furniture & fittings	6	-	-
- Personal computers & peripheral equipment	33	-	-
- Other computers	25	-	-

Notes:

(1) The declining balance basis produces the following results:

Year	1 %	2 %	3 %
First	30.00	40.00	50.00
Second	21.00	24.00	25.00
Third	14.70	14.40	25.00
Fourth	10.30	21.60	-
Fifth	24.00	-	-
	100.00	100.00	100.0

(2) As an alternative to the above accelerated rates for industrial companies, an approved enterprise may elect for 5 years to depreciate industrial buildings at 400% of these standard rates and to depreciate industrial plant and machinery at 200% - 250% of these standard rates - see text.

Appendix 6

The U.S. - Israel Tax Treaty

1. Background

The U.S. Israel Tax Treaty became effective in 1995. The Treaty represents the culmination of efforts stretching as far back as 1947.

The Treaty complements the U.S.-Israel Free Trade Agreement of 1985 which grants import tax concessions in each country for goods produced in the other country.

The Treaty improved the double tax relief previously available under the domestic tax laws of the U.S. and Israel. Following is a brief summary of the Treaty.

2. Who is covered by the Treaty ?

The Treaty applies to U.S. citizens and to U.S. resident persons (corporations and individuals) for tax purposes in each country. A partnership, estate or trust will be resident in either country to the extent that income arising is taxable in that country as income of the entity concerned or of its partners or beneficiaries. A U.S. "Green Card" holder who is not an Israeli resident (e.g. a former Israeli resident) is covered by the Treaty as a U.S. resident if he/she has a substantial presence, permanent home or habitual abode in the U.S.

A "limitation of benefits" clause denies Treaty benefits where third country residents effectively enjoy 50% or more of the ownership or gross income of an entity. This limitation does not apply to entities traded on a stock exchange in either country or on NASDAQ, nor to persons that conduct an active trade or business in the U.S. or Israel, if the income in question is derived from, or incidental to, the trade or business.

3. Dual status persons

Where a person holds dual status, the Treaty provides the following "tie breaker" rules for allocating residence to one country for tax purposes:

Situation under domestic legislation	Treaty rule
Individual resident in both countries	Residency will be allocated to one country based primarily on the person's center of vital interests.
Israeli resident individual who holds a U.S. "Green Card"	As above
U.S. citizen who is an Israeli immigrant ("Oleh)"	Resident in Israel
Corporation resident in both countries e.g. incorporated in the U.S. but controlled and managed in Israel	Residency would be allocated to one country by mutual agreement between the U.S. & Israeli tax authorities. Until then, treaty relief is restricted.

4. When is tax imposed ?

In general, a U.S. resident or citizen will be taxable in Israel solely on income from Israeli sources, as defined in the Treaty. The converse case applies to Israeli residents that derive U.S. source income.

Tax payable in the source country under the Treaty may be credited against any tax arising on the same income in the taxpayer's country of residence, subject to various rules - see para. 10 below.

The Treaty cannot be construed to restrict any exclusion, exemption, deduction, credit or other allowance in the two countries' domestic tax legislation, or in any other agreements between them.

Israeli taxes covered by the Treaty include income tax, company tax, capital gains tax, land appreciation tax and the wage & profit tax imposed on banks and insurance companies. The Treaty also covers U.S. federal income taxes, but not state taxes nor social security.

Standard Israeli and U.S. tax rates may be summarized as follows:

	Israel	U.S. Federal	U.S. State
	%	%	%
Individuals	10 - 50	15 - 39.6	6 - 10 (average)
Corporations - regular- Corporations - approved enterprise	36 0 - 25	15 - 35 N/A	6 - 10 (average) N/A
Standard withholding tax on passive dividend, interest and royalty income	25 (*)	30 (**)	N/A
Approved enterprise dividends	15	N/A	N/A

(*) Interest on certain non-business shekel bank deposits is exempt in Israel. Likewise, interest on non-residents' bank accounts is exempt in Israel for foreign residents who do not conduct a business or profession in Israel.

(**) In practice, portfolio interest and bank account exceptions make virtually all interest exempt in the U.S.A., except for bank loans, loans from related parties (10% related generally), and contingent interest debt.

5. Business profits

A corporation resident in one country should only be taxable on business profits in the other country to the extent that the profits are attributable to a "permanent establishment" (PE) in the other country. A PE is essentially a fixed place of business ("branch") through which industrial or commercial activity is conducted. The Treaty definition of a PE excludes, among others:

- A building site, or construction or assembly project, or related supervision activity, lasting less than six months.
- The maintenance of substantial equipment or machinery for less than six months.
- The maintenance of a goods inventory for the purposes of storage, display, delivery or processing by another person. This does not include a point of sale except for the sale of display goods at the end of a trade fair or convention.
- A fixed place of business for purchasing goods, collecting information (e.g. a news bureau), advertising, supply of information or scientific research, or similar activity with a preparatory or auxiliary character.
- An independent agent.

In addition to the usual corporate taxes, the Treaty allows each country to impose a branch profits tax (in lieu of dividend withholding tax) of up to 12.5% and a branch interest tax of up to 5%. Under domestic law, the U.S. imposes these taxes at a rate of 30%, while Israel imposes a 15% branch profits tax on Approved Enterprise branches.

6. Withholding tax rates - passive income

The Treaty prescribes the following withholding tax rates for payments of passive income by residents of one country to residents of the other.

Payment	Circumstance	Rate
Dividend	Regular rate	25%
	From the profits of an approved enterprise in Israel	15%
	For corporate shareholders that held at least 10% of the voting stock of a payor company since the beginning of the previous taxable year (if any), unless the payor company has an approved enterprise in Israel or derives more than 25% of its gross income from passive interest or dividend income (with certain exceptions).	12.5%
	U.S. Regulated Investment Company	25%
	U.S. Real Estate Investment Trust	25% - 30%
	Israeli fiscally transparent entities (family company or similar)	Regular rates on profits
Interest	Regular rate	17.5%
	To a bank, savings institution or insurance company, or the like	10%
	Alternative election by lender in the above cases	Regular rates on interest profit margin
	Interest on a governmental or government-guaranteed loan	Zero
Royalties (or performance related sale gains from relevant intangible assets)	Film and copyright royalties	10%
	Industrial royalties	15%

7. Capital gains

In principle the Treaty provides a resident of one country with an exemption from capital gains taxation in the other (source) country. However, capital gains relating to the following may be taxable in the other country:

- Assets of a permanent establishment.
- Real estate and certain real property corporations.
- Performance-related gains from intangible assets capable of generating royalties e.g., patents, know-how, copyrights. Withholding tax on such gains in the other country will be generally restricted to the rates shown in para. 6 above, for royalties.
- Individuals who visit the other country for more than 183 days in the taxable year.
- Dispositions of stock in a corporation resident in the other country.

Nevertheless, a stock disposition may be exempt in the other country if the investor (corporate or individual) held less than 10% of the company's voting stock throughout the preceding 12 months. Where an Israeli tax liability does arise under the Treaty, a foreign tax credit may be claimed - see para. 10 below.

Certain corporate reorganizations may proceed on a tax deferred basis in both countries where the transferor and the transferee companies are resident in the same country and one controls at least 80% of the other, directly or indirectly, or they are commonly controlled to the same extent by a holding company in the same country. This provision should augment restrictive Israeli tax reliefs (ITO Secs. 103-105) for reorganizations.

Notwithstanding the above, Israeli residents may enjoy exemption from most U.S source capital gains under domestic U.S. legislation, except for gains from U.S. real property interests and the sale of permanent establishment assets.

8. Real estate income and gains

The Treaty gives a first right of taxation to the country where the real estate is situated. Any tax in the other country may be offset by double tax relief - see para. 10 below.

9. Individuals

Self-employed individuals who are residents of one country will generally not be taxable in the other country on personal services income derived in the other country if they are present there less than 183 days in the taxable year. This is a significant concession not found in some other tax treaties.

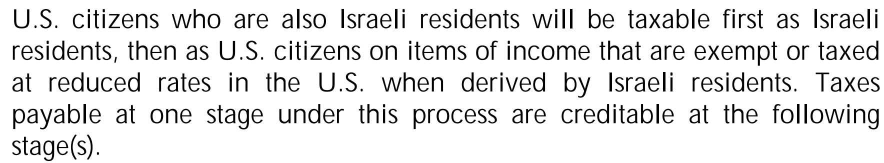
Employees and officers of a corporation who are residents of one country will not be taxable on their remuneration for services performed in the other country if: (1) they are present there less than 183 days in the taxable year, and (2) they are employed by a home country resident or permanent establishment, and (3) the remuneration is not borne by any permanent establishment of the employer in the other country, and (4) the remuneration is taxed in the home country.

Social security payments and other public pensions will be exempt in both countries. Private pensions, alimony receipts and annuities will, in general, be taxable only in the recipient's country of residence. Child support receipts will be exempt in the recipient's country of residence.

The treaty contains additional provisions covering, among others, public entertainers, governmental personnel, teachers, students and trainees, and charitable contributions.

10. Foreign tax credit

Double tax relief for items taxable under the Treaty takes the form of a foreign tax credit, subject to the provisions and limitations in the laws of each country. In addition, 10%-or-more corporate shareholders (by reference to voting stock) in one country who receive dividends from a payor company in the other country may credit the deemed paid (underlying) corporate tax of the payor company.



U.S. citizens who are also Israeli residents will be taxable first as Israeli residents, then as U.S. citizens on items of income that are exempt or taxed at reduced rates in the U.S. when derived by Israeli residents. Taxes payable at one stage under this process are creditable at the following stage(s).

11. Related parties

The tax authorities are empowered to make adjustments as they see fit, if the terms of transactions between related parties appear to differ from those which would have applied between unrelated parties. Application may be made to the other tax authority for a corresponding adjustment. Failing this, mutual consultation procedures may be invoked (see para. 12).

12. Mutual consultation

The tax authorities of the two countries are empowered to discuss transfer pricing and other double taxation issues and to issue joint Advance Pricing Agreements.

Appendix 7

Personal Tax Calculations

The following are sample tax calculations for an Israeli resident and for a non-resident expatriate. Both worked in Israel throughout the tax year. Because of his industrial skills, the expatriate received "foreign expert" status from the Employment Service and "approved specialist" status from the Investment Center. Both individuals have non-working spouses and two children. Monthly tax brackets and rates for September 1, 2000, have been applied on an annualized basis. In practice, these rates and brackets are subject to periodic update or variation.

	Israeli Resident NIS	Non-resident Expatriate NIS
Calculation of Taxable Income		
Salary (US$ 70,000 aprox.)	280,000	280,000
Documented rent expenses (a)	-	(b) (48,000)
Permissible per-diem allowance (a)	-	(c) (91,250)
Taxable income	280,000	140,750
Calculation of Tax		
Income Tax:		
At regular rates of up to 50%	103,436	
At regular rates of up to 25% (d)		30,526
Personal tax credit (e)	(6,513)	-
Income tax payable	96,923	30,526
Employees' national insurance contributions (f):		
Resident employee (at rates of up to 9.7%)	(g) 25,659	
Expatriate employee (at rates of up to 0.6%)	-	(h) 742
Resident employees: organization levy	(i) 1,028	-
Total Israeli taxes	123,610	31,268

(a) These deductions are available to expatriates who obtain "foreign expert" status.

(b) The assumed rent expense is NIS 4,000 (approximately US$ 1,000) per month

(c) The permissible per-diem allowance is the lower of NIS 250 (approximately US$ 62) or 50% of gross remuneration.

(d) Expatriates in the industrial or tourism sectors who are granted "approved specialist" status qualify for taxation at a maximum rate of 25% for up to eight years.

(e) The personal tax credit as of 1/2000 is calculated as follows: 3.25 credit points X NIS 167 per month.

(f) The contributions are based on taxable income and in any event shall not exceed the sum of 31,735 NIS. They include a supplementary health levy at rates of up to 4.8% for Israeli resident employees.

(g) The employer makes contributions at the rate of 4.93%. In the event that the gross salary shall exceed 25,388 NIS per month, than the employer shall make its contribution at the said rate only with respect to the sum of 25,388 NIS. In this example, the employer contribution is NIS 13,804.

(h) This amount is payable if no social security totalization agreement applies. The employer makes contributions at a rate of 0.70%. In this example, the employer contribution is NIS 985.

(i) Israeli resident employees may be liable to an organization levy at rates of 0.7% - 0.9%, up to an income limit (NIS 9,521 per month in the first half of 2000) if they are Histadrut labor federation members or if they work in a unionized workplace.