

# Taxation of investment funds

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## Introduction

Israel – known as the 'start-up nation' – has encouraged and attracted inbound foreign investments for many years. Investors looking to invest in Israeli companies may do so by:

- investing directly;
- investing in investment funds managed by others; or
- establishing a private investment fund.

Recent years have shown an increased interest and investment activity in Israeli companies by foreign investors, several of which have formed an Israeli corporate venture capital (CVC) fund for this purpose.

Among the primary tools for encouraging inbound investments is the special tax regime for private investment funds. Over the years, the Tax Authority has issued substantial guidance and numerous private rulings under the Income Tax Ordinance, providing significant tax benefits to foreign investors and private investment funds operating in Israel.

This article outlines the income tax arrangements applicable to private investment funds operating in Israel. These arrangements are predominantly based on Income Tax Circulars 9/2018 and 10/2018, which govern the taxation of venture capital funds and private equity funds, respectively.

The special tax regime applicable to private investment funds is currently under review by the Tax Authority and the Ministry of Finance. As such, tax benefits that are available under the existing regime may be adjusted and further criteria for entitlement may be added. However, such changes are not expected to affect the existing arrangements for non-Israeli limited partners.

## Criteria for beneficial tax treatment

The principal conditions for beneficial tax treatment for non-Israeli investors regarding their investments in private equity and venture capital funds are as follows:<sup>(1)</sup>

- The fund must have at least 10 unrelated (directly or indirectly) investors.
- Investors may not hold more than 20% of the capital of the fund, with the anchor investor able to hold up to 35% of the capital of the fund.
- At least 30% of the investors in the fund must be non-Israeli investors.
- Total investment commitments must be at least \$10 million, of which at least \$5 million must come from non-Israeli investors.
- The fund may not invest more than 25% of its total commitments (net of management fees) in any single company.
- The fund may not invest more than 20% of its total funds raised (after deduction of management fees) in companies whose securities are publicly traded.
- The fund may not hold short-term cash deposits or publicly traded securities, unless they originate from:
  - monies which investors transferred in accordance with their investment commitments in the fund; or
  - the realisation of profits prior to their distribution or reinvestment.
- The fund must invest in 'qualifying investments' (as defined below) in Israel in accordance with the lesser of the following alternatives:
  - at least \$10 million in qualifying investments of which at least \$6 million must be invested, directly or

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- indirectly, in Israeli resident companies whose intellectual property is owned by them and/or in their non-Israeli parent companies; or
- at least 50% of the fund's total commitments in qualifying investments, of which at least 30% of total commitments must be invested, directly or indirectly, in Israeli resident companies whose intellectual property is owned by them and/or in their non-Israeli parent companies.
- The fund must be managed by the general partner or by a person on its behalf. The limited partners may not take any role in identifying targets or managing the portfolio companies or in the day-to-day management of the fund and will have no voting rights in the investment committee of the fund.
- The fund may be required to provide certain financial information to the Tax Authority.
- Investors in the fund may be required to provide certain information to the fund or the Tax Authority in order to establish their right to enjoy the benefits of a Tax Authority ruling issued with respect to the fund.

## **Definitions**

For purposes hereof:

- a 'qualifying investment' is an investment in shares of an Israeli resident company or an Israel affiliated company whose principal activity is a qualifying activity, including venture capital investments. Investments in securities traded on the stock exchange will not be considered qualifying investments, unless the fund's holding period of a publicly traded portfolio company is at least one year from the time of the fund's first investment therein;
- a 'qualifying activity' is the establishment or expansion of enterprises engaged in activities in Israel in the areas of industry, agriculture, tourism, transport, construction (excluding real estate), water, energy, technology, communications, computing, security, medicine, biotechnology or nanotechnology or research and development in these areas;
- an 'Israel affiliated company' is a foreign company whose principal assets and/or activities, directly or indirectly, are in Israel;
- 'shares' include stock options and warrants, convertible notes and convertible bridge loans which are not secured by assets other than the technology or the assets which the target company owns; and
- 'venture capital investments' are qualifying investments in the high-tech sector, where at least 75% of the total investment is in consideration for the issuance of shares.

## **Beneficial tax arrangement**

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

### ***Tax arrangement for non-Israeli limited partners***

Income derived from non-Israeli investments (ie, non-Israeli companies or non-Israeli affiliated companies) will be exempt from tax in Israel.

Income derived from venture capital investments (ie, capital gains, dividends and interest) will be exempt from tax in Israel.

Income derived from qualified investments that are not venture capital investments will be taxed as follows:

- Income from the realisation of qualified investments will be exempt.
- Dividend income received from the qualified investments will be taxed as follows:
  - Dividend income attributed to individual investors (including if held through a transparent entity for tax purposes in the country of residency of the individual) will be subject to tax at the rate of 15%.
  - Dividend income attributed to corporate investors will be subject to tax at the corporate income tax rate (currently 23%).
  - Notwithstanding the foregoing, foreign investors from a treaty jurisdiction may be eligible for the tax rates set out under the applicable treaty (15%),<sup>(2)</sup> subject to confirmation of tax residency and beneficial ownership by the Tax Authority
- Interest income received from the qualified investments will be taxed as follows:
  - Interest income will be subject to tax at the regular applicable tax rates set out in the Income Tax Ordinance (individuals will be taxed at a rate of 15% to 50% depending on the nature of the interest; corporates will be taxed at 23%).
  - Notwithstanding the foregoing, non-Israeli investors from a treaty jurisdiction may be eligible for the tax rates set out under the applicable treaty (10%), subject to confirmation of tax residency and beneficial ownership by the Tax Authority.
- Any other income (not covered above), including income from management fees received from portfolio companies, will be subject to the regular tax rates set out in the Income Tax Ordinance (up to 50% for

individuals and 23% for corporates).

- Foreign investors in the fund will not be considered tax residents of Israel and will not have filing obligations in Israel as a result of their investments in the fund.

### ***Tax arrangement for non-Israeli fund managers***

Based on the foregoing, and once the fund qualifies for tax benefits, the general partner and the managers of the fund may also be entitled to certain tax benefits. As stated above, the special tax regime applicable to private investment funds is currently under review by the Tax Authority and the Ministry of Finance. As such, tax benefits that are available under the existing regime may be adjusted and further criteria for entitlement may be added.

#### ***Taxation of carried interest***

Carried interest income attributable to Israeli investments will be subject to tax at the rate of 15% in the hands of non-Israeli fund managers.

Carried interest income attributable to investments in foreign entities will not be subject to tax in Israel.

Notwithstanding the foregoing, non-Israeli general partners and fund managers from a treaty jurisdiction may be eligible for the tax rates set out under the applicable treaty, subject to confirmation of tax residency and beneficial ownership by the Tax Authority.

#### ***Taxation of management fees***

Income derived from management fees will generally be subject to the regular tax rates set out in the Income Tax Ordinance (up to 50% for individuals and 23% for corporates).

### **Alternative tax arrangements if conditions are not met**

Over the years, the Tax Authority has issued alternative tax arrangements for funds that do not meet the criteria described above, including funds:

- that have fewer than 10 investors;
- with commitments of less than \$10 million;
- in which the limited partners are involved in the management of the fund; and
- in which the general partner is a substantial investor.

The following is a short description of the beneficial tax treatment available in some of these situations.

#### ***Funds that have fewer than 10 investors***

Income from realisations of qualifying investments will be subject to 15% income tax in Israel.

Income from interest and dividend payments that are derived from qualifying investments will be subject to tax at the lesser of:

- 15%; and
- the tax rates under an applicable tax treaty.

Other income that is not derived or accrued from qualified investments will be subject to the tax rates established in the Income Tax Ordinance.

Income derived from non-Israeli companies (ie, non-Israeli or non-Israeli affiliated companies) will be exempt.

#### ***Funds with less than \$10 million in commitments***

A beneficial tax arrangement will be available to funds that are focused on making venture capital investments.

Income from realisations of venture capital investments will be exempt from tax in Israel.

Income from interest and dividend payments will be subject to tax at the lesser of:

- the tax rates established in the Income Tax Ordinance; and
- the tax rates under an applicable tax treaty.

#### ***Non-Israeli funds investing in Israel without representation in Israel***

Generally, such a fund will enjoy the same tax benefits as described under "[Tax Arrangement for Non-Israeli Limited Partners](#)" above.

Non-Israeli managers of the fund will be entitled to exemption from Israeli tax on their carried interest (as opposed to 15% tax on carry sourced from investments in Israel, for a fund with Israeli representation) and on their management fees.

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## **Endnotes**

(1) Limited partners holding more than 4% of the interests in a fund may not control the entities managing the fund and may not hold more than 10% of the general partner, if they wish to enjoy the tax benefits.

(2) For a percentage holding lower than 25%.

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