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CLIENT UPDATE



Israeli Encouragement of Capital Investments Law – A New Tax Circular on the Separation and Consolidation of "Industrial Enterprises"

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On November 19th, 2019, the Israeli Tax Authority ("ITA") published circular No. 3/2019 (the "**Circular**") on separation and consolidation of industrial enterprises under the Encouragement of Capital Investments Law (the "**Law**").

Background

The Law's main objective is to encourage investments in Israel. There are different conditions for qualifying for the Law's benefits, one of them is the existence of an Industrial Enterprise. The new Circular looks at to determine if certain activities constitute an Industrial Enterprise and under what circumstances a single company could have more than a single Industrial Enterprise or several related companies would be deemed to have a single "Industrial Enterprise".

Once an activity qualifies as an Industrial Enterprise several alternatives, each subject to its conditions, for reduced corporate and withholding tax rates are available, as follows (as of 2019):

Enterprise type	Geographical area "A"	"Other" Geographical area	Dividend withholding rate (rates may be reduced under an applicable tax treaty)
Preferred Enterprise	7.5%	16%	Individual/Foreign company - 20% Israeli company – 0%
Special Preferred Enterprise	5%	8%	Individual/Foreign company – 20% Israeli company – 0% Foreign parent company (*) - 5%

Preferred Technological Enterprise	7.5%	12%	Individual/Foreign company – 20% Israeli company – 0% Foreign parent company (**) – 4%
Special Technological Enterprise	6%	6%	

(*) Temporary provisions for dividends distributed in 2017-2019 to a foreign parent company that holds 100% of the shares of the company.

() Dividend distributed to a foreign parent company if at least 90% of the company's shares are owned by one or more foreign companies.**

What is an Industrial Enterprise?

Section 51 of the Law defines an Industrial Enterprise as an enterprise located in Israel whose majority activity is "production" defined in the same section 51 as including "production and development of software products and industrial research and development for foreign residents, subject to approval". The issue of what qualifies as an "enterprise" and "production" has been subject to much discussion in Israeli case law, and recently there have been some noteworthy developments.

- **Number of employees** – The ITA's approach was that if an enterprise employs less than 10 employees, it will not qualify as an Industrial Enterprise. Although a recent local case law (Visinc Vs Afula Tax Assessor) supported this view, the court mentioned that "there is a necessity to adjust this approach to the modern industry". In a recent ruling 6003/19 the ITA made public a revised approach regarding the number of employees and ruled that in certain conditions, a company that employs less than 10 employees will qualify as an Enterprise (in this particular case, the company employed 3 R&D employees and 3 marketing employees).
- **Services as "production"** - A recent court case (Tipicon Vs Haifa Tax Assessor) ruled that software development services to a customer that owns the IP will not qualify as "production". It should be noted that the Law allows the income from provision of R&D services to a foreign company to qualify as a preferred income subject to reduced corporate tax rate (as stated above), if such services are approved by the Israeli innovation center ("IIA"). The ITA determined in ruling 0933/18 that a company's income shall qualify as a preferred income even before the company obtained the IIA approval. One of the conditions in the ruling was that the company would add the IIA approval for every tax return in which it claims the Law's benefits.

Criteria indicating separate Industrial Enterprises

It is important to determine and identify the enterprises owned by the company since the conditions specified in the Law must be examined with respect to each enterprise separately. Therefore, the determination if a company has more than one enterprise is important since each enterprise would have to meet the conditions separately, and in contrast, if a few activities form one enterprise it may be easier to qualify by combining the activities or at time may be more difficult to qualify since certain disqualifying activities would taint the aggregate.

The Circular sets a non-exclusive list of criteria to indicate the existence of separate industrial enterprises in the same company:

- 1. The products manufactured in the company's enterprises differ materially from one another.**

2. The technologies used in the development and production process in each of the company's enterprises are materially different;
3. The main raw materials used in the process of development and manufacturing are different in each enterprise;
4. The locations of the enterprises are different. For this purpose, different separate locations can be in the same building;
5. The customers and suppliers of the enterprises are different;
6. The employees employed by each enterprise are different, with different skills, and there is no employee exchange between the enterprises;
7. Each enterprise has a separate management and headquarters;
8. The company maintains separate bookkeeping system for each of its enterprises;
9. The enterprises do not constitute an "industrial enterprises with one production line" according to the provisions of the Law for Industry Encouragement (Taxes).
10. Examination of all circumstances, including special circumstances.

In addition, the Circular determines a presumption that an enterprise owned by a company will be separate from another enterprise owned by another company. In a case where a company involve with two activities: manufacturing activity and a non-manufacturing activity, and both related with each other, separation into two separate sectors will not be possible unless it's a separation caused by a corporation reorganization. In such cases the manufacturing activity might not be the majority of the enterprise's activity, which can cause that the enterprise will not qualify as an Industrial Enterprise. In case that each activity will be in a separate company, the activity will be examined separately and accordingly the manufacturing activity may qualify as an industrial enterprise.

Conclusions and recommendations:

The takeaway – the clarification of the definition of "Industrial Enterprise" may increase the benefits for a company under the Law and reduce the tax exposures. Our firm has vast experience in advising on the Law benefits, setting the proper documentation and manuals to support it and in representing internationals and domestic clients in local benefits controversies with the ITA and the Israeli courts.

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