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Proposed Reform in the Taxation of Partnerships and Investment Funds in Israel

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The Ministry of Justice has published a Memorandum for Amendment of the Income Tax Ordinance (Taxation of Partnerships), 5781-2021, for public comments (the "**Amendment**"). The Amendment proposes a wide reform to the taxation of partnerships in Israel. Among other novelties (some of which are rather extreme), the Amendment includes a dedicated chapter for the taxation of private investment funds investing in Israel. The Amendment marks the first Israeli attempt to codify the tax regime applicable to such funds. **If enacted in its current version, the Amendment will significantly worsen the tax results for fund managers and for non-Israeli investors in private equity funds and for all Israeli investors operating through partnerships.**

Background

Despite its thriving investment funds industry, Israel has no dedicated statutory regime for the taxation of investment funds or asset managers. Rather, their taxation is based on general provisions of Israeli tax law and a very extensive practice of private letter rulings. The main issues that have been important to the investment funds industry were: (i) the eligibility of non-Israeli residents for the exemptions from capital gains tax on the sale of securities in Israeli companies, and (ii) the taxation of the carried interest for the funds' managers. **As to the non-Israeli investors** - the concern was around the risk an investor may be deemed to have a "Permanent Establishment" ("**PE**") in Israel and not qualify for the exemption from capital gains tax by virtue of the activities of the fund and the mangers in Israel, since the Israel Tax Authority ("**ITA**") generally applies a very low threshold for having a PE. **As to the fund managers** – the concern was whether the carried interest should follow the classification of the underlying partnership income (usually capital gains), or whether it should be viewed as additional compensation for the management services and thus taxable as ordinary income.

Over the past three decades, the ITA has issued numerous private rulings to both Israeli and non-Israeli investment funds operating in Israel ("**Rulings**") in an attempt to overcome these issues, provide certainty and encourage venture capital and private equity investments into Israel. Over the years, the criteria for these Rulings became uniform, and were eventually made public.[1]

The Rulings distinguished between "Qualifying Investments" and "Qualifying VC Investments". Qualifying Investments were investments in Israeli or Israeli related companies operating in a broad range of qualifying activities (see below). Whereas, Qualifying VC Investments had to meet another criteria, which is to have at least 75% of the investment as an investment into the company in exchange for the issuance of new shares (as opposed to a purchase from existing shareholders). In a nutshell, the Rulings provided that non-Israeli residents were exempt from tax on **any** income from Qualifying VC Investments and on capital gains from other Qualifying Investments. In addition, the Rulings provided a 15% Israeli tax on non-Israeli members of the general partner with respect to carried interest attributed to Israel-related investments, with assurances to prevent possible double taxation. As to Israeli members of the general partner, the Rulings provided a formula based tax rate weighing the mixture of the fund's investors, possibly reducing the tax rate on their carried interest from 50% to as low as 28%.

The Amendment

The Amendment sets different rules for different types of funds investing in Israel as follows:

Venture Capital Investments

The Amendment proposes a special regime primarily for the taxation of venture capital funds. The proposed regime is partial and fails to address many of the issues that are currently covered by the Rulings and that had become key features in the Israeli venture capital industry.

Non-Israeli investors will continue to benefit from the broad exemption on capital gains, interest and dividend on the funds' investments in Qualifying VC Investments. The Amendment proposed certain changes to the conditions for eligibility to those exemptions. Under the current regime, Qualifying Investments (VC and non-VC) include a wide range of companies in various fields. The Amendment narrows the definition of Qualifying Investments to apply only to investments in "Manufacturing Activity" as defined in the Encouragement of Capital Investments Law, 5719-1959, including establishment of national infrastructures. The term "Manufacturing Activity" includes software and development enterprises, particular industrial research and development enterprises authorized by the Israeli Innovation Authority or the Chief Scientist of the Israeli Ministry of Energy, or other activities as determined by the ministers. Particularly excluded are the fields of construction, transportation and communications services. Some of the additional activities that will no longer qualify (unless they are also a Manufacturing Activity) are agriculture, tourism, water, energy, defense, health, bio-technology, nanotechnology and others. This would narrow the scope of Israeli start-up companies that may be Qualifying Investments. The Amendment will also apply to smaller funds by reducing the minimum number of investors in the fund from 10 to 5, and reducing the minimum overall investment amount in Qualifying Investments to USD 5 million. The Amendment lacks some of the currently prevailing arrangements e.g. ad- hoc Co-Investment, annex funds and more.

Carried interest from a Qualifying VC Investment - the Amendment preserves the controversial 15% tax rate applicable to non-Israeli members of the general partner. However, it lacks the crucial mitigation mechanism for potential double taxation specified in the Rulings. If a non-Israeli member of the general partner did not receive a foreign tax credit in its country of residence, the ITA would refund such non-Israeli member of the general partner the Israeli tax that was not credible. The Amendment only foresees the commencement of mutual agreement proceedings in such a situation if the investor is a resident of a treaty country. In addition, **the Amendment does not deal at all with the tax treatment relating to carried interest of Israeli members of the general partner**.

Private Equity Investments

The Amendment proposes a dramatic change to the taxation of private equity investments. Private equity investments are Qualifying Investments (which are not Qualifying VC Investments). The sole provision regarding private equity funds offers an exemption on capital gains from the sale of a Qualifying Investment made only until 31.12.2022. Private equity investments are perceived, according to the Amendment's explanatory commentary, to be less beneficial to Israel than venture capital investments, and thus it is proposed to reevaluate the exemption following a period of two years. No benefits are granted on income from dividends and interest, which historically was exempt at least to some of the non-Israeli investors.

Carried interest from private equity funds, and in fact, any carried interest derived other than in the hands of non-Israeli partners in venture capital funds – shall be taxed in the ordinary income tax rate without any tax benefit, in the hands of Israeli and non-Israeli partners.

Other Funds

The Amendment does not directly address other types of funds such as hedge funds and private debt funds, but rather treats these funds as regular partnerships, the income of which is usually classified as business income and is taxed at the ordinary tax rates. The Minister of Finance is granted the authority to determine otherwise regarding income generated from the sale of certain "financial assets" – i.e., that such gains would be taxable at the capital gains tax rate, under certain conditions. The reasoning for this proposed regime is the ambiguity the legislator finds in the classification of such funds' income. The proposed considerations to be contemplated in the determination in each case include, *inter alia*, the criteria for classification of business vs. investment income and the need to encourage investments that bring special added value to the public, as well as the potential loss of tax earnings by the state of Israel from this activity.

Additional comments and takeaways

In discussions with ITA officials they have indicated that some of the changes in the Amendment compared to the currently applicable regimes reflect an oversight and would be amended.

In these discussions they have also stated that the Amendment, if accepted, will apply only to new funds and would not change the provisions of Rulings which were issued to funds that already operate in Israel.

The Amendment may deter foreign funds, especially those who do not make Qualifying Venture Capital investments from operating in Israel.

The Israeli Advanced Technology Industries (IATI) is leading the effort of the local venture capital funds to preserve some of the tax arrangements, which were key to this thriving industry and its significant contribution to the Israeli high-tech ecosystem.

Our firm has vast experience and is a leader in dealing with the taxation of venture capital, private equity and hedge funds. We have been deeply involved in planning a

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[1] See Income tax circulars 9/2018 – Taxation of Venture Capital Funds and 10/2018 – Taxation of Private Equity Funds.

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