

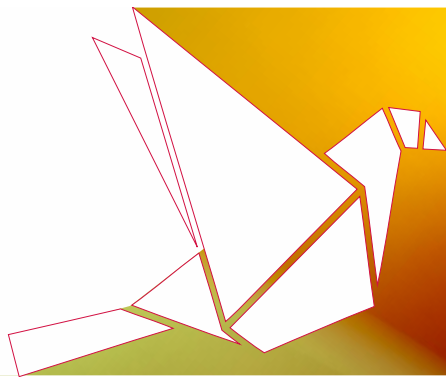
Client Update

New ITA Circulars Dealing with the Taxation of Private Equity and VC Funds, their Investors and Fund Managers

Dear Clients, Colleagues and Friends,

On March 14, 2018, the Israel Tax Authority (the "ITA") issued two circulars (9/2018 – Taxation of Venture Capital Funds and 10/2018 – Taxation of Private Equity Funds) dealing with the conditions and specifics of a beneficial tax treatment route available for private equity and VC funds in connection with their investments in Israel (the "Circulars"). The Circulars update previously published circulars that dealt with the same subject matter. The Circulars set out the conditions for, as well as an explanation of, the beneficial tax treatment awarded within the rulings granted under Section 16A of the Israeli Income Tax Ordinance (the "Ordinance"). Section 16A was enacted to encourage foreign investors and foreign investments into Israel. The tax treatment and tax rates detailed in each Circular (and described below), depend on the type of income derived by the fund, such that a fund can have both VC related and private equity related income. Thus, the income derived by a fund will be taxed in accordance with the Circular applicable to such type of income. The Circulars come off the back of a comment made in an annual report by Israel's State Comptroller and Ombudsman stating that the ITA has been issuing rulings under Section 16A of the Ordinance in excess of the authority granted under the Section. Below we set out the main conditions of each Circular as well as the beneficial tax treatment to be provided under the Circulars. In essence the conditions and tax treatment are similar to what has been provided by the ITA in the past, with some slight updates.


The Circulars also describe some rulings issued in the past to funds that did not meet all the conditions set forth in the Circulars and detail the tax treatment that will be awarded under those specific circumstances. In the event that a fund does not fall into any of the scenarios mentioned in the Circulars, the fund can request that the ITA examine the case to determine the appropriate tax treatment relevant to the specific scenario presented by the fund.



Conditions for a pre-ruling:

1. The fund must have at least 10 investors (limited partners) who are not related to one another, directly or indirectly, and are not partners in the general partner of the fund (the "GP") (subject to the exemption in section 7 below).
2. No investor may hold more than 20% of the equity in the fund, except that one investor may hold up to 35% of the equity in the fund.
Conditions 1 and 2 must be met as of the final closing of the fund and throughout its lifetime. For the purpose of this calculation, indirect investments in the fund as well as investments via funds of funds will be taken into account.
3. The percentage of investments of the foreign investors out of the total investments in the fund must be at least 30%.
4. The aggregate capital commitments to the fund must be no less than 10 million dollars from the final closing and through the life of the fund, out of which at least 5 million dollars must be from foreign investors.
5. The fund may not invest more than 25% of its aggregate capital commitments (less management fees) in one portfolio company and may not invest more than 20%, out of investments in Israel, in companies that are listed on the stock exchange on the date of such investment.
6. The fund will invest in Qualified Investments (as defined below) in one of two alternatives:
 - a. At least 10 million dollars in Qualified Investments in Israel out of which at least 6 million dollars are invested in (1) Israeli R&D companies in which the IP is held by the Israeli entity; or (2) a non-Israeli parent company that has an Israeli subsidiary which holds the IP that is being developed.
 - b. At least 50% of the fund's commitments in Qualified Investments as long as at least 30% of the fund's commitments are invested in (1) Israeli R&D companies in which the IP is held by the Israeli entity; or (2) a non-Israeli parent company that has an Israeli subsidiary which holds the IP that is being developed.

A Qualified Investment is defined as an investment in an Israeli company or a foreign company most of the assets or activity of which are, directly or indirectly, situated in Israel, and the main line of business of which is a Qualified Activity. A Qualified Activity, in turn, is defined as an investment in plants or business in Israel that deal with, among other things, manufacturing, agriculture, tourism, transportation, energy,



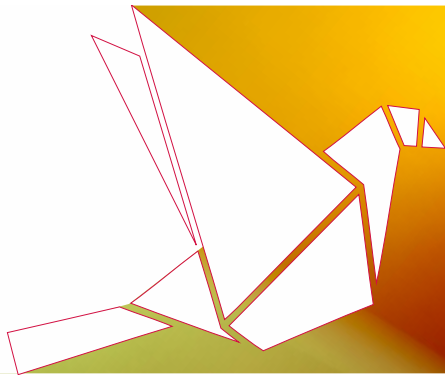
technology, communications, software, water, security, medicine, biotechnology and nanotechnology, and research and development in these fields. Real estate will not be considered a Qualified Activity nor generally would services and financing activities.

7. The fund is managed by the GP and the limited partners do not participate in the management of the fund. Additionally, limited partners who hold more than 4% of the rights in the fund should not hold rights in the GP that constitute more than 10% of the rights in the GP. Note, a limited partner who has rights in the GP (e.g., as an anchor investor) of not more than 10% of the GP rights will still be entitled to the benefits awarded to a limited partner under the Circulars with respect to its profits as a limited partner (but a limited partner holding more than 10% of the GP rights holders, will be subject to higher rates with respect to the investment in excess of 4% in the fund). Finally, the GP and its right holders will not invest more than 4% in the fund (or otherwise the investment in excess of 4% will be subject to a different tax treatment than that provided below).

Tax Treatment for Private Equity Funds with Respect to Investment Related Income -

The Circular provides that if all the conditions listed in the Circular are met, the fund (with respect to its foreign investors), the foreign investors and the GP are taxed as follows:

- Gains from the sale of Qualified Investments are exempt from tax.
- Other income from Qualified Investments;
 - *Dividend Income* – 15% for individuals (also if investing via a flow-through entity) as opposed to corporate tax rates for corporate investors (currently, 23%), in each case subject to reduction under an applicable double tax treaty. Notwithstanding the above, if the investment is performed by foreign exempt investors no tax applies. Foreign exempt investors are investors who are (1) public institutions, or (2) provident funds, or (3) pension funds, and who are residents of a treaty country in which their income is exempt from taxation due to the income being savings for retirement.
 - *Interest Income* – 15%/20% (or 50% in limited cases) for individuals as opposed to the 23% (current corporate tax rate) for corporate investors, in each case subject to reduction under an applicable double tax treaty. Foreign exempt investors are generally exempt from tax (unless the



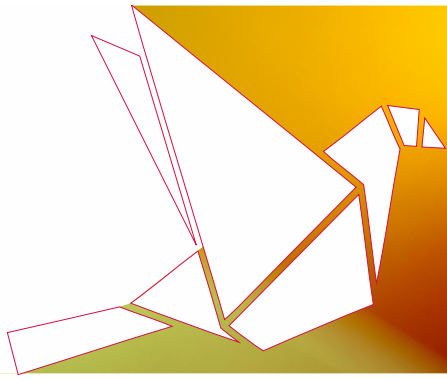
portfolio company deducted the interest expense for tax purposes or the interest expense was capitalized to the cost of the shares, in which case the interest income is taxable at a rate of 5%).

- *Other types of income* – will be taxed or exempt in accordance with the relevant section of the Ordinance and subject to the provisions of any applicable double tax treaty.
- Income from investments in foreign entities will not be subject to taxation in Israel.
- A typical ruling will also confirm that foreign investors are exempt from filing Israeli annual tax returns.

Israeli exempt investors will not be subject to tax on all their income from the fund, if they meet the "control" and the "substantial holdings" conditions under Section 9(2) of the Ordinance. These conditions are examined based on their proportionate share in each portfolio company (and not their share in the fund).

Tax Treatment of Private Equity Funds with Respect to Carried Interest -

- The foreign GP right holders are subject to tax at the rate of 15% on their share of any carried interest attributable to Israeli investments. In some circumstances, the Israeli tax may be refunded if not creditable in the residency country of the right holders. Carried interest attributable to investments in foreign entities will not be subject to tax in Israel.
- *Israeli right holders in the GP* are subject to tax on their carried interest income at a blended rate of 25% and the marginal tax rate for individuals which is currently 47%, depending on the investors' profile (foreign investors' and Israeli tax-exempt investors' portion is accorded 25% and the Israeli investors are accorded the marginal tax rate). The Circular stipulates that this rate is only applicable to individual right holders and not to corporate right holders, which are subject to regular tax rates. In addition, the Circular clarifies, that the current position of the ITA is that the specified tax rate of the carried interest income of Israeli right holders is only a final tax rate if the rights are held by an Israeli individual directly. In the event the rights are held via a company the income will be subject to the provisions of the Ordinance with respect to the distribution of the income to its ultimate owner.



Tax Treatment for VC Funds -

The Circular provides that if all the conditions listed in the Circular are met, the fund (with respect to its foreign investors), the foreign investors and the GP are taxed as follows:

- Any capital gains, interest and dividends from Israeli "Venture Capital Investments" are exempt from Israeli tax. Venture Capital Investments are defined as Qualified Investments (as defined above) in the high-tech industry and Advanced Technology industry in which 75% of the investment is by way of issuance of shares or certain other convertible securities.
- Income attributable to foreign investments is not subject to tax in Israel.
- A typical ruling will also confirm that foreign investors are exempt from filing Israeli annual tax returns.

Israeli exempt investors are subject to the same tests specified above in relation to the tax treatment of Private Equity funds.

The taxation of carried interest in the hands of the GP right holders is generally similar to the taxation under the Private Equity funds.

Taxation of Less than 10 Investors Funds under the Circulars -

In a private equity fund with less than 10 investors (i.e., that do not comply with the first condition mentioned above) that complies with all the other conditions of the Circular, the tax rate for the fund (with respect to its foreign investors) and its foreign investors, on any gains will be 15%. The tax rate on any interest or dividend income will be in accordance with the provisions of the Ordinance or any applicable double tax treaty.

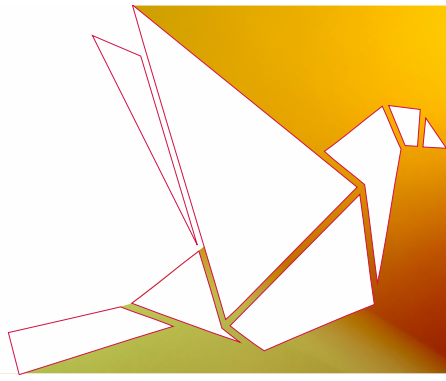
In a VC fund with less than 10 investors that complies with all the other conditions of the Circular, the tax rate for the fund (with respect to its foreign investors) and its foreign investors, on any income (i.e., gains, interest and dividend income) will be 15%.

In both cases the Israeli fund manager will be subject to regular tax rates with respect to its carried interest.

VAT treatment of the Fund, the GP and the Management Company

VAT aspects are not covered in the Circulars. However, for completeness we provide below a few key VAT consequences for investment funds.

The fund, the GP (if not the manager) and the limited partners, are not treated as doing business in Israel for VAT purposes and therefore are not required to register for VAT. The



management company, on the other hand, will be treated as conducting a business in Israel for VAT purposes.

The percentage of the management fee and carried interest earned by the management company, equal to the percentage of the foreign investors in the fund will be subject to VAT at the rate of 0%. The percentage of the management fee and carried interest earned by the management company equal to the percentage of the Israeli investors in the fund will be subject to full VAT rate.

The recent fund rulings stipulate that the VAT authorities have not determined the VAT treatment of carried interest earned by the fund, the GP or the limited partners. Therefore, if any of these entities earn carried interest and are not registered for VAT purposes they should approach the VAT authorities to discuss the treatment of the carried interest.

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Should you require any further information or clarification regarding the issues discussed in this client update, please do not hesitate to contact us.

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