SM/99/50
Correction 1

April 16, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **Israel—Selected Issues and Statistical Appendix**

The attached Information Note III (pages 27–33) of SM/99/50 (2/24/99) has been revised.

Att: (1)

Other Distribution:
Department Heads

ISRAEL: SUMMARY OF THE TAX SYSTEM AND TAX INCENTIVES AS OF JANUARY 1, 1998

A. Corporate Income Tax (CIT)

52. *General nature*: The CIT follows the classic system: profits are taxed at the corporate level and distributed dividends are taxed at the individual level (see withholding tax below). All companies, resident or nonresident for tax purposes, are subject to tax on Israeli-sourced income.

53. *Notable special features*: A comprehensive set of inflation adjustments is available. For resident companies, the adjustments generally involve a deduction from taxable income, the amount of which is linked to the shareholders' equity. These deductions are reduced, however, by assets that are considered inflation-immune, for example, fixed assets. For nonresident companies meeting certain criteria, an option to keep records for tax purposes in U.S. dollars is available.

54. *Rate structure*: The regular rate has been 36 percent since 1996. The tax rate for income accrued outside of Israel and then received in Israel is 25 percent. Numerous special rates are available (see tax incentives below).

55. *Revenue significance*: 3.6 percent of GDP and 11.3 percent of total tax revenue in 1998.

B. Personal Income Tax (PIT)

56. *General nature*: All individuals, resident or nonresident for tax purposes, are subject to the PIT on Israel-source active and passive income. Deductions of national insurance contributions can be made against 52 percent of nonwage income for the self-employed as well as contributions to advanced training funds. Capped deductions or tax credits are also allowed for charitable donations, shift labor, and residents living in certain geographic areas. Tax relief for interest on savings plans and for incomes from pensions and provident funds is provided. A system of tax credits based on points is in operation with a minimum of 2.25 credit points for each Israeli resident taxpayer with, inter alia, working women entitled to an additional 0.5 point, married persons with nonworking spouses an additional 1 point, working women with children under 18 an additional 1 point for each child, recent immigrants an additional 1–3 additional points for periods up to 3½ years, and heads of one-parent families and *individuals with dependent children are entitled to 1 additional point.* As of January 1998, each credit point was worth NIS 153 per month; the value of a credit point is adjusted annually.

57. *Notable special features*: Fringe benefits provided by employers are comprehensively taxed, including an imputed value of usage of company cars.

58. *Rate structure*: In 1998, five brackets of 10–20–30–45–50 percent on active income. Tax brackets are adjusted annually for changes in the CPI. A minimum rate of 30 percent applies to passive income (i.e., nonwage or nonbusiness income), including interest (but not from savings accounts), rental income (beyond NIS 6,350 per month), and capital gains (except gains from the stock market which are tax exempt for individuals); income from these sources is taxed at the marginal personal income tax rate thereafter (i.e., at 45 percent and 50 percent). The tax rate for income accrued abroad and remitted to Israel is 25 percent, for dividend income is 25 percent, and for interest on bonds and foreign securities not traded on the Tel Aviv Stock Exchange is 35 percent.

59. *Revenue significance*: 11.1 percent of GDP and 35.2 percent of total tax revenue in 1998.

C. Withholding Tax

60. *General nature*: Tax is withheld at source on a variety of incomes and payments, including wages, national insurance contributions, royalties and most investment incomes (e.g., interest and dividends). Withholding on investment incomes paid to individuals is generally final.

61. *Rate structure*: For dividends, rates are 25 percent (regular rate) and 15 percent (approved enterprises—see tax incentives below); for interest, rates are 35 percent (on interest from government and private bonds to residents and from residents' foreign currency bank accounts) and 25 percent (on interest from private bonds to nonresidents).

D. Capital Gains Tax (CGT)

62. *General nature*: The CGT is formally a part of the CIT or PIT, as the case may be. Under the CIT and PIT, resident companies and individuals are taxed on their world-wide gains; nonresident companies and individuals are taxed on gains from Israel-source assets. Gains from real estate are taxed under a separate Land Betterment Tax with broadly similar rules (see below).

63. Capital gains arising from the sale of securities listed on the Tel Aviv Stock Exchange and of securities in Israeli industrial companies and industrial holding companies listed on specified foreign stock exchanges are usually taxed only if the seller is a company or an individual who holds securities as part of the primary business. For other individuals (resident or nonresident), their gains are exempt from taxes. Capital gains accruing to dealers of securities are taxed as for regular income under the CIT. Gains from the sale of securities of unlisted companies are taxable as for individuals.

64. *Rate structure*: Nominal gains on assets acquired after 1960 are divided into real and inflationary parts. Real gains are taxable as regular income rates, while inflationary gains accrued until 1994 are taxable at 10 percent; nominal gains accrued after 1994 are tax exempt.

Assets acquired before 1960 are taxed as follows: for assets acquired up to 1948, the final tax is 12 percent; for assets acquired between 1949–60, 1 percent is added to the 12 percent tax rate for each year after 1948, up to a total of 24 percent. Sales by individuals and mutual funds of foreign securities that are not traded on the Tel Aviv Stock Exchange are taxed at the flat rate of 35 percent.

E. Payroll Taxes

65. *General nature*: There are four main payroll categories: (i) national insurance (social security) contributions from both employers and employees to cover an array of benefits, such as old age pensions, disability benefits, family allowances, and unemployment benefits; (ii) national health insurance premiums (effective from 1995) from all residents, in lieu of such payments on a private-billing basis; (iii) employer's tax (paid by public and nonprofit institutions only); and (iv) payroll taxes in lieu of value-added tax (VAT) paid by certain organizations (see VAT below).

66. *Rate structure*: As of January 1998, for category (i), resident employees pay either 4.90 percent or a reduced rate of 2.66 percent on active income (the reduced rate applies to the first 50 percent of the average wage); employers pay a flat amount of 4.93 percent of payroll. For the self-employed, the combined rates (also progressive) are 5.72 percent and 9.62 percent. The maximum taxable income subject to national insurance tax is four times the average wage (NIS 22,240 per month as of January 1, 1998; the value of the ceiling is adjusted). All citizens are required to pay national insurance payroll taxes, regardless of whether they work (except married homeworkers who do not work outside of the home), or whether they reside abroad. Career soldiers, foreign workers in Israel, and workers from the territories are exempt. For category (ii) the arrangements are similar as for those above. Only wage earners and the self-employed contribute, at 4.8 percent and a reduced rate of 3.1 percent on the first 50 percent of the average wage up to NIS 22,240 per month. For category (iii), employers pay 4 percent of payroll, excluding fringe benefits.

67. *Revenue significance*: Categories (i) and (ii); 6.1 percent of GDP; though not part of the general budget, they represent 19.2 percent of total (nonpayroll) central government tax revenue in 1998. For category (iii), 0.3 percent of GDP and 0.9 percent of the total tax revenue.

F. Property-Related Taxes

68. (1) **Land Betterment Tax**: levied on capital gains arising from the sale of real estate. The rate structure applying to the sale of real estate is the same as for the capital gains tax. Sale of one residential dwelling is exempt from land betterment tax once every four years, and the sale of two dwellings with a combined value of NIS 1.2 million (adjusted annually for changes in the CPI) is exempt once per taxpayer's lifetime (subject to a variety of conditions).

69. (2) **Real Estate Purchase Tax**: levied on the purchase of all residential apartments, buildings and vacant land. Rates are 4.5 percent on business buildings and vacant land, 0.5–4.5 percent on residential apartments (rising with value, which in general is adjusted quarterly on the rate of increase in the housing price index), and either 0.5 percent or 5 percent on farms. Various preferences qualify for the 0.5 percent rate for real estate holdings.

70. (3) **Property Tax**: levied annually on the value of vacant urban land. The rate is 2.5 percent, but is taxed at 1.2 percent if the land is part of a business' inventory. Government, public institutions, and United Nations agencies are exempt. Fruit orchards qualify for a deduction of NIS 65,700 per dunam for property tax purposes.

71. *Revenue significance*: Total property tax was 0.9 percent of GDP and 2.8 percent of total tax revenue in 1998.

G. VAT

72. *General nature*: Standard credit-invoice based.

73. *Notable special features*: The base is broad with exemptions limited to certain sales of assets, consumption in Eilat, and many imported services. Major zero-rated items are exports, unprocessed fruits and vegetables, and tourism services.

74. *Rate structure*: 17 percent (apart from the zero rate). Financial institutions pay 17 percent on their payroll and profits (deductible against taxable income under the CIT but not creditable against other VAT payments), and nonprofit institutions pay 8.5 percent on their payroll(not creditable against other VAT payments).

75. *Revenue significance*: 10.6 percent of GDP and 33.6 percent of total tax revenue in 1998.

H. Purchase Tax

76. *General nature*: A purchase tax is imposed on the wholesale price of selected final consumer goods (imported or locally produced), most notably motor vehicles, as well as a limited number of raw materials and intermediate goods.

77. *Rate structure*: Between 5 percent to 95 percent.

78. *Revenue significance*: 2.4 percent of GDP and 7.8 percent of total tax revenue in 1998.

I. Excise and Stamp Duties

79. *General nature*: Excises are imposed on tobacco. Stamp duties are imposed on most legal documents, though several government contracts are exempt.

80. *Rate structure*: On cigarettes, the rate is 55 percent of the consumer price excluding VAT plus NIS 0.916 per pack. On fuel, the rate varies between NIS 1.82–1.87 per liter for petroleum, NIS 0.099 per liter for diesel, and NIS 0.064 per liter for kerosene (adjusted quarterly by the rate of increase in the CPI). Stamp duty rates vary between 0.4–3.0 percent.

81. *Revenue significance*: 1.6 percent of GDP and 5.2 percent of total tax revenue in 1998.

J. Customs Duties

82. *General nature*: Most imports of industrial products to Israel are exempt from customs and duties, and all quotas have been converted into tariffs. For nonfood imports which are not exempt, as of September 1996 customs duties generally varied between 8 percent and 20 percent. Imports of lumber, footwear, fertilizers, sheet metal, ceramic implements, and electric motors attained their final rate of 8–12 percent on September 1998. The textile industry will do so in September 2000. In general, imports of ships, aircraft, diamonds, and inputs and intermediate goods are exempt.

83. For agricultural products, since January 1, 1996 the maximum tariff has been 100 percent, which will be reduced in stages to reach a maximum rate of 50 percent by the year 2003. Processed foods are charged customs duties of 12 percent for the estimated value-added component, plus the relevant agricultural tariff for the estimated raw material component.

84. All goods imported under the Free-Trade Agreements with the United States, European Union, and EFTA (European Free Trade Area) are duty free. There are also trade agreements between Israel and Canada, the Czech Republic, Hungary, Poland, Slovakia, and Turkey, which will reduce tariffs on industrial products to zero by the year 2000 or 2002 (depending on the country).

85. *Rate structure*: See description above.

86. *Revenue significance*: 0.3 percent of GDP and 1.1 percent of total tax revenue in 1998.

K. Local Taxes

87. *General nature*: Local taxes comprise primarily those on property (arnona) and a range of user fees and water charges.

L. Tax Incentives

88. *General nature*: Most tax incentives are granted under the Encouragement of Capital Investment Law (1959, as amended), Encouragement of Industry (Taxes) Law (1969, as amended) , Encouragement of Industry (Taxes) Law 1969, as amended), Encouragement of Capital Investments in Agriculture Law (1980, as amended), and Encouragement of Industrial Research and Development Law (1984, as amended) to: (i) approved enterprises (projects) without sectoral restrictions but mostly in manufacturing and tourism, with varying benefits depending on location (i.e., whether then are in or outside national priority zones A and B); (ii) approved agricultural projects; (iii) income from properties which form part of an approved enterprise enjoying the tax benefits; (iv) companies with at least 25 percent of foreign investment that own approved enterprises; and (v) approved international trading companies (excluding importing to and exporting from Israel).

89. There are, in addition, the Free Port Zone Law (1969), establishing Kishon Port (Haifa), Port of Ashdod, and Port of Eilat as free ports; the Eilat Free Trade Zone Law (1985), establishing the city of Eilat and its surrounding one kilometer area as a free trade zone; and the Free Export Processing Zone Law (1994), under which one such zone is being established near Beer Sheva.

90. Approved enterprise status is granted by the Investment Center at the Ministry of Trade and Industry, and generally required a minimum of 30 percent in paid-up capital by the investor(s).

91. *Forms of incentives*: The system of incentives is complex, with varying incentives subject to differing requirements. In general, it has the following structure.

(1) Investment (cash) grants: provided as a percentage of investment in net fixed assets. The grant is deducted from the value of fixed assets for depreciation and capital gains purposes. Grants range from 5 percent to 24 percent (in 1994), depending on nature and location of the approved enterprise. Approved enterprises may also receive an accelerated depreciation schedule.

(2) Reduced CIT rate: provided on taxable income of an approved enterprise (including agricultural projects) with a reduced CIT rate of 25 percent for 7 years. The withholding tax on dividends paid by an approved enterprise is 15 percent for 19 years. The benefits are enhanced if the approved enterprise has substantial foreign ownership: a reduced rate of 25 percent applies for ten years if the percentage of foreign ownership is 25–49 percent; the applicable CIT rate further decreases (to a low of 10 percent) with

increases in foreign ownership (to 90 percent or more). Dividends paid by approved enterprises with a minimum of 25 percent foreign ownership are subject to a withholding tax of 15 percent with no time limit. Rate incentives on income from approved assets are similar to those applicable to approved enterprises described above.

(3) Tax holidays (alternate track): instead of receiving investment grants, approved enterprises can opt for a CIT holiday of 2–10 years, depending on location (if the holiday period is shorter than the applicable period of reduced CIT rate, the benefits of the latter commence upon the expiration of the holiday). Withholding tax on dividends is applicable as if the enterprises had not chosen the holiday option. Approved international trading companies can enjoy a CIT holiday of ten years.

(4) Industrial incentives: such companies can deduct from taxable income various capital and R&D expenditures.

(5) Free port zones: enterprises established in a free port enjoy a CIT holiday (except on real capital gains, which are taxed under the regular system) of seven years, after which a 25 percent rate applies without time limit. Dividends are taxed at 15 percent, also without time limit. Under the Eilat free trade zone, residents are entitled to a tax credit of 10 percent of their taxable income (but no more than the total tax otherwise payable) under the PIT. Employers are allowed to retain 20 percent of wages from payroll taxes withheld from employees (but no more than the actual taxes withheld). The VAT is also exempted. Under the free export processing zone, there is a CIT holiday of 20 years, but dividends and capital gains are taxed at 15 percent. Imports and intra-zone sales are free from indirect taxes.

92. *Revenue significance*: Total investment grants and subsidies by the central government, which represent explicit outlays, amounted to about 0.5 percent of GDP in 1998. Total income tax expenditures, which represent revenue forgone, are estimated by the authorities at 0.3 percent of GDP.

Table A1. Israel: GDP by Expenditure Components in Current Prices, 1993-98

	1993	1994	1995	1996	1997	1998 Est. 1/
	(In millions of new sheqalim; current prices)					
Consumption	169,663	205,112	238,416	277,144	308,808	335,156
Private	116,475	142,478	161,217	186,596	209,328	225,700
Public	53,188	62,634	77,199	90,548	99,480	109,456
Gross domestic capital formation	46,990	54,234	64,896	74,144	73,692	72,692
Total domestic demand	216,653	259,346	303,312	351,288	382,500	407,848
Exports of goods and nonfactor services	60,536	73,334	83,481	94,232	107,156	120,776
Imports of goods and nonfactor services	90,613	107,843	126,060	141,956	151,336	162,880
Foreign balance	-30,077	-34,509	-42,579	-47,724	-44,180	-42,104
GDP	186,576	224,837	260,733	303,564	338,320	365,744
	(In percent of GDP; current prices)					
Consumption	90.9	91.2	91.4	91.3	91.3	91.6
Private	62.4	63.4	61.8	61.5	61.9	61.7
Public	28.5	27.9	29.6	29.8	29.4	29.9
Gross domestic capital formation	25.2	24.1	24.9	24.4	21.8	19.9
Total domestic demand	116.1	115.3	116.3	115.7	113.1	111.5
Exports of goods and nonfactor services	32.4	32.6	32.0	31.0	31.7	33.0
Imports of goods and nonfactor services	48.6	48.0	48.3	46.8	44.7	44.5
Foreign balance	-16.1	-15.3	-16.3	-15.7	-13.1	-11.5
GDP	100.0	100.0	100.0	100.0	100.0	100.0

Sources. Central Bureau of Statistics, *Monthly Bulletin of Statistics;* and *1997 Statistical Abstract of Israel.*

1/ Estimate by the Central Bureau of Statistics.