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Israeli Mutual Funds for Foreign Investors

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1. It is a known fact that 132nd amendment of the Income Tax Ordinance (further referred to as "the Reform Law") practically constituted a revolution in the field of taxation of Mutual funds in Israel and of the owners of their units. Pursuant to the recommendations of "Rabinovich Committee" on the issues of taxation of capital markets, the Reform Law has revoked tax arrangement as it was set in Law of Joint Investments in Mutual Funds as of January 1, 2003.
2. The new arrangement divides the mutual funds to 3 types: taxable mutual fund (profits and revenues are subject to taxation), exempt mutual funds and mixed mutual funds (liable to partial taxation).
3. The Reform Law had also revolutionary effect on the possibilities of foreign residents to invest in Israeli securities through mutual funds. Currently, there are two types of mutual funds available for foreign residents willing to invest Israel using mutual funds: Taxable Mutual Funds for Foreign Residents and Exempt Mutual Fund for Foreign Residents.

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A. Taxable Mutual Funds for Foreign Residents

4. Income Tax Regulations (Tax Exemption on Certain Income of Mutual Funds for Foreign Residents) define "Foreign Resident Fund" as a mutual fund if all the following conditions are fulfilled:
 - 4.1 It is a mutual fund (according to a definition in the Israeli Law of Joint Investments of 1994) that is taxable (according to section 105K of the Israeli Income Tax Ordinance, and provided that the Commissioner has approved it as a fund with taxable incomes and revenues).
 - 4.2 Pursuant to the fund prospectus, its units are designated for foreign residents only.
 - 4.3 The purchase of fund's units was financed by foreign resident only.
 - 4.4 The foreign resident has served the distributor with the declaration as to his foreign residency.
 - 4.5 The fund was approved by the Commissioner, subject to conditions set (Pre-ruling)

Following all the stated above, it is clear that the fund is designed for foreign residents only.

5. Pursuant to Taxable Funds for Foreign Residents Regulations, capital gains of the fund will be exempted from tax, provided that they originate in sale of banking securities and/or future transactions, which are registered for trade in Stock Exchange in Israel (under the condition that they were acquired after the registration for trade) or if they are foreign securities.
6. In addition, it was determined that the abovementioned funds' income from interest and/or of linkage differences deriving from deposits in foreign currency, which is paid by the state of by banking corporation, are exempted from tax. Also, dividend income, interest and/or income deriving from linkage differences

of foreign banking securities gained by the aforementioned mutual fund are exempted from tax.

B. Exempt Mutual Fund for Foreign Residents

7. Another type of mutual funds designated for foreign investors is the Exempt Mutual Fund, which is subject to several requirements. It should be immediately emphasized that, contrary to Taxable Mutual Fund for Foreign Residents, the requirements for Exempt Mutual Fund for Foreign Residents are less stringent, and this possibility is open for investments of Israeli residents as well as foreign residents, even though the profitability of such actions is questionable (except, may be, from funds designated for investing in foreign securities only).
8. Income Tax Regulations (Income Tax Exemption for Foreign Residents on Incomes from Unit in Exempt Mutual Fund) of 2003 (further referred to as "Exempt Mutual Fund for Foreign Residents Regulations) state that "Mutual Fund for Foreign Residents" is an **exempt** fund (according to a definition in section 105K of the Israeli Income Tax Ordinance, provided that that the Commissioner has approved the tax exemption of its revenues and profits), and that 90 percent at least from the investments of the fund in every tax year are invested in assets whose income would be exempted from tax, if it was gained by foreign resident. That would be the case, for example, for capital gain accruing from investment in securities traded on the Israeli Stock Exchange² or outside of Israel (belonging to a company of Israeli residence)³, for capital gain from foreign securities, capital gain from certain future transactions⁴, and for interest from a foreign resident's deposit⁵.
9. Pursuant to the Exempt Mutual Fund for Foreign Residents Regulation, it was ruled that capital gains from sale or redemption of mutual fund for foreign

² Paragraph 97(2.2) of the Israeli Income Tax Ordinance

³ Income Tax Regulations (Tax Exemption for Foreign Resident on the Capital Gains due to Sale of Securities) 2003.

⁴ Income Tax Ordinance (Tax Exemption for Foreign Resident on the Capital Gains from Future Transaction) 2003.

⁵ Income Tax Order (Tax Exemption on the Deposit of Foreign Resident) 2002.

investment by foreign resident is exempted from tax, if it does not constitute a permanent establishment of foreign resident in Israel and provided that the provisions of the Adjustments Pursuant to Inflation Law and Dollar Regulations do not apply in that case.

10. We have briefly presented here the new provisions and new tax arrangements available for foreign residents in order to invest in Israel without paying any capital gain taxes. We will be happy to be at your service and elaborate further on this matter upon a request.

All the stated above is a general review only, and it is by no means a legal advice and/or a substitute for legal advice. It is recommended to acquire professional advice in every particular case.

Lior Pick & Co. Law Offices specialize in International Taxation, Tax Planning Income Tax, VAT, Corporate Law, Securities, Real Estate and Litigation.

Lior Pick is secretary of the Israeli branch of the STEP organization.