Why Israel CAN NOT Tax "High-Tech Sellouts" Post-2003 & The Rabinovitch Reform

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Israel 1998-2002: “Israeli Technology Leaving by the Front Door”,
“Taxable Dollars are Flying Out the Window”
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“TAXABLE DOLLARS ARE FLYING OUT THE WINDOW”
WHY ISRAEL CAN NOT TAX “HIGH-TECH SELLOUTS”
POST-2003 & THE RABINOVITCH TAX REFORM

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I.INTRODUCTION:

A. “Silicon Valley II”:

“[I]srael has been known for several years as "Silicon Valley II," and for good reason. ...Silicon Valley really has only one rival outside the United States - Israel. Today, some 100 Israeli companies are traded on the NYSE, NASDAQ and AMEX equity markets, in the wake of a large number of public stocks offering in the 1990s. Other than Canada, no foreign country is so heavily represented on Wall Street. Most of the firms are high-tech companies traded on the NASDAQ, and over a dozen have market capitalization of over $500 million.” (Israel Ministry of Foreign Affairs, 2002).}

Israel is a small country, with an inadequate domestic market to sustain its growing high-tech industry, and very few markets available in its surrounding. Despite these adverse conditions, Israel has reportedly sprouted into the world’s second most important high-tech cluster after Silicon Valley.

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3 Israel Ministry of Foreign Affairs, supra note 1. See Anat Urman, Corporate Distributions to Shareholders in Delaware and in Israel, 2001, at 1. available at: http://digitalcommons.law.uga.edu/cgi/viewcontent.cgi?article=1052&context=stu_llm (visited March 25, 2009). See Chaifetz, id. para. 3.3, para. 5 (“The Israeli high-tech industry has been hailed as second only to Silicon Valley's).
But this was not always the case. In its early days, Israel's economy was focused on agriculture and armaments, with little money spent in the private high-tech sector. During the 80’s, high-tech companies such as Gilat Satellite Networks, Scitex, Mercury Interactive and Comverse were founded, and over the years have blossomed into multi-national operations, run by Israelis, with sales and marketing efforts worldwide. Venture capital was practically non-existent. The change came in the mid 90's:

“[S]oon after, Israeli companies caught the attention of the venture capital world for two reasons. First, Israeli companies became the darlings of the Nasdaq. Israel ranks third in the world for the number of Nasdaq-listed companies, with eighty-eight. Second, Israeli companies are popular targets for buyouts by other companies.” (Lesha Chaifetz, 2002)

This last mentioned phenomenon is known as “High-Tech Sellout”; a term refers to a quick sale of technology or of the entire startup company to a large, non-Israeli companies, predominantly American portal, e.g., Yahoo, AOL, Amazon.

2. The Ramifications of the “High-Tech Sellout” Trend:
   i. To be Sold-out to Foreign Multinationals as Quickly as Possible:

   A 2001-study by Joel Bainerman demonstrates that, as of the mid 1990s, the emergence of venture capital funds brought a dramatic changed of the Israeli high-tech scene. As a result of

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4 Chaifetz, supra note 2, para. 2.1.


6 Chaifetz, supra note 2, para. 2.2.3 (“In 1991 there was one venture capital firm in Israel, Athena Venture Partners Fund. In 1994, foreign investments in Israel accounted for only $ 26 million.”).

7 Id.

8 Chaifetz, supra note 2, para. 3.2.

9 Bainerman, supra note 5, paras. entitled: “Preface”, “Chapter V”- The Great Sell Off. See Chaifetz, supra note 2, para. 2.2.3 (“While initial investments came from Europe, the past few years have been dominated by American cash flows. In just the past few years, venture capital investments in Israeli companies have gone from $ 429 million in 1997, to $ 568 million in 1998, $ 1 billion in 1999 and $ 3.1 billion in 2000.”).
the influence the venture capitalists have exerted on Israel’s high-tech industries, companies created after 1994 were of a different ilk to their predecessors.\(^{10}\) Israeli high-tech firms were no longer established to become a multi-national corporation, but “to be sold-out to foreign multinationals as quickly as possible.”\(^{11}\)

Impressive have been the prices that foreign firms have been willing to pay to acquire Israeli start-ups;\(^{12}\) a landmark “Sellout” that generated wide media coverage was the acquisition of \textit{Mirabilis}, inventor of the popular chat program ICQ, by AOL in 1998 for $287 Million;\(^{13}\) another impressive high-tech transaction was the acquisition of \textit{Chromatis Networks}, a two-year-old Israeli-based optical networking firm, by \textit{Lucent Technologies’}, for nearly $5 Billion;\(^{14}\) all together, the twenty largest Israeli high-tech transactions were estimated in the year 2001 to equal more than $12 billion, a figure that was equivalent to 50% of Israel’s export for that year!\(^{15}\)

\section*{ii. The Ramifications of “High-Tech Sellouts”:}

“High-Tech Sellouts” brought money and interest into the once fledgling economy.\(^{16}\) Consequently, at the end of the Millennium, the Israeli high-tech industry reached new peaks

\footnotesize
\begin{itemize}
  \item \(^{10}\) Bainerman, \textit{supra} note 5.
  \item \(^{11}\) \textit{Id}.
  \item \(^{15}\) Sabato, \textit{supra} not 12, at 1.
  \item \(^{16}\) \textit{See} Chaifetz, \textit{supra} note 2, para. 3.2.
\end{itemize}
both in technological achievements and in sales.\textsuperscript{17} The high-tech sector has become a central element in Israel’s economy, so much so, that its continued success was central to Israel’s economy.\textsuperscript{18}

Nevertheless, “High-Tech Sellouts” had negative ramifications for Israel.\textsuperscript{19} As more of the money behind Israeli projects came from the United States, some feared that the country's high-tech industry is losing its unique traits and become “Americanized.”\textsuperscript{20} Certainly, the headlines in Israel did not tell only tales of multimillion dollars “Sellouts” and accelerated growth, but also reports emigration if the high-tech community.\textsuperscript{21} As of the mid 90’s the majority of newly-founded Israeli technology ventures incorporated in abroad,\textsuperscript{22} and numerous technology companies choose to place their headquarters in a major foreign high-tech hub.\textsuperscript{23}

\textsuperscript{17} See Nisso Cohen, The Israel High-Tech Industry-Fifty Years of Excellence, 2002, at 1-4, available at https://www.jewishvirtuallibrary.org/jsource/Economy/idc.html (visited March 25, 2009) (“ In 1998 sales originating in the high-tech sector totaled $8.05 billion, a growth of 12% over 1997 sales. The Israeli high-tech industry is a major contributor to Israel's overall industrial export (excluding diamonds and agricultural products and technologies”. High-tech exports, totaling $6.6 billion in 1998, grew 15.3% over exports in 1997; “Israel’s high-tech industry is experiencing an unprecedented rate of growth which began in the early 1990s. Its growth is evidenced both in total sales - 1997 sales totaled $7.2 billion, a growth of 10.7% over 1996 - and in exports - $5.6 billion in 1997, a growth of 14.2% over 1996. This is in a country with a total population of less than six million; GDP (1996) of $92.3 billion and exports (goods and services, 1996) of $31.3 billion.”). See also Sabato, supra note 12, at 1,2 (“Israeli high-tech companies raised more than $3.2 billion in 2000. This amount is three times higher than the amount raised in 1999, which was $1 billion. The local venture capital market also reached record levels in 2000, with investments of $1.1 billion. This amount, one third of the total amount of capital raised by Israeli high-tech companies, compares to $435 million invested in 1999. From 1991 to 2000, venture capital funds raised a total of $6.5 billion, with $3 billion available for new and repeat investments. The following data gives a good picture of the importance of the high-tech sector in Israel. In 1999, the high-tech portion of the GDP was approximately $2 billion. Exports of the Israeli electronics sector were approximately $7 billion. High-tech accounts for eight percent of total commercial production, with an annual export growth rate for the last decade of more than fifteen percent. As of October 2001, the high-tech electronic and software industries employ approximately 68,000 people. The annual growth rate of high-tech employment over the last decade is 6.7 percent, as opposed to rising unemployment in the general economy.”).

\textsuperscript{18} Urman, supra note 3, at 1.

\textsuperscript{19} Chaifetz, supra note 2, para. 3.2.

\textsuperscript{20} Id.

\textsuperscript{21} See infra para. II-D-1, para. II-D-2.

\textsuperscript{22} See infra para. II-D-1.

\textsuperscript{23} See infra para. II-D-2.
The negative ramifications of these phenomena on Israel’s economy were profound, including enormous loss of revenues; “high-tech emigration”, and “High-Tech Sellouts” were of such magnitude that widespread attention was being focused on the prospect that enormous tax revenues were lost.

B. ABOUT THIS COMMENTRY:

The title of this commentary goes after a 2000-headline, “Tax Engineers; While We Worry About Israeli Technology Leaving by the Front Door, Taxable Dollars are Flying Out the Window. So, What's the Point of a Tax Reform”, a report that display the frustration of the Israeli public with the phenomena of Israeli technology startups moving out of Israel, the loss of revenues on “High-Tech Sellouts”, (in this particular case, the sale of Chromatis, an Israeli venture registered in Delaware to Lucent, the world's biggest communications equipment maker

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24 See Chaifetz, supra note 2, para. 3.2 (“The primary concern was that as Israeli companies become an R&D subsidiary of a larger company, technology ownership is diffused, and profits and IP flow out of Israel and directly into the United State”. “Moreover, by selling at an early stage, Israelis have no means with which to learn the management, sales, and marketing skills needed to sustain a fully-developed industry”. For similar concerns see also Bainerman, supra note 5. Also, many were concerned of the “brain drain”, i.e. the migration of high skilled entrepreneurs and employees, mainly engineers, see Itamar Levin, High-tech Circles Bugged by Taxation, Globes [online] - Israel's Business Arena December 27, 1999. See Aviva Mishmari, The brain drain takes an Outward Direction, Globes [online] - Israel's Business Arena, June 28, 2000. See Elon Ganor, Stop the Brain Drain, Globes [online] - Israel's Business Arena, June 15, 2000.


26 Id.

27 Tzippori, supra note 25.
for $5 billion), and the failure of the Israeli government to reform the tax regularity in Israel for high-tech (in this particular instance the Ben-Bassat Commission, 200028).

On 26 February 2002 Israel's Finance Minister, Mr. Sylvan Shalom, encouraged a Committee chaired by former Income Tax Commissioner, Yair Rabinovitch to draft tax reform recommendations.29 The Rabinovitch Committee was authorized to make recommendations on all direct taxes,30 however, it focused primarily on measures to alleviate the tax burden on wages income, changes to taxes on the capital market; changes to Israel's fundamental international tax rules, expansion of the tax base, educing the number of tax exemptions, and proposed changes to Israel's tax administration system.31 On July 2002, sourced on the report of the Rabinovitch Committee,32 the Israeli parliament approved a major overhaul to the Israeli income tax system, known as: Amendment No. 132 to Israel’s Income Tax Ordinance (New Version), (1961).33

The Rabinovitch reform, as implemented via Amendment No. 132, introduced numerous changes to Israel’s tax law provisions, many of them with relevancy to the high-tech sector;34 Chapter E of the report, entitled “Encouraging Business Entrepreneurship & Technology,”35 is a set of

28 See infra para. II-B-2, para. II-C-2. See also Sabato, supra note 12, at 3. Sabato argues that:

“[T]he Ben-Bassat Committee recommendations have not been implemented and it is doubtful, if they are implemented, whether they will be implemented as they were prescribed. The Ben-Bassat Committee has been added to a long list of other tax reform committees whose influence has been nil.” (Yitzhak Sabato, 2001)


34 For review of Amendment No. 132, its impact on emigration of the Israeli high-tech sector and on the taxation of “High-Tech Sellouts”, see discussion infra Chapter V, Chapter VII.

35 Rabinovitch Report, at 117 - 129.
recommendations designed to create better tax surrounding for high-tech in Israel;\textsuperscript{36} Chapter C of the report, entitled “\textit{Taxation of Overseas Income},”\textsuperscript{37} is as set of modern international tax rules that may apply to “High-Tech Sellouts.”\textsuperscript{38} Accordingly, in 2003, there were expectations in Israel that this “\textit{Carrot}” and “\textit{Stick}” plan will end the massive emigration of startups and enable taxation of “High-Tech Sellouts”.\textsuperscript{39} In 2003, Gary Agron,\textsuperscript{40} Deputy to the Israeli Income Tax Commissioner stated that:\textsuperscript{41}

\begin{quote}
[S]ince 1999, Israeli entrepreneurs found high-tech companies have set up overseas... Faulty tax regulations were among the main reasons for the diversion of this resource to other countries, which reaped the intellectual property harvest. The Rabinovitch tax reform committee recommendations attempt to deal with this phenomenon and reduce its effect as much as possible... The Rabinovitch committee took upon itself to correct the distortion in the investment structure in Israeli companies set up by Israeli entrepreneurs on one hand, while on the other hand, awarding simple and clear benefit without the need for a complicated bureaucratic mechanism to obtain them... There are rules for the dismantling of holding structures...These recommendations combined will make it easier to found Israeli companies” (Gary Agron, 2003)
\end{quote}

\textsuperscript{36} See infra Chapter V.

\textsuperscript{37} Rabinovitch Report, at 97-105.

\textsuperscript{38} See infra Chapter VII.


\textsuperscript{40} Gary Agron was a member of the \textit{Rabinovitch} Committee. He was a former Deputy Commissioner of the Israel Income Tax Authority and head of the International Department. He is considered one of Israel’s leading tax experts, particularly in the fields of international taxation and the high-tech and capital markets.

\textsuperscript{41} Agron, supra note 39, at 1, 2.
This list studies the phenomena of “high-tech emigration” and “High-Tech Sellouts,” with special attention to the Rabinovitch Report, and the 2005-“Mini” Tax Reform; In this list, I examine the notion that fiscal reform is the remedy for Israel’s problems keeping the high-tech sector in Israel and levy tax on revenues of this sector.

Chapter II of the study presents the background of “high-tech emigration” and “High-Tech Sellouts”; Chapter III examines the faulty tax regularity for high-tech before 2003, while Chapter IV considers economic & business forces that can be associated with emigration; Chapter V analyzes the related part of the Rabinovitch Report that is applicable to the “high-tech emigration” (“Carrot”), and assess its impact on emigration; Chapter VI demonstrates how Israeli startups avoided Israeli tax on “Sellouts”, and Chapter VII considers the element of the reform referred to as “Stick” on taxation of high-tech transactions; Chapter VIII reviews, in brief, the relevant parts of the 2005-tax reform, and the reform of the Company Law, 1999; In Chapter IX, I assess the evaluations presented in this study, and make a “judgment” whether Israel can tax “High-Tech Sellouts” post-2003 & the Rabinovitch reform.

II. High-Tech Emigration Post-May 1998:
A. Reform of the Currency Control Regime:
1. Israel’s Foreign Exchange Control Regime:
Rapid internationalization by Israel’s high-tech firms is relatively a new phenomenon. Prior to May 1998 Israel enforced foreign exchange control regime designed to direct the flow of foreign currency and maintain its reserves.42 The Currency Control Law governed all foreign currency transactions as well as all transactions between residents and non-residents.43 Generally speaking, the law prohibited a resident from entering into any transaction with a non-resident or from engaging in any transaction involving foreign currency.44 Also, the law prohibited the establishment of foreign corporations, opening foreign bank accounts, the export of assets from

42 For review of this regime see Business Operating in Israel, II-.Currency & Exchange Control, available at LEXIS 967-4th T.M. II-B BNA Tax Management Portfolios.
43 See Currency Control Law-1978 [Hebrew].
44 Currency Control Law-1978, Section 2.
Israel, the import of Israeli currency to Israel, and the holding of foreign currency and foreign securities by local residents.\textsuperscript{45}

The law prohibited almost every transaction involving a foreign currency or to available which a foreign resident is a party.\textsuperscript{46} In an effort to liberalize the foreign exchange controls, a general permit was issued, and allowed such transactions to take place if pre-approved by the Bank of Israel.\textsuperscript{47} Once permission was given Israelis could take advantage of the archaic Income Tax Ordinance and lack of rules for taxation of international income.\textsuperscript{48} Hence, the requirement to obtain permission effectively discouraged most Israelis from taking this route.\textsuperscript{49}

2. The 1998-Reform of Currency Control Law:

All that changed in May 1998 with the deregulation of the foreign currency market.\textsuperscript{50} On May 1998 a new general permit was issued in lieu of the 1978-Permit.\textsuperscript{51} Under the 1998-General Permit any transaction that required approval under of the Currency Control Law, e.g., the holding of foreign exchange, the importation of Israeli currency, the alienation of assets from Israel, and any transaction in foreign currency or with a nonresident, was now permitted.\textsuperscript{52}

\textsuperscript{45} Currency Control Law-1978, Section 3, Section 4, and Section 6.

\textsuperscript{46} Operating A Business in Israel II, \textit{supra} note 42, at 2.

\textsuperscript{47} \textit{See} Currency Control Permit-1978 [Hebrew].


\textsuperscript{49} \textit{Id}.


\textsuperscript{50} \textit{Id}. See also Operating A Business in Israel II, \textit{supra} note 42, at 2.

\textsuperscript{51} Currency Control Permit-1998 [Hebrew].

\textsuperscript{52} Currency Control Permit-1998, Sections 2 through 6, and Section 9(a).
The extensive liberalization of the foreign exchange control regime in mid-1998 opened the gates for Israeli residents to freely invest abroad.\textsuperscript{53} Accordingly, Israelis could transact freely in foreign currency within or outside Israel, and in practical terms were not subject to any restrictions.\textsuperscript{54} Within our subject matter, this change signals the starting date of the era of “high-tech emigration.”\textsuperscript{55}

B. Israel's Faulty Tax Regularity for High-Tech Pre-2003:

1. Inappropriate Laws in the Era of Globalization:

There were various explanations for what was happening in Israel.\textsuperscript{56} Of all explanations, tax considerations were identified as the most important factor in the flight of foreign investment and local companies.\textsuperscript{57} It was generally accepted that this feature, more than any other feature, drove local entrepreneurs to move to the Silicon Valley.\textsuperscript{58}

Generally speaking, before the \textit{Rabinovitch} reform, Israel's tax laws and the regulatory environment were measured as inappropriate in the era of globalization in which countries

\begin{quote}
[Israel's principal tax statute is the Income Tax Ordinance (New Version), 1961 (ITO), an amended version of the original English ordinance adopted by Israel and incorporated into law after 1948. The ITO taxes the income of any person -- including legal entities -- if the income was accrued in, derived from, or received in Israel, regardless of whether the taxpayer is a national or resident of Israel. Israeli taxation, therefore, is premised on a territoriality and remittance basis. However, following Israel's May 1998 liberalization of its currency control regime, the Ministry of Finance (MOF) has circulated a memorandum of a draft of a proposed law amending the ITO, which would tax any income that escapes the tax net due to the liberalization.” (George Rosenberg, 1998)]
\end{quote}

\textsuperscript{53} See Michael Bricker & Dror Levy, Publishes Tax Reform Proposal, 20 Tax Notes Int'l 2695, para. entitled “International Taxation.” See also Rosenberg, \textit{supra} note 50, para.1, para.2. Rosenberg explains:

\textsuperscript{54} Bricker & Levy, \textit{id}.

\textsuperscript{55} Agron, \textit{supra} note 39, at 1 (“since 1999, Israeli entrepreneurs found high-tech companies have set up overseas.”).

\textsuperscript{56} For presentation of other causes of “high-tech emigration” see discussion \textit{infra Chapter IV}.

\textsuperscript{57} Sabato, \textit{supra} note 12, at 2. (“There are many explanations for what is happening in Israel. Some of them are: Israeli tax laws deter investors, Registering Israeli companies in the U.S. is logical considering the proximity to the U.S. market and its sources of financing. The security situation in Israel deters foreign investors, Israeli corporate legislation makes mergers and acquisitions difficult.”). See also, Chaifetz, \textit{supra} not 2, para. 3.4, para. 4.1.

\textsuperscript{58} Sources cited \textit{id}. See also analysis \textit{infra Chapter IV}.
compete for foreign investments by offering investors user-friendly investment terms.\textsuperscript{59} Israel’s tax burden on entrepreneurs, as well as existing companies, caused investments in Israeli companies to shrink, both in size and number, while encouraged Israeli companies to move their operations to countries that have more favorable tax laws.\textsuperscript{60}

Statements of government officials indicate that Israeli policy-makers agreed to this paradigm.\textsuperscript{61} For example, in 2000, the Israeli government held a panel led by senior government officials and civil servants to discuss the burning issue of “new Israeli high-tech companies are registering in the United States in increasing numbers and established companies also moving their corporate headquarters there.”\textsuperscript{62} The panel stated that\textsuperscript{63}:

\begin{quote}
“One of the main reasons for Israeli companies’ flight to the United States is Israel's outdated tax structure.”…“In order to keep the high-tech community in Israel should amend its antiquated tax structure for example by lowering its corporate tax rates. Expanding the number of companies paying corporate tax in Israel would make up the tax-rate-reduction, and more corporate headquarters in Israel could even increase the tax base.”
\end{quote}

\textit{(Israeli Government Panel, 2000)}

2. The Proposed-Reforms of the \textit{Ben-Bassat} Commission:

\textsuperscript{59} Sabato, \textit{supra} note 12, at 2.

\textsuperscript{60} \textit{Id.}

\textsuperscript{61} See Israel Business Today, Keeping High-tech Companies at Home, WLNR 6944604 IBT Volume 14 Issue 9, 2000, at 1. \textit{See} also statement by Gary Agron, Deputy to the Israeli Income Tax Commissioner, Agron, \textit{supra} note 39, at 1 (“Israeli entrepreneurs found high-tech companies have set up overseas for three main reasons: the lack of an exemption on capital gains tax for foreign investors; products mainly directed to overseas markets; and high tax rates levied on capital gains produced by Israeli residents. Faulty tax regulations were among the main reasons for the diversion of this resource to other countries, which reaped the intellectual property harvest.”). \textit{See} also statements by the Minister of Finance, Press Watch International, Israel’s Former Finance Minster Says “Tax Rates Must Drop to Keep High-tech Industry”, 1999, available at LEXIS WTD 87-9 Tax Analysts Worldwide Tax Daily. \textit{See}, Haim Handwerker, “\textit{Ne’eman}: Lower Tax, or High-Tech Will Die,” Ha’aretz Daily News, May 5, 1999.

\textsuperscript{62} Israel Business Today, Keeping High-tech Companies at Home, \textit{id.}, at 2.

\textsuperscript{63} \textit{Id.}
In 1999, a Committee headed by Finance Ministry Director General, Avi Ben-Bassat, was appointed by then Minister of Finance Avraham Shochat to plan income tax reform. The Committee’s mandate was to examine the Israeli system of direct taxation, identify its main drawbacks, and come up with a proposal for a wide-ranging tax reform.

The Committee declared that:

“[T]ax laws have become a critical tool for determining a country’s competitiveness and determining its market share of international investments and trade, and noted that the ease of capital flow and worker migration.” … “could cause capital and economic activity to move to countries [outside of Israel], resulting in damage to the Israeli economy and a significant reduction in the amount of taxes collected by the Israeli government.” The committee concluded that: “the taxation rate on economic activities in Israel could not significantly differ from those rates customary in the United States and western Europe without damaging the competitiveness of the Israeli economy.” (Ben-Bassat Committee, 2000)

Nevertheless, despite this promising introduction, the Committee’s recommendations for the high-tech sector were limited in scope; Ben-Bassat’s only constructive recommendation was to reduce tax rates on capital gains to 25%, instead of the marginal tax rate in place, which at that time stood on 50%. The report lacked recommendations in areas of taxation that have an effect on foreign investors; worse, it recommended a series of new taxes on savings, retirement funds,

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67 Sabato, supra note 12, at 2, 3.

68 Ben-Bassat Report, at 89, 112.

69 Ben-Bassat Report, p. 143. The Ben-Bassat Committee wrote:
pension funds, and the Tel Aviv Stock Exchange;\(^{70}\) it even recommended imposing gift and death taxes.\(^{71}\) Consequently, The Ben-Bassat Committee recommendations suffered considerable opposition, thus, were never implemented.\(^{72}\) It is doubtful, if implemented would have further Israel’s ability to attract domestic or international investment.\(^{73}\)

C. “Tax Planning in the High-Tech industry is Running Wild”:

1. A War the ITA Operates with One Hand Tied Behind its Back:

Israel’s Income Tax System (Ordinance) is based on a 1941 Ordinance, enacted in the times of the British Mandate over Israel, before the independence of the state of Israel.\(^{74}\) Before the Rabinovitch reform this system was based, largely,\(^{75}\) on the territorial/remittance basis of taxation;\(^{76}\) it follows that Israeli residents who earned income sourced outside of Israel were not subject to tax on this income so long as it was not “first received” in Israel.\(^{77}\)

“The committee does not see any justification to continue to discriminate in favor of foreign investors, to the detriment of local ones, specifically in light of the tremendous foreign investment we have seen in the past few years.”

\(^{70}\) Ben-Bassat Report, at 17, 59, 60.

\(^{71}\) Ben-Bassat Report, Chapter F.


\(^{73}\) Sabato, supra note 12, at 3.

\(^{74}\) ALTER & CALIF, supra note 32, at 68,69.

\(^{75}\) In a marked deviation from this principle, Section 5 of the Ordinance provided that income from a business that is controlled and managed from Israel will be treated as accrued in Israel. Section 5 also declared that wages earned by a person (while abroad) from a profession he generally exercises in Israel is deemed to be “derived” from Israel, hence, sourced therein.

\(^{76}\) In principle, to be subject to tax in Israel income had to be sourced in Israel that is, it had to be “accrued, derived, or received in Israel”, see Section 2 of the Ordinance.

\(^{77}\) ALTER & CALIF, supra note 33, at 71-74. This principle was based on a case law where the Israeli court ruled that the initial location of receipt is of relevance in determining whether income is taxable in Israel. The case at issue involved an Israeli resident whose regular work in Israel was the classification of diamonds. On a trip to Europe, the individual received a commission for arranging a sale of diamonds. The funds were deposited in a bank abroad. Part of the money was used to pay for conducting the activity abroad, and part was transferred to Israel at a later date. The court held that the income is not taxable in Israel since not “first received” in Israel. See 114/89 Bronfmann v. Assessing Officer Netanya, 52(1) P.D.M. 495, 301/85 [Hebrew]; See also Shmuel Ahitov v. Assessing Officer Gush Dan, 16 P.D.A 238 [Hebrew].
As noted, until May 1998 this loophole was effectively plugged by exchange control restrictions.78 As a result of the May 1998 liberalization these restrictions no longer applied to the average Israeli resident.79

Thus, “under the new circumstances the Israeli Tax Authorities were unable to act severely against high-tech emigration and attempts to exploit tax havens.” 80 A Conference took place in Israel, in 2000, dealt with on one key question-“to what extent can tax havens be exploited and how far can high-tech company owners go to avoid paying taxes, particularly at exit when they have managed to sell their companies.”81 In reference to this question, representatives of the Income Tax Commission pointed out that the source of the problem is Israel’s geographical tax method, “while the current situation cries out for a personalized approach”; 82 they argued that “the war against tax haven is one in which the Income Tax Authority operates with one hand tied behind its back”, 83 and added that “under these circumstances, the authorities cannot act severely against attempts to exploit tax havens.” 84

2. The Recommendations of the Ben-Bassat Commission:
The Commission proposed numerous substantive changes to the rules governing the taxation of overseas income.85 The Committee recommended that Israel’s tax system be converted into personal system that taxes worldwide income;86 it also suggested new and modern source rules,87

78 See infra, para. II-A-1.

79 Id.

80 See analysis infra Chapter VI. See Avi Timken, High-Tech Havens; Globes [online] - Israel's Business Arena, December 20, 2000.

81 Temkin id.

82 Id.

83 Id.

84 Id.

85 See analysis of the changes in Bricker & Levy, supra note 53.

86 Ben-Bassat Report, at 120, 121.
new a Controlled Foreign Corporation tax regime, and in light of the proposed legislation and the ever-increasing volume of cross-border transactions the Committee recommended establishing an international taxation unit as a subdivision of the Tax Commission. Thus, as noted, the recommendations suffered considerable opposition and were never implemented.

D. The Scale of the Phenomena:

1. 90% of Israeli Start-ups Incorporated Outside of Israel:

There has never been an official or accurate data on emigration of Israeli technology startups and managements out of Israel, and of the loss of revenues associated with “Sellouts.” Publications, studies and reports indicated that in the years 1998 through 2002 the overwhelming majority of Israeli high-tech ventures chose to incorporate abroad.

According to a 2001-study on high-tech emigration by Sabato, numerous technology companies have moved their operations to the United States, and the majority of newly founded Israeli companies register their corporations as U.S. companies. The study presents few observations on this matter. E.g., Accountant Doron Kochavi of the Ernst & Young Group (Israel) estimated that the number of Israeli companies among his clients that incorporated abroad at 87% for the year 2000, compared to 45% in 1999; Micki Guter, from the venture capital fund Etgar, estimated the number of Israeli companies that initially registered in Israel and then emigrated to the United States, as between five hundred and six hundred. 

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87 Ben-Bassat Report, at 124.
88 Ben-Bassat Report, at 128.
89 Ben-Bassat Report, at 131.
90 See infra footnote 72 and accompanying text.
91 Sabato, supra note 2, at 2.
92 Sabato, supra note 13, at 17.
93 Id.
According to another study by Lesha Chaifetz, 90% of Israeli start-ups incorporated outside of Israel;\(^4\) Aayl Shenhav, a leading attorney in Israel suggests that approximately 80-90% of the high-tech companies formed in 1999 were organized in the U.S., typically under the laws of Delaware;\(^5\) similarly, a panel held by senior Israeli government officials estimated that between 60%-80% of high-tech Israeli start-ups established their corporate offices in the U.S.\(^6\)

2. 10,000 Israelis Relocated to the Silicon-Valley:

Accurate data on emigration of entrepreneurs and employees is also not available. A 2002-study by Eran Carmel, establishes that “Israeli companies have internationalized by moving key functions to key markets, in particular to the U.S.”\(^7\) That included transfer of marketing sales functions, legal structure, executive power structure (President, CEO, CFO, etc), and technical support units to the U.S.\(^8\) According to another source, 90% of Israeli-rooted companies chose overseas registration, and approximately 10,000 Israelis relocated to the Silicon-Valley to work for companies originated in Israel.\(^9\) Sourced on this information I estimate that thousands of Israeli entrepreneurs and employees relocated out of Israel in the years 1998 through 2002.

3. Revenues in Billions Lost in Israel:

The tax avoidance techniques of Israeli startups, entrepreneurs, and employees are presented in Chapter VI of this commentary; in a nutshell, the desire to avoid Israeli tax led to the establishment of overseas formation was known as: “Israeli-related.”\(^{100}\) In most variants of the “Israeli-related” formation, the activity in Israel was restricted to R&D, usually conducted by a

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\(^4\) Chaifetz, supra not 2, para. 3.4.2.


\(^6\) Israel Business Today, Keeping High-tech Companies at Home, supra note 61, at 1.


\(^8\) Id., at 10.


\(^{100}\) See Shenahv, supra note 95, at 2.3. See also infra para. VI-A-1-i, para. VI-B.
subsidiary; the results of the R&D, i.e. the intellectual property, belong to the foreign company, as does the revenue from selling and applying it; Israel was left with taxing only the income of the R&D staff working in Israel, plus negligible revenues determined on the basis of the Israeli subsidiary’s expenses (“cost-plus” method).

Sourced on the analysis of tax avoidance technique presented in Chapter VI, and the figures presented above (i.e., high-tech transactions, 3000 startups that 90% incorporated abroad, and 10,000 relocating employees), I estimate that the revenues lost in Israel because Israel was not able to levy tax on “High-Tech Sellouts” in Billions.

III. Israel’s Archaic Tax Regularity for Technology Ventures Pre-2003:
A. High Tax Rates:
Sabato, and others, argued that a central problem in Israel for high-tech ventures were the capital gains tax rates, that were much higher than in the United-States and western Europe. Israel’s capital gain tax rates are based on one’s marginal rate and at the relevant tears (1998-2002) reached 50%.

This high CG tax rate fueled the phenomenon of emigration. Sabato explains:

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101 Sources cited id.
102 Id. See also Agron, supra note 39, at 2.
103 Id.
104 Sabato, supra note 12, at 3,6, 10,11.
106 See Sabato, supra note 12, at 11, for chart, “Comparison of Capital Gains Tax Rates for Individuals and Corporations.”
107 See Sections 121, 126 of the Ordinance for the applicable CG tax rates for individuals and corporations (respectively).
108 Sabato, supra note 12, at 10.
“[I]n the past few years, the fuel that has fed the Israeli economy has been start-up companies in information technologies that are not initially traded on the public market. Small new companies that appear to have found a market niche are sought by investors, who invest in them by purchasing stock. In this instance, the owners who founded the successful company are required to pay a marginal income tax of 50 percent on the sale of that stock. A tax rate so high is significant enough to motivate companies to incorporate abroad. Established corporations not in need of an immediate cash flow have the option of issuing stock on the Tel Aviv Stock Exchange (TASE) or abroad, and then choosing to delay taxation until the stock is sold. This option is often unavailable to start-ups who instead need to sell their companies for cash and who end up paying high capital gains taxes.”

(Yitzhak Sabato, 2001)

In contrast, in the U.S., for example, as of May 7, 1997, the long-term capital gains on sales of securities in the “higher” tax brackets were taxed only at a rate of 20%, and, in 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 further reduced the capital gains to 15%.

The problem of high capital gain tax rates troubled also foreign investors, in particular, U.S. residents. The tax treaty between Israel and the United States provides that U.S. investor who holds 10% or more of the stocks of an Israeli company is subject to the Israeli capital tax rates


110 The amendment apply to gain in the 28% and higher brackets on assets purchased in 2001 or later and held for at least five years, see Economic Growth & Tax Relief Reconciliation Act of 2001, PUBLIC –LAW 107-16, June 7, 2001, section 101.

111 See Yariv Brauner & Shay Menuchin, Israel to Address Taxation of E-Commerce, 19 Tax Notes Int’l 15, 1999, para. IX. See also Ami Tiebel, Israel’s Capital Gain Policy Driving Down Venture High-Tech Investments, 2001, at 2, available at LEXIS WTD 143-13 Tax Analysts Worldwide Tax Daily (“There’s no doubt that in a problematic market, the tax issue is a serious problem . . . A foreign investor who has a zero capital gains tax in Germany has no incentive to invest in Israel, especially against the background of the political situation.”).

when selling his shares. In some cases, the tax paid in Israel could not fully offset the U.S. tax liability of the U.S. resident, thus, the high Israeli CG tax rates created a deterrent for U.S. persons to invest in Israeli companies.

Additional determents for Israeli corporation were Israel’s high corporate and marginal tax rates. The Israeli corporate tax rate is a flat tax rate, at the relevant years was 36%, and imposed on company's gross income. Studies suggests that this high corporate tax rate was in contrast to the global trend as most countries strived to reduce corporate taxation, particularly in European and other developed countries. Within the context of “High-Tech Sellouts,” this high tax rate had direct and indirect impact; first, it applied to “exit” in a form of technology-sale, and second, it made the Israeli company less attractive in compression to companies located in low-tax jurisdictions. Chaifetz explains:

“[I]srael has a capital gains tax of 50%....Second, the capital gains tax is partnered with Israel's corporate tax rate of 36%. When countries like Singapore tax similar entities at a zero to 10% rate, and Ireland taxes such businesses at a 12.5% rate, Israel cannot compete.” (Lesha Chaifetz, 2002)

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113 See Convention Between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income, (1993), Article 15(1)(e). (“Capital Gains - (1) A resident of one of the Contracting States shall be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets unless...(e) The gain is derived by a resident of a Contracting State from the sale, exchange or other disposition of stock in a corporation of the other Contracting State, but only if the resident of the first-mentioned Contracting State owned either directly or indirectly at any time within the 12-month period preceding such sale, exchange or other disposition, stock possessing 10 percent or more of the voting power of the corporation.”)

114 Brauner & Menuchin, supra note 111.

115 Id.

116 Sabato, supra note 13, at 7- 9.

117 Section 126 of the Ordinance.

118 Sabato, supra note 108. See also Chaifetz, supra note 2. para. 3.4.2.

119 Chaifetz id.
Israel also imposed high marginal tax rates on employment-income, which, at the relevant years, could easily reach 50%;\footnote{Section 121 of the Ordinance.} when combined with other mandatory payments such as: Social Security Insurance and National Health charges,\footnote{Individuals in Israel are also subject to social security tax and a health tax at a combined progressive rate of 5.76% to 9.70%. Employers are also required to pay social security tax on their employees at the rate of 4.93 percent. The premiums above-mentioned are imposed by the National Insurance (Consolidated Version) Law, 1995, and the State Health Insurance Law-1994 [Hebrew].} the total combined tax burden could therefore reach 60%! This high tax burden raised the expenses of local companies, since they took into account the take-home pay of their employees when offering salaries.\footnote{Sabato, supra note 12, at 3. See also Jeremy Cohen, Israel Amends Tax Law to Exempt Stock Swap form Capital Gain, 2001, at 2, available at LEXIS WTD 38-9 Tax Analysts Worldwide Tax Daily.} Understandably, these tax rates had a negative impact on foreign investment in Israel.\footnote{See sources cited Id.}

B. Inadequate Reorganizations Tax Law:

1. The Faults of the 1994 -“M&A Tax Law”:

As of the mid 90’s, Israel’s high-tech scene experienced myriad successful exits,\footnote{See infra para. I-A.} mainly by way of share exchange,\footnote{Sabato, supra note 12, at 14 (“Mergers and acquisitions are especially important in the high-tech sector, which is characterized by its dynamic environment. Companies are bought by other companies, merged, or spun off more frequently and on a larger scale in high-tech than in other sectors.”)} but those have been hindered by the archaic tax treatment.\footnote{Sabath, supra note 12, at 14-16.} Generally speaking, “Israel’s M&A tax laws did not adequately dealt with mergers and acquisitions, in particular in light of the speed in which the high-tech industry needs to perform restructuring.”\footnote{Sabato id. See also Chaifetz supra note 2, para. 3.4.2. Chaifetz argued: “[W]hat causes ninety percent of Israeli start-ups to incorporate outside of Israel? The advice of their venture capital funds. These funds know that when it comes to taxes and merger and acquisition ("M&A") laws, incorporating in Israel is not an option.” “Skewed Israeli M&A laws impose taxes even when a merger involves only a transfer of shares.” (Lesha Chaifetz, 2002)} The law was complex, and riddled with restrictions.\footnote{See discussion ahead.} Hence, it was generally accepted that this factor,
more than any other, fueled the charge by local entrepreneurs to the doors of the Silicon Valley, and Delaware registration of their companies.  

Before the Rabinovitch reform capital gains were subject to tax in Israel if the seller was a “resident” of Israel, and, regardless of the residence of the seller, if the asset sold was located in Israel, or the asset was located outside Israel but constituted a right (whether direct or indirect), to an asset in Israel. There were exceptions to this general rule in.

As of 1994, the tax treatment of corporate reorganizations was consolidated in Chapter E2 of the Income Tax Ordinance, which made mergers and mergers possible without automatically incurring capital gains tax. Sections 103 through 105 of the Ordinance allowed for tax-free asset rollover, mergers, consolidations and spin-offs, provided certain conditions are met. 

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129 *See* Itmar Levin, High-tech Circles Bugged by Taxation, December 27, 1999, Tax Analysts Worldwide Tax Daily. The question of how the high-tech sector should be taxed aroused a great deal of interest at the Jerusalem conference of the Institute of Certified Public Accountants in Israel. Israel's leading accountants argued that outdated tax regulations are making high-tech companies leave the country. *See* also Cohen *supra* note 122. Cohen argued that:

“[T]he problem is that under the normal rules regarding capital gains, disposal of any asset is subject to capital gains tax (CGT) under sections 88 and 89 of Income Tax Ordinance (New Version) 1961. There are few exceptions to the general rule.”...“However, mergers and acquisitions by way of share exchange were still subject to the stringent application of the general rule.” “It is generally believed that this, more than any other factor, has fueled the charge by local entrepreneurs to the doors of Delaware's Registrar of Companies in order to form Delaware corporations, or limited liability companies. While that undoubtedly also has grounds in the proximity to market and other non-tax-driven incentives, the tax motive has definitely been in the forefront.” (Jeremy Cohen, 2001)

130 Section 89(b)(1) of the Ordinance (amended)

131 Section 89(b)(2) of the Ordinance (amended).

132 Law Amending the Income Tax Ordinance (Amendment Number 94), 1433-1993. For review of this law see Business Operations in Israel, Taxation of Domestic Companies, para. 3(b)5, available at LEXIS 967-4th T.M. IV-C BNA Tax Management Portfolios.

133 A merger of two or more companies may be treated as a non-taxable event under Ordinance Section 103. Under Section 104 a tax-free “roll-over” is permitted in certain transfers of assets to a company solely in exchange for its stock. Under Section 105 tax-free treatment is available for split-offs that are either “horizontal” (in which the shareholders of the new company are identical to those of the divesting company) or “vertical” (in which the new company is a 100% subsidiary of the divesting company).
Generally, *Chapter E2* did not deal adequately with merger and acquisitions “particularly in light of the speed in which the high-tech industry needs to perform restructuring.”\(^{134}\) One source of problem was the restriction on the size of the companies that are merging.\(^{135}\) The law intended to prevent a large company from taking over a smaller company for the purpose of receiving a tax exemption.\(^{136}\) This restriction was anachronistic in light of the natural business environment of the high-tech industry, where the majority of mergers are accomplished between corporate behemoths and smaller companies.\(^{137}\) Furthermore, the law did not address the possibility of “chain mergers,” nor did it made tax arrangements for mergers via “stock swapping”, which in the high-tech scene is the means of choice.\(^{138}\) A “stock swap” required immediate payment of taxes by the “seller”, even though the “seller” simply received paper (i.e., stock of the buyer-corporation).\(^{139}\)

2. Slight Improvement via *Amendment No.123* to the Ordinance:

In 2000, *Chapter E2* of the Ordinance was updated “to meet the demands of the new economy in Israel”.\(^{140}\) *Amendment No. 123* was praised by academics and practitioners alike, as an important, step towards reconciling the realities of the markets with the provisions of the law.\(^{141}\) The addition of new transaction formats significantly enhanced the flexibility of the law’s

\(^{134}\) Sabato, *supra* note 12, at 14,15.

\(^{135}\) *Id.*, at 14

\(^{136}\) *Id.*

\(^{137}\) *Id.*

\(^{138}\) *Id.*, at 15

\(^{139}\) *Id.*


\(^{141}\) Herman *id.*,para III.
provisions. Yet, the law did not solve the problems associated with “chain mergers,” and “stock swapping”, which were the main impetus for the change in the law in the first place. Before the amendment, Section 103 dealt with statutory mergers only, specifically mergers in which only one entity survives. The amended-law, broadened the scope of tax-free mergers, in which the merging company's shareholders exchange their shares for shares of another company, so that the merging company becomes a subsidiary of the other. Sabato argues that the law, which allows deferrals in tax-payments until the actual sale of the shares, is largely irrelevant for high-tech industries.

Another option for mergers involving stock swaps allows a person, under certain circumstances, to defer payment of taxes until the sale of the stocks for no longer than two years on half the amount of the stocks, and for four years on the other half of the stock. The essence of the amendment is to defer payment of CGT arising out of a share exchange deal.

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142 Id.
143 Sabato supra note 12, at 15,16.
144 Herman supra note 140, para. II-A-1.
145 Section 103T of the Ordinance.
146 The main requirements are: At least 80% of the rights in the merging company must be transferred; the consideration must be in shares only (not including options and similar derivative rights); A stock-for-stock merger can be effected at any time during the tax year; however, the Limitation Period is somewhat longer compared to statutory mergers, and is two years from the date of the merger; The 51% minimum preservation of interest requirement is imposed with respect to the shareholders' holdings in the recipient company and the recipient's holdings in the merging company. The approval of the Commissioner is required prior to the merger.
147 Sabato supra note 143. For example, the law requires the market value of one company involved in the merger not be more than four times the value of the other company. The acquiring company is further required to allocate stocks of equal rights to the stockholders of the other company. There is also a restriction on selling rights and assets of the acquiring company, and much more. These restrictions make more difficult the opportunity for a tax deferral involving a stock swap.
148 Based on article 104(8) of the Ordinance. Under the amendment, the exchange itself is not a taxable event, but half of the resulting shares received by way of consideration will be deemed, for tax purposes, to be sold after 24 months, and the remaining half will be considered sold after another 24 months. In each case, where sale is blocked by the force of law or stock exchange regulations (but not by contract), the date of the deemed sale of each half will be six months from the date the restriction lapses, provided that is longer than the relevant 24-month period. The value for the purpose of the deemed sale is the average market price during the 30 days prior to the date of deemed sale.
149 Cohen supra note 122, at 3.
Note, from the outset, that the tax event is not properly deferred, as it is in other jurisdictions, to the moment of contact with cash, but is only partially deferred;\textsuperscript{150} establishing a specific time when the tax must be paid without regard to the time of sale, exposes an investor to the great risk of incurring tax liability on profits which were never made.\textsuperscript{151} In order to pay the tax, the investor will need to sell the shares without any connection to its potential economic yield, thus, perhaps, flooding the market with an oversupply of the stock and significantly bringing down the stock value on the day the shares are sold.\textsuperscript{152} Or, alternatively, in order to pay the tax before realizing a profit, the investor may need to take out a large loan with high interest rates, which will hike the cost of capital to him.\textsuperscript{153}

C. Taxation of VC Funds:

1. The “Pre-Ruling” Arrangement:

Israel’s technology sector has been characterized as the economy's “engine of growth.”\textsuperscript{154} Like any other engine the technology sector requires fuel, which venture capital funds supplied.\textsuperscript{155} Venture capital funds are willing to undertake substantial business risks by investing in young companies at seed and even pre-seed stages, but they manifest distaste for any risk concerning tax liability.\textsuperscript{156} For these reasons, Israel’s Income Tax Authorities and Israel’s Venture Association have conducted an ongoing dialogue for several years in an attempt to forge clear, 

\textsuperscript{150} Id.

\textsuperscript{151} Sabato, supra note 12, at 15,16. See also Cohen supra note 149. (“The consequences, where someone chooses not to sell in practice, and where the price subsequently falls, are obvious and horrendous: payment of CGT on an imaginary gain and acquisition of a capital loss (which, in Israel, may be set off only against capital gains and carried over for only seven years. The risk can, of course, be avoided by actually selling, but that is not necessarily the desirable approach.”).

\textsuperscript{152} Sabato id., at 16.

\textsuperscript{153} Id.


\textsuperscript{155} Id.

\textsuperscript{156} Id.
transparent, competitive tax rules for venture capital funds.\textsuperscript{157} The discussions have produced an extensive practice of “Standard” “Pre-Rulings” for foreign funds active in Israel, available on request, aimed to reduce the uncertainty associated with the tax consequences of a fund’s investments in Israeli ventures.\textsuperscript{158}

In general, the “Ruling” shifted the burden of reporting and paying tax from the partners of the venture capital fund to the fund itself.\textsuperscript{159} Under the ruling, the funds were subject to a reduced 20\% tax rate,\textsuperscript{160} on the portion of assets owned by foreign investors.\textsuperscript{161} The \textit{IITC} chose to impose a 20\% capital gains tax because many of the early venture capitalists investing in Israel were U.S. residents. Under U.S. law, a 20\% tax rate is imposed on long- term capital gains (gains from assets held for more than one year).\textsuperscript{162}

2. Non-Taxation of Investments in “Israeli-Related Corporations:

The 20\%-reduced tax rate was offered to funds with the understanding that the tax rate is final, and supercedes any other tax benefits, such as relief from double taxation.\textsuperscript{163} Also, the \textit{IITC}’s policy when applying the ruling was to impose the 20\% tax not only to a sale of shares of Israeli companies, but controversially to a sale of shares of so-called “Israeli-related” companies, that is, a non-Israeli company whose primary assets or activity were, directly or indirectly, located in

\begin{footnotesize}
\begin{enumerate}
\item[157] Id.

\item[159] \textit{Clark id.}

\item[160] \textit{Id.} The legal authority of this arrangement was Section 16A of the Income Tax Ordinance that authorizes the Minister of Finance to grant a tax rebate to a non-resident taxpayer where the Israeli tax borne by the taxpayer is not creditable in the taxpayer’s country of residence even if the credit is derived because of provisions in that country requiring the set-off of losses.

\item[161] \textit{Id.} The \textit{IITC} chose to impose a 20\% capital gains tax because many of the early venture capitalists investing in Israel were U.S. residents. Under U.S. law, a 20\% tax rate is imposed on long- term capital gains (gains from assets held for more than one year). Rulings issued to venture capital funds were negotiated on a fund-by-fund basis, and the terms varied from one ruling to the next.

\item[162] \textit{Id.}, at 2.

\item[163] Sabato, \textit{supra} note 12, at 12.
\end{enumerate}
\end{footnotesize}
Israel, or the majority of whose technology was acquired or developed in Israel.\textsuperscript{164} This policy was sourced on the notion that the fund managers operate a “business of investments,” imputed to the partnership (find), with the result that the whole of the income becomes ordinary rather than capital in character.\textsuperscript{165}

Conversely, the funds and their tax-advisors, maintained that the profit of funds are capital gains that is not always subject to tax in Israeli tax, e.g., if a U.S. resident (fund or U.S. residents with rights), sold a share of non-Israeli company.\textsuperscript{166} They further argued that the policy of the ITC to tax sale of foreign corporation by funds would result in double taxation.\textsuperscript{167} This was indeed the case of Chromatis that was incorporated in the U.S., operated in the U.S., had U.S. investors, and was sold to a large U.S. company, Lucent.\textsuperscript{168} After the finalization of the sale, an Israeli venture capital firm withheld the distribution of Lucent shares as a result of a debate with the Income Tax Authority on the amount of taxes the fund was required to pay,\textsuperscript{169} and, in February 2001, it was agreed that taxes to be paid will be determined at a later time, when the issue is cleared up with the U.S. tax authorities, in order to prevent double taxation.\textsuperscript{170}

On May 2001 the Israeli Minister of Finance Mr. Silvan Shalom announced that an Income Tax Commission team was invited to Washington to try to pin down an agreement with the United States that would allow U.S. non-institutional investors to be taxed at the U.S. rate of 20%, without incurring double taxation.\textsuperscript{171} The IRS’s position on this issue was clear; since Chromatis

\textsuperscript{164} Clark, \textit{supra} note 158, at 2.


\textsuperscript{166} \textit{Id.}

\textsuperscript{167} \textit{Id.}

\textsuperscript{168} Sabato \textit{supra} note 12, at 15,

\textsuperscript{169} \textit{Id.}

\textsuperscript{170} \textit{Id.}

\textsuperscript{171} An Income Tax Commission team is currently in Washington to find a solution to double taxation along with the US Internal Revenue Service (IRS), \textit{see} Zeev Klein, Double taxation on Foreign VC Investors to End, Globes [online] - Israel's Business Arena, April 23, 2001. \textit{See} also Teible Amy, Israel Relaxes Capital Gain Tax Rate for Venture Capital Investors, 2001, available at LEXIS WTD 120-18 Tax Analysts Worldwide Tax Daily.
was incorporated in the U.S., operated in the U.S., had U.S. investors, and was sold to a large U.S. company, thus, Israel has no right to tax the income.\textsuperscript{172}

Following this event, \textit{Shalom} directed the Income Tax Commissioner, \textit{Mr. Yoni Kaplan}, to draw up tax breaks avoiding double taxation;\textsuperscript{173} under the new ruling, an exemption was also available for funds, that invested in non-Israeli companies, if the target companies funneled at least 30\% of the total committed capital of the fund to Israeli companies (such as R\&D centers in Israel);\textsuperscript{174} the \textit{Chromatis} fiasco, and the “new” 2001-rulling assured that foreign funds could avoid Israeli taxation if invested in Israeli venture that choose to incorporate out side Israel. It emphasized the advantage for Israeli ventures to incorporate abroad.

D. Lack of Incentives for Research & Development:

1. Encouragement of Capital Investments & Industrial Research and Development

Over the years, Israel legislated a fairly broad tax regime that encourages commercial activities, promotes industry, create jobs, and increase exports.\textsuperscript{175} The Law for the Encouragement of Capital Investments, 1959 and the Law for the Encouragement of Industrial Research and Development, 1984 both offer incentives to “approved enterprises.”\textsuperscript{176}

\textsuperscript{172} Sabato, \textit{supra} note 12, at 14. \textit{See} also Herman, \textit{supra} note 165 (“Foreign tax authorities, most notably in the United States, continue to view the profits as capital gains that Israel has no right to tax under the applicable tax treaties.”).


\textsuperscript{174} Pre-Ruling for Foreign Investors Investing in VC Funds (2001) \textit{id.}, para. C-13-2.


\textsuperscript{176} To gain “approval enterprise,” status an application had to be filed with the Board of the Investment Center, a statutorily designated body charged with the administration and the implementation of the Law. In deciding whether or not to approve a request, the Board takes into consideration: (i) the general nature of the project; (ii) its emphasis on exporting industrial goods or services from Israel; (iii) the currency in which the investment will be made; (iv) the nature of the income-producing property involved; (v) the duration of the investment; (vi) the increase in jobs
A Study by Doron Herman demonstrates that, in the relevant years, Israel offered wide range of incentives for capital investments, relevant to technology companies.\(^{177}\) Similarly, Chaifetz argues “Israel's government plays a direct role in the growth of its high-tech sector, providing substantial support for start-up companies.”\(^{178}\)

“[S]ince 1991, the Ministry of Trade and Industry has invested in start-ups through its incubator program. Through the Office of Chief Scientist ("OCS"), the Ministry runs a system of twenty-four incubation centers that partially fund accepted entrepreneurial ideas. To be accepted, ideas for business and requests for money must be based in research and development ("R&D"), technologically focused, and adaptable to the export market. Once a business is accepted, the OCS provides a significant portion of the money needed for the business to get started. The government also helps with the more mundane tasks of starting a business, such as an R&D plan, administrative counseling, secretarial services, and legal and accounting advice. If the project succeeds, the government receives a percentage of the profits from the enterprise; in the event of failure, however, they do not require repayment. Out of the 592 projects that were started through the

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\(^{177}\) Herman, supra note 165, para. B. The Law for the Encouragement of Capital Investments, 1959 [Hebrew], Section 17.

\(^{178}\) Chaifetz, supra note 2, at 2.2.1.
incubator program, 308 are still going, 225 found venture capital funding, and 83 were still negotiating for venture funding.” (Lesha Chaifetz, 2002)

2. Discrimination of Technology Startups:
Despite wide range of concessions for technology ventures, before the Rabinovitch reform, Israeli startups had no incentive to prefer Israel over other countries as a place from which its activities would take place.\textsuperscript{179} Subsidies under the 1950s-encourgement laws were granted in ways that discriminated in favor of established companies and against start-ups.\textsuperscript{180} Sabato pointes out that established large and medium-sized corporations received 85\% of the state grants, while startups received 15\%.\textsuperscript{181}

The source of the problem was the definition of “approved enterprise.”\textsuperscript{182} Technology startups failed to get “approved enterprise” status that would qualify them for these tax concessions.\textsuperscript{183} “Approved enterprise” status was given only if the income of the enterprise derives from selling or licensing software;\textsuperscript{184} it did not cover businesses in which the main income stream is either from services, advertisement or royalties.\textsuperscript{185}

IV. Non-Fiscal Causes of “High-Tech Emigration”:
A. Unfitted IP/Security/Company Laws:

\begin{footnotesize}
\textsuperscript{179} Sabato, supra note 12, at 8, 9. See also Chaifetz supra note 2, para 3.4.2. (“Finally, the Israeli government intentionally fails to grant e-commerce start-ups “approved enterprise” status, which would qualify them for tax breaks. See Ronny Lifschitz, CPA Forer to Gvt: Let Us Do Business; Globes [online] - Israel's Business Arena, August 29, 1999. See Yariv Brauner & Shay Menuchin, Taxation of E-Commerce in Israel, 22 Tax Notes Int'l 2509, 2001, para. VII.

\textsuperscript{180} Sabato, supra note 2, at 8.

\textsuperscript{181} Id.

\textsuperscript{182} See sources cited supra note 179.

\textsuperscript{183} Id.

\textsuperscript{184} Id.

\textsuperscript{185} Id.
\end{footnotesize}
Relocation of Israeli startups was attributed also to Israel’s faulty law environment that was problematic in several areas, particularly the laws governing corporations, intellectual property, and issuance of securities to employees.\textsuperscript{186} In these areas Israel’s law has simply not been adapted rapidly enough to the needs of its advancing high-tech industry.\textsuperscript{187} Such laws not only forced businesses to incorporate elsewhere, but also drove them to do business elsewhere as well.\textsuperscript{188}

Israel’s laws have not been protective of IP rights.\textsuperscript{189} Other source of discontent was the law governing the issuance of stocks to employees.\textsuperscript{190} In the high-tech industry it is common practice to give employees options.\textsuperscript{191} Under the Israeli Securities Law a company wishing to issue options to employees, whether public or private, was required to prepare a prospectus.\textsuperscript{192} The law treated the offer of options to employees like a public offering, even though no money was being raised;\textsuperscript{193} a prospectus costs several hundred thousand dollars, and takes time;\textsuperscript{194} also, a company publishing a prospectus could face legal exposure.\textsuperscript{195} This situation was extremely troublesome for startup companies at second-stage of growth, when they are no longer start-ups with not more

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\textsuperscript{186} Chaifetz, \textit{supra} note 2, para. 3.4.
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\textsuperscript{187} \textit{Id.}
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\textsuperscript{188} \textit{Id.} para. 3.4.2.
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\textsuperscript{189} See Chaifetz, \textit{supra} note 1,para. 3.4.2. See also Eizenstat Speaks on Israel’s High-Tech Economy, \textit{supra} note 100, at 6. (“The development of high-technology must also be accompanied by intellectual property laws and effective enforcement mechanisms to protect the rights of the inventors of new technology.”).
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\textsuperscript{191} \textit{Id.}
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\textsuperscript{192} See Public Offering & Prospectus (Amendment No 120) Israel’s Security Law, 1968, March 29, 2000, Israel Law Books 234 [Hebrew]. Under Israel's Securities Law-1968, a person could not offer securities to the public except by way of a prospectus approved by the Israeli Securities Authority. See Securities Law (1968), Section 15 [Hebrew].
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\textsuperscript{193} See Ronny Lifschitz Last to Leave, Switch Off Light, Globes [online] - Israel's Business Arena, January 21, 1998. If to be more précis the Securities authority did not allow options to be allocated to more than 35 employees a year. Beyond this number, the allocation was considered a public issue, entailing preparation of a prospectus.
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\textsuperscript{194} \textit{Id.}
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\textsuperscript{195} \textit{Id.}
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than then employees, but companies employing up to 100 people.\textsuperscript{196} The law was amended only in the year 2000, when Israel adopted an “arrangement” similar to the one in the U.S.\textsuperscript{197}

Lastly, a major turnoff for choosing Israel as a jurisdiction was its unique system of corporate law.\textsuperscript{198} The primary source of funding of Israel’s start-ups industry is originated from U.S. investors who did not believe in the Israeli system.\textsuperscript{199} Much pressure was, therefore, placed on Israeli entrepreneurs to set up their companies in the U.S. rather than in Israel.\textsuperscript{200} To further complicate matters “new” Israeli legislation,\textsuperscript{201} enacted in 1999, was problematic as it did not allow corporations to grant options to corporate directors,\textsuperscript{202} imposed more regulations regarding transparency on corporate directors and far-reaching liabilities on corporate officials,\textsuperscript{203} and also since it made mergers and acquisitions difficult.\textsuperscript{204}

\textsuperscript{196} Id.

\textsuperscript{197} The change included Amendment of Section 15 of the Securities Law (1968), [Hebrew]. The new proposed arrangement that was implemented was similar to the US S-8 form. According to the proposed bill, a company listed in Israel can issue options while publishing an outline instead of a full prospectus. Employee options offers in a company listed outside of Israel would require a prospectus. However, the Authority would have the right to absolve a company from this obligation, under terms it would define. On Feb 16, 2000 based on the proposed bill the Knesset approved in first reading a far-ranging amendment to the Securities Law, which includes easements in issues for overseas listed companies, obviating the need to publish a detailed prospectus for issues and private allocations to employees by stock exchange companies. The definition of an institutional investor has been widened to include investment consultants, portfolio managers and venture capital funds. The most recent financial statements will be the reference point regarding the company’s situation. The amendment also broadens the competence of the Securities Authorities in exempting companies from publishing a prospectus or part of one in cases in which it sees fit, based on regulations to be determined. Exemption from the requirement of publishing a prospectus was also determined for companies listed overseas, seeking to allocate options to their employees in Israel, in the event that a prospectus was published overseas. A new principle proposed in the amendment is that the regulations will be applied according to where the company is traded, instead of according to where it is registered. On this clause, the amendment adopted the principle securities policies of the US, and it represents a legislative breakthrough in preparation for the upcoming enactment of dual listing.

\textsuperscript{198} Chaifetz, \textit{supra} note 2, para. 3.4.2., para 4.1. \textit{See} Urman, \textit{supra} note 2, at 2.3.

\textsuperscript{199} Urman \textit{id.}

\textsuperscript{200} \textit{Id.} \textit{See} also Chaifetz, \textit{supra} note 2, para. 3.4.2 (“Israeli tax and corporation laws have led to potentially irreparable damage, as more than ninety percent of its high-tech start-ups have chosen to incorporate not in Israel, but in Delaware.”).

\textsuperscript{201} \textit{See} Israel Corporate Law 1999, articles 6, 54, in Book of Laws 1711, at 189 [Hebrew].

\textsuperscript{202} Sabato, \textit{supra} note 12, at 2,9 22.

\textsuperscript{203} \textit{Id.}

\textsuperscript{204} \textit{Id.}
B. Economic Forces Pushed Israeli Startups to Internationalize

1. Hypothesis: Business Considerations Driving High-Tech Entrepreneurs Away:

In 1999, during a major conference on “high-tech emigration”, Gary Agron, Deputy to the Income Tax Commissioner argued that 205:

“[I]t was not the tax laws that were driving high-tech entrepreneurs away, but business considerations of foreign investors in Israeli companies”

(Gary Agron, 1999)

Studies by Eran Carmel, (“Issues Facing Israeli Companies as they Internationalize” 206), Edward Rock (“Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets” 207), and Joel Bainerman (“Broken Promises: The Rise and Fall of Israel’s Technology-based Industries” 208), could demonstrate that economic and business forces, were also a dominant factor in the “internalization” of Israeli technology ventures.

2. Demand-Driven relocation:

A study by Eran Carmel demonstrates how this economic force pushed Israeli firms to “internationalized.” 209 Carmel notes that Israeli companies internationalized by moving number

205 See Itamar Levin, High-tech Circles Bugged by Taxation; Israel’s CPAs argue that outdated tax regulations are making high-tech companies leave the country. The tax authorities don’t agree. Globes [online] - Israel's Business Arena December 27, 1999.

206 See Eran Carmel, “Issues Facing Israeli Companies as they Internationalize”, Center for Information Technology and the Global Economy Faculty Research Working Paper series 03-004, 2001. The report is based on our 2001 study of high-technology firms that are Israeli or have a base in Israel. It centers on how Israeli firms made decisions as to how to use their Israeli and US locations, and in particular, examined where firms choose to locate different types of R&D and their strategies for integrating R&D functions into an effective company.


209 Carmel, supra note 206, at 5. (Internationalization is defined in the study as “the process of increasing involvement in international operations”).
of their functions outside of Israel, to their key markets, particularly the U.S..\textsuperscript{210} Carmel argues that it is clear that “Israeli firms internationalized primarily because of the need for a market, and “are thus demand-driven, as opposed to supply-driven ((seeking resources abroad)).”\textsuperscript{211} He adds that “internationalization due to demand factors is common to other small industrialized.”\textsuperscript{212}

The study acknowledges the tax factor but it seems that Carmel gives more weight to the economical force. He argues that\textsuperscript{213}:

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[T]ax and regulatory issues may also be a disincentive to locate in Israel: tax laws are cumbersome in exit strategies such as mergers and acquisitions (particularly if paid for with shares). Exit leaves founders and investors liable for Israeli capital gains taxes, which are double that in the US. Incorporation in the US (usually in Delaware) is also more familiar to investors, and strongly preferred by US investors-partly because of their familiarity with Delaware commercial law and procedure, and partly because of the exit issue. Firms have some flexibility as to where they incorporate and place the firm’s intellectual property; but it is difficult for a small firm to maintain a physical presence in its declared location, without actually basing itself there.” (Eran Carmel, 2001)
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3. The Impact of the “Sellout” Trend:

i. Entrepreneur Who “Get it”:

\textsuperscript{210} Id., at 3. (“The Israeli high-tech internationalization model transfers many functions in part, or in full, abroad (mostly to the US): sales, marketing, legal residence, executive power (President, CEO, CFO, etc), technical support and adaptation units—while ‘core’ R&D remains in Israel.”).

\textsuperscript{211} Id., at 4,5.

\textsuperscript{212} Id., at 5. Open, small industrial economies tend to be more internationalized than large economies. The list of nations includes: Canada, Netherlands, Belgium, the four Nordic nations, Switzerland , Taiwan, Singapore, and Israel. This internationalization is prevalent in high-technology industries. Small European countries, such as Netherlands, Belgium, Switzerland, Sweden, have the highest technological activity abroad.

\textsuperscript{213} Carmel, \textit{supra} note 203, at footnote 9.
Studies by Rock and Bainerman analyze the impact of the “Sellout” trend on emigration, and illustrate how the business strategy of venture capital funds “to cash out as quickly as possible”, led to emigration of Israeli technology ventures.

Edward Rock examined the hypothesis that “venture capital can flourish especially and perhaps only, if the venture capitalist can exit from a successful portfolio company through an initial public offering (IPO), which requires an active stock market.”

Israel provided an important and revealing case for Rock’s study because Israel has an extremely active venture capital industry, but a relatively undeveloped local stock market, and also because the two common “exit” options for Israeli startups were either an IPO on the NASDAQ, or an acquisition by a foreign firms.

Rock notes that, in this process, venture capitalists, in and particular U.S. funds, played a major role as they provided both early-stage financing and non-financial services, including management advice, reputation capital, networking, and cross-fertilization. He states that most start-ups that consulted with a lawyer or accountant and were immediately warned against setting up headquarters in Israel and are told to look for offices in America instead.

At final stage, when analyzing the difference for an Israeli entrepreneur between incorporating in Israel versus the United States, between living in Silicon Valley and Israel, Rock acknowledges that “when the customers are mainly in the United States, the alternative to living

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215 Id.

216 Id.

217 Id., para. I, para. II-A. (“In addition, they provide a bridge between the firm and both product and capital markets, playing a central role in positioning the company, determining how to present the company to the product markets and financial markets, and determining the optimal timing of a public offering or sale.”).

218 Id., para. IV-C.

219 Id., Chapter E.
in the U.S. is spending a lot of time on airplanes,“ 220 but argues that “that does not seem to be the whole story.” 221

When trying to figure out “what is going on” Rock “closes with the speculation” 222:

“[T]he bottom line is that investors, especially investors in the “new economy,” seem to be willing to invest with entrepreneurs who "get it" and not with those who do not. What is meant by “getting it”? A variety of things, but one of them is that the entrepreneur understands how the game is played: the value that a venture capitalist brings to the table”..."The pressure of venture capitalists on entrepreneurs to try to “pass” as American, to relocate to the U.S. and to incorporate in the U.S., is all a shorthand way of capturing--and teaching--the set of understandings that are taken for granted by the repeat players. While one can find examples of firms that succeed without playing the game and of firms that play the game but fail, my guess is that the reason that Israeli entrepreneurs are told to incorporate in Delaware and to be as "American" as possible is that it is part and parcel of getting into the right mindset, social set, business set, and investor set. The decisions to incorporate in the U.S., to set up a corporate headquarters in the Valley, or to seek investments from prominent Silicon Valley venture capitalists are important both for what they contribute and for how they teach the entrepreneurs what it takes to succeed. As such, they signal to investors that this is a company that understands what it takes to succeed today.” (Edward Rock, 2001)

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220 Id.
221 Id.
222 Id.
ii. "VC Propaganda":
A parallel approach is presented in a study by Joel Bainerman. Bainerman argues that Israel’s high-tech industries fundamentally changed directions after 1995. Before then, Bainerman explains, companies operating in the high-tech sector were serving the needs of the Israeli economy by providing jobs, stimulating the economy, and building Israel’s marketing and managerial capabilities. This situation changed profoundly in the mid-1990s, when a new factor entered the equation—venture capital funds backed by major investment banks and financial institutions in the U.S.

Bainerman claims that, as a result of the influence the venture capitalists have exerted on Israel’s high-tech industries, companies created after 1994 were no longer established to become a permanent corporation with multi national operation, rather be sold out to foreign multinationals as quickly as possible. He criticizes the Israeli high-tech sector that went from serving the needs of the Israeli economy, and hence the Israeli public, to the short term needs of the foreign investors and VC fund managers.

When coming to deal with the question “What really drives those start ups away, Bainerman explains that Israeli startups, guided by thoughts of selling the company to American investors, or taking their company public as quickly as possible. He argues that Israeli companies were

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223 Bainerman, supra note 208, para. entitled: “Preface.”
224 Id.
225 Id.
226 Id.
227 Id. Bainerman argues that:

“[I]instead of building companies that would survive over the long haul providing employment opportunities and economic stimulation for the state’s economy, the goal of nearly all the companies created by the venture capitalists after 1995 was first and foremost to make the greatest amount of money for their investors in the shortest period of time. While such goals are legitimate in their view, the best interests of the Israeli public were neglected” (Joel Bainerman, 2001)

228 Id., para. entitled: Israeli Venture Capitalists and Their “Sense of Smell and Luck”
“no longer interested in being based in Israel,” and determines that “it is because the VCs that invest in them warn them that unless they register in Delaware, they won’t invest.”

Bainerman clarifies:

“[A]ccording to the rules set by them, for an Israeli start up to be successful means to “become a US company”, meaning, to transfer all of the marketing and sales operations of the Israeli start up to the US, so that it can appear as if the entity is an American company. In this way, American venture capitalists will consider investing in the company and thus an IPO will be possible, or, the company will appear on the radar screen of a large company, which will acquire the Israeli start up. This strategy is based on selling ideas, not filling up containers for exporters. In the context of these new rules, the goal of the investors is to exit from the company as quickly as possible- not build world-class enterprises for the long-term”

(Joel Baineramn, 2001)

Finally, when dealing with the notion that because of tax reasons, “Israeli companies must be headquartered and operated out of Israel,” Bainerman expresses a strong opinion. He asserts “the notion that for tax reasons we are forced to register in Delaware is VC propaganda”.

V. Encouraging Business Entrepreneurship & Technology:

A. The Rabinovitch Reform:

1. Reduction of Tax Rates:

The Rabinovitch Committee took upon itself to correct Israel’s fiscal distortion for high-tech. Accordingly, in several parts of the report, and in particular in Chapter E, titled “Encouraging

229 Id., para. entitled: “What Really Drives Those Start Ups Away?”

230 Id., para. entitled “What Really Drives Those Start Ups Away?”

231 Id., para. entited: “How The VCs Changed All That.”

232 Id., para. entitled : “Their Track Record: What Have The VCs Created In The Way Of Great Companies?”

233 Rabinovitch Report, at 119,120.
Business Entrepreneurship & Technology”, the Committee recommended changes to the Ordinance that may ease the tax burden on high-tech ventures and related parties.234

The Committee recommended “liberalizing” the income tax brackets and reducing the corresponding tax rates.235 Additionally, the Committee proposed to eliminate the gradual tax rate system for capital gains and adopt a 25% flat tax rate.236 The Committee stressed that the underline policy of this recommendation is to keep Israeli start-up technology corporations from moving abroad.237 The Committee also recommended that the tax rate on gain from stocks traded in foreign exchange investments (35%) will gradually be equalized with the tax rates applicable to stocks traded in TASE (15%).238

The Israeli legislator adopted the recommendations.239 In principle, Amendment No. 132, widened the tax brackets, and reduced the direct tax rates on personal service income, mainly with respect to the middle-income sector.240 Also, pursuant to the recommendations capital gains tax rate from the sale of capital assets other than tradable securities was reduced to 25% for both individuals and corporations.241 The reduced tax rate applied to sales occurring post January 1, 2003, and (only) to post-01.01.2003-gain, calculated linearly.243

234 Rabinovitch Report, at 119 - 129.

235 See discussion in the Report at 19 through at 37. For the new recommended tax brackets see Rabinovitch Report, at 26.

236 Rabinovitch Report, at 107, 119.

237 Rabinovitch Report, at 119.

238 Rabinovitch Report, at 53.


240 See amended Section 121(a) of the Ordinance. The post-reform highest marginal tax rates for income of 34,821, or more, including National Insurance and Health Tax, are as follows: 59.70%, 59.70%, 50.00%, 50.00%, 50.00%, 49.00%, 49.00%, respectively for the years 2002, 2003, 2004, 2005, 2006, 2007, 2008.

241 Amended Section 91 of the Ordinance.

242 Amended Section 91(b1).

243 Id.
An important element of the reform was the equalization of tax rates on income from traded securities. The capital gain tax rates from sale of “Foreign Traded Securities” on “Foreign Exchanges” was reduced to 15%. Under the arrangement, a sale of securities purchased before 1.1.2007 and sold after 1.1.2007, is subject to two tax rates: 35%, 15%, calculated based on a linear division of gain method.

2. Taxation of Venture Capital Funds:
The Rabinovitch Committee proposed broadening the scope of venture capital funds eligible for the relief by eliminating the current $ 20 million minimum capital requirement set by the Ministry of Finance. The Committee also proposed to grant an exemption from capital gains tax to foreign investors investing directly in certain types of Israeli high-tech corporations at the sale or exchange of their interest. The underline policy of this proposal was to encourage Israeli incorporation.

In the year 2003, based on the Committee’s recommendation, the Israeli Income Tax Commission and the Israeli Venture Association reached an agreement regarding the taxation of venture capital funds active in Israel. According to the ruling, specific tax consequences apply to fund that establish an office in Israel from which their investments in Israeli companies are managed, maintain their bookkeeping related to their Israeli, concentrated their operations in Israel and have a minimum committed to invest an amount of at least US $ 10 million.

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244 Blue Print, article 44.

245 Sections 105L(a), 105M (a) of the Ordinance.

246 Rabinovitch Report, at 124.

247 Id.

248 Id.


250 Id., para. 5.
The ruling determines that fund will be exempt from Israeli tax if at least 50% of the fund's investments are made in “qualified investments”, that is investments in the establishment or expansion of R&D or production facilities in Israel in the industrial, technological, communications, computer, medical, and biotechnological sectors, and at least 30% of the investments are made in companies resident in Israel that own the relevant intellectual property, or in foreign companies that hold Israeli subsidiaries that own the intellectual property.  

3. CG Exemption to Foreign Investment in “R&D Company”:
In addition to the proposed exemption of for investments made through venture capital funds, the Committee proposed granting an exemption from capital gains tax to foreign investors investing directly in certain types of Israeli high-tech corporations at the sale or exchange of their interest. It proposed to grant a capital gains tax exemption to corporations with substantial R&D conducted in Israel and substantial use of products developed as a result of that R&D in Israel.

As part of the reform, a special exemption was introduced for non-residents investing in Israeli technology companies. Under the new provision, non-residents are exempt from tax on gains realized upon the sale of shares in “R&D Company”, allotted to them from 1 January 2003. “R&D Company” is defined as an Israeli resident company, the majority of whose activities are research and development activities and the marketing of products developed by that R&D, and the majority of whose assets are used in said R&D activities. Furthermore, 75% of the R&D expenditures of those companies should be made in Israel.

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251 Id., para. 7.
252 Id.
253 Rabinovitch Report, at. 126.
254 Id.
255 Amendment No. 132, supra note 33, article 35.
256 See Section 97(b)(1) of the Ordinance
257 Section 97(b)(3) of the Ordinance and Section 103A(b).
258 Id.
4. Amendment to the Definition of “Approved Enterprise”:
The Committee recommended reforming the archaic legislation by extending the “approved enterprise” benefits.\textsuperscript{259} It recommended that companies will receive the status of “approved enterprise”, not only in relation to sales of products, but also in relation to royalties, and income from services derived from know-how such companies develop under the Law for the Encouragement of Capital Investments (1959).\textsuperscript{260} The recommendation intended to create an incentive for Israeli companies to retain intellectual property.\textsuperscript{261}

As part of the amendment, the definition of income considered derived by the “approved enterprise” has been broadened to include income from the licensing of knowledge, from royalties, and from services related to the knowledge licensed, to the extent that income originates from the enterprise's business activities.\textsuperscript{262}

B. Evaluation of the Recommendations:
The Rabinovitch Committee recommendations for the Israeli high-tech sector, imported into the Ordinance via Amendment No. 132 provided an important and much-needed revision of the tax–regularity in Israel. The amended Ordinance offers a better, clearer and more coherent tax regime for Israeli startup ventures and foreign investors. Taken together, these measures restore Israel’s standing as a country worth investing in; arguably, additional reforms are required in order to keep Israeli startups in Israel.

Particularly, to retain incorporation and stop the migration of managements and employees, Israel should further lower its capital gain tax rates to a rate lower then lower then 25\%,\textsuperscript{263} decisively

\textsuperscript{259} Rabinovitch Report, at 125.
\textsuperscript{260} Id.
\textsuperscript{261} Id.
\textsuperscript{262} Blue Print, article 74.
\textsuperscript{263} Sabato, supra note 12, at 11.
lower its corporate tax rate from rate of 36%,264 remove the restrictions and simplify the term for tax exemption for venture capital funds active in Israel,265 further amend its R&D laws to ease restrictions on creativity,266 and finally, ease the restrictions on mergers and acquisitions that require tax payments on mergers when no shares are actually sold.267

VI. How Israeli Startups Avoided Israeli Tax on “High-Tech Sellouts”:
A. Tax-Avoidance Schemes of Entrepreneurs:
1. Relocation:
i. Change of “Tax-Residence” Within One Year:
Before 2003, the Ordinance imposed tax on the capital gains of Israeli residents worldwide,268 and on non-residents if the underlying asset was located in Israel, or on sale of foreign asset that constituted a right to an asset located in Israel, for example, shares of a foreign company that owns an asset located in Israel.269 In both cases capital gains were imposed at the time of “disposition” of the assets (“realization method”).270

This system made the Israeli tax-base “vulnerable” to non-taxation at emigration, in particular emigration to treaty country. E.g., taking into account the tiebreaker rule in the 1993 U.S.-Israel Double Tax Convention,271 one-year stay in the U.S. could amount to a permanent change in

264 Id., at 21.
265 Id., at 22.
266 Chaifets, supra note 2, para. 5.2.
267 Sabato, supra note 12, at 22.
268 The rules for taxation of capital gain were included in Chapter E of the Ordinance. Under Section 89(b)(1) capital gains were deemed to have accrued or been produced in Israel, whether the sale was made in Israel or abroad, if the seller was a “resident” of Israel.
269 Under Section 89(b)(2) capital gains were deemed from source in Israel if the asset is in Israel, or is outside Israel but is a right, whether direct or indirect, to an asset in Israel, regardless of the residency of the seller.
270 See definition of “disposition” in Section 88 of the Ordinance.
271 Article 3(2) of the treaty (Convention between the United States of America and Israel signed in Washington on November 20, 1975, as modified by the protocol signed on May 30, 1980, and the protocol signed on January 26, 1993, hereinafter- “The U.S. Israel Tax Treaty), determines that “where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States: (a) He shall be deemed to be a resident of that Contracting State in which he maintains his permanent home. If he has a permanent home in both Contracting States or in neither
“tax-residence”. Accordingly, shifting of “tax-residence” was a prevalent tax planning for Israeli entrepreneurs, as they could move abroad shortly prior to a “Sellout”, thus, avoid Israeli taxation.

ii. Common Foreign Structures:

Study by Herman indicates that Israeli startup companies organized under formations that can be broadly classified into three categories: those involving a U.S. parent and an Israeli subsidiary, those involving an Israeli parent and a U.S. subsidiary, and those involving an offshore parent with Israeli and U.S. subsidiaries.

The U.S. parent-Israeli subsidiary formation came in three main variants, differing in the scope of activities undertaken by each member of the group. A common feature of all three variants was that the parent of the group, and hence, the company in which the founders and venture capitalists invest in, was a U.S. corporation. One main difference between the three main variants was the ownership location of the IP asset. In one variation the IP was located in Israel, while in the others the IP was located out of Israel, in the U.S or as an asset of an offshore corporation. The three sub-variants entailed similar (but not identical) tax consequences for the shareholders. In the formation where the IP was located outside Israel, Israel had limited powers to tax sale of shares by relocating entrepreneurs. Conversely, entrepreneurs with

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272 ALTER & CALIF, supra note 32, footnote 345 and accompanying text.
273 ALTER & CALIF id., para. 7.4. See Asher, supra note 39, at 77, para.6.7.2.
274 Herman, supra note 165, para. II-A.
275 Id.
276 Id.
277 Id.
278 Id.
279 Id.
280 Id.
holdings in U.S. parent that in turn held the Israeli subsidiary were at risk that sale of shares of the U.S. parent would be subject to tax in Israel.  

Under the Israeli parent-U.S. subsidiary formation the “target” company (owned the technology) was Israeli corporation. The main detriment for entrepreneurs to use this structure was Israeli taxation imposed on non-residents' capital gains on sale of the Israeli stocks.

The third group was the offshore-parent structure. Under this structure a parent located in an offshore jurisdiction owned the IP. As in the case the U.S.-parent formations, the advantage for relocating entrepreneurs was non-taxation in Israel if selling the shares of the offshore corporation.

2. Foreign Holding Companies:

Foreign holding companies helped Israeli entrepreneurs to avoid Israeli taxation on “Sellouts” without relocating. One popular formation was the U.S. LLC. The differing treatment of LLC for Israeli and U.S. tax purposes provided tax-reduction opportunities. Income derived by LLCs was not subject to Israeli tax if the LLC was not “managed and controlled” in Israel.

281 ALTER & CALIF, supra note 32, para. 6.4.11.1. See also Doron Herman, Israel 2002: Year in Review, 2002, footnote 6 and accompanying text, available at LEXIS WTD 251-13 Tax Analysts Worldwide Tax Daily. (“To date, that later provision has seldom been invoked by the Israeli tax authorities. It may be used, nevertheless, to tax gains from sales of shares in "Israeli-related" companies (foreign companies with little or no business activity whose main assets are shares in an Israeli subsidiary”).

282 Herman, supra note 165, para. II-B.

283 Id.

284 Id., para. II-C.

285 Id.

286 Id.

287 ALTER & CALIF supra note 32, at 91, para. 34. See also Doron Herman, Israeli Tax Authorities Issue Guidance on U.S. LLC’s Foreign Tax Credit, 2002, at 2, available at LEXIS WTD 4-2 Tax Analysts Worldwide Tax Daily. See also Chaifetz, supra note 2, para. 4.1.

288 See sources cited id.

289 Id.
Also, dividends to the shareholders were not taxed in Israel provided that the income was not “first received” in Israel.  

Another common holding vehicle for holdings of Israeli entrepreneurs in Israeli startups was offshore companies. A parent company was established in one tax haven that owned companies in another companies (“double havens”). A sale made by the tax haven was not subject to tax if the companies were not “management and controlled” from Israel.

The Netherlands was considered to be also an excellent tax haven due to its exemption from corporate tax rate and also because of “friendly” taxation rule in the tax treaty with Israel. In the Netherlands corporations are not subject to income tax if a “participation exemption” regime applies, and if the certain conditions are met. Dividends received from Dutch subsidiaries by an Israeli parent company ‘effectively’ enjoyed a tax exemption. Since, in most cases such domestic dividends were excluded from the tax base in Israel the same result applied to the case of Dutch Subsidiary and Israeli parent. A typical structure was a “target” company registered

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290 In few court the court interoperated the term “received” in Israel in Section 2 of the Ordinance to apply only to income “first received” in Israel and not to income received abroad and later on remitted to Israel. Consequently, deposit of foreign source dividend into a foreign bank account was sufficient to “break the connection”. See ALTER & CALIF supra note 32, para. 34.

291 Temkin, supra note 26.

292 Id.

293 Id.

294 Agron, supra note 39.

295 Article 13(1) of the Corporate Income Tax Act, "Wet op de vennootschapsbelasting, 1969” (Wet Vpb 1969). The subsidiary of the company subject to Dutch corporate income tax, the Netherlands company owns at least 5 percent of the nominal paid-up share capital of the subsidiary, the shares in the subsidiary are not held as inventory”, in the case of a nonresident subsidiary, the subsidiary is subject to income tax imposed on its profits by the state in which it is a resident, and the holding of shares of the subsidiary by the Netherlands company is not considered a "passive portfolio investment”.

296 Article 26B of the Israel-Dutch double tax convention provided that dividends paid by a company resident of the Netherlands to a company resident in Israel, which owns at least 25% of the voting power of the company paying the dividends, is excluded from the tax base in Israel if such dividends are excluded from the tax base by Israel tax laws in case both companies had been resident of Israel.

297 Id.
in the U.S. owned by a Dutch company that in turn is held by an Israeli company.\(^{298}\) The Dutch company, which has a “participation exemption” in Holland, paid no capital gains tax on the sale in Holland.\(^{299}\) When the Dutch company paid a dividend to the Israeli company that controlled it, it pays a 5% tax in Holland, while the Israeli company paid no additional tax in Israel.\(^{300}\) As a result, 95% of the proceeds of the sale of shares of the target company come to Israel, without the State of Israel receiving any tax revenue from the sale!\(^{301}\)

B. Tax Consequences of Technology Sale:
As noted, a study by Herman illustrates that there were three common formations for Israeli technology startups.\(^{302}\) The three variants entailed deferent tax consequences not only to the shareholders (as presented above), but also to the companies involved.

The U.S. parent-Israeli subsidiary formation came in three variants, differing in the scope of activities undertaken by each member of the group.\(^{303}\) A common feature of all three formations was that the parent of the group was a U.S. corporation.\(^{304}\) One main difference between the three main variants was the ownership of the IP asset.\(^{305}\) In one variation the IP was located in Israel, while in the other two the IP was located in the U.S or offshore-related corporation.\(^{306}\)

Locating the IP in Israel enabled the Israeli subsidiary to enjoy the tax incentives of “approved enterprise”, and allowed the group to allocate a larger share of its income to Israel, where it was

\(^{298}\) Agron, supra note 39.

\(^{299}\) Id.

\(^{300}\) Id.

\(^{301}\) Id.

\(^{302}\) See infra, para. VI-A-1-ii.

\(^{303}\) Herman, supra note 165, para II-A.

\(^{304}\) Id.

\(^{305}\) Id.

\(^{306}\) Id.
subject to a significantly lower tax rate.\textsuperscript{307} The downside of the structure was high tax burden in Israel if either the technology was sold.\textsuperscript{308} In the two other formations the Israeli subsidiary acted as an R&D sub-contractor.\textsuperscript{309} To qualify as an “approved enterprise” under the Law for the Encouragement of Capital Investments the Israeli subsidiary would have to bill the principal (be it a U.S. or offshore entity) on a “cost+12.5\%”.\textsuperscript{310} In both cases, the intellectual property belonged to a foreign company, as does the revenue from selling and applying it.\textsuperscript{311} Locating the IP in offshore corporation allowed a sale of the IP to be taxed at the lower capital gains tax rates in the offshore jurisdiction.\textsuperscript{312} If the IP was an asset of the U.S.-parent corporations, situation investors prefer for non-tax reasons, a significant share of the group's income had to be allocated to the parent and be subject to the U.S. corporate tax rate.\textsuperscript{313}

A second formation was the Israeli Parent-U.S. Subsidiary.\textsuperscript{314} This formation allowed the company to maximize its use of the “approved enterprise” benefits and allocate most of the income to Israel, where it was subject to an effective tax rate of as low as 10\%.\textsuperscript{315} The main detriment to using this structure was that Israel imposed a tax on sale of the IP asset.\textsuperscript{316}

A third possible formation was the Offshore-parent.\textsuperscript{317} Under this structure, a parent located in an offshore jurisdiction owned the IP, and subcontracted the R&D and production activities to

\textsuperscript{307} Id.
\textsuperscript{308} Id.
\textsuperscript{309} Id.
\textsuperscript{310} Id.
\textsuperscript{311} Id., para. II-A
\textsuperscript{312} Id.
\textsuperscript{313} Id.
\textsuperscript{314} Id., para. II-B.
\textsuperscript{315} Id.
\textsuperscript{316} Id.
\textsuperscript{317} Id., para II-C.
the Israeli subsidiary on a cost-plus basis.\textsuperscript{318} Sales were made by the U.S. subsidiary, possibly under a “cost-plus” arrangement as well.\textsuperscript{319} The benefit of the structure was the low tax imposed by the offshore jurisdiction on the income allocated to the parent including gain from a sale of the IP.\textsuperscript{320} On the other hand, the minimal 12.5%-“cost plus” agreement exposed the offshore-parent the risk of “re-domiciliation”, i.e. a claim that the offshore company is “tax-resident” in Israel because it is domestically “managed and controlled.”\textsuperscript{321}

VII. Taxing Overseas Income:
A. The Rabinovitch Reform:
1. Transition to a Personal Tax Method:
The Rabinovitch Committee proposed that Israel adopts a residence-based income tax system.\textsuperscript{322} The Committee pointed out that residence-based regime could reduce loopholes that make avoidance of Israeli tax possible.\textsuperscript{323} One of the most prominent changes introduced, as part the reform was a shift in the definition of the international tax base for Israeli tax purposes.\textsuperscript{324} Amendment No. 132 transforms Israel's tax base by imposing taxation on Israeli residents' worldwide income.\textsuperscript{325} The intent of this legislation was to discourage residents from moving their business activity and investments outside of Israel based solely on tax considerations.\textsuperscript{326}

Other related amendment was concerning the tax rate on dividends received from Dutch company. Post the reform, dividends received by an Israeli corporate shareholder from foreign

\textsuperscript{318} Id.
\textsuperscript{319} Id.
\textsuperscript{320} Id.
\textsuperscript{321} Id.
\textsuperscript{322} Rabinovitch Report, at 79, 80.
\textsuperscript{323} Id.
\textsuperscript{324} Id.
\textsuperscript{325} See amended article 2 of the Ordinance.
\textsuperscript{326} Blue Print, section 2.
Dutch subsidiary will be subject to Israeli tax at 25% rate, subject to a foreign tax credit in appropriate circumstances.327

2. Amending the Definition of Israeli “Resident”:
The Committee proposed that an individual’s income tax residence will be based on an individual’s “center of life” test.328 The Committee also recommended that definition of a “resident” in respect to corporations be changed to include corporations incorporated in Israel.329 The Report indicates that the recommendation to include an incorporation criterion was with a determination to have a definition, which has been applied in the tax laws of most Western countries, and since this test is clearer than the registration and principal activity criterion contained in the Israeli Income Tax Ordinance before amendment 132.

The Committee’s recommendation were imported into the bill and resulted in an amendment of the definition of “resident”.330 The “center of life” test was adopted as a major test, meaning an individual would be considered a resident of Israel if at the taxable year his life center is in Israel.331 Amendment No. 132 also modifies the definition of a “resident” concerning a body of persons.332 The first part of the definition has been modified, so that the only test thereby is the test of incorporation.333 The second alternative remained unaffected by the law.334 As a result, a body of persons will be considered a resident of Israel if one of the following is fulfilled: it was

327 See amendment to section 126(b) to the Ordinance.
328 Rabinovitch Report, at 80-81.
329 Rabinovitch Report, at 82.
330 Blue Print, article 1.
331 Sections 1(6)(a)(1)(a) through (e) of the Ordinance.
332 Blue Print, article 1.
333 See “new” definition of “resident” in respect to corporations in section 1 of the Ordinance.
334 Id.
incorporated in Israel, i.e. associated according to the Israeli law, or if the “control and management” of its business is in Israel.  

3. Expansion of the CG Tax Source Rules: 

*Amendment No. 132* introduced a new rule with the purpose of broadening the Israeli tax base by expending the definition of Israeli source capital gain income. The new Section 89(b)(3) of the Ordinance establishes that income is deemed “incurred” or “derived” in Israel if either the alienated asset is in Israel; the asset is outside of Israel but is a right, direct or indirect, to an asset in Israel - with regard the portion of the consideration derived from the asset in Israel; the asset is a share or a right to a share in an Israeli body of persons; the asset is a right in a foreign body of persons, that owns a right, direct or indirect, to an asset in Israel, with regard the portion of the consideration derived from the asset in Israel.

4. Controlled Foreign Corporations Tax Regime: 

The *Rabinovitch* Committee recommended that Israel will adopt a CFC regime. The declared policy goal of the Committee in proposing the CFC rule is the prevent taxpayers from shielding passive income from Israeli tax by storing it in a foreign company.

In the spirit of the recommendations, a CFC regime rule was introduced. Under the new regime, Israeli shareholders are subject to tax on there pro rata share of earnings of a CFC. A foreign corporation is a CFC if, during the taxable year, more than 50% of its stocks are held by

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335 See amended definition in Section 1 of the Ordinance.

336 See *Rabinovitch Report*, at 96. See *Blue Print*, articles 27,28.

337 See Section 89(b)(3)(a) through (d) of the Ordinance.

338 *Rabinovitch Report*, at 98 - 103.

339 Id., at 98.

340 *Blue Print*, article 25.

341 See Section 75B(a) of the Ordinance. For coverage of the new rule, see Income Tax Circular 5/2003, ”The Income Tax Reform -Taxation of a Controlling Shareholder in a Controlled Foreign Company,” 30 May 2003 [Hebrew].
an Israeli shareholder, and most of its income consists of passive income.\(^\text{342}\) For purposes of the new Israeli CFC rules, an Israeli shareholder is defined as a resident of Israel owning at least 10% of the CFC’s stock.\(^\text{343}\) The new provision applies only to corporation established at low tax jurisdictions that are defined as tax jurisdiction where the applicable tax rate on the passive income is less then 20%.\(^\text{344}\)

5. Exit Charges on Capital Assets:
One of the new taxes introduced by the *Rabinovitch* reform that pertains to high-tech emigration is an “exit tax”.\(^\text{345}\) The Report of the *Rabinovitch* Committee indicates that the introduction of emigration tax rule was with the intent to provide an answer to the situation where a resident of Israel owns an asset located outside Israel, becomes an overseas resident, and only then sells the asset.\(^\text{346}\) In this scenario, there would not be tax liability in Israel under the normal CG tax rules, as the seller is an overseas resident and the asset sold has no connection with Israel.\(^\text{347}\)

Article 100A is aiming to correct this failure. The general rule of the new provision establishes that “an asset of an individual residing in Israel who ceases being a resident of Israel will be considered sold on the day preceding his the day he ceased to be a resident of Israel”.\(^\text{348}\) Considering that tax is imposed on a deemed sale, one of the most difficult aspects of taxpayer compliance is funding the payment of tax.\(^\text{349}\) In recognition of that fact, the provision establishes a presumption that a person who failed to pay the exit tax on the required date shall be viewed as

\(^{342}\) Section 75B(a)(1)(d) of the Ordinance.

\(^{343}\) Section 75B(a)(3) of the Ordinance.

\(^{344}\) Section 75B(a)(1)(c) of the Ordinance.

\(^{345}\) Section 100A of the Ordinance.

\(^{346}\) *Rabinovitch Report*, at 109.

\(^{347}\) *Id*.

\(^{348}\) Section 100A(a) of the Ordinance.

having requested a deferral of the payment. In this case, there is no need for payment of the tax at the time of change of residency, but rather at the realization date. On the date of “actual sale”, the tax will be paid for the part of the gain that is proportional to the term of the possession of the asset while the seller was tax-resident of Israel.

B. Evaluation of the Recommendations:
This study illustrated that, since 1998, Israeli startup companies have “internationalized” by moving key functions to key markets, in particular to the U.S.; that model included transfer of marketing sales functions, legal structure, executive power (President, CEO, CFO, etc), and technical support units to the U.S.; also, a complementary action was the establishment of overseas companies through a direct, or indirect holdings; if adopting this model, the activities of the “portfolio” company (e.g., Delaware corporation) in Israel were restricted to research and development; the results of the R&D, i.e. the intellectual property, belong to the foreign company, as does the revenue from selling it; Israel was left with taxing the income of the R&D staff working in Israel, plus negligible revenues determined on the basis of the Israeli subsidiary’s expenses (the “cost-plus” method); as many entrepreneurs moved to the U.S. prior to an “exit” (i.e., sale of the

350 Section 100A(b) of the Ordinance.

351 Id.

352 Section 100A(d). The gain in this case will be calculated from the original day of purchase to the actual day of sale as follows: The first step is to compute the excess of fair market value on the date of actual disposition over the taxpayer's basis in the asset. That excess then should be multiplied by a fraction, the numerator of which is the number of days from acquisition of the asset until the deemed sale date, and the denominator of which is the number of days from acquisition of the asset until its actual sale by the taxpayer.

353 See infra para. IV-B-2.

354 Id.,

355 See infra paras. VI-A-1-i, VI-A-2, VI-B.

356 See infra paras. VI-A-1-i.

357 See infra para. VI-B.

358 Id.
stocks), Israel was also unable to levy tax when they sold their holdings.\footnote{359}{See infra para. VI-A-1-i.}

The \textit{Rabinovitch} Committee took upon itself to correct the distortion in the investment structure in Israeli companies set up by Israeli entrepreneurs; the new set of international tax rules could apply to international high-tech formation, and enable the authorities to levy Israeli tax in some cases where at the past their efforts were doomed to fail; e.g., the residence-based system would reduce loopholes that make avoidance of Israeli tax possible by taxing foreign source dividends;\footnote{360}{ALTER & CALIF, supra note 32, at 93 para. 4.1., p. 68 para..2.6.25,} the CFC rule should dismantle the advantage in setting up complex holding structures;\footnote{361}{Agron, supra note 39.} and, the imposing emigration charges, a regime that exists in tax systems of many countries,\footnote{362}{See Goldberg, Sanford H.;Vann, Richard J.;De Broe, Luc;Ward, David A.;Fontaneau, Pierre-Marie; Legall, Jean-Pierre;Strobl, Jakob; Killius, Juergen; Giuliani, Federico; Maisto, Guglielmo; Miyatake, Toshio;Ellis, Maarten J.; Van Raad, Kees; Wiman, Bertil; Torrione, Henri; Avery Jones, John F.;Roberts, Sidney I., Taxation Caused By or After Change of Residence, Part I, 21 Tax Notes Int'l 643, para. II-A-1.} could also be helpful in taxing “Sellouts” post-emigration.\footnote{363}{Asher, supra note 39, para.6.7.2. See also, Joel Lubell, Israel Implements Exit Tax, 2002, at 3, available at WTD 26-8 LEXIS Tax Analysts Worldwide Tax Daily. See also Hary Kirsh, The New Exit Tax: Section 100A, Misism TZ/6- A/53, 2003 [Hebrew], para. A., para D.}

Nevertheless, despite the momentous reforms of Israel’s tax system, taxing “High-Tech Sellouts” post-2003 and the \textit{Rabinovitch} reform is yet a difficult task; first, since some of the rules are incomplete, and second, since domestic tax reforms, and a change in local tax rule could have only a limited impact on taxation of high-tech transactions as this area is covered by a treaty law.

In respect to the first factor, Israel should consider a regime similar to the newly-adopted CFC, but that can also apply to corporation that are not “controlled” by Israelis (i.e., less then 50% Israeli shareholders),\footnote{364}{See Shenhave, supra note 95, at 2.} and to adopt an emigration tax regime that could apply to tax post-
relocation built-in-gain, e.g., an extended tax liability regime (‘‘trailing tax’’), that is assessed at
the time income is actually realized.365

As to the second factor, taking into account the business model of Israeli startups presented in
this study, and since the majority of the economic ties of Israeli ventures are in foreign country,
e.g., place of incorporation, place of ownership of IP, residence of the seller, this country, in
many cases the U.S., would have, under common DTC rules regarding taxation of CG income,
the first right to tax the income, and in some cases an exclusive right; Israel’s right to levy tax on
“Sellouts” would be secondary, and could not be effective in terms of tax collection.

VIII. Post-2003 Reforms:
Following the Rabinovitch reform, Israel took additional steps to slowdown corporate flight out
of Israel, and also implemented additional tax rules that could enable taxation of international
transactions. The legislation included an overhaul of the Encouragement of Capital Investment
Law-1959, revised under the, *Amendment No. 147* to the Income Tax Ordinance (New Version),

The legislation was sourced on a committee report recommended further material changes to
virtually every aspect of the Israeli tax system, within the framework of a five-year plan.368 The
report states that the main goal of the present reform is “adapting the Israeli tax system to the global
(tax) competition.”369

365 Several countries, including the Canada, Australia, Germany, Sweden, Norway, Spain, Italy, United States, the

366 *See* Law for Amending the Israeli Income Tax Ordinance (*Amendment No. 147*), 2005, Israel’s Law Books 2023,
August 10, 2005, at 766.


368 *See* Doron Herman, Israel Puts Competitiveness High on Tax Reform Agenda, 2005, at 1,2, available at LEXIS

369 *Id.,* at 4.
In the spirit of the recommendations the Knesset passed on July 25, 2005 a five-year tax reform plan; the most notable changes in this plan are: gradual reduction of individual’s income tax rate from 49% to 44% by 2010; reduction of capital gains tax rates to 20%, capital gain tax exemption that apply to foreign investments; “participation exemption” tax regime for foreign investors that establish companies in Israel; and an amendment to the Law for Encouragement of Capital Investments (1959) and the introduction of a new incentive for companies that establish an “approved enterprise” in Zone A (“Ireland Track”).

Continuing the tax-base-broadening theme that dominated the 2003 reform the proposed plan introduced several anti-abuse provisions that may be applicable to aggressive international tax planning scheme; Amendment No. 147 to the Ordinance added new chapter governing trust taxation. Other anti-abuse-provision added in the 2005 reform is a rule intended to combat


371 See amended section 121(a) of the Ordinance.

372 See amended section 91(b)(1) of the Ordinance.

373 Section 97(b3) of the Ordinance, enacted as part of Amendment No. 147, provides for a tax exemption for residents of Israel’s treaty partner countries, on the sale of securities otherwise taxed by Israel, provided the securities were purchased between July 1, 2005 and December 31, 2008 or sale of foreign corporation that the majority of its assets are directly or indirectly rights for assets located in Israel. The main intended beneficiaries of the extension would be U.S. investors, as the Israel-United States income tax treaty is one of few that does not completely exempt U.S. residents from Israeli tax on their Israeli capital gains.

374 See newly-added Section 67B of the Ordinance. Within the framework of the tax regime, various benefits are granted, e.g. tax exemption in respect income of a “holding company”; and benefits to dividends distributed by a Holding Company to its shareholders. The legislation, which is designed to encourage foreign investors to establish holding companies in Israel, seeks to make the country’s domestic system more competitive with similar regimes in Europe.

375 Amended Section 51 of the Law for the Encouragement of Capital Investment-1959 [Hebrew]. See Law for the Encouragement of Capital Investment, 5719-1959, Amendment 60, April 11, 2005 [Hebrew], amended as part of Economic Policy Law-2005, supra note 369. The “Ireland Track” provides for a 10-year term with a company tax rate of 11.5%, and a tax rate of 4% upon the dividend distribution to foreign investors with no further company tax implications arising when distributing the dividends. Consequently, in the case of foreign shareholders, the aggregate company tax and withholding tax burden shall be 15%. For review of this track see Income Tax Circular 2/2006, Professional/Legal Section Regarding: Amendment 60 to The Law for the Encouragement of Capital Investment, published July 12, 2006 [Hebrew].

376 See newly-added Section 75C to the Ordinance. Trusts are taxable according to the grantor’s residence, as opposed to the residence of the beneficiaries. The corpus of the trust and the income it derives would be attributed to the grantor; hence, trusts created by nonresident grantors generally would be outside the scope of Israeli taxation. Distributions from the trust would be taxed much like direct transactions between the grantor and the beneficiaries:
“aggressive tax planning”;377 capitalizing on recent experiences in other countries, most notably the United States and the United Kingdom, the new anti-abuse regime mandate disclosure by taxpayers that apply a tax planning strategy that is identified by the authorities (in a published list) as “aggressive”. 378

In 2005, the Company Law-999 was also amended;379 the reform was initiated soon after the final approval of the law in 1999; 380 the official explanation accompanying the bill was that no similar legal provisions exist in Delaware's General Corporation Law.381

IX. Can Israel Tax "Sellout" Post 2003 and the Rabinovitch Reform?
A. Why Israel still CAN NOT Tax "Sellouts":
The Rabinovitch Committee recommendations for the Israeli high-tech sector, imported into the Ordinance via Amendment 132, together with the 2005 tax reforms, provided an important and much-needed revision of the tax regularity in Israel. The amended Ordinance offers a better, clearer and more coherent tax regime for Israeli startup ventures and foreign investors; the “Carrot” component of the reforms marks an historic step towards reaching a point of tax-neutrality with

Gifts to close relatives generally would be tax-exempt. Furthermore, a trust settled by a foreign grantor that subsequently immigrates to Israel would be eligible for the same exemptions and incentives as for new immigrants.

377 See new Section 131(g) of the Ordinance.

378 Failure to report the use of an “aggressive plan” would be a criminal offense, and plans that are found to be "artificial” could result in punitive fines.


381 See Yossef Gross, Membership on the Board of Directors - Not only a Respected Way to Retire, Globes Electronic Archive, Mar. 23, 2004. For review of the bill see Yael T. Ben-Zion, The political Dynamics of Corporate LEGSLATION: lesson from Israel, 11 Fordham J. Corat & Fin. L. 185, 2006, at 15,16. Among others, it restricts the contents of the doctrine of veil piercing and annuls its application to managers and directors, further erodes the prohibition of the chairperson from acting as the CEO of the company, extends the list of issues that the board may delegate to committees, narrows the definition of material private placement that requires special approvals, imposes legal fees of a plaintiff in a derivative action on the company, further reduces the limitations on the individuals who are qualified to act as independent directors because of their relation to the company but at the same time it sets certain professional qualifications for such directors, excludes additional situations from the definition of a “personal interest” of a manager or director that necessitates a special approval mechanism; it relieves directors' duties in the case of a prohibited distribution; and it modifies certain issues of mergers and acquisitions.
foreign competitive markets; Israel's new, post-2003 tax environment, may attract Israeli startups and managements, and encourage them to stay in Israel, thus enable taxation; the elements included in the “Stick” component will also play a key role in the mission to levy tax on high-tech transactions; the new set of modern international and anti-avoidance rules will apply to aggressive international tax schemes, and may enable the authorities to levy Israeli tax in many cases of emigration where at the past their efforts were doomed to fail.

Yet, despite the momentous reform of Israel’s tax laws, the underline policy of the reform to expend the Israeli tax base (with respect to “High-Tech Sellouts”) would not be accomplished. Post 2003 observations of the phenomenon of “Sellouts” and emigration support my findings; interviews that I have conducted with leading practitioners in Israel in the years 2008, 2009 directed me to the conclusion that high-tech emigration has not discontinued; recent observations also indicate that “Sellout” is still the preferred “exit” of Israeli technology ventures; since this study demonstrated that taxation post relocation could be a hard task (despite the new rules of the reform), the inevitable conclusion of this paper is that Israel, an incubator for world-class technological innovations, would continue to struggle levying tax on high-tech transactions.

The realistic remedy for Israel's difficulties to levy tax on "Sellouts" is one that would discourage emigration; taxation rules in the modern era could not be an adequate respond to many cases of emigration, particularly to "treaty countries." In that context, one may - why, following the Rabinovitch reform, foreign investors and Israeli entrepreneurs still prefer Delaware incorporation and Silicon-Valley headquarters over Jerusalem and Tel-Aviv? For over a decade this dilemma eluded the Israeli public; Aliba de the conventional wisdom and accepted notion in Israel, Israel's faulty tax and law surrounding for high-tech ventures was the chief reason for high-tech relocation; this thesis is now proven to be incorrect!

In the absence of clear tax or legal reason for emigration this study calls to consider, by default, the notion that, not (only) tax considerations, but business considerations drove Israeli ventures out of Israel; this somewhat "surprising" conclusion was presented in studies by Carmel, Rock and Bainerann (presented in Chapter IV of this study), already in the year 2001, hence this agenda was largely ignored; the findings and methodology in this paper provides a retrospective
evidence that the thesis presented in these 2001-papers is correct. Accordingly, in paragraph 2 of this Chapter I will present correlated plans that should accompany the Rabinovutch reform, and could assist in the task of stopping high-tech emigration, thus, in taxation of "Sellouts."

2. How to Stop Emigration of Israeli Startups:
2.1. Free Export Processing Zone (FEPZ):
A proposal that the Israeli government should look into is a plan presented by Ron Tira, Director in the U.S. Amidex Fund in the year 2001. Generally speaking, Tira proposed to revive the Free Export Processing Zone (FEPZ), a project that was initiated in 1994 and that has fallen victim to governmental “red tape” policy and bureaucracy. He offers to set-up free technology zones, as a way to boost Israel’s competitive edge and as a measure to stop technology startups’ emigration.

The FEPZ is not unique as a concept. The first free zone started in Taiwan in the '60s. There are now between 120 and 150 special free-market zones in 70 countries. On June 20, 1994, Israel joined these countries as the Israeli parliament approved the creation of Israel's first free-export processing zone (FEPZ). The plan was to create FEPZ that covers about 500 acres located near Beersheba in the Negev desert. Soon afterwards, the bill passed more than 100

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382 See Ron Tira, Adv. Bye-Bye-Tech; Globes [online] - Israel's Business Arena July 06, 2000. The article was published in respond to the Lucent-Chromatis deal and to express the frustration of the publishers of the growing phenomenon of high-tech emigration and the failure of the Israeli government to attract entrepreneurs to establish their companies Israel.

383 Id.

384 Id.


386 Id.

387 Id.

388 Id. It began as an offer from a group of Jewish-American venture capitalists that Israel quite literally couldn't afford to refuse”.

389 Id. When the law was published the intentions were that it will operate as a privately run, semi-autonomous laissez-faire state. Israel was assumed to award the rights to serve as concessionaire in the zone. The winning investors had to purchase the land and be responsible for providing all infrastructure and services. In return, they would have got to lease the land for a profit. This means roads, water, sewers, electricity, and telecommunications, as well as police and fire protection, would have been privately provided-another bonus for potential tenants. Backers expect the zone to be able to offer the lowest telecommunications rates in the world.
companies have expressed interest in locating in the zone. These companies would have been benefit from exemptions from tariffs, personal and corporate income taxes, and a whole host of regulations. Also, they would have benefit from the fact that Israel is the only country in the world to have signed free-trade agreements with both the United States and the European Union, a fact that would have given companies in the zone a competitive advantage abroad. Unfortunately, this plan has never been implemented.

*Tira* suggests, based on the 1994 Free Manufacturing Regions Law, and subject to necessary adjustments and changes, that exporting technology companies would be offered a competitive living space, in terms of both taxation and regulatory aspects.

He notes that the taxation of the FEPZ should be based on separation between the routine management of the venture, which should be entirely tax-exempt, and the actual derivation of fruits (exit), which should also be taxed at a competitive rate. He suggest that a tax rate of 15% should be set for capital gains derived from the private or stock exchange sale of shares and a similar rate of dividend tax should apply to profits actually distributed.

Such a tax policy, *Tira* believes, will encourage companies to incorporate in Israel and engage there, not only in R&D, but also in manufacture, marketing and customer support. *Tira* emphasizes that since the high-tech industry's gravity and profit center is at exit point, the proposed tax structure will encourage technology companies to make that exit in Israel, which will tax the transaction at a rate lower than the 15% be imposed in the US, for example.

390 *Id.*
391 *Id.*
392 *Id.*
393 *Id.*
394 *Id.*
395 *Id.*
396 *Id.*
397 *Id.*
Tira also comments on the fact that Israel will have to waive both sovereignty and taxes, but the waiver is merely theoretical.\textsuperscript{398} He notes that technology companies in any case pay most of their taxes to Uncle Sam, rather than to Israeli authorities.\textsuperscript{399} He also adds that under the proposed method, Israel will benefit from the exit and the dividends of the more mature companies.\textsuperscript{400} He also mentions that Israel will benefit by engaging workers and contracting with suppliers, as the wealth of the latter percolates down into business circles such as real estate, finances, consumer goods and other things.\textsuperscript{401}

\textit{Tira} recommends that since the activity of FEPZ companies will be restricted to exports, they can be placed beyond the reach of local anti-trust laws and exempted from import and export licensing requirements (between the FEPZ and other countries, but not vis-à-vis Israel).\textsuperscript{402} He also proposes that concessions should also be instituted in planning and building laws, while the FEPZ should be exempt from expansion orders and collective agreements, thus making it easier for foreign workers to be engaged.\textsuperscript{403}

2.2. No More \textit{Dot.Coms}:

Already at the beginning of the millennium scholars acknowledged that the “Sellout” model has negative ramifications for the Israeli industry in the long run.\textsuperscript{404} In 2001-study, \textit{Lesha Chaifetz} noted that as more of the money behind Israeli projects comes from the United States, some fear that the country's high-tech industry will lose its unique traits and become “Americanized.”\textsuperscript{405} Chaifetz added that:

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{398} Id.
\item \textsuperscript{399} Id.
\item \textsuperscript{400} Id.
\item \textsuperscript{401} Id.
\item \textsuperscript{402} Id.
\item \textsuperscript{403} Id.
\item \textsuperscript{404} See Lesha, supra note 39, para. 3.1, para 3.2.
\item \textsuperscript{405} Id.
\end{itemize}
\end{footnotesize}
"The primary concern, however, is that as Israeli companies are bought up by the likes of Intel and Motorola, Israel loses out on having an Intel or Motorola of its own. Instead, the Israeli company becomes an R&D subsidiary of a larger company, technology ownership is diffused, and profits and IP flow out of Israel and directly into the United States. Moreover, by selling at an early stage, Israelis have no means with which to learn the management, sales, and marketing skills needed to sustain a fully-developed industry." (Lesha Chaifetz, 2002)

Continuing this line of thinking a 2001-study by Joel Bainerman calls to cease the where Israelis establishing Dot.com companies and instead build long-term enterprises with headquarters, marketing and sophisticated production facilities that will be located in Israel.\footnote{See Joel Bainerman, Broken Promises: The Rise and Fall of Israel's Technology-based Industries, 2001, available at http://www.joelbainerman.com/articles/broken_promises.asp, (last visit March 2008).} Bainerman acknowledges that that over the years (1998-2001) the Israeli high-tech sector has made billions from selling start ups, but if fears that the entire high tech industry plans to build itself on founding and selling or floating start ups, will be prove to be very fragile.\footnote{Id.} Hence, he argues that many of the startup success stories of the last three years (1998-2001) were not about real creation of technological innovation, but about the Wall Street bubble.\footnote{Id, para. titled "The Next Phase- No More Dot-Coms, Please", part of the Chapter titled, "EPILOG".}

Accordingly, Bainerman introduces a detailed-plan where he calls,\footnote{Id, Chapter Titled: "What Can We Do?"} to end the encouragement of more start ups and end financing of R&D expenditure for small and large companies alike;\footnote{Id.} to change the tax code and offer a tax incentive for Israeli high tech startups to merge with each other, and with European companies;\footnote{Id.} to offer tax incentives for Israeli companies to invest in startups which come from within their own company, or in Israel, rather than having the

\footnote{Id.}
entrepreneur go to the venture capitalist for funding;\textsuperscript{412} to give an incentive for capital available for investment in companies that are not start ups or not in high tech, but nevertheless provide significant benefit to the economy;\textsuperscript{413} to subsidize (finance, but not operate) seminars, efficiency experts, manufacturing consultants, and other services to companies, in order to improve the quality and efficiency of Israeli enterprises and manufacturing techniques;\textsuperscript{414} and to refocus Israeli companies away from the US towards the European market.\textsuperscript{415}

X. EPILOGE:

A decade after the Mirabilis “Sellout”, and, despite two major tax reforms, Israel still CAN NOT tax "High-Tech Sellouts." This list provided another clear evidence that the road to taxation goes through stopping high-tech emigration; hence, the formula to attract Israeli entrepreneurs to establish their companies in Israel and keep their headquarters, marketing and production facilities in the country is yet to be found.

This list demonstrates that emigration of the high-tech sector out of Israel during the past decade was not only tax motivated (as many believed), but was also driven by economical and business forces; regrettably, the Israeli government failed to grasp this when the problem was still in its infancy.

The clock cannot be turned back but part of the past-damage can still be contained; it requires a determined decision on the part of the government to deal with the subject as a matter of top national priority; considering Tira's plan ("FEPZ"), or Bainerman's proposal ("No More Dot.coms"), both presented above, would be an excellent starting point.

\textsuperscript{412} Id.
\textsuperscript{413} Id.
\textsuperscript{414} Id.
\textsuperscript{415} Id.