

Israel

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TAXES ON CORPORATE LENDING/BORROWING

1. What are the main corporate taxes potentially chargeable on interest and other amounts receivable under a loan? In each case, explain briefly:

- Its key characteristics.
- How it is calculated.
- How it is triggered.
- The applicable rate(s).

Corporate tax

Generally, corporate lenders are taxed on their taxable income resulting from a loan under the Income Tax Ordinance [New Version] 5721 - 1961 (ITO). Costs and income are usually reported using an accrual basis (that is, a method to report income when earned and expenses when incurred). The company's taxable income is usually based on the financial reports prepared by the company in accordance with Israeli generally accepted accounting principles.

Figures are submitted to the tax authorities and adjustments are made in accordance with relevant tax laws to determine the taxable income. Certain companies can calculate and report their taxable income on a cash basis (a method to report income when received and expenses when paid). These companies are usually those without inventory (in general, any movable or real estate sold in the ordinary course of business, or which would be so sold if it were ripe or if its manufacture, preparation or construction had been completed, and any material used in the manufacture, preparation or construction of that asset) such as professional companies (for example, law firms). The taxable income is the lender's profits from the loan minus any deductible expenses.

There is no specific definition of interest in the ITO (although the term "debentures interest" is defined (*section 1, ITO*)). The courts interpret interest widely and usually include linkage differentials and/or exchange rate differentials (*see Question 2*). The term "linkage differentials" is defined as any amount added to a debt or amount of claim in consequence of linkage to the currency exchange rate, the consumer price index or some other index, including exchange rate differentials (a limited definition exists for tax exemption purposes which is relevant, mostly, for individuals) (*section 1, ITO*). "Exchange rate differentials" is defined as an amount added in consequence of a change in the currency exchange rate to the principal of a loan, which is a foreign currency deposit or a loan repayable in

foreign currency (*section 1, ITO*). Any future references to linkage differentials include exchange rate differentials.

Generally, there are two main types of interest income for corporate tax purposes:

- **Business income.** This is the income of lenders, the core business of which includes lending money (for example, banks and other financial institutions) (*section 2(1), ITO*).
- **Passive income.** This is the income of lenders, the business activities of which do not involve lending money (*section 2(4), ITO*).

This classification may have consequences, for example, for setting off losses against income (if the interest income is classified as business income then the lender can set off any sort of loss against such income).

The corporate tax rate on interest income is generally the regular corporate tax rate, which is 29% for the 2007 tax year and a lower tax rate for subsequent tax years (up to a maximum rate of 25% for the 2010 and subsequent tax years).

The borrower must usually withhold the tax (*see Question 4*).

Value added tax (VAT)

If the lender is registered as an authorised dealer (basically, a company, other than a non-profit organisation or a financial institution, that sells assets or provides services in the course of its business and that is lawfully registered with the VAT authorities) for VAT purposes, the interest on the loan may also be subject to VAT (the current rate of VAT is 15.5%) (*sections 1 and 2, Value Added Tax Law 1975 (VAT Law)*). The lender usually collects VAT from the borrower and transfers it to the VAT authorities, after making any deductions for its own VAT payments (in certain circumstances).

The taxable base for VAT purposes is the interest and other amounts (for example, linkage differentials) receivable under the loan.

If an authorised dealer lends money to a financial institution, it is exempt from VAT (*section 31(5), VAT Law*).

If the lender is registered as a financial institution for VAT purposes, it must pay a wage-and-profit tax (instead of VAT) on the loan (*section 4(2), VAT Law*), and it cannot receive a refund for input tax (that is, VAT it pays). Financial institutions are subject to wage-and-profit tax at the rate of 15.5% of wages they pay and profit they earn (the terms "wage" and "profit" are defined in section 1 of the VAT Law).

Non-profit organisations are not subject to VAT and cannot receive a refund for input tax. However, non-profit organisations pay wage tax at the rate of 7.5% on wages paid to their respective employees and employers' tax at the rate of 4% on salary payments made to their respective employees.

2. What corporate tax reliefs are available for borrowing costs (including interest and other amounts payable under a loan)? In each case, explain briefly:

- Its key characteristics.
- How it is calculated.
- How it is triggered.
- The applicable rate(s).

Generally, a borrower can deduct sums payable as interest or linkage differentials on the loan if the tax authorities are satisfied that those sums are payable on borrowed capital used wholly and exclusively in generating the borrower's income.

However, following certain court decisions (*for example, civil appeal 638/85 Assessing Officer v Plaza Hotel Ltd and civil appeal 627/73 M.D.M. Ltd. v Assessing Officer*), the borrower's right to deduct borrowing costs may be limited, depending on the type of income generated using the borrowed capital, as follows:

- A company that receives business income from interest (*see Question 1, Corporate tax*) may be entitled to deduct its borrowing costs more easily, even if it generates no income as a result of the loan made using the borrowed money in the tax year in which the expenses were incurred.
- A company that uses borrowed money to produce passive income from interest (*see Question 1*) can usually only deduct the borrowing costs against income generated from using the borrowed money.
- If the loan is used for capital investments (for example, the purchase of a factory or machinery), the borrowing costs are not deductible during the tax year in which they were incurred. They are capitalised (that is, the investment is valued for depreciation calculations) to the cost of the capital asset and become deductible on the date the asset is sold.
- If the loan is used for private investments, the borrowing costs are not deductible.
- If the loan is used to finance a dividend distribution, the borrowing costs may not be deductible, according to some court decisions (*for example, civil appeal 6557/01 Paz-Gaz v Assessing Officer*), except in certain specific circumstances that the tax authorities are expected to set in the near future.

The tax authorities may limit or prohibit the deduction of expenses or reclassify any sums paid in the form of borrowing costs.

3. What corporate, transfer, stamp or other taxes are payable on the transfer of a debt under a loan? In each case, explain briefly:

- Its key characteristics.
- How it is calculated.
- How it is triggered.
- Who is liable.
- The applicable rate(s).

The transfer of a debt under a loan may be subject to corporate tax or capital gains tax under the ITO. The type of tax payable depends on the transferring party's identity and the circumstances of the transaction (for example, if the transferring party transfers debt in the ordinary course of its business, then corporate tax is payable; however, in most other cases, capital gains tax is payable).

Corporate tax

See *Question 1, Corporate tax*.

Capital gains tax

Generally, the corporate tax rate on real capital gains (that is, the capital gain minus inflation) is:

- 25% for the part of the capital gain accrued after 1 January 2003.
- The regular rate that applies for business income earned by a company on the date the asset is sold (29% for the 2007 tax year) for the part of the capital gain accrued before 2003.

When calculating the capital gains tax payable, certain basic principles must be considered (for example, type of asset, transferring party's identity, tax exemptions and set off of losses).

For a sale of shares with a loan, a certain tax benefit/calculation may apply in certain circumstances (*section 94A, ITO*). In a capital sale of an unlinked interest-free loan (that is, a loan given by a shareholder to its company, the terms of which do not include linkage differentials and interest) with shares, when the sale is made at least three years after the loan was granted by a shareholder to the company, the consideration payable for the loan is deemed to be the part of the aggregate consideration for the shares and the loan equal to the adjusted balance of the cost price of the loan.

VAT

In practice, in most cases, the transfer of a debt is not subject to VAT. For example, VAT is not payable when the debt is transferred by means of a security or a merchantable document. There is no definition of "merchantable document" in the VAT Law, but it can basically include any document the transfer of which gives rise to the transfer of the rights attached to it (for example, a debenture or a promissory note).

Stamp duty

The obligation to pay stamp duty in Israel was abolished in 2006.

4. Is there withholding tax on interest or any other payments under a loan? If so, provide brief details of:

- **When it applies.**
- **The applicable rate(s).**
- **Any exemptions.**

Withholding tax

In general, the party paying interest or other incremental payments under a loan must, at the time of payment, deduct tax from the amount paid. If the receiving party is a corporate body, the regular withholding tax rate is usually the rate of corporate tax (29% for the 2007 tax year and a lower tax rate for subsequent tax years), unless the tax authorities allow an exemption (*see below, Exemptions from withholding tax*).

In practice, it seems that only companies registered in Israel for tax purposes or that have a business presence in Israel must withhold tax.

Exemptions from withholding tax

A large proportion of parties (usually, most parties that pay taxes and report lawfully) receiving interest under a loan may receive an approval from the tax authorities, which entitle them to either:

- Be exempt from withholding tax.
- Pay a lower rate of withholding tax (for example, payments of interest under a loan that are made to a known foreign-resident financial institution such as CityBank or Credit Suisse may be subject to a lower tax rate).

In addition, lower withholding tax rates are set under most tax treaties to which Israel is a party, in relation to, among other things, interest payments (generally, between 0% to 25%). (Israel has tax treaties with more than 40 countries.)

For a comparative summary of withholding tax on interest, see table, *Withholding tax on interest on corporate debt*, in this Handbook.

5. Do any particular tax issues arise on the provision of a guarantee? If so, provide brief details.

The main tax issue that arises in relation to guarantees occurs when a guarantor has repaid a loan and claims a tax deduction.

If a guarantor issues a guarantee in the course of its trade, any payment to be made is generally deductible, because it is made wholly and exclusively for the purposes of its trade. However, in other cases, the deductibility of the expense is the same as any other capital expense or loss (*see Question 2*).

BOND ISSUES

6. For corporate taxation purposes, are bonds treated any differently from standard corporate loans? If so, provide brief details of the differences, referring to *Questions 1, 2, 4 and 5* as appropriate.

There is no specific tax regime that applies to corporate bondholders or bond issuers, which are largely taxed as described in *Questions 1 to 4*.

Generally, the interest paid through the bond or the discount payments is classified as income (in most cases under *section 2(4), ITO*) and is subject to corporate tax (*see Question 1, Corporate tax*). The consideration for the sale or redemption of the bond is classified as capital gains income in most cases, or as a business income (*section 2(1), ITO*).

7. What stamp, transfer or similar taxes are payable on the issue and/or transfer of a bond? In each case, briefly explain:

- **Its key characteristics.**
- **How it is calculated.**
- **How it is triggered.**
- **Who is liable.**
- **The applicable rate(s).**

If the bond is deemed to be a merchantable document, its issue and transfer is generally not subject to VAT or any other similar taxes (*see Question 3, VAT*).

8. Are any exemptions available? If so, provide brief details.

Not applicable.

PLANT AND MACHINERY LEASING

9. What are the basic rules for enabling the lessor or lessee of plant and machinery to claim capital allowances/tax depreciation?

Generally, the lessee's rental payments are classified as either a (*see also Question 1, Corporate tax*):

- Capital allowance.
- Business/passive expense.

The specific classification depends on:

- The particular asset.

- The lessee's identity.
- The length of the lease.
- Other circumstances relevant to the lease agreement.

In a real estate lease, the classification depends (subject to certain exceptions according to court decisions) on the length of the lease (a lease period of more than 25 years usually indicates that the lease payments are capital allowances).

If the lease payment is a capital allowance (rather than a business allowance which can be deducted easily), the lessee can make a claim for an allowance and/or depreciation under certain alternative regulations (*sections 20 and 21, ITO*), as follows:

- **Income Tax Regulations (Deduction of Lease Payments) 1977.**

The lessee deducts lease payments it makes either through lump sums or instalments from its income in equal annual amounts during the lease period. To qualify for this, the lessee must have a lease:

- in real estate;
- used for producing its income; and
- for a period of less than 49 years.

It does not qualify if:

- the lessee is the lessor's relative;
- the lessor and the lessee are both controlling members of one another; or
- the same entity controls both the lessee and the lessor.

In addition, the lessee deducts expenses incurred in the leased real estate from its income in equal annual amounts. The expenses must be for constructing or installing fixtures, or for planting fixtures that will remain part of the lessor's property after the end of the lease period.

The deduction starts from the year that the construction, installation or planting was completed and lasts until the end of the lease period. If the lessee and the lessor agree in the lease that, at the end of the lease period, the value of the fixtures is to return to the lessee, then the deduction during the lease period for the expense is the rate of depreciation specified in the ITO for that asset category.

- **Income Tax Regulations (Rules on Deduction of Expenses for the Adaptation of Rental Property) 1998.** The lessee deducts expenses it or the lessor incurs for adapting rental property for producing the lessee's income at a rate of 10% in each tax year (and not the regular depreciation rate). This starts from the tax year in which they were incurred, but not before the tax year in which use of the rental property started for producing the lessee's income.

The rental property must be a building both:

- the construction of which has finished;

- which is fit for residential use, business use or any other purpose for which it was built.

The lessee must be a holder of rights to real estate for a period of not more than 25 years and must not:

- be a relative of the lessor;
- be a controlling member of the lessor, or the lessor must not be controlling member of it; or
- be controlled by an entity that also controls the lessor.

At the end of the rental period and when the rental property is vacated, the remainder of the lessee's expenses for adapting the rental property is deductible. If the lessor has refunded the lessee for adapting the rental property or as payment for it, then these amounts are not taken into account when calculating the deduction.

The lessee can elect to rely on either the Income Tax Regulations (Rules on Deduction of Expenses for the Adaptation of Rental Property) 1998 or the Income Tax Regulations (Deduction of Lease Payments) 1977 (*see above*) to claim a deduction, but cannot rely on both.

- **Section 21 of the ITO.** If the lease of real estate property is for a period of 49 years or more, the lessee is deemed the owner of the property for depreciation purposes. This means that the lessee can deduct the regular depreciation rate, generally 2% to 4% of the building's value (usually, one-third of the value of a real estate property is deemed the land that is not depreciated, and two-thirds is the building's value). The lessee can also claim its financing costs (interest and other payments it makes for leasing the asset) as a deduction (*see Question 2*).

- **Income Tax Regulations (Special Deductions for Users of Hire Purchase Equipment) 1989.** A lessee of equipment under a hire-purchase agreement can claim a deduction for the sums it pays for using the equipment to produce its income (instead of claiming the financing and depreciation costs). For the lessee to benefit from this reduction, it must meet certain conditions, including those relating to:

- a minimum lease period;
- the type of asset involved (for example, real estate assets are not included);
- the dates for making lease payments;
- the type of lease contract; and
- the lessee's right to purchase the asset at the end of the lease period.

- **Income Tax Regulations (Accelerated Depreciation for Asset Purchased at the Determining Period) 2005.** A lessee can claim accelerated depreciation (for example, 100%) in certain conditions (conditions include the use of the equipment in Israel for the production of income from certain activities such as manufacturing, agriculture or construction). However, the regulations apply only to assets purchased

between 1 July 2005 and 31 December 2006 (similar regulations are enacted from time to time in Israel).

10. What is the rate of capital allowances/tax depreciation; does it depend on the type of assets?

Depreciation allowances include the following:

- Usually 2% to 4% each year for buildings.
- 7% to 10% for machinery and equipment.
- 6% to 12% for fixtures and fittings.
- 15% to 20% for motor vehicles.
- 7% to 20% for mines and quarries.
- 25% to 40% for aircraft.
- 10% to 100% for ships.
- 2% to 15% for water supplies and other utilities.
- 5% to 20% for agricultural and forestry buildings and works.
- 15% to 33% for computer software, hardware and electronic equipment.
- 10% for goodwill if it is both:
 - purchased for payment;
 - not purchased from a relative of the lessor or from a foreign resident (unless the tax authorities are convinced that the purchase is essential for the production of income and was conducted on a bona fide level and for business reasons only).

In addition, the rate of capital allowances/tax depreciation may be greater under the different regulations (see *Question 9*).

11. Are there special rules for leasing to lessees that do not carry on business in your jurisdiction?

There are no special rules for leasing to lessees that do not carry in business in Israel (see *Question 9*).

12. How are rentals taxed?

In general, there are two main types of rental income for corporate tax purposes (see *Question 1, Corporate tax*):

- Business income, which is relevant for lessors, the core business activities of which include the rental of assets (section 2(1), ITO).
- Passive income, which is relevant for lessors, the business

activities of which do not involve renting or a similar activity (section 2(6), ITO).

Usually, a lessor (that is, the owner of the asset or a lessee that holds a lease for a period of at least 49 years) can claim a regular depreciation rate (depending on the type of asset involved), which, for a concrete building component, is an allowance of 2% each year (generally, two-thirds of the value of the real estate). However, the lessor of a residential apartment can claim depreciation calculated from a larger base or at a higher depreciation rate (for example, 4%), under certain conditions and restrictions (section 21(d), ITO, *Income Tax Regulations (Rate of Depreciation for an Apartment which is Rented for Residential Purposes) 1989*, and *Inflationary Adjustments Law 1985*).

Lessees can claim deductions for rent due and payable.

13. Is a ruling or clearance necessary or common? If so, provide brief details.

A ruling or a clearance may be necessary or relevant in special circumstances, where a legal issue is unclear (for example, the right to deduct the lease expense or the calculation of tax). In most cases, such a ruling or clearance is unnecessary.

SECURITISATION

14. Briefly explain the key features of the tax regime applicable to securitisations, including details of any specific tax rules that apply or issues that arise in relation to securitisations.

There are no specific rules under the ITO for taxing securitisations. However, the tax authorities have dealt with the issue of securitisations on several occasions, and recently published rulings on the issue that set out their position in relation to taxing securitisations in certain circumstances. Therefore, the tax regime that probably applies for securitisations is the following:

- The securitisation transaction is classified as a financing (not sales) transaction for tax purposes.
- The amounts received from issuing debentures are transferred from the special purpose (note-issuing) vehicle (SPV) to the originator.
- The originator uses the sums received in consideration for issuing debentures for its business activities only (including its activities in related companies), and does not, for example, distribute the sums to its shareholders.
- The SPV is a transparent company for tax purposes and all of its income and expenses are deemed the income or expenses of the originator. Therefore, the transfer of receivables by the originator to the SPV is not deemed a sale of capital assets and the SPV's income from the debentures is deemed the originator's income.
- If there is a difference between the receivables transferred by the originator to the SPV and the consideration paid by

the SPV on the date of such transfer (whether or not the consideration was paid by cash as a postponed liability of the SPV to the originator), it can be classified as a financial expense (discount), and the discount is classified (for tax purposes) as an interest income or expense in Israel (where relevant).

- The discount may be deductible by the originator in equal annual amounts during the term of the debenture. The postponed liability (if any) may be deductible on the date of payment of the entire debenture or on the date of termination of the agreement between the originator and the SPV, whichever is the later.

15. Are there any tax-related requirements imposed on a securitisation note-issuing company? If so, briefly explain them.

See *Question 14*.

16. Are there any tax reasons why a securitisation note-issuing vehicle should or should not be associated with (for example, part of the same group as) the originator? If so, briefly explain them.

There are no tax reasons why the SPV should not be associated with the originator. Usually, the SPV is a subsidiary of the originator.

CLEARANCES

17. Is it possible or necessary to apply for tax clearances from the tax authorities before completing a finance transaction? If so, briefly describe:

- **The circumstances in which clearance may be claimed.**
 - **Whether obtaining clearance is mandatory or optional.**
 - **The procedure for obtaining clearance.**
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Circumstances in which clearance may be claimed

It is possible to apply for tax clearances (or rulings) from the tax authorities before completing a finance transaction. For securitisations and other complicated finance transactions, it is advisable to obtain a pre-ruling or tax clearance. However, the application is not necessary in most circumstances.

Generally, a taxpayer's request for a tax ruling must include all relevant information and documents relating to the issue (for example, certificates, statements, evaluations and contracts). However, the right is limited and the tax authorities can refuse to grant the request in certain circumstances at their discretion. Although the tax authorities have not formally set specific rules, it appears that the main circumstances in which they may refuse to issue a tax ruling are where:

- A criminal investigation is being conducted against the taxpayer.

- The taxpayer is considered a hard tax evader (that is, an assessee that did not pay tax and report lawfully during preceding tax years) or the taxpayer failed to submit tax returns during the preceding tax years.
- On the date of the request, a discussion at the assessment level is being conducted relating to the same issue, or other issues concerning the content of the request for a tax ruling.
- The tax authorities did not receive sufficient information to enable them to respond to the request.
- The taxpayer requests to receive the tax ruling anonymously.
- The answer to the tax issue is clear from the wording of the law and/or the tax authorities' rulings.
- The issue involves a question of principle that is being deliberated in court (except for some exceptions).
- The issue in question is mainly a factual matter (except for some exceptions).
- The issue in question is the valuation of an asset, a service or a transaction (except for some exceptions).
- After considering the request, the conclusion is that it deals with a transaction, the main purpose of which is the avoidance or illegitimate reduction of tax.
- The request is hypothetical, contentious or concerns a minor issue.
- The tax authorities have other special reasons not to issue a tax ruling.

Clearance legitimacy

Until 1 January 2006, tax rulings were given according to the tax authorities' directives and practice (that is, the tax authorities' self-interpretation of their powers), and without reference to law. Therefore, there was no fixed and complete procedure for the request and no limitations existed on the tax authorities' ability to refuse the taxpayer's request or revoke a tax ruling.

From 1 January 2006, an amendment to the tax law granted taxpayers the right to request a tax ruling (*sections 158B to 158F, ITO*). Although certain regulations (for example, in relation to collecting a fee) and tax directives relating to the issue have not been published yet, tax rulings are being issued to taxpayers. The tax authorities can issue two types of tax ruling:

- **Tax Ruling in Agreement.** This is a tax ruling that is agreed between the tax authorities and the taxpayer.
- **Tax Ruling.** This is a tax ruling by the authorities that is not agreed between it and the taxpayer.

The taxpayer can state its case to the tax authorities before it issues a Tax Ruling (or Tax Ruling in Agreement). In addition, the taxpayer can appeal a Tax Ruling during its appeal of the assessment, but there is no similar right of appeal for Tax Rulings in Agreement. The taxpayer cannot revoke its request for a Tax Ruling, unless approved by the tax authorities.

The tax authorities cannot generally revoke a Tax Ruling (or a Tax Ruling in Agreement) unless:

- The taxpayer failed to submit certain relevant details or documents.
- The circumstances relevant to the Tax Ruling change.
- The tax authorities were given false, misleading or incorrect information.

DISCLOSURE

18. Is it necessary to disclose the existence of any finance transactions to the taxation authorities? If so, briefly explain:

- The circumstances in which disclosure is required.
- The manner and timing of disclosure.

Generally, every individual or company that earns income (including Israeli-resident individuals and foreign residents that earn taxable income in Israel) must submit an annual return to the tax authorities for the relevant tax year (*section 131, ITO*).

However, certain individuals or companies are exempt from this obligation (*section 134, ITO and Income Tax Regulations (Exemption from the Submitting of Report) 1988*). The exemptions are relevant, in general, to either:

- Israeli-resident individuals in certain circumstances.

- Foreign residents that have income which was accrued or produced in Israel if the tax was deducted entirely at source, and have one of the following:
 - income derived from a business or an occupation for a period of not more than 180 days in the tax year;
 - income under sections 2(2) (employment income) or 2(5) of the ITO; or
 - income under sections 2(4) (income from interest), 2(6) or 2(7) of the ITO.

Therefore, if the individual or company must submit an annual return, it must include details of its income, including income from finance transactions.

The seller of a capital asset must report the sale within 30 days from the sale date and make an advance payment in relation to its capital gain tax (if any) (*section 91(d), ITO*).

In addition, certain transactions and activities must be reported by submitting a special return (*section 131(g), ITO and Income Tax Regulations (Tax Planning which should be Reported) 2006*).

REFORM

19. Please summarise any proposals for reform that will impact on the taxation of finance transactions described above.

There are currently no proposals for reform.

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