

# U.S. INTERNATIONAL GRANTMAKING

## Country Information

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### Israel

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### I. Summary

#### A. Types of Organizations

In the State of Israel, there are primarily four types of not-for-profit organizations, each with different requirements for formation, membership, and public purpose. These include:

- Associations (Amutot, singular Amuta), governed by the Law of Associations, 1980;
- Private Companies for Public Benefit, governed by the Companies Act, 1999;

- Cooperative Societies, governed by the Cooperative Societies Ordinance, 1933; and
- Endowments, governed by the Trust Law, 1979.

## **B. Tax Laws**

The tax laws in Israel treat all not-for-profit organizations the same, regardless of their method of formation or incorporation. Tax implications are governed by the Income Tax Ordinance and the Value Added Tax Law.

*Tax Exemption.* The Income Tax Ordinance grants tax exemptions to organizations that qualify as "public institutions." To determine which organizations may be recognized as public institutions, it is important to examine the legal structure and public aims of the organization as well as the activities in which it is engaged. Generally, any activity involving religion, culture, education, science, health, welfare, sport, or anything approved by the Minister of Finance constitutes a public aim. Discussion of the tax laws is included here because the "public institution" status, when obtained, will help to allow the organization to be qualified as a section 501 (c) (3) equivalent.

*Tax Allowance.* Tax credits are available for donations, as long as they are made to organizations recognized as public institutions by the Income Tax Ordinance. These tax allowances may not be granted for contributions to a foreign not-for-profit organization, however, unless the foreign organization adheres to the Israeli standards for public institutions and is registered in Israel.

## **II. Applicable Laws**

- Companies Act, 1999
- Cooperative Societies Ordinance, 1933
- Income Tax Ordinance (New Version – seeking correct citation)
- Law of Associations, 1980
- Political Parties Law, 1992
- Property Tax and Compensation Fund Law, 1961
- Trust Law, 1979
- Value Added Tax Law, 1975

## **III. Relevant Legal Forms**

Not-for-profit organizations ("NPOs") are divided into two general categories: associations and foundations. Associations unite a group of individuals having a common aim and no intention to distribute profits. Foundations collect assets, which then are used to fund charitable projects. The relevant incorporation and tax laws do not distinguish between the various forms of Israeli NPOs, associations, organizations, foundations, charities, etc.

The concept or category of "associations" includes organizations formed under the Law of Associations ("Amutot"), 1980; the Companies Act, 1999; or the Cooperative Societies Ordinance, 1933. As a technical matter, incorporation is not required for tax purposes for classification as an NPO. All that is required is the commitment by those forming the association not to distribute profits. On the other hand, incorporation is necessary to receive certain governmental grants, so unincorporated NPOs may be at a disadvantage.

The category of "foundations" includes, inter alia, public and religious endowments that do not intend to distribute profits. An endowment formed under the Trust Law is not a legal entity.

**The Association ("Amuta")** - The Law of Associations ("Amutot") of 1980 introduced the Amuta as a type of corporate entity that has all the legal rights and benefits of an incorporated legal entity. For not-for-profit institutions, the Amuta has become a popular form of incorporation. This legal entity comes into being upon the act of registration. Articles of Association, i.e., by-laws, may be attached to the registration application, or the model Articles appended to the Law will serve as the Amuta's by-laws.

Registration of an Amuta requires the following:

1. two or more members, whether individuals or corporations (This membership is non-transferable.);
2. legal purposes, i.e., almost all purposes other than those that undermine the State of Israel and its democratic nature or those that provide a safe haven for illegal activity (Other than these prohibitions, the Law of Associations does not provide further guidance regarding permissible public purposes of the Amutot.);
3. prohibition of distribution of earnings (the "non-distribution constraint"); and
4. a name that is not misleading or prejudicial to the public and is not the same as, or similar to, other registered Amutot or Israeli corporations.

**Private Companies for Public Benefit** - Private companies may be created to serve as not-for-profit institutions, according to the Companies Act of 1999 ("the Act"). Unlike the Amuta, a company's purpose must be in accordance only with the Act, morality, and public order. The Act does not include the express prohibition against aims that negate the existence of Israel or purposes that seem to disguise illegal activities; rather, it states that a company must act in accordance with the law. The Companies Registrar is charged with ensuring that the company complies with all the conditions of the Act, and the Court oversees the Registrar's determinations.

There is no minimum membership detailed in the Companies Act, and therefore a company may be formed with only one person. The name of the company must not be misleading or in opposition to public order. Once the company has been registered and has received its certificate of incorporation, it becomes an independent legal entity. When applying for registration, a company must submit Articles of Association. The standard Articles of Association must be modified significantly in order for a company to be

regarded as a not-for-profit organization that would qualify for a tax exemption. Some of these changes include:

1. Modifying the company's aims to comport with the aims of a public institution, as per the Income Tax Ordinance;
2. Including a prohibition on the distribution of profits;
3. Defining the value of the shares as non-economic and preventing the transfer of such shares, and
4. Providing for equal voting rights per share.

**Cooperative Societies** - The Cooperative Societies Ordinance of 1933 ("the Ordinance") governs the formation of associations called cooperative societies. The Ordinance sets forth the aims of cooperative societies as fostering "economy, independent assistance, and reciprocal assistance between persons having common economic interests, in order to effect an improvement in their living conditions."

There are several requirements for forming a cooperative society:

1. At least seven members are required to form a cooperative society (other corporate entities may be members);
2. The aims of the cooperative society must be in compliance with the Ordinance;
3. The name of the cooperative society is subject to all the restrictions contained in the Companies Act. Additionally, the words "cooperative" and "limited" must follow the names of all cooperative societies;
4. A cooperative society must specifically prohibit distribution of profits in order to be treated as an NPO. Although cooperative societies generally do distribute profits, an express prohibition is permitted, and thus required, for consideration as an NPO; and
5. Shares are non-transferable.

Before a cooperative society may register, the Registrar must determine that the cooperative has complied with all the provisions of the Ordinance. The Registrar also must categorize the cooperative and decide in which of twenty-five classes of cooperative societies the applicant belongs. Once the Registrar is satisfied, the cooperative society may register and become an independent legal entity.

**Endowments (under the Trust Law, 1979)** - An endowment is a type of trust in which the assets are set aside to benefit a specific public community or accomplish a particular public aim. The Trust Law of 1979 governs the formation of public endowments. Endowments are not membership organizations and are not independent legal entities. The Law does not require the formation of an endowment as a trust. A trust can also register in a religious court.

To create a public endowment, three steps must be taken:

1. The endowment must be created through a deed of endowment. This document sets forth the creator's public interest aims and intention to create an endowment. The endowment is created once control of the assets is transferred from the creator to the trustee;
2. A trustee must be appointed; and
3. The endowment must be registered. After the trustee is appointed, he or she must notify the Registrar of Endowments within three months and provide details of the endowment, assets, creator, and trustee(s). In the event that there is no trustee, whether none is appointed or the appointed party is unable to fulfill the duties of office, the Public Trustee may take control of the endowment until the appointment of another trustee.

#### **IV. Public Benefit Status**

According to the Income Tax Ordinance, an organization must satisfy certain conditions to be recognized as a "public institution" for purposes of tax exemption. One of these conditions requires a public aim, defined broadly to include activities related to religion, culture, education, science, health, welfare, sport, and any other public aim approved by the Minister of Finance.

The Law of Associations requires a general public benefit purpose. NPOs organized under the Companies Act must articulate a public purpose in the Articles of Association. Cooperatives typically are characterized by public benefit in the form of mutual aid and reciprocal assistance. Endowments are either "public" or "religious"—the former are required to promote public purposes, and the latter are required to promote religious purposes.

#### **V. Specific Questions Regarding Local Law**

##### **A. Inurement**

While the distribution of assets or profits to members is prohibited, there is a range of transactions with interested parties that are permitted under certain circumstances. How each type of organization approaches these transactions may influence the form of incorporation that founders of an organization ultimately choose.

Private Companies for Public Benefit - The Companies Act clearly addresses the subject of transactions with interested parties and imposes a fiduciary duty on the officers of the company. When there is a potential conflict of interest, the interested officer has a duty to disclose his interest and obtain approval for the activity or transaction at issue from both the internal comptroller committee and the board of directors. Failure to do so may result

in sanctions; the transaction may be canceled or the officer may be subject to damages claims.

Amutot and Cooperative Societies - Interestingly, neither the Law of Associations (Amutot) nor the Cooperative Societies Ordinance expressly addresses the issues of fiduciary duty and how to handle a conflict of interest. While the Law of Associations does state that members must act for the good of the Amuta, the Cooperative Societies Ordinance is silent.

Despite the lack of express provisions, office holders in Amutot and cooperative societies are expected to adhere to fiduciary duties similar to those applicable to for-profit companies. Further, other general laws, such as the Penal Law impose certain responsibilities on members and directors.

Endowments - The Trust Law expressly forbids a trustee from obtaining any personal benefits from management of the trust assets. As such, a beneficiary of a trust is not permitted to act as trustee, unless the deed of endowment specifies otherwise. In certain circumstances, however, the court may grant the trustee permission to derive benefits from the management of the trust when such an action is also advantageous to the trust.

## **B. Proprietary Interest**

Properly-registered Amutot, private companies for public benefit, and cooperative societies are all independent legal entities. The non-distribution constraint requires that the members do not have a proprietary interest in the organization; the articles of association filed with the organization's registration create a contractual relationship between the members and the organization itself.

An endowment, however, is not a separate legal entity. The endowment is created when control of the assets is transferred to the trustee, so a trustee may have a proprietary interest in those assets.

## **C. Dissolution**

There are two ways in which an NPO may be dissolved: voluntarily, by special resolution of the general meeting; or by filing a petition with the court. If an organization is insolvent, it must be dissolved by the court, while solvent organizations may be dissolved voluntarily or by the court.

The appropriate distribution of assets that remain after payment of outstanding debt differs according to the type of organization. An Amuta must distribute its remaining assets according to its articles, which most likely provide for the transfer of assets to an NPO engaged in the pursuit of similar goals. The Companies Act and the Cooperative Societies Ordinance, however, allow remaining assets to be distributed to shareholders and members. Therefore, as noted above, NPOs formed under the Companies Act or the Cooperative Societies Ordinance need an express non-distribution clause in order to qualify for tax exemption.

## **D. Activities**

### **1. General**

All the legal forms discussed above, except the endowment, become independent legal entities upon completion of the proper registration procedures. As such, these legal entities gain the right to participate in all the appropriate activities to which such entities are entitled, unless otherwise prohibited.

### **2. Public Benefit Activities.**

The Law of Associations does not specify what public purposes are permissible for an Amuta, but it does prohibit activities that either undermine the democratic nature of the State of Israel or serve as a screen for illegal activity. The purposes of a private company for public benefit, on the other hand, must comply with the Companies Act, morality, public order, and the general laws of the State of Israel. A cooperative society's purpose is set forth as fostering "economy, independent assistance, and reciprocal assistance between persons having common economic interests, in order to effect an improvement in their living conditions." And finally, an endowment's aims must be simply to benefit a particular public community or fulfill a public aim.

### **3. Economic Activities.**

NPOs may participate in business activities by conducting such activities as part of the organization's operation or by holding shares in a for-profit corporation. The business activities, however, may be taxed unless they are an integral part of the organization's fulfillment of its public aims. Additionally, only active income, rather than passive income, will be taxed. An NPO's status as a "public institution" qualifying for a tax exemption may be affected if business activities predominate.

## **E. Political Activities**

There is no express provision governing the extent to which an NPO may participate in the political process. The Amutot Law does not prohibit lobbying or any other political activity, so long as these activities are not aimed to win representation of the organization (Amuta) in the Israeli parliament or Knesset. An NPO can work to influence the legislation process as well as the outcome of political elections. It can support publicly a political party or candidate and call on the public to vote for a particular candidate or party. Under the law, a minister or a member of parliament cannot be a member of a NPO.<sup>[1]</sup>

## **F. Racial Discrimination**

The definition of what constitutes a public aim, as set forth in the law, court rulings, administrative orders, and the orders of the Minister of Finance, includes the improvement of public welfare without discriminating. Israeli law does not otherwise address racial, ethnic, gender, or religious discrimination in connection with NPOs.

## **G. Control of Organizations.**

It is possible that an Israeli NPO could be controlled by a for-profit entity (which will lead to additional IRS scrutiny) or by an American grantor charity (which requires that the charity specifically so provide in the affidavit).

## **VI. Tax Laws**

The tax laws in Israel do not distinguish among legal forms or types of NPOs. Therefore, the determination of taxable income and tax exemption does not depend on how an organization was originally formed. The two main tax laws – Income Tax and Value Add Tax – do not have the same definition for “public institution.” While the Income Tax Ordinance (“Tax Ordinance”) relates primarily to the aims of the organization, the VAT Law refers to the nature of its activities.

Not-for-profit organizations that may benefit from tax exemption can be divided into four types:

- Government NPOs that benefit the domestic sector (for example, a hospital, owned and run directly by the government);
- Private NPOs that benefit the domestic sector;
- Government NPOs that benefit the business sector; and
- Private NPOs that benefit the business sector.

### **A. Tax Exemption**

Only “public institutions” are granted some exemption from taxes, according to the Tax Ordinance. Although there is no automatic exemption upon incorporation of an organization, there are some forms of organizations that are given a preference in being recognized as “public institutions.” For example, Amutot, private companies for public benefit and endowments are given preferential treatment because of their prohibitions on distribution of profits to their members. To determine which organizations may be recognized as public institutions, it is important to examine the legal structure and public aims of the organization, as well as the activities in which it is engaged.

There are six criteria that an organization must meet to qualify for tax exemption:

1. The organization does not have to be an association, but must consist of a collection of people;
2. There must be at least seven members;
3. The majority of the members may not be related to each other;
4. The organization must have a public aim;
5. The income and resources of the organization must be used in pursuit of the public aim; and
6. The organization must provide annual reports detailing its expenditures, resources, and income to assure compliance with its public aims.

The law, court decisions, and administrative rulings have defined "public aim" broadly to include activities related to religion, culture, education, science, health, welfare, and sport, as well as any other public aim approved by the Minister of Finance.

An NPO may engage in both commercial and not-for-profit activities, but the business activities may be taxed. If income is generated by a business that is a critical part of accomplishing the organization's public aim, it will be exempt from tax. The Minister of Finance may grant a tax exemption for income of a public institution from business sources, as long as the public will still benefit. Additionally, according to the Tax Ordinance, only active income will be taxed, not passive income (i.e., dividends and interest).

## **B. Value Added Tax**

The Value Added Tax Law of 1975 imposes a tax on the ultimate consumer. With a focus on the nature of an organization's business, the Law provides that not-for-profit organizations engaging in non-commercial business are exempt from paying value added tax ("VAT").

In order for an organization to be exempt from VAT, it:

1. Must be an association of people, but not necessarily incorporated;
2. Must not engage in for-profit business activities; and
3. Must not be a financial institution.

The Value Added Tax Law requires NPOs to pay a payroll tax (Wage Tax), based on the amount of wages paid to its employees. This tax is in addition to the Employer Tax which is being imposed only upon NPOs. In 2006, VAT rate in Israel is 16.5%, Wage Tax is 8.5% and Employer Tax is 4%

An NPO is not reimbursed for the VAT it pays (input tax).

## **C. Property Tax**

The Property Tax and Compensation Fund Law of 1961 governs the taxation of property owners in Israel. The law adopts the definition of "public institution" and therefore NPOs may be exempt from property tax if:

1. The association has at least seven members;
2. Most members are unrelated to one another;
3. The purpose of the NPO involves the pursuit of a public aim - religion, culture, education, science, health, relief, or sport;
4. The property is used in pursuit of one of the above-named aims; and
5. Any income generated from the property is used to pursue the organization's aims.

Alternatively, the Property Tax and Compensation Fund Law gives the Minister of Finance discretion to grant tax exemptions for property that serves a public aim. The Finance Committee of the Knesset (Israeli Legislature) also must approve the exemption.

#### **D. Tax Allowances**

The Income Tax Ordinance provides donors with a tax credit for donations to public institutions. To qualify for such an allowance, the following conditions must be met;

1. The organization must satisfy the Tax Ordinance definition of a “public institution; and
2. The organization must be approved by the Finance Committee of the Knesset (the legislature of Israel).

Individual donors may receive a 35% tax credit for contributions to certified NPOs exceeding 370 NIS but not greater than NIS 2, 165,000 or up to 30% of one’s total tax. The tax credit afforded to corporations equals the company tax (32% in 2006), under the above limitations.

Foreign not-for-profit institutions must be registered in Israel according to the Israeli standards for public institutions in order for donors to benefit from tax allowances.

#### **E. Double Tax Treaties**

On January 1, 1995, the 1975 U.S.-Israel Income Tax Treaty ("Israel Treaty") took effect. Article 15A of a 1980 Protocol to the treaty allows U.S. donors to deduct contributions to Israeli charities as long as the charitable organization would have qualified for exemption according to U.S. standards. The Israel Treaty fixes the percentage limitation on charitable deductions at 25%. This percentage is calculated according to the amount of income the U.S. donor has from sources within Israel. The treaty provision makes it easier for some US grantmakers – those with business in Israel – to make grants to Israeli charities.

It should be noted that the U.S. definition of the territory of Israel is different from the way the State of Israel defines itself. This issue of territorial definition may introduce complications regarding the proper application of the Israel Treaty.

### **VII. Knowledgeable Contact**

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## Footnotes

[1] The Political Parties Law of 1992, however, distinguishes between registered parties and NPOs. The law defines a party as: “A body of persons organized in order to advance political or social objectives by legal means and to win their representation in the Knesset through election.” Although registered parties are associations, they are not governed by the Law of Associations.

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