

International Practices Task Force (IPTF)

June 2, 2008 – Joint Meeting with SEC Staff

Discussion Document C

Topic: Approved Enterprise Zones in Israel – Tax Holidays

Background

Companies that have qualified for Approved Enterprise Zone status in Israel (“Qualifying Companies”) are entitled to receive a tax free holiday period on undistributed earnings under the Alternative Benefits Track (Section 51) of the Law for the Encouragement of Capital Investments – 1959 and its 2005 Amendment (“the Law”). The intent of the Law is to encourage investment in certain industries and specific geographic areas.

The preamble to the Law states that the purpose of the Law is to promote economic development, increase export and encourage wide geographic distribution of the country’s population. In order to meet these goals, the Law provides for investment grants, tax exemptions and reductions and other benefits for varying periods of time, as indicated in the Law. Both start-up activities and expansion programs are entitled to such benefits.

The Alternative Benefits Track of the Law is “operationalized” for the Qualifying Companies as follows:

- Taxable income derived from an approved enterprise in certain geographic areas (e.g. Zone A) that elects the “Alternative Benefits Track” is tax exempt during the ten years of the specified benefit period.
- The tax exemption will commence in the first year in which taxable income is generated from the approved enterprise.
- The benefit period is limited to the earlier of 14 years from the year in which the approval letter was received or 12 years from the commencement of operation (i.e. upon completion of the approved investment program).
- A zero percent tax holiday period only becomes available when the cumulative taxable income exceeds zero (i.e., the existing NOLs have been fully utilized at that point in time).

Qualifying Companies are generally comprised of technology companies that incurred significant research and development costs in their initial stages of development without

significant revenue and as a result have generated net operating losses. NOL's have indefinite lives under Israeli law.

As an example, Company A, a start-up technology company, commenced operations in 1998 and obtained its Approved Enterprise Zone status in 2001. Its benefit period will end in 2014. For purposes of this example, it is assumed that 12 years after commencement of operation as defined under the law is not the limiting factor. Company A generated profits and losses in the Israeli entity as follows:

Time Line	Year	Israeli taxable Profit / -Loss NIS (000)	Cumulative
Operations Commenced	1998	-19,000	-19,000
	1999	-19,000	-38,000
	2000	-19,000	-57,000
Enterprise Zone Status Obtained	2001	-43,000	-100,000
	2002	-30,000	-130,000
	2003	-9,000	-139,000
	2004	33,000	-106,000
	2005	36,000	-70,000
	2006	-5,000	-75,000
	2007	-29,000	-104,000
	2008		
	2009		
	2010		
	2011		
Enterprise Zone Status Ends	2012		
	2013		
	2014		

The NOL's generated by Company A are expected to be consumed before 2014. However, if Company A does not fully utilize its NOLs before the expiration of the fourteen year period, it will not be entitled to the zero percent tax rate and any future earnings after utilization of the NOLs will be at the full tax rate.

Issues:

- 1 Is it appropriate to establish a deferred tax asset (DTA) at a zero percent rate for NOLs that have been generated and will reverse prior to the commencement of the tax holiday period?

- 2 If the answer to 1 above is that a DTA should not be established using a zero percent rate prior to commencement of the tax holiday period, what rate should be used to establish the DTA?

Discussion and Analysis of Literature

The FASB considered whether a deferred tax asset should ever be recognized for the expected reduction in taxes payable during a “tax holiday.” In this regard, the FASB considered tax holidays generally available to all enterprises, as well as unique tax holidays made available in certain circumstances (paragraphs 183-184 of Statement 109). Because of the practical problems associated with distinguishing “unique” tax holidays from “generally available” tax holidays, the FASB concluded to prohibit the recognition of a deferred tax asset for all “tax holidays.” However, in the case of the Alternative Benefits Track of the Law, the Company has not yet commenced the zero percent tax holiday period. Therefore, paragraphs 183-184 are not applicable.

Task Force Discussion:

The Task Force conclusion below does not address the need to establish or evaluate the ongoing requirement to maintain a deferred tax asset valuation allowance. This conclusion only addresses the need to establish a deferred tax asset and the measurement of that asset. We would note that many of the Qualifying Companies would require full valuation allowances on DTAs if an asset is established. The Task Force reached the following conclusions:

- 1 It would not be appropriate to establish a DTA using a zero percent tax rate if the NOLs were expected to be realized prior to the benefit period in which a zero percent rate were to commence (i.e. before the tax holiday period). In other words, if the NOLs could be used to (1) delay the start of the holiday rate to a subsequent tax year or (2) against non-tax-holiday qualifying activities, they have provided the company with an economic benefit that should correspond to a recorded DTA at the appropriate tax rate. In the above example, a zero percent tax holiday period only becomes available to Company A if between 2008 and 2014, cumulative taxable income exceeds zero (i.e. the existing NOLs have been fully utilized at that point in time).
- 2 For NOLs that are expected to reverse prior to the commencement or subsequent to the termination of the zero percent holiday period, the rate to be used should be the applicable statutory rate (pursuant to the Israeli taxing authority) that relates to the period of expected realization.

Proposed Task Force Recommendation:

We ask the Staff to confirm this position.

Staff Response:

The staff agrees with the Task Force's view.