The Start-Up Nation Reinvents the Exit: Israel's Novel Tax on Undistributed Profits

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Introduction

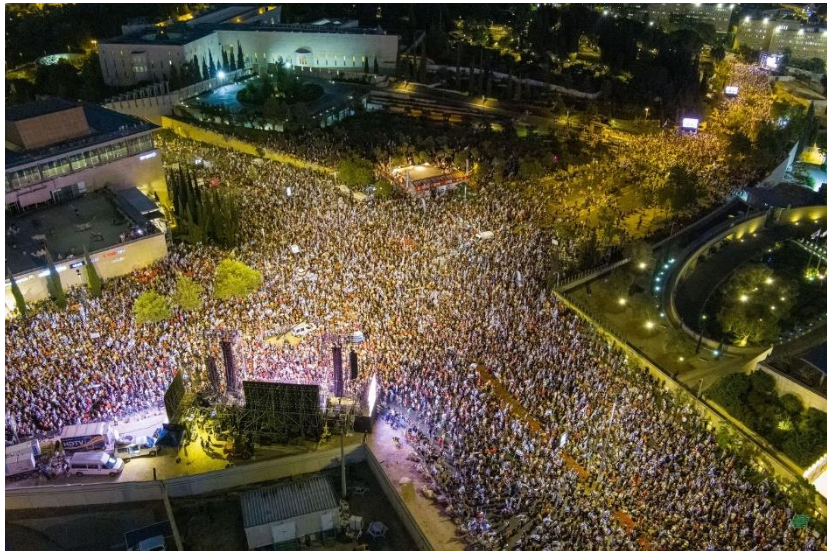
- The Israel Tax Authority meets the start-up nation.
- The purpose of the new legislation: tax deferral through companies.
- Why is it important for non-Israeli?
  - “It’s a very tiny world”.
  - Ex-territorial validity.
  - Business opportunities?
- Disclaimer.

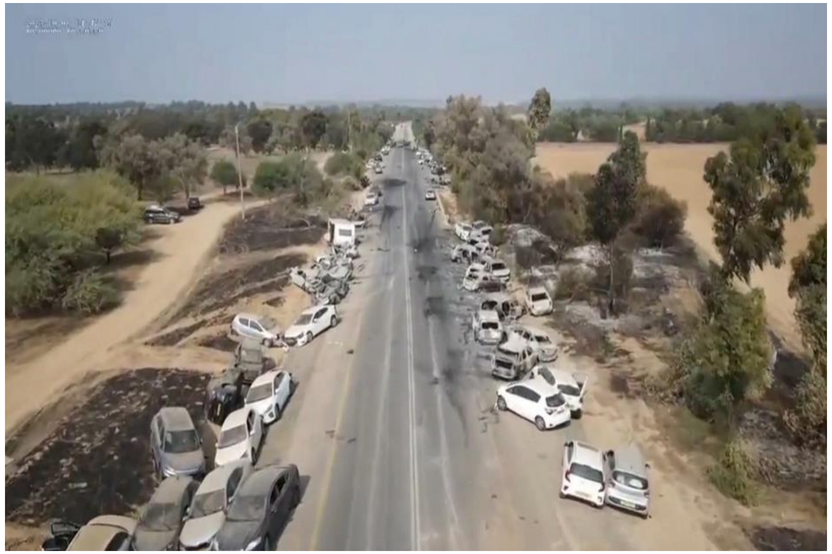
Financial Background

- “Trapped earning” – amounts at stake.
- Past endeavors of the ITA to address these issues.

Policy Background

- **General background:**
  - **2023-2025: from political turmoil to horrific war.**
  - **High taxes and social fairness.**





Mechanics of the law – General Background

- “Closely Held Companies”:
    - Limited number of shareholders.
    - Limited number of companies?
- Exemptions for companies with low retained earnings.

Mechanics of the law – First Method – Wallet Company

- **2017 legislation.**
- **Wallet Company definition:**
  - **Controlling shareholders: five or less.**
  - **Number of employees: less than four.**
  - **Source of income: 70% from a single client.**
- **Tax treatment: disregarded.**

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Mechanics of the law – First Method – Example

- Company A:
  - Controlling shareholders: 1
  - Number of employees: 2 (including the controlling shareholder).
  - Source of income: a single client.

Company A	
Total income	200
Total expenses	100
Taxable income subject to Corporate Income Tax	0
Taxable income subject to Individual Tax	100

Mechanics of the law – Second Method – Partial Attribution of Active Profits

- Applicability:
  - An "Active Shareholder".
  - Active income.
  - Profitability exceeds 25%.
  - Number or employees or clients: not relevant.
- Tax treatment:
  - Income below 25% profitability: corporate income tax.
  - Income above 25% profitability: attributed to the shareholder.

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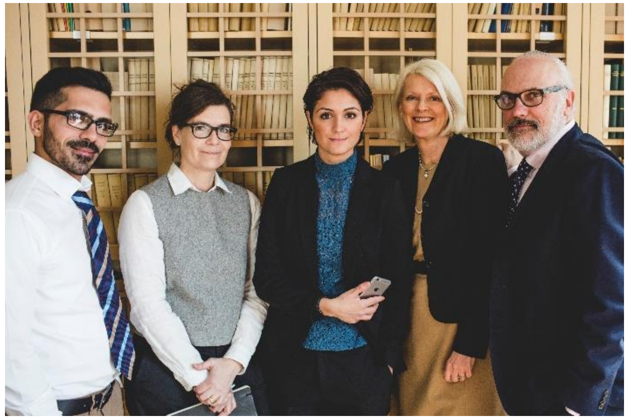
Mechanics of the law – Second Method – Example

- Company B:
  - Controlling shareholders: 3
  - Number of employees: 20
  - Source of income: Multiple clients



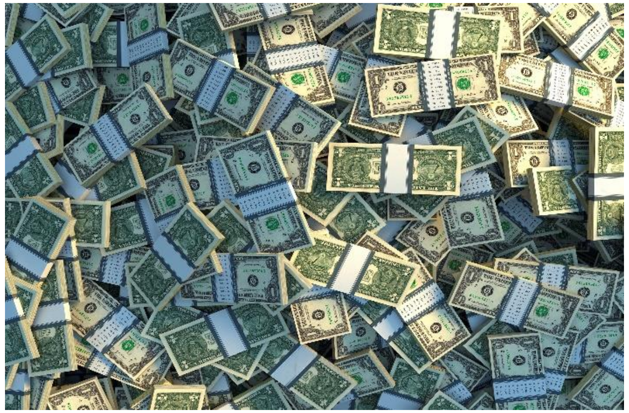
Company B	
Total active income	100
Total expenses	60
Taxable active income (Profitability)	**40 (40%)**
Passive income	50
Taxable income subject to Corporate Income Tax	75 $(100 * 25\% + 50)$
Taxable income subject to Individual Tax	15 $(40 - (100 * 25\%))$

Mechanics of the law – Third Method – Taxation of Retained Earnings

- **Applicability:**
  - **A Closely Held Company.**
  - **Type of income, profitability, Number or employees or number of clients: not relevant.**
- **Tax treatment:**
  - **2% "interest tax", unless:**
    - **Dividend distribution: 6% of last year's accumulated profits.**
    - **Dividend distribution: 50% of last year's adjusted accumulated profits.**
    - **Annual losses: 10% of of last year's accumulated profits.**

Mechanics of the law – Third Method – Example

- **Company C:**
  - **Controlling shareholders: 4**
  - **2024 accumulated profits: NIS 1,000.**



	Company C – Scenario 1	Company C – Scenario 2
2025 taxable income (loss)	500	(150)
2025 accumulated profits	1,500	850
6% distribution exemption	60 $(1{,}000 * 6\%)$	N/A
Interest tax	30 $(1{,}500 * 2\%)$	N/A

Summary and Ending Comments

- Grandfathering rules and temporary provisions.

- A Unicorn, a poison pill or a flop?

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