The New Regime for Taxation of Undistributed Profits: A Comprehensive Overview

Background

A new legislation in Israel, which was published on January 1, 2025 and is effective as of this date, aims to reduce the ability of companies to defer taxes indefinitely by retaining profits within closely held companies (non-public entities controlled by fewer than five individuals).

This reform follows earlier legislation, including an increase in the surplus tax rate by an additional 2% for individuals with passive income exceeding an annual threshold of approximately 721,560 NIS (approximately $190,000).

This new law addresses specific tax strategies employed by Personal Service Companies, Labor-Intensive Companies, and Holding Companies, while also introducing measures regarding forced profit distributions and temporary provisions for company liquidations.

Key Provisions of the New Legislation

1. Companies Generating Income from Labor-Intensive Activities

A new tax regime targets Labor-Intensive Companies, imposing an individual marginal tax rate on profits exceeding a 25% profitability ratio. This applies to closely held companies with an annual turnover below 30 million NIS. This new revolutionary provision aims to target companies with high profitability rate under the assumption that such companies are not entitled to be taxed under the "double tier" regime. Under this regime, companies' profits are taxed at a reduced 23% tax rate whilst the dividend are taxed at the rate of 30%-35%. Instead, "closely held companies" will be required to pay immediately the marginal tax rate on profits above 25% of their turnover.

Key provisions include:

- **Partnerships:** Where closely held companies hold at least 10% of a partnership's profits, the partnership will be treated as a transparent entity for profitability tests. If less than 10%, the company will be taxed at the marginal rate on 55% of its taxable income from the partnership.
- **Exemptions:** Companies with retained earnings below 750,000 NIS or specific shareholder structures may be exempt from these provisions.

2. Taxation of Holding Companies

Holding Companies classified as closely held companies will face an additional 2% annual tax on accumulated retained earnings.

Calculating Accumulated Retained Earnings

Accumulated Retained Earnings are determined by the company's taxable income over the years, excluding unrealized profits or revaluations, and are capped at the retained earnings available for distribution as reflected in the company's financial statements. From this base amount, specific deductions apply:

i. **Exempt Income:** This includes profits from preferred enterprises, income from industrial activities, and gains from the sale of certain assets.
ii. **Safety Cushion:** A minimum deduction designed to provide financial stability. This is the higher of:
    a. 750,000 NIS (allocated proportionately if multiple companies are under a single shareholder's control);
    b. The company's total expenses for the current tax year or the average expenses over the past three years; or
    c. The cost of company assets, reduced by the value of special assets (e.g., real estate, financial instruments) and equity adjustments.

Avoiding the Tax

Companies may avoid the 2% tax by electing one of two dividend distribution options:

i. Distributing more than **50% of Accumulated Retained Earnings**, calculated after applying Exempt Income and the Safety Cushion deductions.
ii. Distributing at least **6% of Accumulated Retained Earnings** (or 5% if completed by November 2025), without considering Exempt Income or the Safety Cushion.

Loss Provisions

The tax will not apply to companies with losses exceeding 10% of the previous year's Accumulated Retained Earnings.

Compliance and Reporting

Closely held companies must report the additional tax paid and its calculation method in their annual tax filings. This provision's implementation is particularly intricate in corporate group structures, necessitating careful planning and compliance reviews.

3. Forced Distribution of Profits

The current provision regarding forced distribution of profits remains in force, allowing the Israeli Tax Authority to compel distribution of up to 50% of accumulated retained earnings.

4. Temporary Provisions Regarding Company Liquidations

For 2025, closely held companies undergoing liquidation may benefit from tax exemptions on asset transfers to shareholders, excluding taxes applicable to the distribution of the company's available retained earnings. Highlights include:

- **Tax Mechanisms:** when the asset that was transferred from the company will be sold in the future by the individual shareholder, gains accrued prior to transfer will be taxed at marginal rates, while post-transfer gains will be subject to reduced capital gains tax.
- **Shareholder Options:** Shareholders may choose between maintaining original cost values or allocating company share costs among transferred assets.
- **Non-Liquidation Transfers:** Assets can be transferred to the shareholders without to liquidating the company. In such a case, the dividend amount will be equal to the depreciated cost basis of the asset.

5. Taxation of Personal Service Companies

Personal Service Companies classified as closely held companies typically employ fewer than four individuals, derive over 70% of their income from a single client, and rely on services provided by the controlling shareholder. Such companies are subject to income tax at the individual marginal tax rate. The new regime mainly proposes:

- **Narrowing Existing Exceptions:** To qualify for the exception where payments to the Personal Service Companies are excluded from the regime, the controlling shareholder must hold at least 25% in the paying company (up from the current 10%).
- **Eliminating Partnership Exemption:** Payments from partnerships to partners will no longer be exempt. Instead, an alternative regime for partnerships will be introduced below.

Conclusion

The new legislation, which will be effective as of January 1, 2025, aims to limit the ability of companies to defer taxes on retained profits by setting thresholds and stricter requirements for taxing undistributed earnings. The reform focuses on various types of companies, including Personal Service Companies, Labor-Intensive Companies, and Holding Companies, introducing mechanisms to determine retained profits, avoidance strategies, and restrictions on unrealized profits.