Meir Mizrahi with A.Rafael & Co.

# Israeli Tax Updates

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## Major Tax Hike in 2025—But a Limited Window for Smart Tax Savings

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### Introduction

As part of the approval process for the Budget Law, and in the wake of the ongoing war in Israel, several significant tax law amendments were introduced, starting January 1, 2025. The Amendments apply to privately owned companies that will no longer be able to enjoy the reduced corporate tax rates, and will have to distribute their retained earnings or be subject to additional tax of 2% on their earnings.

This article aims to summarize some key aspects of the proposed tax law amendments. **In addition, the Law provides a Sunset Clause, as covered in Sec. 5 of this Article and the Appendix, that may provide some alternatives for restructuring assets held by the company with possible tax advantages.**

**Corporate Taxation and the Concept of "Wallet Companies"**

Israel's tax system distinguishes between individual and corporate taxation. Individuals (employees or self-employed) are subject to progressive tax rates, the highest of which is 50% for annual incomes exceeding slightly more than 720,000 ILS. The corporate structure enjoys a two-tier taxation system: the company is subject to a flat rate tax of 23% on its profits and a 25%-30% dividend tax is imposed on the shareholders when profits are distributed.

To maintain "economic equivalence" between individual and corporate taxation, Israel's tax laws aim to prevent tax advantages from operating through a corporation rather than as an individual. However, businesses often use companies to defer dividend taxation and reinvest profits at the lower corporate tax rate.

These tax principles resulted in overuse of "**wallet companies**"—private corporations that accumulate their earnings without distributing them, thus avoiding the second-tier taxation. These funds are often invested in real estate, financial instruments, or other non-business-related activities. Therefore, Israeli tax authorities have sought to limit these practices by tightening tax regulations on retained earnings.

### The Law Amendments

Private companies, particularly those controlled by up to five individuals, excluding publicly traded entities ("**Closely Held Companies**"), are subject to stricter tax regulations under the new amendments, as follows:

**1. Taxation of Wallet Companies**

Closely Held Companies that primarily provide management or professional services to a single main client must attribute their taxable income to shareholders at the individual level. As a result, the income will be taxed at the individuals' tax rate continuing the framework introduced in the 2017 Law.

For example, Company A's CEO provides management services through his Closely Held Company ("Company B") – Company B will be disregarded for tax purposes, and the CEO will be taxed at the individual tax rate.

**2. Excess Profit Companies**

Closely Held Companies with a profit margin exceeding 25% must allocate the excess profit to their individual shareholders.

The provision applies only to business income and active trading companies.

**3. Partnerships**

A Closely Held Company that is a partner in a partnership that has business and occupational income, must allocate 55% of the income attributed to it by the partnership to the individual shareholder.

The provision only applies to Closely Held Companies holding less than 10% of the partnership's rights.

**4. Mandatory Dividend Distribution**

Regardless of the taxation of Wallet Companies, the tax law amendments also introduce a significant shift in the taxation of retained earnings, requiring companies to distribute profits regularly to avoid additional taxation.

Hence, Closely Held Companies must now distribute at least 6% (5% in 2025) of their undistributed earnings every year, or otherwise be subject to additional 2% tax on their retained earnings, allowing certain exemptions.

**5. Temporary Tax Relief ("Sunset Clause") – see Example in the Appendix**

To encourage Closely Held Companies to distribute more dividends, a **temporary tax relief measure (sunset clause) is being offered for 2025**

- Companies that liquidate and distribute their assets before the end of 2025 will only be taxed on their retained earnings at the time of liquidation, with capital gains tax deferred until a future sale by the shareholder.
- Assets transferred from a Closely Held Company to its shareholders will maintain their original tax basis. Once the individual shareholder disposes the asset, a 47% tax (excluding 5% High Income Tax) will be applied for the period which the asset was held by the company.

**Key takeaways:**

- **Wallet companies and excess-profit companies will face stricter taxation.**
- **Certain partnerships will be affected by expanded attribution rules.**
- **Mandatory dividend distributions will be enforced through new taxes on retained earnings.**
- **A temporary tax relief window allows businesses to restructure at lower tax costs.**

Given the complexity of these changes, **business owners and investors should reassess their tax planning strategies to mitigate increased liabilities.**

For any questions or further clarification on this matter, please feel free to reach out to our team:


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### Appendix - Example for the use of the Sunset Clause

In this Appendix we would like to illustrate the tax scenario by using an example of an Israeli Closely Held Company that holds assets and wish to transfer them to the individual shareholder, using the Sunset Clause.

The Company purchased securities for USD 1 million in January 1, 2024, using its undistributed retained earnings. The value of the securities to date (1/1/2025) is USD 1.5 million.

Should the company liquidate, the following transactions are deemed to occur:

(a) The securities will be transferred to the shareholder at their value, and the company will pay corporate tax of 23% for a profit of USD 500,000.

(b) The Company will distribute dividend in the amount of USD 1,385,000. The Shareholder will be subject to dividend tax (assuming 35%).

(c) Assuming the securities will be sold by the individual on December 31, 2027, for a value of USD 1.7 million, capital gains tax will be payable by the individual for USD 200,000.

By utilizing the Sunset Clause, the individual will be taxed on the original cost basis of the security (USD 1,000,000), potentially reducing the overall tax burden, as demonstrated in the following table.

| | **Regular Liquidation** | **Sunset Clause liquidation** |
|---|---|---|
| Retained Earnings of the Company dated to 31.12.24 | 1,000,000 | 1,000,000 |
| Capital gains from Liquidation on January 1, 2025 | 1,500,000 – 1,000,000 = 500,000 | 0 |
| Capital gains tax | 500,000 X 23% = 115,000 | 0 |
| Tax on distribution to shareholder | 1,385,000 X 35% = 484,750 | 1,000,000 X 35% = 350,000 |
| Disposal of the Securities by the individual on December 31, 2027 | | |
| Capital gain | 1,700,000 – 1,500,000 = 200,000 | 1,700,000 – 1,000,000 = 700,000 |
| Capital gains tax | 200,000 X 30% = 60,000 | 700,000 X 1 year /4 years = 175,000 X 52% = 91,000<br>700,000 X 3 years / 4 years = 525,000 X 30% = 157,500 |
| Total Tax | **659,750** | **598,500** |

**Important Notes:**

1. The Sunset Clause may also apply for single asset, without liquidation of the Company.
2. The Sunset Clause is intended for Closely Held Company that are required to distribute dividends, and may prefer distributing assets instead of cash.
3. In case of an immediate sale of the distributed asset, the Sunset Clause may not provide any benefit, and there is a risk of additional tax charge due to the High-Income Tax, resulting in 52% tax instead of 50%.
4. The use of the Sunset Clause may not be tax-efficient if the individual shareholder will dispose of the asset for a lower price than its initial cost base.