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Temporary Reduced Tax Rate for Dividend Distribution

Over the past few years there has been an increase in the exploitation of the two-stage taxation model in Israel for the purpose of deferring and reducing tax liability. Numerous individual shareholders elect to conduct profit-generating activities through companies under their ownership, without withdrawing the company's profits as dividend. Also, in cases where the individuals serve as officers or provide services to a sole entity, they choose to act through a fully owned company and not in their personal capacity. These companies are known as "wallet companies".

In order to access and make use of the funds accumulated by wallet companies and avoid payment of taxes as aforementioned, many shareholders withdraw funds from the companies in a variety of manners, inter alia, by way of loans or guarantees or through utilization of the company's assets.

In the interest of preventing the exploitation of wallet companies in order to avoid payment of tax on dividends, the Israeli Parliament (the Knesset) passed new amendments to the Income Tax Ordinance (new version) 1961-5721 (the **"Ordinance"** and the **"New Legislation"**, respectively), effective as of January 1, 2017.

The New Legislation deals with the two situations mentioned above upon the existence of certain conditions:

- **Payment for providing services through wallet companies is attributed to the individual shareholder and thus shall be subject to the individual's marginal tax rates.**
- **Utilization of funds that accumulated in wallet companies by way of a loan or by way of provision of a guarantee for a loan, or provision of an asset for the use and benefit of the shareholder, shall be deemed as the shareholder's income.**

Since the New Legislation sets a material change in the existing corporate tax system, and in order to allow taxpayers to adequately adapt to the new strict measures, the New Legislation includes a temporary order granting taxpayers **a reduced tax rate for dividend distributions on profits accumulated up to December 31, 2016.**

Under the temporary order, dividends distributed by a company from profits accumulated up to December 31, 2016 to an individual shareholder who holds, directly or indirectly, individually or jointly, at least 10% of one or more of the means of control of the company, shall enjoy a reduced dividend tax rate of 25%, rather than the prevailing rate of 33% (30% + 3% excess tax). Any such dividend distribution must be made **until September 30, 2017** in order to benefit from this tax relief.

The temporary order outlines the following conditions that must be satisfied in order to benefit from the reduced dividend tax rate:

- The dividend is distributed from profits accumulated up until December 31, 2016 (including from accumulated profits of subsidiaries), which were subject to or exempt from corporate tax (excluding distributions originating from a capital reduction or revaluation profits).
- The dividend must be distributed and paid to the individual shareholder between January 1, 2017 and September 30, 2017, but according to a tax ruling published recently, the dividend does not have to be paid in practice. Instead, a credit balance in favor of the shareholder may be created by the company. In any case, tax on the dividend income must be paid to the ITA until October 15, 2017.
- With respect to the 2017-2019 tax years, the aggregate income from employment (including retirement compensation and pension funds), management fees, linkage differentials or interest and other payments paid by the company, directly or indirectly, for the benefit of the shareholder can be no less than the average amount of payments paid to the shareholder, directly or indirectly, during the 2015-2016 tax years. The purpose of the New Legislation in this respect is to avoid a situation in which payments that are expected to be paid in the future are instead paid by way of dividend distributions which enjoy a lower tax rate.
- A capital loss that is derived from a sale of securities may not be offset against dividend income that was paid in the current tax year, pursuant to the temporary order.

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