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Israel Tax Authority Targets Tax-Avoiding Private Holding Companies

By Matthew Kalman

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- Uses increased powers to eliminate “abuse” of two-stage taxation
- Companies with no commercial activity used to reduce tax forced to distribute dividends

Executives in Israel will lose access to a popular tax loophole, previously available if they took on arms-length consultancy roles at companies where they used to work.

The companies are used for receiving funds that usually would be paid as salaries, fees, or income from the sale of shares. By leaving the funds in the company, the owners could re-invest them while paying only 23 percent corporate tax instead of up to 50 percent income tax. They also avoided paying national insurance.

But now Israel’s tax office will exercise powers—never before used—to force company owners to distribute dividends so they can be taxed at the full marginal rate. Doing so will also mean a crackdown on private holding companies that accumulate and reinvest earnings, shutting down a popular tax avoidance loophole used by senior executives and some investors .

If a company with five or fewer shareholders has accumulated revenue of 5 million shekels ($1.35 million), hasn’t distributed a dividend of at least 50 percent of its net revenues, and such distribution wouldn’t jeopardize its financial security, the tax authority director may recommend that up to 50 percent of its net revenues be deemed distributed and demand tax payable at the marginal rate from its shareholders, the ITA said in Circular 20/2018 issued Dec. 31.

Companies Being Assessed

“Each assessing officer is looking at the companies in his area and has started calling companies and shareholders to a hearing in order to assess whether they should apply this section or not,” said Daniel Paserman, a partner and head of tax at Gornitzky and Co. law firm in Tel Aviv.

“It’s important,” Paserman said by phone Jan. 6. “I think they will increase the pressure and start using the section effectively because it gives them a lot of power. They will go over the tax returns of all these private companies and they will see which have accumulated profits and they will start applying the section.”

“It’s a huge issue,” agreed Boaz Feinberg, a partner and head of tax and financial regulation at Zysman, Aharoni, Gayer and Co. law firm in Tel Aviv. “This was something that was never really addressed before. Israel did not have any kind of legal tool to have companies distribute their accumulated profits to their shareholders.”

To avoid a forced deemed distribution, taxpayers will have to ensure their private holding companies don’t accrue revenue in excess of 5 million shekels. Officials believe that most such companies voluntarily distributed their funds as dividends at the lower rate offered in 2017, but some dozens remain in the tax authority’s crosshairs.

“The authority to order the distribution of the profits of a company for tax purposes is one of the three methods promoted in legislation in order to eliminate the abuse of two-stage taxation solely for the purposes of reducing tax,” ITA Director General Eran Yaacov said in an emailed statement.

“I hope that the taxpaying public will unite behind the provisions of the law and its underlying rationale because the tax authority will not hesitate to use the tools provided by the legislator in order to eradicate and combat the abuse of two-stage taxation,” Yaacov said.

Masking Employer-Employee Relationship

The tax loophole was commonly used in Israel among senior executives who resigned their positions and became classified as supposedly arms-length consultants to the same firm. This enabled them to channel their remuneration to their private holding company and enjoy the benefits of such tax planning.

The Israel Tax Authority argues that the arrangement masks what is still an employer-employee relationship and the income should be taxed in the same manner as a salary. Using such powers for the first time, the authority hopes to eliminate the use of such companies that have no commercial activity, and usually are owned by a single individual or family.

Three-Pronged Attack

The circular completes a three-stage assault on the use of private holding companies. In 2017, shareholders became liable for tax on company funds used to pay living or rental expenses. The same year, the tax authority lowered the tax on dividends to 25 percent from 33 percent—a move that unlocked more than 48 billion shekels of undeclared revenue and netted 12.1 billion shekels tax in nine months.

Under Section 77 of the Israeli Tax Ordinance, the tax commissioner has had the authority to order the distribution of the profits of a company for tax purposes since 2003, but it has never been used. A 2017 amendment clarified the powers, which Yaacov says he will now start to exercise.

The circular doesn’t have the force of law and could still be challenged in court, Feinberg added.

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