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New Case Law: Obligating National Insurance Contributions for Family Company Income

Recently, the Regional Labor Court of Tel Aviv published a ruling in the case of **Refael Nechushtan et al.** (the "**Lawsuit**") which determined that individuals are required to make national insurance contributions for all income derived from a "Family Company", irrespective of its source or type, including income that would have been exempted if the individual had incurred it directly (and not through the Family Company).

An Individual's Obligation in National Insurance Contributions

The National Insurance Law (the "**Law**") provides that the calculation of the required insurance contributions should be made on the basis of an individual's taxable income, as determined by the Income Tax Ordinance (the "**ITO**"). However, according to the Law, **capital gains and income such as income from interest, dividends and rental payments generated directly by an individual are exempt from insurance contributions** ("**Exempt Income**").

What is a Family Company

According to the ITO, a company whose shareholders are all close family members can choose to be treated as a look-through entity for tax purposes (Family Company). The income and profits of a Family Company are attributed to the shareholder who is entitled to the largest share of the Family Company's profits, and she or he should report the Family Company's income and pay the taxes accordingly. The taxation of the Family Company's income is calculated as of the date at which the income is generated by the Family Company and not the date of the distributions to the individual shareholders.

National Insurance Contributions for Income attributed from a Family Company

Until 2008, the income of a Family Company was subject to insurance contributions only with respect to income that was actually distributed as dividend to the shareholders, regardless of the type of income.

In 2008, the Law was amended to provide that income generated by a Family Company be seen as having been distributed to its shareholders as a dividend, at the end of the tax year in which it was generated, even if it was not actually distributed, and hence it was subject to insurance contributions.

In 2014, the National Insurance Institute ("NII") published a statement establishing that an individual's exemption from insurance contributions with respect to Exempt Income shall also apply to income attributed to the individual from a Family Company. Thus, if the type of income was exempt from taxes for an individual, it was also exempt from taxes for income derived by a Family Company.

At the end of 2019, during the proceedings of the Lawsuit, the NII announced that they withdraw from their published position of 2014, and as of 2018, the NII should no longer apply the individual's exemption to the Family Company's income. Thus, as of 2018, the NII returned to the position it held between the years 2008 - 2014 of requiring insurance contributions on all income deriving from a Family Company regardless of the type of income and regardless of the actual distribution. However, the NII noted that no payment requests will be sent for the years 2014 - 2017.

The Lawsuit was submitted under the argument that income attributed from a Family Company, even prior to 2014, should be treated as Exempt Income for individuals.

Court Ruling

The Regional Labor Court dismissed the Lawsuit and argued that that the Family Company's income should be viewed “as if distributed" as a dividend obligated in insurance contributions. The Court further added that the legislature did not intend to distinguish between the sources of income in a Family Company and that all of the income of a Family Company should be regarded as having been distributed as a dividend obligated in insurance contributions, irrespective of the type of income (the ruling is in accordance with the position that was taken between the years 2008 - 2014).

It should be noted that the plaintiffs have submitted an appeal to the National Labor Court.

In light of the above ruling, when examining the establishment of a Family Company for any activity, including the holding of assets, the effects of insurance contributions on the profits received from such Family Company should be carefully weighed.

In this context, it is worth mentioning that the calculation of insurance contributions paid by an individual in connection with her or his income are limited to an income amount of NIS 44,020 per month (as of 2020). That is, for individuals whose income exceeds this amount, this ruling will have no effect on their obligation to pay insurance contributions. In addition, there are certain exemptions from insurance contributions. For example, an insured male over the age of 65 and an insured woman over the age of 60 do not have to pay insurance contributions.

For further information please contact:

Daniel Paserman
Adv. (CPA), TEP, Head of Tax
paserman@gornitzky.com

Inbar Barak-Bilu
Partner (CPA), TEP
inbarb@gornitzky.com

Tamar Barchad
Associate (CPA)
tamarb@gornitzky.com

45 Rothschild Blvd. Tel-Aviv, 6578403, Israel | Tel: +972-3-7109191 | Fax: + 972-3-5606555 | www.gornitzky.com