Office of the State Comptroller
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Israel Tax Authority

Taxation of Undistributed Profits

Abstract

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Background

In recent decades, a phenomenon developed in Israel of "wallet companies" – tens of thousands of individuals who establish designated wholly owned companies and, instead of receiving their income as salaried employees, as service-providers or as controlling shareholders of the company, they receive their income through the company. In this way, they can use money directly through the company unrelated to ownership and avoid paying the taxes applying to wages or dividends. Within the framework of the Economic Efficiency Law for the 2017 and 2018 Budget Years, several amendments to the Income Tax Ordinance were enacted that came into effect on 1.1.17, including Amendment 235 to the Income Tax Ordinance, which sought to regulate tax planning that could constitute abuse of the two-stage taxation method applying to companies. Additionally, in 2016, the Israel Tax Authority formulated a temporary order defining a reduced tax rate of 25% on dividend distributions to "material shareholders" of companies.

Key figures

27,000 companies
number of companies that distributed a dividend between January and September 2017 within the framework of the temporary order

ILS 61 billion
monetary volume of the dividends distributed

ILS 15.6 billion
tax revenue for dividends, mostly within the framework of the temporary order

ILS 4 billion
volume of the assessed tax benefit within the framework of the temporary order

91%
of the dividends at the reduced tax rate were distributed to individuals included in the top decile income bracket

57%
of the dividends at the reduced tax rate were distributed to people included in the top percentile income bracket

ILS 1.9 million
average dividend distributed to an individual in 2017

ILS 5.2 billion
total dividends at the reduced tax rate that were distributed to accountants, attorneys and tax advisors within the framework of the temporary order

Audit actions

From October 2017 to April 2019, the Office of the State Comptroller audited the staff work performed in the Israel Tax Authority with regard to taxation of undistributed profits and the staff work in preparation for the enactment of the temporary order regarding the distribution of reduced tax dividend. Supplementary audits were conducted in the National Economic Council, in the National Insurance Institute, in the Ministry of Finance and in the Ministry of Justice.

Key findings

- **Volume of accumulated profits in companies** – even subsequent to Amendment 235 and the dividend distributions at reduced tax rates in 2017 – distributions that embodied a tax benefit of about ILS 4 billion and which led to a one-time tax collection that totalled about ILS 15 billion – accumulated profits still remained within the companies. In 2018, the accumulated profits were estimated to reach about ILS 600 billion. As a result, the Tax Authority's assumption regarding the amendment to section 77 and its impact on the taxation of undistributed profits in companies in subsequent years did not materialize.

- **The Tax Authority's handling of the tax loophole** – the tax loophole involving private use of accumulated profits in companies was identified already in 2004. An interministerial committee that engaged in the matter concluded its work in 2013, but failed to submit a final report to the Minister of Finance. This situation is inappropriate, mainly considering the repercussions of the loss of tax revenues to the State deriving from the prolonged handling of the matter.

- **Presentation of alternatives in the staff work in preparation for draft bills for taxation of undistributed profits** – only one taxation alternative was presented to the decision-makers, and the interministerial committee's work addressing the potential taxation of undistributed profits did not receive optimal expression.

- **Estimates of the tax collection in preparation for draft bills for taxation of undistributed profits** – the tax collection estimate submitted to the decision-makers is the estimate prepared by the Tax Authority in the memorandum of law – ILS 300 million per annum. The chief economist in the Ministry of Finance, who is responsible for preparing tax collection estimates, did not prepare this estimate. In fact, dividends were distributed at the inclusive sum of about ILS 61 billion, and the increase in tax revenues was about ILS 15.3 billion.

- **Adapting the proposed temporary order to the government's socio-economic policy** – during the formulation of the proposed temporary order and prior to the discussion by the Knesset Finance Committee, the macro-economic implications for 2017 and for subsequent years and the temporary order's repercussions on the markets in general and on the housing market in particular, were not discussed,. The proposed temporary order was not disseminated to all departments in the Ministry of Finance for their information and comments prior to the discussion.

- **Discussions with the professional bureaus during the staff work in preparation for the draft bills for taxation of undistributed profits** – the discussions with the professional bureaus were not documented and there was no transparency in this regard, even though these discussions resulted in a significant reduction of the taxation targets specified in the government resolution of August 2016.

- **Realization of the tax benefit by various parties** – according to data received from the Tax Authority in July 2020, about ILS 35 billion out of the total dividends at reduced tax rates, which totaled about ILS 61 billion (about 57%), were distributed in about 30% of the taxpayer files that recorded a reduced-tax-rate dividend – to the upper percentile income bracket according to the Tax Authority's segmentation. About ILS 59 billion out of the total dividends at reduced tax rates which, as stated, totaled about ILS 61 billion (about 97%), were distributed in about 94% of the taxpayer files that recorded a reduced-tax-rate dividend – to the tenth and ninth percentile income bracket according to the Tax Authority's segmentation. Furthermore, analysis of the data found that 2,593 companies – in which some of their shareholders are members of professional bureaus that were involved, by virtue of their professional capacities, in the process of formulating the draft bill in the Knesset (accountants, attorneys, tax advisors and bookkeepers) – distributed reduced-tax-rate dividends totaling about ILS 5.2 billion to 2,904 of their shareholders. This represents an average of about ILS 1.8 million per shareholder.

- **Collection of national insurance fees from "wallet companies"** – as arises from the National Insurance Institute's response to the draft audit report, as of June 2020, more than three years after Amendment 235 came into effect, legal uncertainty still exists with regard to imposing national insurance contributions and health tax on income generated in respect of Amendment 235 to the Income Tax Ordinance. As a result, the insured's ability to fully exercise his rights to receive a pension are also adversely affected.

Use of collection surpluses – collection surpluses in 2017, totaling about ILS 13 billion, were largely used to reduce the deficit in 2017, so that the actual deficit was about ILS 25 billion, compared to the planned deficit of about ILS 37 billion.

Staff work by the National Economic Council – in 2014, the National Economic Council performed staff work on the subject of taxation of undistributed profits. The staff work was comprehensive and thorough and included an analysis of the database of all companies in the economy over several years.

Key recommendations

- It is recommended that the Ministry of Finance should examine the issue of profits accumulating in companies in Israel and the mode of taxation these profits and should consider the potential collection and the timing of the tax payment.

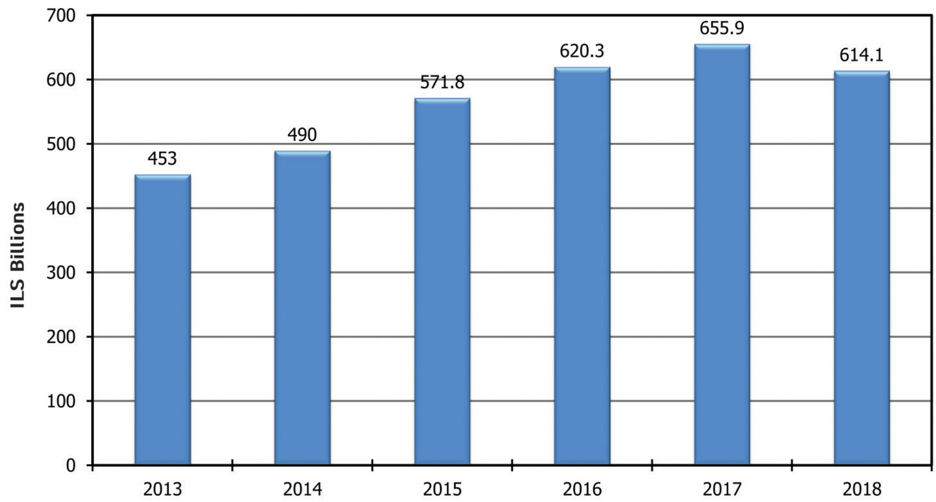
- It is recommended that the Tax Authority and the Ministry of Finance (the budget and chief economist departments) should examine a format for presenting changes to the legislative authority for every item of legislation so that it will include the main changes; reasons for sections that exclude taxpayer populations; calculation of the cost of excluding these populations and a general calculation of an updated estimate of annual tax collection.

- It is recommended that the Tax Authority should consider determining that particular databases will be defined as "permanent files" and used for current updating. Such a database may be used by all relevant parties to examining the effectiveness of legislation. It is also recommended that periodic comparisons should be made between the permanent collection estimates and estimates produced by other parties, such as the Chief Economist's department and the National Economic Council. It is also recommended to consider regulating the involvement of the State Revenue Administration in the process of preparing tax estimates in preperation for the enactment of tax legislation for the purpose of improving the estimates.

- It is recommended that the Ministry of Finance should perform a preliminary analysis of the impact of "tax campaigns" from a systemic and multiyear perspective as a basis for decision-making with regard to the tax policy, and particularly with regard to the economic profitability of the tax campaigns, their volume and timing.

- It is recommended that the National Insurance Institute should consider regulating the status of individuals working through a wallet company in relation to the aspect of payments to the National Insurance Institute and in the aspect of these insureds' exercise of their rights, and should clarify their statusin orderly directives. Accordingly, the National Insurance Institute should include in its audit plan an audit of wallet companies as defined in the Efficiency Law, and should draft, in collaboration with the Tax Authority, a procedure for information exchanges regardingtaxpayers and insureds.

Accumulated profits in companies 2013 – 2018 (in ILS billions)



Summary

This report addressed the issue of taxation of undistributed profits. Staff work performed on the subject of taxation of undistributed profits continued for about two years, but was not formulated as a final report in accordance with the committee's letter of appointment. This situation is Inappropriate, mainly considering the repercussions of the loss of tax revenues to the State deriving from the prolonged handling of the matter. Additionally, deficiencies were found in the staff work and in the presentation of the complete picture as a foundation for initiating amendments to tax legislation.

It was found that, apart from the one-time collection of about ILS 15 billion in 2017, which reflected a tax benefit of about ILS 4 billion, the Tax Authority's assumption regarding the amendment to section 77 and its impact on taxation of undistributed profits in companies over the years did not materialize.

The Office of the State Comptroller recommends that the Ministry of Finance and the Tax Authority should take action to draw conclusions from the deficiencies detailed in this report, particularly in relation to the performance of staff work in preparation for the initiation of tax legislation. It is also recommended that the Ministry of Finance should consider defining tax collection targets from trapped profits in companies and should periodically and methodologically examine the achievement of these targets.