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Israel issued draft bill for repatriating 'trapped profits' at a reduced tax cost

Overview

The Israeli Finance Minister recently announced a temporary provision that would provide an incentive for certain companies owned by multinational investors to repatriate 'trapped earnings'. According to this announcement, the main objective of the incentive is to encourage Israeli companies to distribute dividends out of undistributed profits that were tax-exempt under Israel's Approved Enterprise regime. Further, the projected immediate tax collection upon application of the temporary relief should reduce the Israeli government's budget deficit. The proposed draft bill and related commentary (the 'draft bill') were published on July 9, 2012. The publication of the draft bill triggered strong opposition from various sectors of the Israeli economy; consequently, it is currently unclear if and when the draft bill will be enacted and whether it will remain in its current version.

If enacted, the draft bill may affect certain Israeli companies significantly. Such companies may have enjoyed a tax exemption on undistributed profits that the companies have retained because of the potential tax burden upon repatriation, commonly known as 'trapped profits.'

Background

Many Israeli companies owned by multinational investors enjoy significant tax benefits in Israel if they qualify for Approved Enterprise or Benefited Enterprise (collectively, AE) status. However, such companies are subject to certain restrictions and limitations, such as those regarding repatriation of earnings, as relevant.

Under the Law for the Encouragement of Capital Investments, prior to its amendment in 2011 (the 'old law'), companies with AE status in certain cases were entitled to a tax holiday (an exemption from corporate income tax) for undistributed profits. Eligible companies generally could enjoy this tax exemption for two to ten years, depending on the enterprise's location.

Distributions or deemed distributions of earnings that benefited from the tax holiday are subject to recapture provisions under which they are subject to both corporate tax and withholding tax at the time of distribution or deemed distribution. Here, the applicable corporate tax rate is the reduced rate that would have applied to those profits upon their accrual had the tax holiday not been available -- between 10 percent and 25 percent depending on the foreign ownership percentage. In addition, dividend withholding tax of 15 percent (or a reduced rate under an applicable tax treaty) generally applies to such dividend distributions.

Effective January 1, 2011, various tax benefits (including the tax holiday) were abolished for taxpayers that elected to apply a newly legislated regime and replaced with new uniform tax rates. ***Note:*** The recapture provisions for distributions from accrued exempted earnings have remained unchanged. For prior coverage of these amendments, see "European Tax Newsalert: New Legislative Amendments to the Encouragement of Capital Investments Law" dated January 14, 2011.

As a result of the significant tax burden that a company may incur upon a dividend or deemed dividend distribution, many companies have refrained from distributing their accumulated tax-exempt AE profits. Thus these companies have large amounts of accumulated retained earnings remaining.

Proposed temporary incentive

The proposed temporary incentive is designed to encourage companies to better use exempt AE undistributed profits by providing discounted tax rates for a limited time. According to the draft bill, the corporate tax relief would be available only for tax-exempt AE profits accumulated through December 31, 2010, i.e., where such profits were generally accrued under the old law. It is our understanding that consideration may be given to possibly extend this period through December 31, 2011. According to the draft bill, this relief would be available from the date the final legislation is officially published until December 31, 2013 (the 'relief period').

The discount would increase in relation to the percentage of the accrued AE exempt income to which a taxpayer applies this legislation. The discount would range from 40 percent to 70 percent. The corporate tax rate would be discounted from the regular corporate tax rate that would have applied under the old law.

In other words, when a company would be subject to a 10-percent tax rate recapture upon distributing its exempt earnings, the discounted tax rate would range between 30 percent and 60 percent of the tax rate that would have applied. This would result in a corporate tax rate between three and six percent.

Note: The discount would not apply to the general additional dividend withholding tax rate for AEs under the law, which would remain at 15 percent (unless a reduced treaty rate is available). Furthermore, upon paying this discounted corporate tax liability, the company would not have to distribute a dividend from these profits (that is, a taxpayer may elect to pay only the discounted corporate tax and postpone the dividend withholding tax payment to a future date on which the dividend is actually distributed).

Key conditions under the proposed incentive

According to the draft bill, to qualify for the special reduced corporate tax benefit (the Benefitted Corporate Tax), taxpayers must meet certain conditions, including:

- The company must have an AE or Preferred Enterprise during the relief period; thus, a company with a benefit plan that has accumulated AE exempt income that is currently not benefitting from the Law for the Encouragement of Capital Investments seemingly would not be entitled to the relief provided by the proposed bill.

- The company must pay the Benefitted Corporate Tax within a certain period, as determined in the draft bill.

- The company must make a 'Designated Investment,' based on the mechanism set forth in the draft bill, (by purchasing productive assets, investing in research and development, and/or paying wages of new hires) in Israel during a five-year period beginning in the tax year in which it elected to pay the Benefitted Corporate Tax.

  A Designated Investment is defined as follows: *(a)x(b)x(c)x(d)*, where:

  (a) is the accumulated AE exempt income amount for which the company is requesting to pay Benefitted Corporate Tax (the Elected Amount);

  (b) is the proportion of the Elected Amount to the total accumulated AE exempt income amount;

  (c) is 30 percent; and

  (d) is the corporate tax rate that would have applied to the company if not for the relief under the draft bill.

  If the company does not make the full Designated Investment amount during this five-year period, it would have to pay an additional corporate tax based on the deficiency.

If the draft bill is enacted, the temporary tax relief could affect significantly Israeli companies owned by multinationals based in the United States and other countries, given the discounted tax rate that could apply to the deferred tax-exempt AE earnings upon payment of the respective taxes. This would enable them to distribute these earnings to their investors at an overall reduced tax cost. Consequently, investors may wish to consider the potential impact on their investments and plan accordingly.

Note: As the proposed temporary incentive has not yet been enacted, and given strong opposition of certain sectors of the Israeli economy, it could undergo further changes during the legislative process, if applicable.

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