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Israel Publishes Draft Legislation on the Proposed Pillar Two Implementation – Focus on QDMTT

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On October 5, 2025, the Israeli Treasury published draft legislation concerning the implementation of Pillar Two of the OECD/G20 Inclusive Framework on BEPS. As anticipated, and detailed in the "Memorandum of Law on Minimum Corporate Tax in a Multinational Group, 2025" (the "Draft Law"), Israel intends to implement only the **Qualified Domestic Minimum Top-up Tax (QDMTT)**, effective **January 1, 2026**.

This client alert provides a high-level overview of the key aspects of the Draft Law, emphasizing its alignment with OECD principles and highlighting considerations for multinational enterprises (MNEs) operating in Israel.

Israel's Approach: QDMTT Only

The Draft Law explicitly states that Israel will adopt only the QDMTT mechanism, as outlined in the OECD's Global Anti-Base Erosion (GloBE) Model Rules. This strategic decision aims to **preserve Israel's taxing rights while keeping it a competitive jurisdiction**. By imposing a domestic top-up tax, Israel ensures that any undertaxed profits generated within its jurisdiction are taxed locally, rather than being subject to the Income Inclusion Rule (IIR) or Undertaxed Profits Rule (UTPR) in other jurisdictions.

The Draft Law applies to Israeli Constituent Entities (CEs) that are part of an MNE Group with consolidated annual revenues of EUR 750 million or more in at least two of the four preceding fiscal years.

Interaction with Israeli Corporate Tax Incentives

The Draft Law mandates that Israeli CEs will be subject to a top-up tax if their Effective Tax Rate (ETR) on GloBE Income is below the minimum rate of 15%. The implementation of QDMTT in Israel significantly impacts the country's existing corporate tax incentive regimes. Israel currently offers various tax incentives, notably under the Law for the Encouragement of Capital Investments, which can significantly reduce the standard corporate tax rate of 23% for eligible companies. For example, a "Preferred Technological Enterprise" may be subject to a corporate tax rate as low as **7.5%** in development areas or **12%** in other areas. A "Special Preferred Technological Enterprise" (SPTE) can benefit from an even lower corporate tax rate of **6%** on its preferred technological income. With the implementation of QDMTT, MNEs benefiting from these reduced corporate tax rates will likely face an additional top-up tax in Israel to reach the 15% minimum (unless they have other income subject to the standard rate of 23% the **blending** with which will result in an ETR of at least 15%).

The adoption of QDMTT in Israel could have implications for the taxation of capital gains derived from the **sale of intangible assets** created as of 2017 that would otherwise benefit from a 6%

corporate tax rate under the Law for the Encouragement of Capital Investments (e.g., for a Special Preferred Technological Enterprise). If an Israeli CE sells an intangible asset and the resulting capital gain is taxed at a preferential rate of 6%, the QDMTT may require an additional top-up tax to be paid in Israel to bring the effective tax rate on that income up to 15%.

Adoption of OECD GloBE Rules

A crucial aspect of the Draft Law is its **absolute adoption of the OECD GloBE Model Rules**. The Draft Law explicitly incorporates the GloBE Rules by reference (**including the transitional safe harbors)**, including the "Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)" published by the OECD on December 14, 2021, and subsequent administrative guidance. Under the Draft Law the interpretation of Israeli law must consider the English text of the GloBE Rules, as well as the OECD's Commentary and Administrative Guidance, to ensure consistency and uniformity in international application.

Key Concepts and Calculations under the Draft Law

As aforementioned, the Draft Law mandates that Israeli CEs will be subject to a top-up tax if their ETR on GloBE Income is below the minimum rate of 15%.

The GloBE Income or Loss of each CE is determined by adjusting its Financial Accounting Net Income or Loss (FANIL) based on specific items. Key adjustments include:

- Net Taxes Expense: Excluded from GloBE Income.
- Excluded Dividends: Dividends from Ownership Interests (excluding short-term portfolio shareholdings and certain investment entities) are generally excluded.
- Excluded Equity Gain or Loss: Gains or losses from changes in fair value of Ownership Interests (excluding portfolio shareholdings) and gains/losses from the disposal of such interests are excluded.
- Intra-group Transactions: Transactions between CEs in different jurisdictions that are not recorded at the same amount or are inconsistent with the Arm's Length Principle must be adjusted.
- Qualified Refundable Tax Credits (QRTCs): Treated as GloBE Income.

Adjusted Covered Taxes are calculated by taking the current tax expense accrued in the CE's FANIL for Covered Taxes and adjusting it for:

- Additions to Covered Taxes: Includes amounts of Covered Taxes accrued as an expense in profit before tax, GloBE Loss Deferred Tax Assets utilized, and certain uncertain tax positions.
- Reductions to Covered Taxes: Includes current tax expense related to excluded income, Non-Qualified Refundable Tax Credits (NQRTCs), refunded or credited Covered Taxes (excluding QRTCs), uncertain tax positions, and current tax expense not expected to be paid within three years.
- Deferred Tax Adjustment Amount: Adjustments for deferred tax expenses/benefits, generally recomputed at the 15% minimum rate.
- QDMTT Exclusion: Importantly, any Top-up Tax accrued by a CE under a QDMTT is **not** included in Covered Taxes. This prevents double counting of the QDMTT itself when calculating the ETR.

The ETR for a jurisdiction is calculated by dividing the Adjusted Covered Taxes by the Net GloBE Income. The Top-up Tax for a jurisdiction is then calculated based on the Top-up Tax Percentage, Excess Profit, Additional Current Top-up Tax, and Domestic Top-up Tax. **The Substance-based Income Exclusion (SBIE)** reduces the Net GloBE Income subject to the top-up tax, reflecting the substance of the MNE's operations in a jurisdiction. It is composed of a payroll carve-out (5% of Eligible Payroll Costs) and a tangible asset carve-out (5% of the Net Book Value of Eligible Tangible Assets).

QDMTT in Practice: Allocation of Top-up Tax for Multiple Israeli Entities

The Draft Law addresses scenarios where an MNE Group has multiple CEs in Israel. This is a critical aspect for many MNEs with a significant presence in Israel, specifically because Israel generally (with one notable narrow exception) does not allow for consolidation for tax purposes. Each Israeli CE is primarily liable for its "independent top-up tax" if its ETR on its independent tax base is below 15%. To simplify compliance and potentially optimize the overall tax burden (as a group-level calculation allows for the blending of ETRs across all Israeli CEs), Israeli CEs within the same MNE Group can elect to designate a single "Designated Entity." This Designated Entity will then be responsible for calculating, reporting, and paying the proportional top-up tax for the entire Israeli group. The total top-up tax for the Israeli group will be allocated among the CEs based on their proportional share of GloBE Income. However, CEs with GloBE Losses in a given year will be treated as having zero GloBE Income for the purpose of this allocation, ensuring they are not allocated a share of the top-up tax.

To facilitate the payment of the group's QDMTT by the Designated Entity, the Draft Law specifies that transfers of funds from other Israeli CEs to the Designated Entity for this purpose will **not** be treated as income for the recipient or an expense for the transferring entity, provided the amount transferred does not exceed the transferring entity's proportional share of the top-up tax.

Reporting, Payment, and Penalties

The Draft Law establishes clear requirements for reporting and payment of the top-up tax, along with penalties for non-compliance. An Israeli CE (or a Designated Entity) **must submit a report detailing the top-up tax calculation** to the Tax Authority no later than **15 months** after the end of the fiscal year. For the first year an entity becomes part of an MNE Group, the deadline is **18 months**. **The top-up tax must be paid by the reporting deadline**. Overdue payments will incur linkage differences and interest.

Failure to submit the required report by the deadline may result in a civil penalty of **NIS 150,000** (approximately USD 45,000) for each full month of delay. Before imposing a penalty, the Director must issue a notice of intent to charge, allowing the defaulting entity 30 days to present its arguments. A repeated violation within two years of a previous penalty for the same offense will result in a doubled penalty. The Tax Authority may publish details of the penalty, including the name of the defaulting entity. For the first two years of the law's implementation, a notice of intent to charge a penalty will only be issued after the entity has been requested to rectify the violation and warned in writing that failure to do so within 60 days will lead to such a notice.

Interaction with US NTCI (GILTI) and the "Side-by-Side" Approach

On June 28, 2025, the G7 issued a statement agreeing to a "side-by-side" approach to the OECD's Pillar Two global minimum tax framework, allowing US-parented companies to be exempt from the IIR and UTPR in recognition of existing US minimum tax rules. The Draft Law does not directly address the "Side-by-Side" approach, and it is likely that Israel will follow any international agreement led by the G7 and OECD.

It is noteworthy that the implementation of a QDMTT means that any top-up tax paid in Israel will reduce the amount of top-up tax that would otherwise be collected by other jurisdictions under the IIR or UTPR. This in turn could impact their foreign tax credit calculations under GILTI for US MNEs.

Planned Incentives and QRTCs

The Israeli Ministry of Finance noted in the explanatory notice that it is actively working on a comprehensive incentive framework adapted to Pillar Two rules, primarily focusing on **Qualified Refundable Tax Credits (QRTCs)**.

For a tax credit to be considered a QRTC under Pillar Two, it must be designed to be paid in cash or available as cash equivalents within four years from the date the CE meets the conditions for the credit. QRTCs are treated as GloBE Income, meaning they do not reduce the Covered Taxes and thus do not negatively impact the ETR calculation for Pillar Two purposes.

The Ministry of Finance explicitly stated it intened to publish this incentive framework by the time the draft legislation is submitted for approval.

Other Important Forthcoming Development – ITA Expected Circular for Development Centers

The Israeli Tax Authority (ITA) is expected to release a long-awaited circular which is expected to further impact MNEs operating in Israel. This circular is expected to introduce new guidelines and clarifications regarding the valuation of Intellectual Property (IP), especially in the context of a post-acquisition change in the business model, and the allocation of income derived from R&D activities. Key points of discussion and potential implications for MNEs include a safe harbor for IP Valuation, more rigid internal processes within the ITA in case of tax audits aiming at challenging IP valuations within the safe harbour or the utilization of the TNMM / CPM for R&D services.

Conclusion

Israel's decision to implement only the QDMTT reflects a strategic move to protect its tax base and maintain fiscal autonomy within the new global tax landscape. MNEs with operations in

Israel should carefully review the Draft Law and its implications, particularly regarding their ETR calculations and potential top-up tax liabilities. The forthcoming incentive framework, especially the use of QRTCs, will be a critical factor in maintaining Israel's competitiveness for local subsidiaries of MNEs.

Our firm has vast experience in advising multinationals on corporate tax and transfer pricing strategies and in representing international and domestic clients before the ITA and the Israeli courts in corporate tax and transfer pricing controversies.

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