TAX
IN THE SPOTLIGHT

Dramatic Change in the Taxation of Share Redemptions – a New Israeli District Court Ruling

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A recent ruling (November 1, 2020) by the Haifa District Court in the tax appeal of **Beit Hossen Ltd.** and its shareholders[1] may change dramatically the taxation of share redemption transactions in Israel. As explained below, the **Beit Hossen** Ruling constitutes a deviation from past rulings issued by another Israeli District Court and the published position of the Israel Tax Authority (the "**ITA**"). This new ruling presents important tax planning opportunities, especially with respect to inbound investments in Israel.

The main legal question in the **Beit Hossen** Ruling related to the taxation of a non-pro-rata redemption of shares. Specifically, the court was required to determine whether a redemption of shares constitutes a deemed dividend distribution for the shareholders whose shares were not redeemed.

The court accepted the taxpayers' position ruling that the redemption is taxable only to the shareholder whose shares were redeemed. **The Beit Hossen ruling provides that a redemption should generally be viewed as resulting in a capital gain only for the redeemed shareholder.**

This determination has far-reaching implications. The position of the ITA so far has classified a share redemption as a combined event of capital gain and a deemed dividend distribution. This position has significant implications both for non-redeemed shareholders (who are required to pay tax on a deemed dividend distribution without receiving any cash consideration) and for redeemed shareholders (whose consideration for the share redemption is at times partially classified as a dividend subject withholding tax, instead of a capital gain that is usually tax-exempt for a non-resident investor).

[1] Tax Appeal 74155-12-18 Beit Hossen and others vs Assessing Officer Acre (the "**Beit Hossen Ruling**")

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We note, however, that most practitioners expect the ITA will appeal the **Beit Hossen** Ruling to the Israeli Supreme Court in light of the contradictory rulings issued by the District Court on this issue. The final word on the tax treatment of redemptions in Israel has yet to have been spoken, and taxpayers are strongly advised to seek professional advice based on specific facts.

Redemptions in General

Israeli Companies Act of 1999 (the "**Companies Act**") allows a company to purchase shares (or other rights convertible to shares) from its shareholders in a redemption transaction. The Companies Act views such redemption, whether done directly or indirectly through a subsidiary, as a distribution, similar to a dividend. In other words, a redemption can only be effectuated to the extent the company has earnings and profits (surplus) at the amount of the redemption consideration and the earnings and profits of the company are reduced by the amount of the redemption consideration.

The fact that a redemption, unlike a dividend under Israel law, can be carried out on a non-pro-rata basis makes it an important commercial tool for companies. For example, a disproportional redemption allows the company to cash out a single shareholder in case of a standoff between shareholders, which may affect the company's ability to operate its business.

Despite the important commercial benefits of a redemption, the ITA's position with respect to redemptions in recent years, as described below, has placed a high price tag on redemptions.

The Position of the ITA before the Beit Hossen Ruling

In the past, the ITA considered non-pro-rata redemptions as taxable only to the selling shareholders.[2] This position was changed in Income Tax Circular 2/2018 (hereinafter: "**Share Redemption Circular**"), which stated that the consideration paid by a company in a redemption should be treated as a dividend distribution to the non-selling shareholders. The ITA views the increase in the holding percentages of the non-selling shareholder in the company as a taxable benefit that should be characterized as a dividend. In some cases, the Share Redemption Circular even determined that a portion of the redemption consideration would be considered a deemed dividend to seller.

According to the ITA, there are two approaches for determining the tax event:

1. Under the **first approach**, a deemed dividend equal to the consideration amount is initially distributed to all shareholders. The remaining shareholders then purchase the shares of the selling shareholder for the (gross) dividend amount that they have been deemed to receive. This approach is particularly relevant in cases where only some of the shareholder's shares are redeemed.

[2] This position was articulated in Income Tax Circular 10/2001 "The Effects of the New Companies Law on Tax Law".

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2. Under the **second approach**, the remaining shareholders are first deemed to have purchased the shares of the selling shareholder for the consideration amount in accordance with their relative holdings in the company. They then are viewed as selling the purchased shares back to the company in exchange for the consideration amount, so that it is in fact a pro-rata redemption by the remaining shareholders (and accordingly, the second stage is classified as a dividend distribution). This approach is particularly relevant in cases where all of the selling shareholder's shares are redeemed.

We note that the ITA also published a reportable position (position No. 42/2017) that corresponds to its approach in the Share Redemption Circular.

The position stated in the Share Redemption Circular relied on two court rulings dealing with share redemptions on a non-pro-rata basis. Both rulings were issued in 2014, the first is the **Baranowski**[3] ruling and the second is the **Bar Nir**[4] ruling. In both cases, the Tel Aviv District Court ruled that the share redemption constituted an "artificial transaction," which the Assessing Officer could reclassify as a dividend distribution, because the redemption was motivated by the personal interests of shareholders rather than the commercial interests of the company.

Beit Hossen Ruling

As noted above, in the **Beit Hossen** Ruling, the Haifa District Court rejected the position of the ITA, while taking the view that a non-pro-rata redemption should be viewed as a capital gain for the selling shareholder, without triggering a deemed dividend to the other shareholders. In addition, the District Court took the principle position that a taxpayer may be subjected to tax on a deemed distribution, as the ITA argued, only where there is clear legislative authority to do so.

The ruling of the Haifa District Court was based on several principle legal determinations. First, the court ruled that the so-called 'enrichment' of the remaining shareholders as a result of an increase in their holding percentages in the company is not sufficient to impose a tax liability on them, in light of the tax law realization principle. A taxpayer is liable to pay tax only when it realizes a built-in gain in its property. So long as such built-in gain is not realized the taxpayer can only be liable to tax in exceptional cases. A share redemption does not constitute a realization of gain by the shareholders whose shares have not been redeemed.

In addition, the court questioned whether the remaining shareholders were in fact 'enriched' by the non-pro-rata share redemption. The shareholders' holding percentage in the company increased, but the value of their holdings in the company decreased by the amount paid by the company to the redeemed shareholder, which should have left them in the some economic position. The court was unfavorable also to the argument that an increase in ownership should

[3] T.A. 21268-06-11 Dan Baranowski v. Assessing Officer Gush Dan, Taxes 28/2 (April 2014) e-9.

[4] T.A. 1100-06 Bar Nir Tamar v. Assessing Officer Gush Dan, Taxes 28/6 (December 2014) e-7.

necessarily be viewed as benefitting the shareholder as a result of gaining additional control over the company.

The **Beit Hossen** court further provided in its ruling that the establishment of a tax event should be set out clearly in primary legislation and not by interpretation of the ITA or a court.

According to the ruling, not every share redemption transaction can be classified as an artificial transaction intended to reduce the tax liability. It is actually the ITA's position on this matter that seems more artificial than the straightforward redemption classification. The taxpayer, per the **Beit Hossen** Ruling, is allowed to choose a low-tax alternative and it seems that the artificial classification of the transaction by the ITA was done in a manner intended to increase the tax liability relating to the transaction.

Finally, the court determined that it is not sufficient that the shareholders in the company control its actions in order to classify the share redemption as a dividend. Purchasing a shareholder's entire stake in a company by way of redemption may serve the interest of the remaining shareholders as well as those of the company.

Conclusion

The **Beit Hossen** ruling allows companies to redeem shares on a non-pro-rata basis where there is a valid business reason, without having to deal with the problematic tax consequences of taxing deemed income or classifying income from the sale of shares by a nonresident (who is typically exempt from Israeli tax under domestic law or the provisions of a double taxation treaty) as a dividend subject to withholding tax.

Notwithstanding the foregoing, the anti-avoidance rules still apply also to redemptions. A redemption that is effectuated for the sole purpose of reducing tax liability of a taxpayer, who is unable to present a valid business purpose for the transaction, may still be challenged, even under the **Beit Hossen** standard. In addition, we expect the ITA to appeal this ruling to the Supreme Court, which will be required to choose between the contrary rulings issued by the District Courts in recent years.

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Our tax department is available and will be happy to advise on the aforementioned matters and assist in dealing directly with the relevant units at the ITA. We are, of course, at your service and available for any inquiry you may have.

Sincerely,

The Tax Department

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