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Recent Developments in International Taxation

Israel

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Recent highlights

During the majority of 2022 and the beginning of 2023, the most significant developments with international tax orientation that took place in Israel involved several court rulings. Recent changes in Israeli governments and various domestic events have led to a recent decrease in the volume of legislation in different tax areas. However, recently, signs of change have been observed. Widespread global inflation has slowed down the steady growth rates that several countries, including Israel, have enjoyed. This situation has triggered awareness and is expected to result in reforms in various areas. These reforms range from mechanisms for determining Residency to comprehensive future taxation reform in the field of Partnerships and the expected treatment of 'Exit Tax' for those leaving Israel.

Although these are currently just proposals, given the extensive discussions on these topics, we anticipate significant changes in the foreseeable future.

The taxation contributions and distributions of Israeli real estate assets to Trusts – Galis Case

Intro

In accordance with the provisions of the Israeli Income tax Ordinance, the <u>contribution</u> of an asset (without consideration) to a trust, by itself, does not trigger a tax event (as it is not deemed as 'sale'). While so, the <u>distribution</u> of asset to a beneficiary, is treated as if the asset was transferred directly from the settlor (or grantor) of the trust to the beneficiary, and the taxation method is determined based on the nature of the relationship between them.

This is, in fact, our starting point in the 'trusts chapter' of the Income Tax Ordinance. While it is generally clear regarding contribution of assets subject to the Income tax Ordinance, the question of the contribution of real estate assets to a Trust has been a matter of dispute until it reached the Supreme Court, and just in the past year, it was finally resolved with a definitive ruling.

The Legal Dispute

The court case dealt with a Canadian couple (the Glis couple) who established a trust in Israel for their granddaughter, an Israeli resident. The couple contributed several real estate assets held through a trust assets holding company. The main dispute between the tax authorities and the couple revolved around whether the provisions of the Trusts Chapter in the Income Tax Ordinance, which states that a contribution (made with no consideration) of asset from the settlor to the trustee in an Israeli residents Trust is not considered a "sale" (meaning that the tax will be deferred to the date of the asset's sale by the trustee or its distribution to the beneficiary). The question was whether this provision applied to real estate assets in Israel as well. Alternatively, whether the transfer of real estate assets to the trust should be considered a "sale" already at the time of the acquisition, thus subjecting it to purchase tax and appreciation tax, and when the real estate is transferred to the beneficiary, it will be subject to purchase tax and appreciation tax as a "sale" from the trustee to the beneficiary, as argued by the tax authorities – as if the contribution and distribution of the asset are both considered as "sale" and therefore taxed twice.

Supreme Court Ruling

The Supreme Court ruled that, in the specific circumstances of the case, there is no basis for applying a tax exemption at the time of the contribution as the Israeli Land Taxation Law does not include a specific exemption for the contribution to such Trust. As for the distribution, the Court held that the exemption under Section 69 of the Land Taxation Law is not applicable due to two reasons: first, the essential condition of the trust, which is the existence of a known and specific and beneficiary; and second, the procedural condition, as the trustee did not disclose the identity of the beneficiary to the tax authorities.

Implications of the Ruling

Regarding land taxation (unlike the provisions of the Income Tax Ordinance), the tax event upon transferring real estate assets in Israel to the trustee occurs already at the time of the contribution, and it is not deferred to the date of sale or distribution. Under the broad definition of "sale" in the Land Taxation Law, even contribution of Israeli real estate asset to a trustee falls under the category of "sale," and it incurs appreciation tax and purchase tax at the time of acquisition.

Some might say that this ruling signifies a change in the taxation rules, others might say it is closing a legal loophole. Consequently, this ruling probably triggers a need for some changes to be made in existing structures or arrangements of trusts.

Summary

In summary, this legal ruling clarifies the tax treatment of Israeli real-estate asset contributions to Trusts in Israel and imposes taxation on such transfers at the time of contribution, affecting the overall taxation of real estate assets under trust arrangements. Trust settlors and beneficiaries must consider these tax implications and adjust their estate planning strategies accordingly.

Ultimately, I should mention that our firm represented the trust in this case. Despite disagreeing with the court's ruling, it is not the 'demise' of the Trust institution in Israel; on the contrary, this result opens the door for a new and creative establishment of trusts in Israel.

Taxation of Share Buyback – the case of Beit Hosen

Intro

These two cases (which were discussed together) dealt with the tax implications arising from a share buyback by a company. The mechanism of a share buyback is a common commercial practice in which the company repurchases its own shares from its shareholders, either from all of them or some of them. The reasons for calling on share buyback vary between events that a company wishes to create credibility and its trust in its activity to events of deadlock between the shareholders.

In Israel, the question arose regarding the tax aspects when such a share buyback is executed. On one hand, there was a question of whether this action does not trigger a tax event for the remaining shareholders (as long as there was no pro-rata buyback among all shareholders) because the value of their holdings remains the same in their eyes (despite the change in their percentage of ownership). On the other hand, it was considered whether it could be viewed as a distribution of dividends to the shareholders, given that there was a reduction in the company's equity.

An initial perspective over the situation raises the question relevancy to international tax aspects. However, delving into the discussed issue leads to the understanding that foreign investors need to be aware of the implications of this mechanism. Such awareness is crucial because the derived consequences from it might lead to unexpected tax ramifications (from tax withholding, mismatches between tax events in different jurisdictions and the inability to receive such paid taxes as credits), even if those shareholders did not gain financially from the transaction on a cash-flow basis.

The Legal Dispute

The Supreme Court, in its ruling, needed to address two contradictory verdicts from the lower district courts. And still, even in this case, the three justices of the Supreme Court did not reach a unanimous decision regarding the proper categorization of the share buyback events.

On one hand, before this ruling, the Supreme Court followed the "dominant purpose" principle, which led to the execution of the share buyback, and if the buyback was intended to serve the personal interests of the shareholders, it was considered a distribution of dividends. On the other hand, if the buyback was intended to serve the interests of the company, it was considered a withdrawal of funds (or reduction of equity) that did not trigger a tax event for the remaining shareholders.

Supreme Court Ruling and Tax Implications

After a thorough examination of the share buybacks event by all the Supreme Court justices (each provided a separate analysis), the Court, based on the joint opinion of two judges, ruled that the "dominant purpose" test is a reasonable conceptual test. However, applying it in the context of companies, as in this case, is extremely challenging. Moreover, it is susceptible to manipulation by the shareholders and does not provide certainty to the public.

As a result of this ruling, the Supreme Court introduced a new concept, which is the "quasi-partnership" company. This refers to a company in which a minority of shareholders are involved personally and have a high level of trust-based relationships with the management in a joint management of the company. According to the Court's approach, in such cases where the interests of the shareholders and the company are intertwined, it is appropriate to consider it as the interest of the shareholder, and thus, it creates a taxable event in their hands.

Ultimately, the Court determined that the dividend event related to the share buyback expresses a full dividend distribution to all shareholders who were shareholders before the buyback.

The exchange rate in a transaction to be used in order to determine the capital gain – the Case of Shpont

Summary

When a transaction in foreign currency takes place, whether it is a purchase or a sale, the question arises of which exchange rate should be used (for calculating the consideration or determining the cost of the asset) while reporting to the Israeli tax authorities.

Over the years, the prevailing approach in Israel was to determine the transaction, and thus the exchange rate, based on the date when the transaction was finalized. This issue has sparked many debates about whether the date of finalization is the date of signing the agreement, the closing date, or some other date.

Recently, the Supreme Court issued a ruling, following joint deliberation and agreement between the parties, precisely on this question. After a discussion and with the arguments presented by both parties, it was agreed that the date for determining the exchange rate should be the date when the transaction was approved by all relevant entities for its execution—meaning, even before the formal signing of the agreement.