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by Amnon Rafael and Shlomi Lazar

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PRACTITIONERS' CORNER

Determining When a Dividend Becomes Remuneration In Israel

by Amnon Rafael and Shlomi Lazar

Amnon Rafael and Shlomi Lazar are partners with A. Rafael & Co. Law-Offices in Tel Aviv.

In *Dr. Eily Barnea v. Assessing Officer Haifa* (Nov. 23, 2010, TA 906/07), the District Court of Haifa faced the problem of categorizing a payment made by a company to a former employee.

The taxpayer was allotted redeemable preference shares of the parent of the employer company, which were to pay dividends out of the earnings derived by the employer from three of its Israeli subsidiaries. The shares issued to the taxpayer accounted for 10 percent of the share capital of the employer company. The shares were financed by a loan granted by a trust company set up by the employer company. (At the time the Companies Ordinance prohibited financial assistance by a company for the acquisition of its shares.) The trust company received the dividends and used them to pay the employee's loan. Dividends that were not set off against the loan were paid to the taxpayer. The preferred redeemable shares did not carry voting rights. They vested in their holders the right to a noncumulative preferred dividend. They were convertible into ordinary shares. In the allotment agreement it was decided that the holder would sell his shares to the employer company upon the termination of his employment. Thus, a direct link was established between the employment and the holding of the shares. Some nine years after the allotment of the shares, the taxpayer's employment was terminated.

Over the years, dividends were distributed on the redeemable preference shares. However, the dividends were not distributed exclusively out of the earnings of the three Israeli subsidiaries contemplated by the allotment agreement. The earnings included those of foreign and sister companies engaged in projects in which the holders of the redeemable preference shares were actively involved.

Following the termination of the taxpayer's employment and prolonged negotiations, it was agreed that:

- a dividend would be distributed on the redeemable preference shares so that the taxpayer would receive $2 million;
- the taxpayer would receive $100,000 for services provided to the companies; and
- the taxpayer would sell his shares for $280,000.

The redeemable preference shares were duly converted into ordinary shares.

The assessing officer assessed the dividends as ordinary income, claiming they were regular remuneration. Moreover, the taxpayer had deemed almost his entire gain from the sale of the shares to include a ratable portion of the retained earnings of the parent company of the employer company on which the tax payable was at the time limited to 10 percent. The assessing officer denied this inclusion, claiming that retained earnings eligible for the 10 percent tax did not include balance sheet equity earnings.

The assessing officer did not contend that the allotment agreement constituted an artificial transaction. Instead, he argued that the transaction should be recharacterized, that is, the court should construe the facts presented to it as giving rise to the payment of ordinary remuneration income and not dividends. At the time, ordinary income was subject to a 50 percent maximum marginal rate while dividends were subject to a 15 percent flat rate (approved enterprise).

The court held that the assessing officer was obligated to examine a transaction in accordance with its true economic substance, whether in accordance with corporate law or fiscal law, which limits taxpayers' tax planning opportunities.

The court also held that nomenclature used in the transaction cannot be conclusive of its nature. The assessing officer is under no obligation to accept the characterization of a distribution of profits. He must examine the services provided by the taxpayer to the paying company or the context in which the payments were made. If following an examination it appears that the distribution was not a dividend but rather a bonus to an employee holding special shares in the paying company, the assessing officer may regard the payments as remuneration for services and tax them as such. Therefore, even if the appropriate corporate procedures were followed regarding the distribution of dividends, if the substance of the transaction points in a different direction, the distribution will not be a dividend for tax purposes.

A distribution will be regarded as a dividend only when payable to a shareholder in his capacity as such and in accordance with the rights to which the shares entitle him. The evidence in this case demonstrated that the payment was made as a result of the performance of services and as an expression of gratitude in view of the success of the project for which the services were rendered. This was quite apparent from the fact that the earnings out of which the distributions were made were derived from projects in which the distributing company was not engaged (affiliated companies) but for which the recipients of the distributions supplied their personal services. Moreover, the distributions were made solely to the owners of the redeemable preference shares, with the ordinary shareholders receiving no dividends whatsoever.

The distributions were therefore characterized as ordinary income subject to regular marginal rates. (It would be interesting to know if the paying company received a corresponding adjusting expense.)

As for the retained earnings to be taken into account in computing the capital gain, these, the court held, reflect earnings taxed at the corporate level or exempt from tax at that level. Following this logic, equity earnings could not be part of the retained earnings for purposes of computing the capital gains tax, for they were not liable to tax in the hands of the company whose shares were sold. The court held that equity earnings did not constitute ''income'' and therefore could not be ''exempt income.''

In *Barnea*, substance as opposed to form carried the day for the assessing officer. Perhaps the employees were a bit too greedy. Had the distributions come from the earnings of the distributing company as originally envisaged, had bonus payments not been made for projects served by them and handled by other companies, and had dividends been paid on the ordinary shares, the result might have been different. One should remember that something always is better than nothing. ◆