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Dividend Payment Prior to Share Sale Was Artificial, Court Holds

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COUNTRY DIGEST

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The Tel Aviv District Court recently held that a dividend paid exclusively on shares that were subsequently sold to the dividend-paying corporation constituted part of the consideration paid for the shares and was therefore taxable as part of the capital gain achieved on the sale.[1]

Facts

In the case at issue, the taxpayer and her brothers inherited, in equal parts, the shares of a corporation. The heirs entered into lengthy negotiations to allow the taxpayer to part from the corporation, eventually agreeing that her shares would be converted into class A shares and that she alone would receive a dividend of ILS 3,485,000 (approximately $935,432), after which her class A shares would be sold to the corporation for ILS 1,681,000 (approximately $451,209). The articles of association of the corporation were altered to allow for the conversion of the shares and the distribution of the exclusive dividend, the two-step transaction was carried out, and proper returns were filed.

Arguments

The assessing officer contended that the dividend received by the taxpayer prior to the sale formed part of the consideration paid on the shares. It therefore was to be added to the consideration of ILS 1,681,000 and taxed in accordance with the capital gains tax regime, the officer said.

This argument was based on the true economic substance of the transaction or in the alternative — in view of the series of coordinated transactions — on the Income Tax Ordinance's provisions entitling the assessing officer to disregard artificial transactions undertaken primarily to unduly decrease tax liability.

[1]*Golan v. Assessing Officer Kfar Sava* (TA 1110-06), Dec. 31, 2011.

The taxpayer claimed that the dividend had been lawfully distributed in accordance with the Companies Law and that the assessing officer could not characterize it differently. She said the profits of the corporation had not been distributed in the past because the other shareholders who controlled the corporation vetoed a distribution. The dividend that was paid out constituted the profits to which she would have been entitled if they had been paid out in a timely manner, she argued. Moreover, the dividend represented past earnings that were paid to compensate her for the investment risk inherent in the shares, and the consideration for the shares was paid in return for a waiver of any future rights in the corporation, she added.

Also, the taxpayer claimed that the assessing officer's assessment resulted in a tax of 68 percent, consisting of the tax levied on the company's income combined with her personal CGT, while the maximum CGT (at the time) was 50 percent.

Decision

The court held in favor of the assessing officer. It found that the dividend could not be recharacterized on the basis of corporate law; therefore, it examined the applicability of the provisions dealing with artificial transactions.

The court held that during their negotiations, the parties negotiated the sum payable for the shares. The separation of the sum into a dividend and into consideration for the shares was an afterthought, it said. The parties did not negotiate the value of the shares combined with the dividend.

The court then concluded:

> I must comment with all due respect, that in the circumstances of this appeal, the use of the terminology ''legitimate'' impairs the contention raised and harms the notion of ''legitimate tax planning.'' This is not a case of choosing a tax savings course as opposed to a fully taxable course in a transaction which enjoys true economic reasons. . . . The taxpayer did not choose a tax savings course but rather the construction of a detour which required the alteration of the corporation's articles of association. . . .

> The parties chose a course lacking any commercial reason and it is therefore a far cry from ''legitimate tax planning.'' . . . To create on the eve of the transaction calling for an exit of a shareholder, discrimination amongst the shareholders, so that only one shareholder, the taxpayer, who one moment later sells her shares to the corporation, will be entitled to the dividend, this action is one whose illegitimacy colors its entirety as such.

The court further held that an artificial transaction cannot be justified by the taxpayer's desire to achieve a result similar to one denied by the provisions of the Income Tax Ordinance. The court referred to section 94B of the Income Tax Ordinance, which mitigates the tax on that part of the consideration representing retained earnings from the seven-year period preceding the sale that is subject to CGT. In the case at hand, the seven-year limitation barred full enjoyment of the relief under consideration. The taxpayer could not overcome that limitation bar by means of an artificial transaction according her an exclusive dividend, the court concluded.

Summary

This case does not mean that all sales of shares after a dividend distribution are artificial. The finding in this case was reached because the dividend distribution was made only to the taxpayer. If the other shareholders had also enjoyed the dividend distribution, if the shares had originally been allotted to all the shareholders as class shares with an economic motive, or if more time had elapsed between the distribution to the taxpayer and the sale of the shares, the results could have been very different. The court in this case did not mention the *Ramsay* doctrine, but its ruling is remindful of the principle that a preordained series of transactions designed to achieve a tax savings will not attain its ultimate goal. ◆

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