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Transaction Not Eligible for Tax Break as Sale of Goodwill, Court Rules

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COUNTRY DIGEST

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The Tel Aviv District Court on March 24 ruled in *Landau Insurance Agency v. Assessing Officer* (joined cases TA 1046/05, 1048/05, and 1049/05), and that a transaction undertaken by the taxpayers did not qualify as a sale of goodwill and thus was not eligible for beneficial capital gains tax treatment.

In *Landau*, the taxpayers, who are insurance agents, entered into an agreement under which:

- the parties would establish a corporate insurance agency in which the taxpayers would hold a major equity interest; and
- a buyer would purchase 49 percent of the goodwill of the taxpayers' existing agency and transfer it, together with the remaining goodwill of the taxpayers (51 percent), to the new corporate agency.

The taxpayers agreed not to compete with the new corporate agency and to be in its employment for a lengthy term.

The taxpayers claimed CGT treatment on the sale of the goodwill. The assessing officer countered that the subject matter of the sale was not goodwill, which in the tax year under consideration was eligible for generous tax relief while other, noninflationary capital gains were subject to ordinary income tax rates (now limited to 20 percent on all assets except for shareholdings of 10 percent or more, which are subject to a rate of 25 percent on the sale of the shares).

The court ruled in favor of the assessing officer, saying the transaction did not constitute a sale of goodwill because the taxpayers were under an obligation to continue to indirectly work for the buyer. The taxpayers did not dispose of the goodwill; rather, they continued to make use of it in the new corporate environment, the court said. The buyer did not acquire the clients, and the taxpayers retained an economic risk in the goodwill, and thus could not be treated as having sold it, the court said.

It stressed that selling only part of the goodwill made it difficult to distinguish the personal goodwill from the business goodwill of the selling taxpayer.

The net result is difficult to accept because in the final analysis, the entire business of the taxpayers found its way into the new corporate entity. The circular route they took (with the buyer purchasing 49 percent of the goodwill) was necessitated by the parties' desire to receive both cash and shares in the new entity upon the liquidation of their insurance agency. The two-step strategy allowed for a tax-deferred transaction involving the remaining goodwill (51 percent), for which shares in the new corporate insurance agency were issued to the taxpayers. Their attempt to defer tax resulted instead in a higher tax. ◆

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