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Loan Repayment in Triangular Market is Taxable Dividend: Israel

By Matthew Kalman

Multinationals acquiring Israeli companies through reverse triangular mergers won't be able to avoid tax by treating the cash provided to purchase the target as a loan to the newly merged company.

A circular from the Israel Tax Authority has plugged a hole in the law, which doesn't address the tax treatment of such mergers, but disappointed practitioners in its treatment of the resulting debt, both from the acquiring company and third parties.

Snapshot

- ITA confirms longstanding practice
- Decision, open to court challenge, disappoints but doesn't shock practitioners

The guidance (Circular 3/2018), published Jan. 23, confirms that Israel regards the repayment of a parent company or third-party loan used to acquire the shares of a target company in a reverse triangular merger as a dividend under Israel's tax code, and therefore subject to tax.

"I would classify it as an anti-avoidance circular," said Daniel Paserman, a partner and head of tax at Gornitzky and Co. law firm in Tel Aviv. It will increase the price of purchasing Israeli companies and can still be challenged in court, he said.

"It will make it more expensive. I'm not sure it will deter multinationals but it for sure makes it more expensive," he said.

Triangular Structure

The triangular acquisition structure, in which the purchaser creates a wholly owned subsidiary which then merges with the acquisition target, is commonly used to avoid the need under Israeli law to issue a public tender for the target company's shares and receive approval from 95 percent of the shareholders. A merger requires the approval of more than 50 percent of the target company's shareholders.

Under Section 103 of the Israeli Tax Code, some mergers are exempt from tax, including those where "the companies wish to merge for a business and economic purpose, with the main objective of the merger being to enable the joint management and operation of their activities." Unless the transaction fulfills other specific requirements to meet the tax exemption, the use of a reverse triangular merger alone isn't usually enough to qualify for an exemption under Section 103, according to the circular.

Some Certainty

The tax authority "could have taken a more favorable approach," Paserman said Feb. 6. Practitioners understood how to treat the transactions and were used to them being taxed, he said.

"The circular published for the first time the formal guidelines of the tax authority in respect of this type of transaction and the bottom line is that in most cases all these kind of transactions are subject to tax and you will not be entitled to the exemption."

The circular "gives some kind of certainty about the tax implications of a reverse triangular merger" in the absence of specific rules in the law about the taxation of such deals, said Binyamin Tovi, partner in charge of international taxation at Shekel and Co. law firm in Tel Aviv. Although the loan repayment is taxed as a dividend, acquiring companies can retrieve their loan without having to comply with dividend distribution rules under Israel's company law.

"Under Israeli corporate law, if you don't have sufficient earnings, you cannot distribute dividends," Tovi said. "You can either distribute the accumulated profits of the company or of the last two years. When you repay a loan you don't need to comply with this test.”

Debt Push-down Response

The Israel Tax Authority is reacting to an acquisition structure known as a debt push-down, “under which a newly-formed leveraged Israeli subsidiary of the buyer with no assets is merged with and into the Israeli target or acquired company, where the target survives the merger,” said Yuval Navot, a tax partner at Herzog Fox and Neeman law firm in Tel Aviv.

The loan of the merger subsidiary is repaid with cash from the target company after the merger. While the loan repayment would only trigger a withholding tax on the interest, the tax authority doesn't realize there is a loan repayment and recharacterizes it as a dividend distribution. But now, the tax authority will levy a withholding tax on the entire loan amount, he said.

“This makes leveraged buyouts of Israeli companies more difficult to make. The fact that this structure is impossible to implement in Israel often comes as a surprise to foreign multinationals buying Israeli companies,” Navot said by email Jan. 30. “They used to do this debt pushdown acquisition structure and they see that in Israel it's not possible and it makes the transaction more expensive. There are other ways to do it but they are less efficient.”

Treatment of Third-Party Debt

Though the loan repayment is taxed as a dividend, acquiring companies can retrieve their loan without having to comply with dividend distribution rules under Israel's company law.

“Under Israeli corporate law, if you don't have sufficient earnings, you cannot distribute dividends,” Tovi said. “You can either distribute the accumulated profits of the company or of the last two years. When you repay a loan you don't need to comply with this test.”

Any flexibility offered in the circular is offset by its treatment of third-party debt, Tovi said. Loans from banks or other third parties also can't be pushed down into the merged company and repaid from its funds, which would avoid the need to distribute a dividend to shareholders and trigger a tax event to serve the debt.

“The tax authority is saying this is not acceptable, and they will deem the inclusion of the bank debt in the purchased company as a result of this merger as a dividend distribution on the day of the merger, not similar to shareholder's debt in which the tax event is on the repayment of the loan,” Tovi said. “This is bad news. I would expect similar treatment both for bank debt and for the shareholders’ loan. The circular is saying bank debt will be taxable immediately.”

The stance is “a bit aggressive” and could deter investors because there will be high dividend taxes on the transaction, he said.

I don't think a purchaser would want to create additional transaction costs, especially if you are a foreign resident. I'm not sure this is a good development,” he said.

To contact the reporter on this story: Matthew Kalman in Jerusalem at correspondents@bloomberglaw.com

To contact the editor responsible for this story: Penny Sukhraj at psukhraj@bloombergtax.com

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