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## Indirect Tax Credit in Sale of Foreign Companies

**A recent landmark ruling of the Israeli Tax Court regarding the sale of shares in a foreign company held by an Israeli entity, ruled that a tax concession granted in connection with the sale of Israeli companies, extends and applies to the sale of share interests in foreign companies. In making its ruling, the Israeli Tax Court heralded a clear shift in the assessment of taxation disputes.**

Under Israeli tax law, the profits of a target company that are not distributed to shareholders prior to a sale, may, under certain circumstances, be treated as a dividend distribution immediately preceding the sale, meaning, that such undistributed profits may be characterized as dividend income rather than as a capital gain.

The ability to characterize such undistributed profits as dividend income gives rise to a tax neutrality, as the tax treatment will be the same irrespective of whether the profits are distributed or retained by the target. Importantly, this allows the selling shareholder to decide on commercial grounds whether retained profits should be distributed, and not on the basis of tax considerations. Additionally, in the event that the selling shareholder is a company subject to taxation in Israel, such profits will not be subject to additional taxation in Israel, until distributed to an individual shareholder.

Previously, this special income recharacterization was customarily interpreted to apply only to the undistributed profits of an Israeli target company, which were already subject to corporate tax in Israel.

In the case of Delek Hungary, this ability to characterize undistributed profits as dividend income was extended by the Israeli Tax Court to the sale of shares in foreign companies, which were subject to corporate tax abroad.

In this case, the taxpayer, Delek Hungary, represented by Gornitzky & Co., had sold share interests in Delek US, a US publically traded company. Delek Hungary claimed that the portion of its earnings from the sale attributable to the undistributed profits of Delek US, should not be taxed in Israel, as such profits were already taxed at the US corporate rate. It was argued that had these profits been distributed as a dividend prior to the sale, no Israeli tax liability would have been incurred due to the indirect tax credit received on account of the payment of corporate tax in the US on such profits. Accordingly, Delek Hungary was entitled to characterize these profits as dividend income, rather than as a capital gain, and no additional tax was required to be paid in Israel.

The Israel Tax Authority rejected this interpretation, and issued Delek Hungary with a NIS 200 million tax assessment, whereby a capital gains tax liability was imposed on the entire earnings of Delek Hungary from the sale.

In a precedential ruling, the Israeli Tax Court ruled in favor of Delek Hungary. The Israeli Tax Court applied a purposeful approach to the application of the underlying legislation, determining that the legislation should be interpreted in a manner consistent with the legislative intent, even in circumstances where the language of the law may appear to be unclear, and that this approach was particularly pertinent to legislation concerning international taxation.

In the circumstances relating to the sale of shares in a US company by an Israeli company, the Israeli Tax Court found that the legislative intent mandated that there should not be variable tax treatment depending on the investment structure. On the contrary, a consistent approach is to be applied, and no distinction should be made concerning the manner in which the business activity in the US was carried out, whether by a branch, an Israeli company or a foreign entity. Moreover, the Israeli Tax Court further found that, ultimately, the taxation treatment, and the characterization of profits as dividend income or capital gains, should reflect the underlying commercial nature of the transaction at hand. The Israeli Tax Court ruled that in consideration of the legislative intent, Delek Hungary was correct in characterizing the profits attributable to the part of the consideration corresponding to the undistributed profits of Delek US as dividend income and was entitled to “deemed” indirect tax credit on account of the payment of corporate tax in the US on such undistributed profits.

The case of Delek Hungary underscores the intent of the Israeli Tax Court to focus on the principal economic factors and legislative intent, in assessing a tax dispute, rather than to rigidly interpret and apply the provisions of legislation.

## For further information please contact:



**Daniel Paserman**  
**Adv. (CPA), TEP, Head of Tax**  
✉ paserman@gornitzky.com



**Shlomo Aviad Zider**  
**Adv. Partner**  
✉ shlomoz@gornitzky.com