Client Update | Tax

Value Added Tax: Tax Liability in a Transaction for the Sale of Shares on Credit

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Dear Clients and Friends,

The Israeli Tax Authority recently published a tax decision (the "**Decision**"), which concerns the issue of liability for value added tax (VAT) with regard to the sale of shares, where the proceeds for such sale will be paid partly in cash and partly by way of credit. In accordance with the Decision, the interest component and the linkage differentials, which derive from the credit component, will be subject to VAT as a taxable transaction, as described below.

As part of the transaction, which is the subject of this Decision (resolution no. 0599/19), Company A sold to Company B, shares it owned in Company C (the "**Shares**"). The share sale agreement stated that the consideration for the Shares will be paid partly in cash and partly by credit, with the portion attributable to credit, to be provided to the buyer as a loan, bearing interest which is linked (principal and interest), on an annual basis to any increase in the consumer price index.

The Decision states that the granting of credit by the seller to the purchaser for the purchase of the Shares, should be regarded as a separate transaction from the sale of the Shares. As a result, the Tax Authority decided as follows:

(1) In view of the fact that securities are excluded from the definition of "goods" under section 1 of the VAT Law, the sale of shares is not a "transaction", as defined in the VAT Law and consequently, is not taxable.

(2) The consideration for providing the credit to the purchaser for the purpose of financing the purchase of the shares, including the interest component and linkage differentials received by the seller, is part of the price of the transactions that are subject to Value Added Tax by the seller, as stated in Section 7 of the VAT Law.

(3) In light of the "**Matching Principle**" set out in section 41 of the VAT Law, the input tax included in the tax invoice, which the seller will issue to the purchaser in connection with the granting of the credit for the purchase of the Shares, is not deductible by the purchaser. The rationale is that the credit granted is used to purchase shares rather than to generate taxable transactions.

It should be noted that the position of the Tax Authority in the Decision, according to which two separate transactions are involved, one of which is the sale of shares and the other a loan, contradicts the position of the Tax Authority, as reflected in **memo 1/2002 regarding operational leasing** (**"Operational Leasing Circular"**) and in **assessment appeal 406 / 86 Tavor Electronics Ltd. v. Director of Value Added Tax** (**"Electronics Ruling"**), both of which adhere to the literal and accepted interpretation of section 8 of the VAT Law, namely: "in a transaction that includes an asset and a service, the price of the transaction shall be all together".

In the Operating Leasing Circular, the Tax Authority determined that in the case of transactions involving the leasing of a car over a long period of time (in excess of 12 months), where the lessee is required to pay expenses due to the payment of a license fee and compulsory and comprehensive insurance, regulation 6 of the Value Added Tax Regulations, shall apply to these elements of the transaction. Accordingly, the amount of the refund shall not be considered part of the price of the car rental transaction and shall not be subject to VAT. However, in reaching its Decision the Tax Authority has determined that if the Company grants credit to the customer in respect of these expenses, said credit will be considered part of the Company's taxable transactions, which will be considered an integral part of the rental transaction, such that the tax in respect thereof will not be deductible.

In the Electronics Ruling: Electronics Ltd. (hereinafter: **"Electronics"**), purchased a private car from Tiferet Cars Ltd. (hereinafter: **"Tiferet"**), the consideration for which was paid partly in cash and partly by way of credit provided to Electronics by the Investment Company Ltd., a company under the control of Tiferet. In this case, the Court discussed the question of whether to recognise the interest payments on the purchase of a vehicle as “financing expenses” as part of Electronics’ business, and if VAT on the interest should be deductible as input tax.

The Court rejected the position of the appellant, Electronics, according to which, there is a clear separation between: (i) the selling company and the lending company, and (ii) the private car purchase transaction and the loan, which is a separate service transaction. In this regard, the Court adopted the position of the Tax Authority by which the purchase transaction and loan should be considered inseparable and intertwined in an “organic manner”, such that they should be seen as part of the terms of sale, and any attempt to separate these two components in an attempt to determine that there are two separate transactions, would be artificial. The following are the main reasons for the Court's ruling in its decision:

“While in a regular sale contract, it is not the seller's business as to how and where the buyer raises the means to pay, in this case, it is determined in advance that a significant part of the price will be paid by means of a loan which the seller repays to the buyer, through another company, which, however, appears to be under the control of the seller. Otherwise he would not have been able to make a commitment on behalf of that company...

In the contract of sale itself, the means were determined to guarantee the repayment of the loan… from that it could also be deduced that although the lender is a separate legal body, nevertheless,

the seller has a clear interest in guaranteeing the repayment of the loan. If the financing transaction were detached from the sale, then the seller would be satisfied that the consideration would be paid to him, without any interest in the source of financing and as to how the loan would be secured in favour of the lender.

The order letter issued by the seller details the arrangements for repayment of the loan, including the VAT on the interest as part of the consideration, and as is known, the price of the transaction also includes "interest due to installment payments... (Section 7 (2) to the VAT law)".

In conclusion, it appears that the Tax Authority's position in the Decision (according to which the granting of the credit by the seller in a transaction for the sale of shares should be seen as a separate transaction from the sale of the shares itself) does, in fact, differ from the position of the Tax Authority as described above, according to which, a transaction that includes the provision of additional services that accompany or complement the main transaction, will be classified according to the characteristics attributable to the main component of the transaction (and the tax liability for the accompanying services will be determined in accordance with the tax liability that applies to the main transaction).

In this context, we note that even in a recent ruling (given on October 16, 2018) in the matter of **Irgunit design of backdrops v. Ramla VAT Manager** (tax appeal 2930-12-16), the Tax Authority claimed that in a transaction with components of both sale of assets and services, the test of the "main" and the "minor" in order to classify a transaction as a sale transaction or a service providing transaction must be applied, and the total price will be the price of the transaction. The District Court rejected the Tax Authority's position due to the unique circumstances of the case at hand. It should be noted that the Tax Authority submitted an appeal on the District Court's ruling to the Supreme Court.

Accordingly, in the case of sale transactions in which credit is granted by the seller (for all or part of the consideration), our recommendation is to obtain legal advice before making a decision regarding the classification of the transaction and the VAT implications deriving from the transaction.

We will be happy to assist you with any questions or clarifications.

Sincerely,

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