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Global Tax Alert

Israeli Tax Authority publishes its view regarding classification of different types of preferred shares

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On 23 July 2019, the Israeli Tax Authority (ITA) published a Tax Circular (the Circular) outlining the accounting and legal treatment, as well as the tax classification, that applies to different types of preferred shares.

The Circular provides background on the accounting rules for financial instruments, as set by the International Financing Reporting Standards (IFRS) (International Accounting Standard (IAS) 32[1]), which allows the classification of preferred shares as an equity instrument, a financial liability or a compound financial instrument, based on the substance of the contract. The Circular then lists different examples with their accounting outcome. For instance, a preferred share that holds a redemption obligation of the issuer at a fixed amount and at a specific future date, or that gives the holder the right to demand the redemption of the instrument at a fixed date in consideration for a fixed amount, will be classified as a financial liability. However, a redemption option given to the issuer does not meet the definition of a financial liability and will be classified as an equity. Another example is described with respect to preferred shares that do not hold a redemption right but are only entitled to participation in profit, being such profit distribution based on the sole discretion of the issuer – such instrument will be classified as an equity. Preferred shares that include both the holder's redemption right, as well as the participation in profit that its distribution is based on the issuer's sole discretion, will be classified as a compound financial instrument, i.e., a combination of a financial liability and an equity instrument.

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The Circular also discusses a specific legal provision under the Israeli Corporate Law (the Law) that allows a company to issue redeemable shares, including preferred shares (Redeemable Securities). Such Redeemable Securities do not constitute part of the equity and therefore are not subject to the distribution rules set by the Law, but only to the extent that the same treatment is taken for accounting purposes. In other words, to determine whether certain securities will be classified as a liability or an equity for legal purposes, the accounting rules should be followed. Therefore, preferred shares with a redemption right that is given to the issuer (which are classified as an equity for accounting purposes) will not be classified as Redeemable Securities under the Law.

For tax purposes, however, according to the ITA's position, the classification of preferred shares is based on the economic substance of the instrument, which will not necessarily follow the accounting treatment.

As a general rule, preferred shares will be classified as an equity for tax purposes (including those that are classified as compound financial instruments according to IAS 32), and therefore a preferred dividend received for them will be considered dividend income for the recipient and will not be deductible for the distributing company.

Having said that, if the preferred share does not hold any voting rights, is classified as a financial liability in accordance with IAS 32, and its preferred dividend is based on a fixed rate of the preferred share's face value at the time of issuance – it will also be classified as a liability for tax purposes. Under such classification, the preferred dividend will be considered interest income for the recipient and will be deductible for the company, subject to any applicable interest deduction rules. It is then clarified that a redemption option that is controlled by the issuer will not allow the classification of the instrument as a liability, but rather as equity. Certain examples are provided for additional guidance on the tax classification of different types of preferred shares.

Impact

As this Circular may allow flexibility for different holding and financing planning alternatives, companies that consider acquisition, financing and/or restructuring of Israeli entities, as well as those that already use preferred shares as part of their Israeli structure, should carefully examine its implications and opportunities related to their existing or potential activity in Israel.

Endnote

1. International Accounting Standard 32: Financial Instruments: Presentation.

For additional information with respect to this Alert, please contact the following:

EY Israel, Tel Aviv

- Sharon Shulman sharon.shulman@il.ey.com

Ernst & Young LLP (United States), Israel Tax Desk, New York

- Lital Haber lital.haber1@ey.com

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