CA 2026/92

1. Income Tax Assessor Petah Tikvah

v.

1. Sadot Transportation Corporation (1982) Ltd.

2. David Brandeis

3. Haj Yihyeh Abed El Jabar

The Supreme Court Sitting as the Court of Civil Appeals

[May 20th, 2001]

Before President A. Barak, Vice President S. Levin, Justices T. Or, T. Strassberg-Cohen, I. Englard.

Appeal on the Judgment of the Tel-Aviv District Court (Justice Pilpel) on March 4, 1992 in CC 98/98, 88/98, 83/89.

Facts: Respondents 2 and 3 were partners in the 'Sadot' Partnership. These two partners established a corporation, Sadot Transportation Company (1982) Ltd., and transferred all the assets and obligations of the partnership to this company, allocating the Company's shares to the respondents at an identical proportion to their holdings in the original partnership.

These partnership assets included trucks. The dispute between the parties relates to the characterization of the transfer of these trucks from the partnership to the company The respondents presented this transfer as free of gain, while the income tax assessor believes that the transfer of assets from the partnership to the Company is a 'sale' according to the definition in section 88 of the Income Tax Ordinance, and that this transfer therefore triggered a capital gains tax.

Held: The majority opinion was written by Justice Englard. The key question in this case relates to the essence of the transfer of an interest in a partnership in the eyes of the Tax Authority. Specifically the question arose as to whether it was possible to transfer an overall share of a partnership, or rather, whether only individual assets be transferred. The Court accepted the view of the court of first instance that for purposes of taxation the transfer of the partnership business from the partners to the corporation was to be seen as a transfer of the interest of each partner in the partnership and not as the transfer of each and every asset separately. The appeal was therefore denied.

Vice President S. Levin wrote a separate opinion supporting the majority conclusion.

Justice Strassberg-Cohen joined the opinions of Justice Englard and *Vice President* Levin.

Justice Or joined by President Barak wrote a dissenting opinion.

For petitioners – Yehuda Livlein; Leah Margalit.

For respondent – Giora Amir.

Legislation:

Income Tax Ordinance [New Version].

Property Betterment Tax Law 5723-1963.

Law for Encouragement of Industry (Taxes) 5729-1969 .

Partnership Ordinance [New Version] 5735-1975 ss. 1(a), 2, 20, 20(b), 31, 34(1),

66(a).
Corporations Law 5759-1999 s. 4.
Law of Adjustments for Inflation.
Capital Gains Law

Israeli cases cited:

[1] CA 289/66 *Kirshenberg v. Income Tax Assessor Gush Dan*, Padim A 58.
[2] CA 441/88 *Yarchi v. Goldberg* IsrSC 43(4) 378.
[3] CA 583/88 *Barnea v. Arkia Israeli Airlines Ltd. and others*, IsrSC 45(5) 670.
[4] CA 306/88 *Felsenstein and others v. Income Tax Assessor, Haifa* IsrSC 45(3) 542.
[5] CA 896/90 *Income Tax Assessor Haifa v. Halevi* IsrSC 49(1) 865.
[6] CA 3574/92 *Income Tax Assessor Gush Dan v. Pereg* IsrSC 50(3) 690.
[7] CA 536/88 *Etz Levod v. Income Tax Assessor for Large Plants*, IsrSC 46(4) 738.
[8] CA 425/79 *Angel Ltd. v. Income Tax Assessor, Income Tax, Jerusalem*, IsrSC 36(3) 829.
[9] CA 20/63 *Ben-Zvi v. Income Tax Assessor, Bet-Hadar, Tel-Aviv-Yaffo* 1, IsrSC 17 1963.
[10] CA 82/60 *Poychtunger v. Income Tax Assessor, Tel-Aviv* 4 (Central) IsrSC 14 1366.
[11] CA 477/71 *Shtetner v. Income Tax Assessor, Haifa*, IsrSC 26(2) 513.
[12] CA 231/58 *Income Tax Assessor, Rehovot v. Amos Bohanik*, IsrSC 13(3) 1948.

Israeli District Court cases cited:

[13] ITAp 367/70 *Shternzis v. Income Tax Assessor Tel-Aviv*, Pada C 327.
[14] ITAp 118/90 *Lev Hagalil Partnership v. Income Tax Assessor, Tiberias* Pada 20 122.

American cases cited:

[15] *Commissioner of Internal Revenue v. Shapiro*, 125 F.2d 532 (1942).
[16] *United States v. Shapiro*, 178 F.2d 459 (1949).
[17] *Thornley v. Commissioners of Internal Revenue*, 147 F.2d 416 (1945).
[18] *Hatch's Estate v. Commissioner of Internal Revenue*, 198 F.2d 26 (1952).
[19] *Williams v. McGowan*, 152 F.2d 570 (1945).
[20] *Meyer v. U.S.*, 213 F.2d 278 (1954).
[21] *C.I.R: v. Smith*, 173 F.2d 470 (1949).
[22] *Long v. C.I.R.*, 173 F.2d 471 (1949).
[23] *Helvering v. Smith*, 90 F2d 590 (1937).

Israeli books cited:

[24] G. Procaccia, *the Corporation, Its Essence and Creation* [1965].
[25] A. Raphael, D. Ephrati *Income Tax Laws* (volume 2, 1986).
[26] S. Bornstein, *Taxation in Corporate Dissolution* (1987).

Israeli articles cited:

[27] Y. Ne'eman 'Method of Calculation of Capital Gains in the Sale of the Interests of a Partner in a Partnership' *Roeh Heshbon* 21 (1971-1972)

195.
[28] A. Alter ‘The Separate Legal personality of a Partnership of the Purposes of Tax Law in Israel’ *Roeh Heshbon* 34 (1986) 336.
[29] Y. M. Edri and Y. Eden ‘On the Problem of the Excess Tax Liability, Statutory Veil and the Taxation of a Partnership, a Cooperative Agricultural Association, a House-Corporation, and a Family Corporation in the Income Tax Ordinance’ *Iyunei Mishpat* 13 (1988) 307.
[30] D. Glicksberg ‘Averaging Property Betterment and Spread of Capital Gains’ *Mishpatim* 21 (1992) 371.
[31] M. Kaputa, ‘Tax Planning in the Context of Partnerships and International Joint Transactions.’ *Misim* 13/1 (1999) A 64.
[32] A. Yoran (Yorakvitz) ‘Tax Planning in Incorporation of a Partnership as a Corporation’, *Roeh Hachesbon* 22 (1972) 163.
[33] Z. Sharon ‘Assets that are not Transferable according to Section 104 of the Ordinance’, *Misim* 8/5 (1994) A 34.

Foreign books cited:
[34] H. Kelsen *Introduction to the Problems of Legal Theory* (Wien, 1934, transl. of 1st ed., by B. Litschewski Paulson, S.L. Paulson, Oxford, 1992); H. Kelsen Reine Rechtslehre (Wien, 2 Aufl., 1960).
[35] H.E. Abrams, R.L. Doernberg *Essentials of United States Taxation* (The Hague, 1999).
[36] B.I. Bittker *Federal Taxation of Income, Estates and Gifts* (Boston, New York, vol. III, 1981).
[37] Mertens *Law of Fed Income Tax* (vol. IX).
[38] R.E. Beam, S.N. Laiken *Introduction to Federal Income Taxation in Canada* (Don Mills, 9th ed., 1988-89).
[39] *Canadian Master Tax Guide* (44th ed., 1989).
[40] *Simon’s Direct Tax Service* (London, 1995).
[41] J. Waincymer *Australian Income Tax – Principles and Policy* (Sydney, 1991).
[42] R.L. Deutsch and Others *Australian Tax Handbook* 1996 (Sydney, 1996).
[43] A.S. Silke *On South African Income Tax* (Durban, memorial ed., by A. De Koker, vol. II, 1995).

Foreign articles cited:
[44] E.J. Schnee ‘The Future of Partnership Taxation’ 50 *Wash. & Lee L. Rev.* (1993) 517.

JUDGMENT

Justice I. Englard

This appeal raises a fundamental problem in the complex area of partnership taxation. The problem relates to the essence of a partnership and its ramifications on the taxation of the partnership in the case of the transfer of assets out of the partnership. In this case all the assets of the partnership were transferred to a company that was set up by the partners.

1. These are the relevant facts: Respondents 2 and 3 were partners in the ‘Sadot’ Partnership whereby the former’s share in the partnership was 60% and the latter’s share was 40%. It should be noted that it was

not clarified fully whether the partnership was registered or not. The two partners established a corporation, Sadot Transportation Company (1982) Ltd. (hereinafter: 'the Company') and transferred all the assets and obligations of the partnership to it. The company was registered and incorporated on May 26, 1982 and began operating on July 1, 1982. The Company's shares were allocated to the respondents, such that they are shareholders in the Company at an identical proportion to their holdings in the original partnership. The respondents also serve as the Company's directors.

2. The partnership assets, as is apparent from its balance statement, were made up of fixed assets (which included trucks, a van, communication equipment, and inventory) and current assets (which included various customers and debtors). The liabilities of the partnership included long term liabilities and current liabilities. In the Company's books the closing balances of the partnership balance statement as of June 30, 1982 were recorded as the opening balances of the Company as of July 1, 1982.

3. The dispute between the parties relates to the obligation of the partners, respondents 2 and 3, due to capital gains they realized, according to the appellant, from the transfer of the trucks from the partnership to the Company. The respondents presented this transfer as free of gain, since the value of the trucks in the opening balance of the Company is the same as their value in the closing balance of the partnership. This value represents the cost of the 'depreciated value' of the trucks – meaning the original cost that was paid by the partnership less the permitted rates of depreciation, or in the language of the Income Tax Ordinance [New Version]: the balance from the original cost. According to the respondents' claim, absent a difference between the two values, no capital gain is to be attributed to them. The income tax assessor thinks otherwise: in his opinion the transfer of assets from the partnership to the Company is a 'sale' according to the definition in section 88 of the Income Tax Ordinance. If it is a sale, then the amount of consideration that was given to the partnership ('the seller') by the Company ('the buyer') is to be determined by the market prices of the trucks on the day of transfer. Indeed, the income tax assessor determined the cost of the transfer by the insurance appraisal of the trucks and with the agreement of an accountant. As the market price determined in this manner is greater than the depreciated cost, the income tax assessor imposed a capital gains tax on the partners for the difference. A change in the price of the trucks also influenced the Company's appraisal in that it was charged the differences in income which stem from increasing the sums of the protected/fixed assets and increasing the depreciation addition and the depreciation deduction.

4. The respondents objected to these appraisals, and after their objections were dismissed they filed an appeal to the District Court. Their appeal was granted by Justice A. Pilpel and from there the appeal of the income tax assessor comes before us. The respondents appeal in the lower court relied on two central points; one: transfer of the trucks from the partnership to the Company does not constitute a 'sale' as

defined in section 88 of the Income Tax Ordinance, and therefore the provision of section 89 of the Ordinance which imposes income tax on capital gain does not apply. This argument relied on the fact that registration of the ownership of the trucks was not transferred to the Company's name, and that the owners of the trucks (the original partners) are the same as the shareholders in the Company. It is found – the claim is made – that there was no transfer or real 'sale' as the identity of those with control of the trucks has not changed. The respondents explained that they avoided transferring ownership of the trucks to the Company because such a transfer would create an additional 'hand' in the chain of owners, which would lower their market value by at least 20%.

5. The other point the respondents relied on in their appeal in the lower court was that in contrast to the approach of the Income Tax Assessor the transfer of all the assets and liabilities of the partnership to the Company is not to be viewed as the transfer of each asset individually. The 'asset' which is sold to the Company – if in fact we are dealing with a sale – is the total share of the partner in the assets of the partnership and not each item separately. Therefore, it is not proper to see the price differences of the trucks as the capital gain of individual assets that were transferred by the partners. The asset which each one of the partners transferred is not his share in the trucks, but his overall share in the partnership, including its assets and liabilities. Consequently, the capital gain is to be calculated as to the overall share in the partnership and not as to the individual items in the assets of the partnership. Meaning, according to their claim, the partners transferred to the Company their non-specific interests in the assets of the partnership, which are directly impacted by the rights and obligations of the partnership to third parties and not just by the ownership of the trucks. The difference between the two approaches has significant ramifications as to the scope of the tax liability of each partner, as according to the approach of the Income Tax Assessor, the gain from selling the tangible assets of the partnership will be taxed without taking into account its ongoing liabilities and its long term liabilities, which, no doubt, impact the value of the overall share of each partner in the partnership. Relying on the judgment in the case of CA 289/66 *Kirshenberg v. Income Tax Assessor Gush Dan* [1] at p. 61, the respondents claimed that just as the transfer of shares in a company and the gain which stems from this is not to be equated with the transfer of lots that were the inventory of the company's business, so too the interests of the respondents in the partnership is not to be equated with the transfer of each truck or any other asset to the Company.

6. The lower court dismissed the claim which denied the existence of a 'sale' as that term is defined in section 88 of the Income Tax Ordinance. The court decided that in light of the broad definition of the term that includes '. . . any other activity or event consequent to which an asset leaves a person's possession and all this whether directly or indirectly. . .' it is appropriate based on the law to determine that in the transfer of all the partnership's assets to the Company, including said

trucks which it operated, a sale transaction took place according to the meaning of this term in section 88 of the Ordinance.

7. On the other hand, the court accepted the respondents' second claim, in determining that 'the asset' which was sold to the Company is the overall share of each partner in the partnership assets and not each item from these assets individually. In doing so the court relied on the article of Y. Ne'eman 'Method of Calculation of Capital Gains in the Sale of the Interests of a Partner in a Partnership' (Roeh Heshbon 4 (205) January 1971, p. 195) in which the author critiques the decision of Justice S. Asher in ITAp 367/70 *Shternzis v. Income Tax Assessor Tel-Aviv* [13]. In the aforementioned case the partner sold his share in a cafeteria business. The judge raised the possibility that in fact no asset was sold as follows.

> In this case the subject of the sale is half of the business which belongs, ostensibly, to the partnership and it could be argued that no asset has been sold here – as the partnership is the owner of the various assets which make up the business and it has not sold anything. But, in fact, the representatives of both parties related to the appellant's sale as the sale of the various assets included in the business – apparently out of the assumption that the partnership was not registered and the partners are the owners of the property; there is also support for this approach in the contract of sale N/1. Clause 2 of said contract states that the appellant is selling to the buyer – 'all his interests in the business rental, the reputation, the equipment, and the merchandise' – meaning he is selling his half in these defined assets as stated, and the consideration paid to him is in consideration of these assets; I will relate therefore to the appellant's sale as though it was the sale of assets as defined in said section 88.

8. The quoted section it arises that Justice Asher did not consider the idea of sale of an overall share in the partnership but rather raised the possibility that it this transaction is not at all a matter of sale of an asset. This approach is the basis for Y. Ne'eman's critique, in which he holds that the sale of an interest of a partner is to be regarded as the sale of a capital 'asset' on which tax is owed according to the Income Tax Ordinance. The lower court adopted, as said, the opinion of Y. Ne'eman and determined that the share of the partner in the partnership is to be viewed as an 'asset' 'as he is the owner of an 'interest . . . eligible or presumed' in the partnership as a legal personality separate from the partners themselves.' The Court distinguished the Shternzis case, by explaining that in contrast to what was stated in that judgment 'in fact in the case before us it is entirely clear that the sale from the partnership to the Company is not the sale of defined separate assets but the transfer of the partnership assets to the Company.' It is to be noted that it is difficult to accept this distinction as it is clear that in the Shternzis case the partner sold his entire half in the partnership business. Because the contract of sale here establishes that each partner is selling to the buyer

'all his interests in the business rental, the reputation, the equipment, and the merchandise' it is not to be understood that he is selling his half in defined individual assets, where the sale of each and every asset constitutes a separate sale. As said, the contrast between the sale of a share of a partnership and the sale of a share of each of the partners' assets was not considered at all by Justice Asher.

9. Be that as it may, the approach of the lower court is that for the purpose of calculating capital gains tax, the sale of a partner's share in a partnership is to be seen as the sale of an overall share and not as a separate sale of each and every asset separately. Y. Ne'eman, in his article, bases his approach regarding the transfer of an overall share in the partnership on the fact that the partnership is a separate legal personality. The author notes that the Shternzis case dealt with an unregistered partnership. However, he was of the opinion, relying on the view of G. Procaccia, The Corporation, Its Essence and Creation (1965) 190, that even the unregistered partnership is a legal personality in Israeli law. Y. Ne'eman's conclusion is that 'by force of the separate nature of the legal personality of the partnership, the assets are to be regarded as held by the partnership and not by those holding the interests in it.' The lower court here touched upon the question of the legal personality of the partnership under consideration before it. It did not find evidence in the testimony and the documents for the respondents' claim that the 'Sadot' partnership was registered. But the court added:

> I am of the opinion, however, that even if we treat the partnership as an unregistered partnership – that would not change the situation. It appears to me that the determining variable in this matter is the fact that in fact the totality of interests and liabilities in the partnership, and not separate assets that served them in the partnership business, were transferred here from the partnership to the company that was set up by the partners (and their holdings in it are identical to their share of the partnership). Therefore, it appears to me that by law the tax assessment on the capital gains – to the extent that it was created as a result of this transfer according to the provisions of the Ordinance, is to be determined based on 'the consideration' and the 'balance of the original price' (as these terms are defined in section 88 of the Ordinance) of the overall share of the partner in the partnership that was transferred to the Company, and not of each item separately.

10. Based on the lower court's opinion it is not entirely clear if the Court was of the opinion that an unregistered partnership constitutes a legal personality – as is the view of G. Procaccia – or rather whether it was of the opinion that there is no importance to the essence of the partnership as a legal personality for the purpose of the decision as to the calculation of the capital gain in the case of a sale of a share of the partnership by a partner. The appellant claims before us in this context that absent evidence on the part of the respondents that the 'Sadot' partnership is a registered partnership, this matter is no longer in dispute.

Therefore, according to his approach, in terms of the general law 'Sadot' is not a legal personality. It is to be emphasized, however, that the two parties are not hanging their fate on the registration of the 'Sadot' partnership; the appellant focuses on the claim that for the purposes of the Income Tax Ordinance, in any case, a statutory lifting of the veil of the legal personality of the partnership takes places, and the tax laws apply to the individuals in partnership. The respondents, for their part, emphasize the independent economic existence of any partnership, not necessarily of a registered partnership.

11. At the conclusion of its judgment the lower court dismisses one of the claims of the Income Tax Assessor, according to which the second legal argument for the appeal was raised by the respondents only at the summations stage. The court dismisses this claim with the rationale that such a formal claim is not sufficient to impact the results of the discussion, but is relevant only to the question of costs. The practical conclusion of the court is that the appeal is to be granted and the discussion is to be sent back to the objection phase in order to give the Income Tax Assessor the opportunity to look into the question of the capital gains that were obtained by the transfer of the overall share of each partner in the partnership.

12. In the appeal before us the Income Tax Assessor broadens the scope to both the substantive problems of the sale of assets by a partner as well as to the formal rationale of 'change of direction'. In contrast, the respondents repeat their rationales, with an emphasis on the concept of sale of a share in a partnership, as opposed to selling a part in each and every asset separately. The claim that under the circumstances the transfer of a share in the partnership is not to be considered a 'sale' in the sense of section 88 of the Income Tax Ordinance is now barely heard.

13. I will say at the outset that the formal claim of 'change of direction' is not to be accepted. The respondents in this case already raised the issue of the sale of an interest in a partnership in their summations both orally and in writing before the District Court. The appellant, for its part, responded broadly to the substance of the claim in its written summations in the lower court, even though there was nothing to prevent raising the formal claim at the final stage of the appeal. Against this background, the complaint of 'change of fronts' is not to be heard. As was said by this Court in the case of CA 441/88 *Yarchi v. Goldberg* [3] at 384 (in the words of Justice Maltz):

> '… at times the parties amend the pleadings silently, by handling the case along different tracks than those established in the pleadings, and if they do so, the claim will not be heard later – and certainly not at the appeals phase – that the court was not to have deviated from the case route as marked in the pleadings.'

Moreover, I will add that it is possible to find the kernel of the substantive claim as to the sale of an interest in a partnership already in the rationales of the appeal to the lower court. Indeed, the respondents noted there that 'the Company received the liabilities and assets of the partnership'. Therefore, the lower court was correct in dismissing the

mentioned formal claim of the appellant.

14. The respondents' other claim, that the transfer of the partnership assets does not constitute a 'sale' in the sense of the provision of section 88 of the Income Tax Ordinance, meets a similar fate. The lower court was correct in determining that the assets of the partnership left its possession and the possession of the partners when they were transferred, from a business perspective, to the hands of the Company. These assets now appear on the Company's balance sheet, and even if the ownership is still registered in the name of the (former) partners, nonetheless at this point they are being used by the Company. Beginning with the 1983 tax year the Company had been deducting depreciation of the trucks adjusted on the basis of the historical purchase prices. It is to be noted that the event that constitutes the subject of this case, the transfer of an asset that is in the ownership of a partnership to a company that is established expressly for the purpose of this transfer, is now regulated in the provision of section 104B of the Income Tax Ordinance. This provision replaced the prior provision in section 95 of the Income Tax Ordinance that also dealt with the sale of an asset from a number of a people to a company in exchange for shares in that company. This arrangement of deferral of the tax until the sale of the transferred asset by the company to which it is transferred shows that an event such as the one discussed here is a tax event. Otherwise there would be no need to establish a tax deferral arrangement. It follows that transfer of an asset owned by a partnership to a company that does not fulfill the conditions detailed in the arrangement constitutes a sale and establishes an obligation in the framework of capital gains tax. This also shows that the lower court was correct in dismissing this claim of the respondents.

15. This brings me to the crux of the legal problem in this appeal, which is: the essence of the transfer of an interest in a partnership in the eyes of the Tax Authority. More specifically: is it possible to transfer an overall share of a partnership, or is it only possible to transfer individual assets? The solution to this problem is disputed both among the various legal systems and among scholars. Y. Ne'eman in his aforementioned article already noted the existence of differences of approaches between the English legal system and the law in the United States. There is therefore no escape from looking into this matter and making a determination in the aforementioned substantive issue.

16. Some of the scholars base the entirety of the problem on the essence of the partnership as a legal personality. Thus, for example, we have seen that Y. Ne'eman in the aforementioned article provides the rationale for his approach that selling the interest of a partner is considered the sale of a capital asset, in that according to Israeli law every partnership – even one that is not registered – is a legal personality that is separate from the partners that make it up. The truth is that the question whether an unregistered partnership is a legal personality, meaning a corporation, has yet to be settled in our system. As this Court pronounces on the matter in CA 583/88 *Barnea v. Arkia Israeli Airlines Ltd. and others* [4] at pp. 683-684 in the words of President M. Shamgar:

'The question of whether an unregistered partnership is a

> legal personality separate from the partners who make it up is a complex question, to which there is no clear resolution in the case law of this Court. . .
>
> There is also a difference of opinion among scholars as to this question. . .'

See **ibid** as to the various sources in case law and literature which were brought by the Court. As it turns out, we do not know whether the partnership before us was registered or not. My opinion concurs with that of the lower court that the question of whether a partnership is in principle considered a legal personality does not add or detract from the matter before us.

17. As Hans Kelsen has shown in his book on pure legal theory, the concept of legal personality is no more than a construct of legal theory and does not have social substance. It is a helpful concept which describes a set of rights and duties that relate to the behavior of a number of people who strive to reach a joint aim. The concept is a metaphor of personification that serves as a description of a very intricate system of norms that are beyond the scope of the present analysis. [H. Kelsen, *Reine Rechtslehre* (2. Aufl. Wien 1960) 172-195. And see the core of the idea already in the first edition of the book in the English translation. H. Kelsen, *Introduction to the Problems of: Legal Theory* (transl. B. Litchevski Paulson & S.L. Paulson, Oxford 1992) 46-53]. However, it is not necessary for the term to be exclusive to a system with a fixed normative content. Some see a legal personality in a group of people which is solely defined by the fact that they are entitled to file a suit in its name; some demand that it must be able to own property; and some demand that the property be considered absolutely separate from the property of the members who make it up in the case of insolvency (meaning the idea of limited liability). It is found that the concepts 'legal personality' and 'corporation' do not compel normative conclusions upon us, but rather they are heuristic legal concepts that serve jurisprudence by describing a normative reality that precedes it. Against this background the idea of 'lifting the veil' also has to be understood as no more than a parallel metaphor which describes the reduction of the idea of personification regarding the normative system titled 'corporation' or 'legal personality.' The combination of corporation and lifting of the veil is nothing other than an external description of the set of rights and duties which relate to certain people.

18. Therefore, the question is not if the partnership is a legal personality in terms of jurisprudence – be the tests for that what they may be – but rather if from a normative perspective there exist provisions which relate to the partnership as a separate unit for income tax purposes. Meaning, in our matter determinative weight is not accorded to the question of whether there exist procedural provisions which allow the partnership to sue in its name, or provisions which enable it to register property in its name, or provisions which limit the right of certain debtors in that they are permitted to access only property considered to belong to the partnership. The substantive question here is as follows: what is the fate of the partnership for tax purposes? Is the partnership

business a separate business or perhaps is it considered the business of each and every partner? In other words, in the eyes of the tax law the partnership business may be considered the business of each partner even if according to legal theory the partnership reaches – due to the existence of certain provisions – to the level of a corporation, and vice-versa.

19. Is the partnership a separate business for taxation purposes? The starting point for providing an answer is found in the provisions of the tax law, and in our matter, in the provisions of the Income Tax Ordinance. It is to be noted that it is not necessary that the answer be uniform in the framework of the totality of the tax laws. Quite the opposite, frequently the tax laws – not just ours but those of other countries as well – create an arrangement that is not methodical as to the essence of certain entities: some provisions will consider a certain entity as a separate business and some provisions will identify this entity with the persons that make it up (a process which as to legal entities is called 'lifting of the veil'). A striking example of such hybrids is the family corporation as regulated in the Income Tax Ordinance. See section 64a of the Income Tax Ordinance, as to which this court established in the case of CA 306/88 Felsenstein and others v. Income Tax Assessor, Haifa [5] at p. 547[c] (in the words of the President M. Shamgar): 'It is a matter therefore of a corporation that is taxed as an individual. This heterogeneity raises a string of questions in tax matters, whose common denominator is in the choosing of the laws that apply – the law of the individual or the law of the corporation.' (See further in this context CA 896/90 *Income Tax Assessor Haifa v. Halevi* [6]; CA 3574/92 *Income Tax Assessor Gush Dan v. Pereg* [7]).

20. A central provision as to the partnership is found in section 63 of the Income Tax Ordinance. Section 63(a)(1) of the Ordinance establishes in the following language.

> Where it has been proven to the satisfaction of the Income Tax Assessor that two or more people are engaged together in a certain business or certain occupation – the share each partner is entitled to in the tax year from the partnership incomes – and it will be determined in accordance with the provisions of this Ordinance – will be viewed as the income of that partner, and it shall be included in the report of his income which he must submit according to the provisions of this Ordinance.

From this provision the principle arises that for income tax purposes the taxpayer is the individual partner and not the partnership as a separate business. It is found that we have before us a general provision of 'lifting of the veil', which disregards the independent existence of the partnership business.

21. However, in contrast to this provision, there is a string of other provisions in the Income Tax Ordinance, which perceive of the partnership, explicitly or implicitly, as a separate business unit. First, in section 63(a)(2) of the Ordinance establishes that the chief partner must prepare and submit, at the request of the Income Tax Assessor, a report of the partnership's income. It is found, that at least from an accounting

standpoint, the partnership is considered a separate business. From sections 63(b), 131(a)(5) combined with 131(c) and (d), and 224-A of the Ordinance it can be inferred, apparently, that the partnership is 'an association of persons' in the sense of section 1 of the Ordinance. Most of these provisions exclude the partnership, for certain taxation purposes, from the rules which apply to an association of persons. Some sought to learn from these exceptions that all the rest of the provisions which relate to an association of persons – meaning to the concept which signifies a separate business – also apply to a partnership. (In this vein see, A. Alter 'The Separate Legal personality of a Partnership for the Purpose of Tax Laws in Israel' [28] at p. 340; compare also Y. M. Edri and Y. Eden 'On the Problem of the Excess Tax Liability, Statutory Veil and the Taxation of a Partnership, a Cooperative Agricultural Association, a House-Corporation, and a Family Corporation in the Income Tax Ordinance' [29] at p. 315; see, on the other hand, a different opinion offered by A. Raphael and D. Ephrati, Income Tax Laws, Volume 2 [25] 299-300.) It should further be noted that the definition of the term 'association' in section 1 of the Property Betterment Tax Law 5763-1963 – also includes a registered partnership.

22. It is no wonder that the bifurcated status of the partnership raises and continues to raise many problems regarding its taxation. From the short and general provisions on the topic of partnership taxation it is difficult to attribute to the legislator a general and consistent approach as to the various aspect of partnership taxation. The case law, by nature, has dealt with specific questions, thus, in the case of CA 536/88 *Etz Levod v. Income Tax Assessor for Large Plants* [7] (hereinafter: 'the *Etz Levod* Case'), the problem arose surrounding section 19 of the Ordinance, which places limitations on the deduction of interest expenses of a taxpayer with preferred loans. In that case, the partnership borrowed money and paid interest for these loans. The taxpayer, a partner in that partnership, had preferred loans, as they are defined in section 19 of the Ordinance. The dispute surrounded the question of whether the preferred loans that the partner had were to also be adjusted as to interest expenses and rate differences that were expended by the partnership because of the loans. The position of the tax authorities was that according to section 63 of the Ordinance, income and expenses of the partnership, including loans it took out, are income, expenses and loans of the partners according to the proportion of their share in the right to profits. Therefore, the partner must, according to sections 63 and 19 of the Ordinance, conduct the necessary adjustment also as to interest and rate difference expenses that he spent via the partnership. The position of the taxpayer was that it was not proper to adjust the preferred loans that he held. He explained this as being in accordance with the language of section 63(a)(1) of the Ordinance, under which the 'partnership income' is to be worked out 'according to the provisions of this ordinance.' He took this to mean that one is to calculate the taxable income of the partnership in accordance with rules as to deductions, off-sets and exemptions in the Ordinance and attribute to each partner as per his share only the result which is reached in the bottom line, meaning profits or

losses.

23. President M. Shamgar accepted the position of the tax authorities, relying on the provisions of section 63 of the Ordinance, and stated as follows (at p. 742):

> The broad topic of partnership taxation is not laid out before us as such. Our topic in this case is in a narrower sector, and it is the permitting of interest expenses, which the partnership expended for a loan that it took out during the course of running its business. This court has dealt in the past more than once with examining various legal topics that arose incidentally to taxation of economic and business activity undertaken via a partnership. According to the rules which were delineated, be the status of the partnership what it may be according to the provision of the general law, the provision of section 63 of the Ordinance is to be viewed as a specific provision for income tax purposes, according to which the partnership is not a taxpayer and does not carry an independent income tax liability.
>
> > Incomes from a partnership are the direct income of the partners. It follows that the incomes of the partners are to be viewed as stemming directly from their original source, without the independent legal personality of the partnership interjecting between this source and the eligible partner. (CA 425/79 *Angel Ltd. v. Income Tax Assessor, Income Tax, Jerusalem* [9] at p. 835).
>
> This means that the partnership incomes are not to be discussed as a separate concept from the incomes of the partners. Tax liability is imposed on the partners directly for the share of each of them in the income of the partnership. In this sense 'one is not to separate between the involvement of a person in an individual manner and the involvement of that person (in that business) as a partner. . .'
>
> (CA 20/63 *Ben-Zvi v. Income Tax Assessor, Bet-Hadar, Tel-Aviv-Yaffo 1*, [10] at p. 1968).
>
> As we have seen, section 63(a)(1) of the Ordinance contains two operative provisions: first that the share that each partner is entitled to from the partnership income is to be regarded as the income of that partner. The position of the Court, as brought supra, relies on this provision, in which the statutory source for attributing the income of the partnership to the partner for the purpose of the latter's tax liability is contained. According to the second provision in this section, the partnership income is to be clarified in accordance with the provisions of 'this Ordinance' (and see also section 63(a)(2)). This latter provision is in apparent contradiction with the automatic attribution of the partnership income to the partners as it does not elucidate

> the nature of this required 'clarification' regarding the partnership income. The appellant is of the view that this clarification is none other than clarification of the taxable income of the partnership, which is to take place at the level of the partnership, and only after that assessment is the final result reached to be attributed to the lone partner. The appellant's position therefore places the central interpretive weight on the clarification of the income at the partnership level. However, this approach was not adopted in the case law which dealt with the topic. The Court regarded the principle that was established as to attribution of the partnership income to the partners the central arrangement of the article, while the provision as to clarification of the partnership income was interpreted as establishing a 'mechanistic stage in order to reach the income of the partner from the partnership. . .' (CA 82/60 *Poychtunger v. Income Tax Assessor, Tel-Aviv 4 (Central)* [11] at p. 1368). The basic point here is that the incomes of the partnership are directly attributed to each and every partner according to their share. The term 'partnership income' as such does not have ramifications in terms of the income tax laws, but only as an accounting tool for clarifying the income of the partner, who is the final taxpayer according to the Ordinance's provisions. The same is the law as to the deduction of expenses, which is the question before us.

In the continuation, President Shamgar states (at p. 744):

> The rule is that examining the entitlement to deduct expenses is done only as to the income of the partner, that is the 'taxable' income, and therefore the expenses borne by the partnership will be examined, for purposes of allowing them, as though they were expended by the individual. It follows that the law for interest expenses borne by the partnership in our matter, is as the law of the premium in CA 477/71 *Shtetner v. Income Tax Assessor, Haifa*, [12]. In both cases permitting the deduction of expenses is to take place at the level of the final taxpayer, which is the partner.

24. The importance of the legal rule that was determined in the *Etz Levod* Case is that in the entire realm of the deployment of section 63 of the Ordinance the partnership is not to be viewed as a separate business. Indeed, it was earlier ruled in this vein that '. . . the business of the partner and the business of the partnership are one and the same for the purpose of section 23(2)', in the sense that regarding a husband and wife who are partners in a business, the source of the wife's income is seen as dependent on the source of the husband's income. (CA 82/60 *Poychtunger v. Income Tax Assessor, Tel-Aviv 4 (Central)*[10]). It was also ruled that bringing an asset into the partnership by a partner in consideration for receiving a payment from the rest of the partners proportionate to their share in the partnership is not a sale to an entity that is separate from the selling partner, and therefore the income tax

liability is not determined separately from the obligation of the selling partner: 'therefore, the dealing of a person on an individual level is not to be separated from his dealing (in the same business) as a partner, and to be referred to. . . as two separate assessments' (CA 20/63 *Ben-Zvi v. Income Tax Assessor, Bet-Hadar, Tel-Aviv-Yaffo 1*[9]) It was further ruled that 'the incomes of the partners are to be seen as stemming directly from their first source, without the separate legal personality of the partnership partitioning between this source and the entitled partner,' meaning the incomes of the partnership are the direct incomes of the partners. It follows that as to a partner which is an industrial company, which benefits from reduced tax as stated in section 19 of the Law for Encouragement of Industry (Taxes) 5729-1969, a reduced tax is to be regarded as due on the income of the partnership attributed to that partner, as well. (CA 425/79 *Angel Ltd. v. Income Tax Assessor, Income Tax, Jerusalem* [8]).

25. All this regards the realm of application of section 63 of the Ordinance. On the other hand, in other matters relating to the taxation of a corporation, it has at times been ruled that the law of the partnership is as the law of a separate business. It was ruled in this vein in ITAp 118/90 *Lev Hagalil Partnership v. Income Tax Assessor, Tiberias* [12] (in the words of Judge Haas). The question under consideration was whether a partnership which grants its partners or employees a benefit beyond what the law recognizes as a business expense must pay an advance on the excess benefit, as per section 181B of the Ordinance, and whether a partnership is to be included in the definition of 'an association of persons' in section 1 of the Ordinance. After surveying the case law which relates to section 63 of the Ordinance the Court summarized that 'it is possible, perhaps, to understand, that in light of the provision of section 63 of the Ordinance the Ordinance disregards the separate legal personality of the partnership, for this matter only. But, it is not to be learned from this that the Ordinance disregards the separate legal personality of the partnership when it is a matter of the partnership's obligations to third parties; the relationships among the partners; as to ownership of assets; and as to the existence of work relationships between the partner and the partnership.' The Court examined whether the provisions of section 181B of the Ordinance are included in the 'decrees' by which the legislature has imposed partial disregard of the separate legal personality of the partnership, meaning 'whether the provisions of section 181B and 181C, which deal with payment of advances on excess expenses, which the section imposes on 'an association of persons,' are also overridden by section 63 of the Ordinance. The Court's conclusion is:

> The provisions of section 181B which speak of 'an association of persons' in a manner that includes the partnership – despite the provision of section 63 of the Ordinance which speak of obligating the partners as 'a taxpayer'. The section is to be interpreted according to its meaning and basic text when there is a definitive presumption that the legislature knew of the existence of the

> provisions of section 63 and despite this did not qualify the term 'association of persons' in section 181B in order to remove the partnership from it. The claim of the representative for the appellant that section 63 of the Ordinance, being a special law (Lex Specialis), caused a statutory lifting of the veil as explained supra, is too sweeping and does, necessarily, need to also include the provisions of said section 181B, which can also be seen as a separate statutory provision and there is no need to conclude that there is a contradiction between the provisions of section 63 and section 181B. Each section could certainly stand on its own as each serves a different statutory purpose. Even if the partners themselves, in the end, are liable for payment of the tax on the excess expense, still this is not sufficient to cancel the statutory provisions in section 181B, which require the payment of an advance.

26. We can see that the legislature's approach is pragmatic and does not regard itself as subject to an overall approach as to the essence of the partnership from the perspective of taxation. As S.Bornstein summarized in his book *Taxation in Corporate Dissolution* [26] at 287: 'In principle the case law has chosen to determine these questions according to the interpretation of the purpose of each and every provision at issue, and not necessary in reliance on the formal definition of the terms of which the Ordinance makes use in each and every one of those provisions. . .'

27. Absent an overall approach as to the essence of the partnership from the perspective of taxation, the problem returns to its starting point: how is the transfer to another person of the share of a partner in a partnership to be regarded? Is it a matter of the transfer of individual assets or the transfer of an overall share in the partnership? I will state at the outset that the Income Tax Ordinance does not contain an explicit provision which will directly answer this question. First, section 63 of the Ordinance does not regulate this matter, as it deals with the establishment of the income and expenses of the partnership. According to the arrangement established in the Ordinance, the partnership's income is attributed directly to each and every partner according to his share. This arrangement does not answer the question which arises in our matter, which is in terms of section 63 of the Ordinance: what is the income of the partner when he transfers part of his interests in the partnership to another person, or even all of them? Meaning, the problem is not attribution of the income to the partnership or the partner, but rather, how to conceive of the assets transferred by the partner, with the clear assumption that this is a matter of his income. Therefore, I cannot agree with the central rationale of my colleague Justice Or, according to which section 63 of the Ordinance is an indication of an overall approach as to the essence of the partnership. Granted, if we apply the conceptual formula at the base of the provision of section 63 – which is a disregard of the separate existence of the partnership business – then we will also resolve the problem in our matter by way of ruling out of the approach as to the transfer of an overall share of the

partnership. The necessary conclusion of this approach is that the partner transferred nothing more than individual assets. However, as the question in our matter is situated, as stated above, beyond the defined realm of the provision of section 63, then the determination as to broadening the applicability of the approach at the foundation of the provision is not compelled by the reality. This requires separate weighing of considerations that are based on appropriate legal policy.

28. Second, even the other provisions, which work from the assumption that the partnership is an 'association of persons' cannot require us to apply this presumption to our matter which is not directly regulated by it. Therefore, even if we hold – as do some authors – that as long as there is not a contradiction between the provisions of the Ordinance which relate to the taxation of an association of persons and the specific arrangement established in relation to taxation of a partnership, those same provisions will apply and co-exist with the specific arrangement (S.Bornstein, *Taxation in Corporate Dissolution* [26]), this does not provide an answer to our question, as the provisions mentioned do not regulate the matter of transfer of the share of a partner to another person. And again, broadening the fundamental approach at the basis of these provisions – the approach of a separate business – also must be determined separately.

29. It becomes clear that the starting point of this analysis – the provisions of the Income Tax Ordinance – has not led us to a resolution of the special problem before us. Analysis of the provisions has shown us that the regulation of the partnership in tax laws is based on two opposing approaches, each of which presents a different solution to our problem. A similar situation existed in U.S. law prior to the passing of Internal Revenue Code §741 in 1954. In the U.S. it is also common to juxtapose two fundamental approaches as to the essence of a partnership. On the one hand the 'aggregate' theory (aggregate theory) also called the pass-through or conduit theory, which views the partnership as a cluster of individuals, and on the other hand the approach which views it as a separate unit from the partners that make it up (entity theory). However, there too, the overall regulation of partnership taxation is not methodical and rules can be found within it, some of which stem from the one approach and some from the opposing approach.

30. Prior to 1954, absent an explicit statutory provision, the courts in the U.S. were called upon to determine whether the sale of a share in a partnership by a partner constitutes the sale of a total capital asset or the sale of the share of the partner in each and every asset in the partnership. The federal courts ruled in favor of the first alternative. A classic example of a decision in this vein is found in the case of *Commissioner of Internal Revenue v. Shapiro* [15]. Here, a partner in a partnership of two sold his share (which was one half) to his partner. The state claimed that the tax rate was to be calculated on the basis of the income from the sale of the partner's share in each and every asset. The court stated in this context (at p. 535):

> Petitioner presses the point that the issue depends primarily upon the extent to which the partnership is to be regarded as

> an entity, separate and apart from its members. In our opinion, a decision of this more or less troublesome question would throw no light on the present controversy. The case must be viewed as though the entire assets of the partnership with its value as a going concern added were sold. The fact that one-half interest in the partnership assets and its good will only were sold has nothing to do with the issue, and the further fact that the sale was from one partner to another has no more to do with the question than if the sale had been made to a stranger.

The Court reached the conclusion that:

> Respondent sold all his interest in the partnership, tangible and intangible, as a going concern, which in all essentials is different from the ordinary assets of the partnership used in the usual course of its business.

The legal rule established here took root in case law, as the federal court attests to in a later decision: *United States v. Shapiro* [16] stating (at p. 461):

> The denial ...of the petitions for certiorari ...indicates to us that the Supreme Court is not disposed to disturb the rulings of the Courts of Appeals of the Second, Third, Fifth, and Sixth Circuits and of the Tax Court to the effect that the sale of an interest in a partnership is the sale of a capital asset, regardless of the nature of the partnership properties.

31. Moreover: in another case a problem arose in a context that was almost identical to the one before us. This would be the case of *Thornley v. Commissioners of Internal Revenue* [17]. Here the partners transferred all the partnership assets to a new company in exchange for allocation of shares in proportion to their relative share in the partnership. Later, the former partner sold the shares in the company at a profit. . The problem before the court was whether for purposes of taxation of the profit, the action of transfer of the partnership assets to the company was to be viewed as a transfer of an overall share in the partnership or as a transfer of his share in individual assets. The difference in approach related to the calculation of the years in which the partner held the capital stock of the company, which he sold after a number of years. The number of years for which a shareholder is considered to be holding the capital stock influenced the tax rate which was owed at the time of the sale. The special question was whether a shareholder can also add the period in which he held his share in the partnership to his period of holding of the company shares, or whether he must show his period of holding for each and every asset separately. This special question does not concern us here; the importance of the decision is in the approach of the Court to the essence of the transfer of the partnership assets at the time of the founding of the company. As to this the Court says (at p. 421):

> From the above it is clear that the subject matter of the *direct* exchange between the partnership and the corporation was the partnership interest in the entire business and its

> physical assets, real and personal and goodwill *as a going concern.*

And later (at p. 422):

> In our opinion, however, applying the rule that 'taxation deals with realities not semblances; with substance not form' the transaction is one of an exchange of partnership interest for corporation stock. Simply stated what happened here was incorporation by the partners of their partnership business. The transaction from partnership to corporation was accomplished by the transfer by the partners (acting in their identity as co-partners as co partnership) of all of the assets of the partnership to the corporation with the partners receiving from the corporation shares of stock in proportion to their respective partnership interests. There was never at any time any liquidation of partnership assets to the partners. Had the stock been issued by the corporation to the partnership in exchange for their respective proportionate interest in the partnership, certainly no question could have been raised by even the most aggressive tax-collector. The fact that that was not done but that the corporate stock was issued directly to the partners, does not in any way change the nature or complexion of the transaction.
>
> ...
>
> The critical test is not whether the corporation technically acquired the 'partnership interest' but, as was pointed out in *Kessler v. United States* (124 F.2d 152) *whether the petitioner gave up 'his partnership interest in exchange for the stock even though that interest as such did not pass to the corporation'.*
>
> Here clearly the petitioner and his co-partners acting in concert gave up his partnership interest in exchange for the stock of the corporation.'

32. This approach was also accepted eventually by the tax authorities in the United States, as is explained in the decision in *Hatch's Estate v. Commissioner of Internal Revenue* [19]. In that case partners in a partnership that was the owner of a motorized vehicle business sold the partnership business to a foreign company. A debate arose regarding, whether, under the circumstances, the transaction was the transfer of assets or the transfer of an interest in a partnership. The Court stated the following (at pp. 28-29):

> Where a partnership interest had been sold, the Commissioner of Internal Revenue for many years treated it as the sale of the selling partner's undivided interest in each specific partnership asset....
>
> However, in 1950, the Commissioner of Internal Revenue acquiesced to the overwhelming case authority to the effect that for income tax purposes the sale of a partnership interest in a going concern should be treated as the sale of a

> capital asset. ...And this partnership interest is personal property which is separate and distinct from his co-ownership of the specific partnership property.

As I mentioned above, the case law received legitimization in 1954 in an amendment of the Internal Revenue Code which regulated the issue of transfer of interests in a partnership. The general principle that the transfer of interests in a partnership constitutes the transfer of a capital asset was established in section 741 of this statutory code, subject to the exceptions established in section 751 of the code (Unrealized receivables and inventory items). So too, specific provisions were established, which detail the manner of calculation of capital gains in the transfer of an interest in a partnership. (See generally as to the American arrangement H.E. Abrams & R.L. Doernberg, Essentials of United States Taxation (1999) pp. 3-1 - 3-244).

33. In my view, it is appropriate to adopt the approach that was developed at the time in the U.S. case law and which the lower court agreed with. Absent an explicit statutory provision, when we come to determine the method of taxation in accordance with the proper legal policy, the true essence of the transaction, which establishes the tax liability and its economic content, is to be examined. Transfer of a share in a partnership is in essence the transfer of an interest in a 'going concern' with the totality of its assets and liabilities. An interest in a 'going concern' of a partnership is close, at its core, to the concept of a share in a business corporation. Here too it is a matter of an economic entity unique and separate from those holding it. The status of the partnership as an independent economic entity is also strengthened by its recognition in the general law, which grants it various capacities that bind the partnership's operations. In this regard the partnership differs from a one person business, as to which it is difficult to distinguish between the activities, assets, and obligations of the individual, and those of his business. Artificial dissolution of the partnership, which constitutes one economic entity, and imposing a selective tax on tangible assets alone from the 'going concern' of this entity, does not comport well with the economic reality. This is because the economic reality relates to the entity of the partnership as a 'going concern' in the totality of its aspects. It is to be presumed that the appraisal of the economic worth as well, which dictates the consideration for the sale of an interest in a partnership, is also achieved in keeping with this approach.

34. On the other hand, the approach that imposes a capital gains tax on the total interest in the partnership in the case of the transfer of the partner's share gives full force to the economic entity of the partnership and thereby gives expression to the true essence of the transaction. This approach gives significance, for tax law purposes, to the 'phenomenon' of a partnership, which is recognized in the general law. This approach also accords with the principle of attempting to coordinate the understanding of foundational terms in civil law and tax laws. This stands out particularly when the partnership is perceived of as a legal personality. It is, of course, not necessary that the partners transfer their overall share in the partnership. The path is always open to them to

transfer their share in individual assets. In accordance with their choice, the fixed tax rate will be determined according to the appropriate tax event.

35. In opposition to the proposed approach, criticism, which has also been adopted by my colleague Justice Or in his opinion, has been voiced by scholars, who claim that recognition of the separate entity of the partnership may carry with it unwanted results, and that it may create a tool for inappropriate tax reduction or the imposition of too heavy a tax burden, and this due to the 'capital' taxation arrangement for assets, which are 'earned' in their essence. (Y. M. Edri and Y. Eden 'On the Problem of the Excess Tax Liability, Statutory Veil and the Taxation of a Partnership, a Cooperative Agricultural Association, a House-Corporation, and a Family Corporation in the Income Tax Ordinance' Iyunei Mishpat 13 (1988) 307, at pp. 322-323).

36. I will comment in this context, that, fundamentally, it is not necessary that taxation of capital income differ from taxation of earned income. And indeed, the current global trend is to narrow, if not eliminate, this distinction. (See D. Glicksberg 'Averaging Property Betterment and Spread of Capital Gains' *Mishpatim* 21 (1992) 371 at p. 371). However, if there is a distinction in the taxation arrangement, then the tax laws are to be applied according to the essence of the matter. This is the law with the taxation of the sale of shares in a company. The sale of the shares creates an obligation for capital income, which is not dependent on the character of the specific company assets. (See for example, CA 289/66 *Kirshenberg v. Income Tax Assessor Gush Dan,* [1] where it was ruled that given that the company was a separate legal personality from its members, no tax liability would be imposed on earned income at the time of the sale of shares in it, even though the company's assets included primarily business inventory, and that the sale of shares would be taxed as capital income only.) In particular, the 'aggregate' approach is likely to create difficulties, as it requires the application of different laws on different assets within the partnership. According to the 'aggregate' approach, one is to distinguish, as to individual assets, between equipment, which is a capital asset, and business inventory, which is an earned asset. This distinction, may, for example, create difficulties in the framework of the personal principle. The legislature applied this principle only to capital gains tax (section 89(b)(1) of the Ordinance). The result will be that in selling a share of a partnership, several assets will be subject to the personal principle and others not. It appears that this situation is not satisfactory. There is no doubt that under these circumstances, there is an advantage to considering all the assets as one unit.

37. The criticism that an arrangement that is in essence 'capital' should not be applied to assets that are in essence 'earned,' does not appear to me to be well-grounded. The idea that there is something 'natural' in the categorizations applied to assets is not clear to me. A tax event is determined by its economic significance, which is capital or earned. This is the situation in the case of a corporation with shares and this is how it should be for a business partnership as well.

38. In his opinion, my colleague Justice Or brings an example in order to concretize the difficulties of applying a 'capital' taxation arrangement on 'earned' assets. This example deals with the provision of the possibility of spreading out the profits for the partner that stemmed from the sale of the interest in the partnership, over the course of four years, even when the partnership only accumulated profits in the fourth year. Spreading the profit out will lessen the effective tax the partner will bear, since he had no income in past years. In my opinion, this example does not raise any difficulties. The reasons that justify the spreading of capital gain over the course of four years in 'natural' capital assets (and company shares) are also valid as to the interest in the partnership. It is to be remembered that the presumption at the base of the arrangement of spreading out the capital gain, which assumes an equal annual growth of the value of the capital asset, is also not always consistent in reality regarding 'natural' capital assets (See D. Glicksberg 'Averaging Property Betterment and Spread of Capital Gains' [30] at p. 379 and p. 389).

39. Still, it is clear that the attempt of a taxpayer to arrange any transaction with the primary purpose of evading taxes will be judged by the criteria which apply to artificial transactions (section 86 of the Ordinance). Therefore, criticism that relies on the concern for tax evasion is not very convincing.

40. Additional criticism is rooted in the claim that the proposed approach is not applicable without the legislation of specific provisions, as arises from the experience in the U.S., where the legislator found it necessary to complete the judicial work via a series of statutory provisions. (See Y. M. Edri and Y. Eden, **Ibid**, at p. 322). But, the American experience in fact provides refuting evidence: the case law made the step from an 'aggregate' philosophy to an 'entity' philosophy on its own initiative, without waiting for a statutory arrangement and specific coordinating provisions. Moreover, the American legislator felt the need to supplement the details of the particular legal arrangement because of the special background in American law, regarding the significant gap between capital taxation and earned taxation. The situation in Israel is different in this regard. In any event, the existence of such provisions in the U.S. is not a determining factor when we must decide the fundamental question. Should the adoption of the proposed approach lead to problems, then the hand of the legislator is poised to fill in what is necessary.

41. My colleague Justice Or describes the difficulties regarding the absence of a coordinating provision by means of several examples. I will touch upon them briefly. First, I do not see a special problem regarding the calculation of the original price and the balance of the original price. The solution will be to calculate these values similarly to how they are calculated in a corporation. Second, regarding the concern of double tax collection absent specific statutory provisions, it is possible to prevent double tax collection via purposive construction of the law, based on the fundamental principle that prohibits collecting double taxes for the same income. (See S.Bornstein summarized in his book *Taxation in Corporate*

Dissolution (Jerusalem, 1997) 301). Third, a similar approach would also solve the problem of receiving remuneration which is tax exempt; the fundamental principle mentioned necessitates increasing the original price by the amount of the remuneration or reducing the consideration at the same rate. Fourth, in the opinion of my colleague Justice Or, there is a need for a coordinating provision that will prevent the indirect deduction of expenses that are not deductible, by turning them into a capital loss. It appears that a similar phenomenon could also occur as to 'natural' capital assets.

42. It is to be remembered, that the 'aggregate' approach, proposed by the Income Tax Assessor is also not easy to implement. Let us examine, for example, the ramifications of the 'aggregate' approach on taxation of the partnership income when the makeup of the partners changes during the course of the life of the partnership. An outcome of the 'aggregate' approach is that after sale of a share of the partnership to a new partner, the method of calculation of the ongoing income necessitates its distribution among the partners according to their investments. This means that, at the time of calculation of the taxable ongoing income of the new partner out of the partnership incomes, the amount that he invested in the business inventory of the partnership is to be taken into account and he is to be given the opportunity to deduct depreciation, in accordance with the consideration paid by him, for the depreciation bearing assets of the partnership. This method is complicated and difficult to apply, as it necessitates much adjustment and an accounting distribution of the partnership transactions among the partners (see A. Raphael, D. Ephrati, Income Tax Laws, Volume B [25] at pp. 334-335). In this context it has been written as to the situation in the U.S.:

> 'The result is that each partnership asset has two bases - one for the continuing partners and one for the purchasing partner. In the extreme, each asset could have as many different bases as the partnership has partners. The recordkeeping requirements in this situation are a nightmare.' (J. Schnee 'The Future of Partnership Taxation' [44] 517, 534).

I will reiterate that our situation is substantively different from the situation that exists in the U.S. and therefore the difficulties there are not to be equated with those that are likely to arise here. Each and every method has its problems. It is appropriate that the legislator regulate the matter of partnership taxation in a general arrangement. And indeed, the absence of a clear and consolidated statutory arrangement also creates difficulties in the realm of international taxation of activity in the framework of partnerships, such as the question of the location of the domicile of the partnership (see in this context M. Kaputa, 'Tax Planning in the Context of Partnerships and International Joint Transactions.' [31] p. 64A.

43. Our situation has yet to be resolved. Under the present circumstances there is an additional element which may impact the tax liability. We have before us a case where all the partners transferred their

share in the partnership to a new corporation. The result is that now the new owner of the partnership assets is the corporation. The partnership has thereby been entirely liquidated. I will clarify the matter: by transferring the overall share of a partner to the corporation, the latter becomes a partner in the partnership in place of the outgoing-transferring partner and its proportion in the partnership is in accordance with the transferred share. Let us now assume that the other partner as well – in the partnership of two – transfers his overall share in the partnership. The result is that from this moment the partnership has ended, since a partnership, in accordance with its name and definition in the Partnership Ordinance [New Version] 5735-1975, is a connection among persons who manage a business together for the purpose of making profits (section 1(a) of the Ordinance). In the case of the transfer of all the shares of a partnership to an association, the latter manages the business transferred to it on its own.

44. Dismantling a partnership is a tax event. This was explained by A. Yoran (Yorakvitz) 'Tax Planning in Incorporation of a Partnership as a Corporation' [32]: 'Granted that for the purposes of determining the tax on earned income the independent legal existence of the partnership is ignored and each partner is held to his share in the partnership income. But this fact does not enable one to say that a business was not transferred, using the argument that the partnership was not viewed as the owner of the business' (at p. 164). A separate question is what is the nature of this event. In the case of the liquidation of a corporation, the principle established in section 93 of the Ordinance is that two separate tax events occur: the corporation is considered as the one selling its assets to the shareholders, while the shareholders are considered to be the ones selling the shares in their possession. The two separate tax events produce separate tax liabilities, however, the shareholder is entitled to a credit for the tax paid by the company in order to avoid a double tax. (See at length, S.Bornstein, summarized in his book *Taxation in Corporate Dissolution* (Jerusalem, 1997) 193-219). But the problem is: do the taxation rules in corporate liquidation apply in the case of the dismantling of a partnership? And more precisely: does the dismantling of a partnership also produce two separate tax events, meaning, both at the level of the partnership and the level of the partners, similar to what occurs with the liquidation of a corporation regarding the relationship between the corporation and the shareholders? Moreover, assuming this is the case, is it possible to avoid double taxation? These questions stem from the need to integrate the 'aggregate' approach of section 63 of the Ordinance with the 'entity' approach of the partnership, which views it as an 'association of persons.' (See S. Bornstein, **Ibid**, at pp. 281-302). The author is of the view that there is nothing to prevent applying the legal arrangement in section 93 of the Ordinance to a partnership. The result is that the partnership being dismantled is considered to have sold its assets to the partners, and the partners as having 'sold' their interests in the partnership. (Compare also A. Raphael and D. Ephrati, Income Tax Laws, [25] at pp. 337-340).

45. Be the law what it may as to the details of taxation in the case of

the dismantling of a partnership, in any case, the claim is that it is not a matter of the transfer of a right in a partnership, but the transfer of the individual assets of the partnership. As, we will discover if we examine the essence of the event according to its results, the assets which the partnership held are now held by the corporation. The partnership itself disappeared – for lack of partners – and ostensibly there is no other explanation as to the assets being in the hands of the corporation other than that the partnership is the one which transferred the assets to it. This transfer took place alongside the dismantling of the partnership. We find that in the circumstances of the matter before us, justice is still on the side of the Income Tax Assessor, who demanded taxation in accordance with the assumption that the individual assets of the partnership, rather than an interest in the partnership, were transferred to the corporation.

46. Indeed, such an argument was raised by the appellant in his written summations before the court of first instance. There it was argued that the corporation did not purchase a share of the partnership and that ‘it is impossible to purchase part of something that no longer exists.’ And further that ‘at the time of the dismantling of the partnership . . . it is no longer the interest in the partnership that is sold, but its assets themselves, each separately.’ The appellant also repeated this argument in his summations before us: ‘from the moment the partners transferred to the corporation the assets and liabilities of the partnership **and the partnership ceased to exist**, and then the corporation could not receive the interest of the partners as an asset. The corporation could not purchase an asset that no longer exists, meaning that the partners too have sold their interests in the partnership assets and no more.’ There is no doubt that such a formal-conceptual argument is substantial.

47. The question then is must we reach the conclusion provided for by the world of legal concepts? We will concretize the question with the tax planning possibilities. Let us imagine that in the circumstances of the case before us, one partner transferred his entire share in the partnership (50%) to the corporation, but the other partner held on to a miniscule share of the partnership (such as one thousandth). In these circumstances the partnership would not be not dismantled, since there are still two partners in the business, the corporation and the minor partner. (Another possibility to consider is the transfer of the partnership business to the company and its daughter-company). The substantive question at issue is whether there is a tangible-economic difference between the two situations which justifies different taxation. I am not referring to the problem of an artificial transaction for the purpose of tax evasion, but to a fundamental approach as to taxation of the original transaction. In my view, there is no point in distinguishing between the two situations just described. This is because our view of a partnership is not as a ‘legal personality,’ but rather is as a ‘going concern.’ Therefore, the fact that the partnership as a legal concept disappeared from the normative horizon does not detract from the economic reality, according to which the business continues to exist in the framework of the corporation that purchased it. This means that the partners transferred their share in the

partnership business to the corporation and under these circumstances the dismantling of the partnership, which is necessitated by the very transfer, is not to be seen as an additional tax event. In this way the business of a partnership differs from a sole proprietorship. And if one would ask, why do we not relate to a sole proprietorship, in its transfer to another person, as a separate legal personality, my answer would be that, as explained above, it is very difficult to distinguish between the personal assets and business assets of an individual. On the other hand, with regard to a partnership, in which there are natural conflicts of interest between the two partners, identifying the business assets is easier. Therefore, the idea of an independent business is not to be broadened beyond the templates created by the legislator. It is to be noted that the individual may today, according to the Corporations Law 5759-1999, incorporate his business and distinguish it by means of a corporation of an individual.

48. Support for this approach may be found in U.S. case law. Justice Frank stated as follows in his dissenting opinion in the case of *Williams v. McGowan* [20] at p. 573:

> I agree that it is irrelevant that the business was once owned by a partnership. For when the sale of the Corning Company occurred, the partnership was dead, had become merely a memory, a ghost. To say that the sale was for the partnership's assets would, then, be to indulge in animism. But I do not agree that we should ignore what the parties to the sale, Williams and the Corning Company actually did. They did not arrange for a transfer to the buyer, as if in separate bundles, of the several ingredients of the business. They contracted for the sale of the entire business as a going concern..... To carve up this transaction into distinct sales - of cash, receivables, fixtures, tracks, merchandise, and good will - is to do violence to the realities. I do not think Congress intended any such artificial result....Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize; so, too, I think, did Congress. Interpretation of our complicated tax statutes is seldom aided by saying that taxation is an eminently practical matter (or the like). But this is one instance where, it seems to me, the practical aspect of the matter should guide our guess as to what Congress meant. I believe Congress has those aspects in mind and was not thinking of the nice distinctions between Roman and Anglo-American legal theories about legal entities.

The federal court in the case of *Hatch's Estate v. Commissioner of Internal Revenue* [18] adopted the dissenting view of Justice Frank. See also the decision in the case of *Meyer v. U.S.* [22].

49. In conclusion: the position of the court of first instance that for taxation purposes, the transfer of the partnership business from the partners to the corporation is to be regarded as the transfer of the interest of each partner in the partnership and not as the transfer of each and

every asset separately, is to be accepted. As I noted, the partners have before them several possibilities for executing the transfer of assets in a partnership. Apart from the possibility of transferring an overall share, they can, of course, transfer assets separately. Moreover, in certain defined situations section 104B of the Ordinance now provides the possibility of transferring partnership assets to the corporation without an immediate tax liability (this arrangement replaced, beginning in 1994, a similar arrangement which was established in section 95 of the Ordinance, which was in effect during the dates relevant to the issue before us). According to the arrangement in section 104B of the Ordinance:

> Partners in a partnership or joint owners who transfer an asset in the ownership of the partnership or who transfer an asset in their joint ownership, respectively, to a corporation that was specifically established for this purpose and this corporation did not have any other asset or other activity at that time or beforehand, and this in exchange for allocation of shares in that corporation alone, will not be held liable for taxes according to this Ordinance, according to the Law of Adjustments for Inflation, or the Capital Gains Law, according to the matter, if the following conditions are fulfilled. . .

Fulfillment of the conditions established in the provision results in deferral of the tax payment: section 104E and 104F of the Ordinance defer the collection of the tax that would be due were it not for this legal arrangement. They establish, *inter alia*, that the original price, the date of purchase, and the value of the purchase of an asset that was transferred as described will be as they were in the hands of the transferors, meaning in the hands of the partners. As a result, when the asset is sold by the corporation, the capital gains tax that would have been collected were it not for the legal arrangement is paid. For a discussion of the types of assets that are transferable according to section 104 of the Ordinance see Z. Sharon 'Assets that are not Transferable according to Section 104 of the Ordinance' *Misim* H 5/(1994) p. 35A.

Therefore the appeal is to be dismissed. The appellant will pay the respondents attorneys fees and expenses in the amount of 25,000 NIS.

Vice President S. Levin

Once the respondents agreed to transfer the totality of all their rights and liabilities in the partnership to the corporation – and not to the transfer of individual assets – this agreement is to be approved not only in the civil realm, but also for the purpose of tax matters, unless there is in the tax laws a specific provision to the contrary. I have not found an explicit provision such as this in section 63(a) of the Ordinance and I have not seen a sufficient reason to expand what is stated in it to additional matters. I do not take lightly the difficulties that arise with the acceptance of the approach of Justice Englard, some of which may not have received a sufficient response; but this is a matter, in my opinion,

for the legislator to address. I join my opinion to the opinion of Justice Englard that the appeal is to be dismissed.

Justice T. Strassberg-Cohen

I join with the opinion of Justice I. Englard and the comments of my colleague Vice President S. Levin, for their reasons.

Justice T. Or

Partners in a partnership set up a corporation and transferred all their rights and liabilities in the partnership to it. Will they be taxed as one who has sold an interest in a partnership (similar to a share) or as one who sold his share in each and every asset of the partnership assets (similar to a sole proprietorship)? That is the question at the center of this appeal.

The primary facts and proceedings

1. The respondents 2 and 3 (hereinafter: 'the respondents') were partners in a partnership titled 'Sadot' (hereinafter: 'the Partnership'). The Partnership dealt in transport and among its assets had fixed assets and current assets. During the course of the year 1982 the respondents decided to change the form of the association in which they ran their business and established a company named Sadot Transportation Corporation (1982) Ltd. (hereinafter 'the Corporation'). All the assets and liabilities of the Partnership were transferred to the Corporation. Each one of the respondents held shares in the Corporation in the same proportion of holdings in the Partnership that he had in his possession prior to that. In the Corporation's books the closing balances of the Partnership balance sheet were recorded as the opening balances of the Corporation.

The Income Tax Assessor (hereinafter: 'the appellant') taxed the partners for the capital gain they acquired, according to his claim, from the transfer of fixed assets (trucks) of the Partnership to the Corporation. The respondents objected to these assessments and their objections were dismissed.

The respondents appealed to the District court. Their argument was that transfer of their interests in the Partnership to the Corporation is not a 'sale' according to its meaning in section 88 of the Income Tax Ordinance (New Version) (hereinafter: 'the Income Tax Ordinance' or 'the Ordinance'). Alternatively the 'asset' that was sold is not their interest in each and every asset of the Partnership assets, rather, the asset that was sold is their overall interest in the Partnership.

The District Court determined that the transfer of the Partnership assets to the Corporation is within the broad definition of the term 'sale' in section 88 of the Ordinance. However, the court determined that the tax assessment of capital gain to the extent that such a gain indeed has been generated from transfer of the fixed assets to the Corporation will be determined as per the overall share of each partner in the Partnership that was transferred to the Corporation and not as to each and every asset separately. It was determined that the discussion be remanded to the objection stage for the capital gain to be calculated, to the extent that indeed such capital gain was created. From here comes the appeal before us.

The parties' arguments and the framework of the dispute

2. The appellant claims that the Income Tax Ordinance does not recognize the separate legal personality of a partnership. Therefore,

unlike a share, which reflects the conglomerate of rights and duties of a shareholder in a corporation, the Ordinance does not recognize an interest in a partnership which similarly reflects the conglomerate of rights and duties of a partner in a partnership. A partner in a partnership has the right to a certain percentage (in accordance with the partnership agreement) in each of the partnership's assets and liabilities. Therefore, in the transfer of the partnership assets, the partner is taxed on each asset separately, according to the character of the partnership asset, and according to the partner's share in this asset. The appellant also raises the procedural claim according to which the claim that we are dealing with the sale of an interest in the Partnership was not raised in the appeal that was submitted to the District Court, and therefore should not have been heard.

The appellant further emphasizes that the decision of the District Court is difficult to implement. Determining the worth of an association in and of itself is a complex and complicated task, all the more so in this case where the calculation is to be done many years after the event.

The respondents, for their part, argue that the Ordinance does not refute the legal character of the partnership, but it ignores it for certain purposes. In any case, the partnership is undoubtedly an economic entity in which the partner can sell his interest. An interest in a partnership is an 'asset' as per its meaning in section 88 of the Ordinance. Which includes, inter alia, any right or benefit merited or held. In light of what was said, when a transfer of all the assets and liabilities of a partnership takes place, the interest of the partner in the partnership is transferred and not his share in each and every asset. As for the procedural claim, the respondents argue that the dispute as to the substance of the transferred asset was raised and discussed fully and no injustice was caused to the appellant. Therefore, the argument is to be dismissed.

The respondents further claim that even if the transfer of the trucks is to be taxed with a capital gains tax, detached from the transfer of the rest of the assets and liabilities to the company, then under the circumstances the transfer is not included in the framework of a 'sale' as defined in section 88 of the Ordinance.

It is to be noted that we do not have before us the claim that section 95 of the Ordinance that deals with the transfer of an asset to a corporation in exchange for shares (this section, which applies to transfer of assets to a corporation during the time period relevant to our matter, has been replaced by a more comprehensive arrangement which is set in section 104B of the Ordinance) applies to the transfer of the trucks from the Partnership to the Corporation. According to the conditions established in it, said section enables deferral of the tax liability. According to the appellant's claim, section 95 and its replacement section 104B, do not apply to cases such as those before us, in which assets are transferred to a corporation in exchange for payment of debts. This, according to his claim, for the reason that a condition for applying that arrangement is that the transfer of the assets is for shares alone. It should be commented, that this construction of the appellant is not the only one possible. However, in light of the fact that the respondents

themselves are not claiming that transfer of the asset in this case fulfills the conditions of section 95 we will leave the question of the construction of sections 95 and 104B of the Ordinance to an instance where it is necessary.

4. I do not accept the procedural claim of the appellant as to 'change of direction' for the reasons detailed in the opinion of my colleague, Justice Englard. So too, I accept my colleague's view that the right of a partner to his share in the partnership is within the broad definition of the term 'asset' in section 88 of the Ordinance, and that the transfer of the partner's share in the partnership is within the framework of the broad definition of the term 'sale' in said section 88. However, this is not sufficient to settle the primary dispute in this appeal. Just as the interest in a partnership is an asset, so too the interest in each and every asset of the partnership assets is an asset. The dispute remains therefore as to the substance of the transferred asset in the sale of the partner's share in the partnership. Whether, in terms of the tax, the transfer of the share of a partner in a partnership is to be related to as the sale of an asset which is an 'interest in the partnership' or as the sale of his interest in each and every asset?

5. In the topic of partnership taxation, there exist two analytical theories in which the basic concepts which are at their foundation contradict each other. Accordingly, they address the question before us differently. The entity theory sees the partnership as an independent unit separate from the partners that make it up. The partnership is the taxpayer and the tax is levied on its income. It is clear, that this theory if applied to the case before us, will regard the sale of the share of a partner in a partnership as the sale of an interest in the partnership. The second, the aggregate theory holds that for tax purposes, the partnership does not have its own independent existence. It is not a tax unit. The tax units are the partners that make up the partnership. Each partner is taxed separately according to his share in the partnership incomes. Applying this theory to the case we are dealing with will lead to the determination that in the sale of a share of a partner in a partnership in fact his share in each and every asset of the partnership assets is being sold. As I will detail *infra* (in paragraph 10) it is not necessary to adopt either of these theories in a sweeping manner, and it is possible to adopt an integrated approach which applies both theories – each in different taxation matters.

These conflicting theories, are reflected in the disagreement between scholars as to the topic of partnership taxation. Some hold that in light of the separate legal personality of the partnership, the assets are held by the partnership and not the partners, and therefore the sale of interests in the partnership is not the sale of each asset individually, but the sale of the interest in the partnership which holds the assets (Y. Ne'eman 'Method of Calculation of Capital Gains in the Sale of the Interests of a Partner in a Partnership' [27], p. 195; A. Alter 'The Separate Legal personality of a Partnership of the Purposes of Tax Law in Israel' [28] 336; A. Raphael and D. Ephrati, Income Tax Laws, Volume 2 [25] 299). Others are of the view that for purposes of the tax laws, the partnership assets are viewed as belonging to the partners, in accordance with their share in the

partnership, and therefore when a partner sells his share in a partnership he is selling a proportional share in each of the assets which belong to the partnership (see: Y. M. Edri and Y. Eden 'On the Problem of the Excess Tax Liability, Statutory Veil and the Taxation of a Partnership, a Cooperative Agricultural Association, a House-Corporation, and a Family Corporation in the Income Tax Ordinance' [29] at p. 320).

6. I will preface and state that my view is that as to the sale of the share of a partner in a partnership, our legal system adopts the aggregate theory which views this as the sale of the share of the partner in each and every asset of the partnership assets. This is how the case law has seen it, this is the practice and it is not appropriate to change this approach by way of case law. Below, I will clarify my rationales for this stance. The following will be the order of things: first, I will present the normative background relating to partnership taxation; later, I will survey the legal situation in the matter we are dealing with in various legal systems in which there exists a normative background similar to ours; and finally, I will detail my rationales which are at the foundation of the conclusion I have reached.

Normative background

The Income Tax Ordinance is lacking comprehensive and coherent regulation as to the overall topic of partnership taxation, and the specific matter before us in particular. The provision in the Ordinance which deals with partnership taxation is the provision of section 63. Section 63(a) which is important for our matter, prescribes as follows:

> '63(a) Where it has been proven to the satisfaction of the Income Tax Assessor that two or more people are engaged together in a certain business or certain occupation
>
> > (1) The share each partner is entitled to in the tax year from the partnership incomes – and it will be determined in accordance with the provisions of this Ordinance – will be viewed as the income of that partner, and it shall be included in the report of his income which he must submit according to the provision of this Ordinance.
> >
> > (2) The chief partner, meaning that partner from among the partners who are residents of Israel whose name appears first in the agreement as to the partnership – and if this head of partners is not active then the head of partners who is active – will prepare and submit according to the demand of the Income Tax Assessor, a report of the partnership income for each year, as it is determined in accordance with the provisions of this Ordinance, and will specify in it the names and addresses of the other partners in the firm and the share that each partner is entitled to in the income of that year; if none of the partners is a resident of Israel, one with power of attorney, an agent, a manager, or a broker of the firm who resides

in Israel will prepare and submit the report.'

From this section it arises, that on the topic of the income tax liability for partnership incomes, the Ordinance relates to a partnership as a collection of individuals and not as an independent unit separate from the partners who make it up. The section expresses, therefore, the view of the aggregate theory. Indeed section 63(a)(2) directs that the head of the partners will submit a report of the partners incomes, however, the report of the partnership incomes is not submitted for the purpose of taxing this income to the partnership but for the purpose of distributing it among the partners and for the purpose of taxation of each partner for his share in this income.

It is to be emphasized, that the provision of section 63 is an important provision in all that relates to the tax laws which apply to a partnership and to partners, being the provision which relates to one of the topics of importance in tax laws, which is the provision as to the tax liability. It deals, like the question in the dispute in the appeal before us, with the question which relates to the tax liability in its broader sense. And here, the provision of the section views the partnership, in terms of the tax laws, as a collection of individuals and not as a separate legal body.

8. By the nature of things, given that section 63 is the only provision which deals with partnership taxation, it stands at the center of the discussion in matters which arise in the areas of partnership taxation. Courts have turned to the construction of section 63 in a long line of decisions which dealt with specific matters in this area. The case law which dealt with section 63 of the Ordinance has gone clearly in the direction of disregarding the independent existence of the partnership for tax purposes. Justice Witkon expressed this approach in the following manner:

> 'Indeed, it is true, our legislator granted the partnership a legal personality, but be the significance and purposes of this legal personality what they may be, one cannot disregard the basic provision in the Partnership Ordinance (section 2) which defines the term 'partnership'. Partnership, according to this definition is the relationship that exists between persons dealing in a joint business for the purpose of making a profit. Learn from this that the partners are those dealing with the business and they are making the profits. . . in this vein section 52 of the Income Tax Ordinance also places the tax liability on the partners themselves for the share of each of them in the partnership income, and we find that determining this income is none other than a mechanistic phase in order to reach the partner's income from the partnership. . . we cannot therefore learn by analogy from the law of the corporation to the law of the partnership, as the appellant has done (CA 82/60 *Poychtunger v. Income Tax Assessor, Tel-Aviv* [8] at 1368)'.

President Shamgar explained this when noting:

> 'According to the rules that were delineated, be the status of the partnership according to the general law what they may be, section 63 of the Ordinance is to be seen as a specific provision for income tax purposes, according to which the partnership is not a taxpayer and does not bear independent liability in income tax:. . .That is to say, one is not to speak of the partnership incomes as a separate concept from the incomes of the partners. The tax liability is imposed directly on the partners for the share of each one of them in the partnership incomes. In this sense, 'one is not to distinguish, therefore, between the dealings of a person on an individual basis and their dealings (in the same business) as a partner. . .' (CA 20/63 at p. 1968)' (CA 536/88 *Etz Levod v. Income Tax Assessor for Large Plants* [7]).

This approach was expressed consistently in the case law. Thus, for example in CA 477/71 *Shtetner v. Income Tax Assessor, Haifa* [11] Justice Witkon discussed the question of permitting deduction of life insurance expense that the partnership paid to insure the lives of the partners. In order to answer the question, Justice Witkon examined whether this expense was an expense in generating the income of the partner and not the income of the partnership. This, since the taxable income is the income of the partner and not the income of the partnership. He established as to this matter that:

> 'An expense that is prohibited to the partner cannot be permitted for the partnership. It is found that in the end the two are not to be separated.' (**Ibid**, [11] at p. 516).

In CA 425/79 *Angel Ltd. v. Income Tax Assessor, Income Tax, Jerusalem* [10], a partnership was established between the appellant corporation which was an industrial corporation as per its definition in the Law for Encouragement of Industry (Taxes) 5729-1969 – and another person. The Income Tax Assessor sought to deny the appellant the tax benefits which are granted by said law to an 'industrial corporation' based on the claim, that the partnership is a separate legal personality, and it produces said incomes and not the 'industrial corporation'. The court dismissed this claim. The Court determined that:

> 'The partnership incomes are the direct incomes of the partners. From here that the partners incomes are to be seen as stemming directly from their first source, without the separate legal personality of the partnership partitioning between this source and the entitled partner.' (**Ibid**, at p. 835. See also: CA 231/58 *Income Tax Assessor, Rehovot v. Amos Bohanik*, [12]; CA 20/63 *Ben-Zvi v. Income Tax Assessor, Bet-Hadar, Tel-Aviv-Yaffo 1* [9]).

9. To summarize this point, in all that relates to the construction of section 63 of the Ordinance, the case law has consistently adopted the aggregate theory. It viewed the partnership as a collection of individuals who together manage a joint business. This does not contain a direct answer to the matter we are dealing with, however, it does contain an

indication as to the manner in which the tax legislator views the status of the partnership for tax purposes.

Transfer of a the share of the partner in the partnership – comparative law

Perusal of comparative law provides a window through which it is possible to understand the various arrangements followed in this matter in other legal systems with a normative background similar to ours, and enable us to learn from their experience. The similar side to the legal systems which we will present later is that, similar to the law applicable in Israel, income tax is imposed on the partners according to the share of each one of them in the partnership assets.

In comparative law there is no uniformity in relating to the taxation of the transfer of a share in a partnership. In the United States, prior to legislation of Chapter K of the Internal Revenue Code (hereinafter: 'IRC') the U.S. Appeals Court ruled in a long line of decisions, that the sale of a share of a partner in a partnership will be taxed with capital gains tax for the sale of the overall interest in the partnership. (See: *C.I.R v. Shapiro* [15]; *C.I.R : v. Smith* [22]; *Long v. C.I.R.* [23]; *Thornly v. C.I.R.* [17]; *United States v. Shapiro* [16]; but compare *Helvering v. Smith* [24]; *Williams v. McGowan* [20]). This legal rule created a loophole which was taken advantage of by taxpayers in order to tax earned income with capital gains tax. The American legislator later anchored the legal rule according to which the sale of an interest in a partnership is the sale of an overall interest in the partnership in section 741 of IRC 1954. However alongside this section, section 751 was legislated whose purpose is to close up the loophole which enabled evasion of taxation of earned income. (See: B. Bittker, Federal Taxation of Income, Estates and Gifts (Volume 3) [36] 82-7; Mertens, the Law of Federal Income Taxation (Volume 9) [37] 460-525). Section 751 establishes as follows:

> '(a) The amount of any property, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to-
>
> (1) Unrealized receivables of the partners, or
>
> (2) Inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset'.

This exception taxes the current assets that come within it with regular tax and not capital gains tax. From here that the American method indeed represents the entity theory approach in the matter we are dealing with, however, it is a very tempered version.

As for the American law it is also worth noting that the American Law Institute (ALI), supports, in its position paper from 1984, changing the law. The view was expressed in the position paper that policy considerations do not support the present rule which taxes the transfer of an interest in a partnership with capital gains tax. Among the rationales for changing the law, the position paper explains the complexity of the

present system and the difficulty of actually implementing it.

In Canadian law as well it was determined that the sale of the interest of a partner in a partnership will be taxed with capital gains tax for the overall interest in the partnership. (See: R. Beam & S. Laiken, Introduction to Federal Income Taxation in Canada [38]; Canadian Master Tax Guide [39]; J. Weinstein, 'Sale of a Partnership Business', 1996 Corporate Management Tax Conference (1996)). As we will detail below, both the American Legislation and the Canadian Legislation deal with the sale of the interest of a partner in a partnership, including adjustment provisions whose purpose is to adjust laws of capital gains taxation to an 'interest in partnership' asset.

11. As opposed to the law applied in the United States and Canada, in England it was determined, in a guideline of the tax authorities (from January 17, 1975) that the sale of the interest of a partner in a partnership is viewed as the sale of each and every asset of the partnership assets. The text of the guideline is as follows.

> '1. Nature of the asset liable to tax [TCGA 1992 s 59] treats any partnership dealings in chargeable assets for capital gains tax purposes as dealings by the individual partners rather than by the firm as such. Each partner has therefore to be regarded as owing a fractional share of each of the partnership assets and not for this purpose an interest in the partnership.
>
> ....
>
> 2. Disposals of assets by a partnership.
>
> Where an asset is disposed of by a partnership to an outside party each of the partners will be treated as disposing of his fractional share of the asset. Similarly if a partnership makes a part disposal of an asset each partner will be treated as making a part disposal of his fractional share...' (See: Simons Direct Tax Services, p. 1860).'

Similar to the situation in England, it was determined by the tax authorities in Australia, in Guideline IT 2540 (from June 22, 1989) that the sale will be viewed as the sale of each and every asset of the partnership assets. This guideline was anchored in the law in Taxation Laws Amendment Act which added sections 160A-160C to the Income Tax Assessment Act 1936 (see J. Waincymer, Australian Income Tax: Principles and Policy [41] 306-317; Australian Tax Handbook [42] 822-844). In South African law as well such an event is taxed as though each and every asset of the partnership assets is sold (see: Silke on South African Income Tax : ((Volume 2) [43] p. 11.1-11.25).

12. We can see, that in countries with a similar legislative history to ours, various approaches were adopted as to the manner of taxation of the transfer of a share of the partner in a partnership. They have an echo both of the aggregate theory and the entity theory. However, at least in all that relates to American law, in which the transfer of the interest of a partner in a partnership is taxed with capital gains tax, it is a matter of a very weak version of the entity theory, as from the rule of transfer of an

interest in partnership as a capital asset, many assets with an earned character are excepted. So too, in legal systems that adopted the entity theory in the area, specific adjustment provisions are included in the relevant legislation whose purpose is to adjust the capital taxation to the special asset of an 'interest in a partnership'.

The considerations for adoption of the aggregate approach as to the sale of the share of a partner in a partnership

13. As said, my opinion is that in the matter we are dealing with the aggregate theory, which taxes a partner in accordance with his relative share in each of the partnership assets, is to be adopted. The central rationale which supports the conclusion I reached, is the rationale which is at the basis of section 63 of the Ordinance. From this section it can be learned that the Israeli legislator is of the opinion that the partnership resembles more closely a business run by a private individual than a business run by an association such as a corporation. In my view this rationale must guide us even in determining the question which is at the center of our matter. In addition to what has been said, there are two additional rationales which strengthen my said conclusion. The one, a determination according to which it is a matter of the sale of an interest in an asset, will lead to a blurring between capital assets and earned assets, and will lead to distortions and unwanted results. The second, the Ordinance, in its present formula, is not set up to absorb such a determination. Its absorption may lead in its wake to severe implementation problems due to the lack of adjustment provisions in the Ordinance for capital gains taxation of the special asset of 'an interest in partnership'.

A. The rationale at the basis of section 63

14. I join the position of my colleague Justice Englard that in our matter there is no relevance to the question whether the partnership is a legal personality or not (and this in contrast with the view of Y. Ne'eman in said article, which bases the substance of the problem on the existence of the separate legal personality of the partnership). The question is as my colleague defined it, how do the tax laws view the business of a partnership. If we want to simplify it, the question which must be determined is, whether in terms of the tax laws, a partnership more closely resembles a limited liability corporation or a private business.

Section 63 points clearly to the fact that at least, from the perspective of the 'incomes' of the partnership, the tax legislator views the partnership as a private business in the hands of several individuals and not as a separate entity such as a limited liability corporation. Indeed, this section, on its own, is not sufficient to provide a clear and final answer to the question before us. However, as mentioned above, section 63 can also serve as a guide for the direction of the tax legislator on the topic of taxation of transfer of the share of a partner in a partnership. In taxation of a partnership, the taxable income is of each of the partners who owes taxes for his profits in the partnership and not of the partnership. The emphasis is on the partner as an individual. In this vein it can also be said that as to the matter of determining the capital gains

which apply to each partner, he is to be regarded as any other individual and the capital gains tax which apply to him are to be calculated, under the assumption that he is an individual with interests in each of the assets of the partnership, which he transferred to the purchaser of the interests. My view is, that as to the sale of the share of the partner in the partnership, there is no good reason to deviate from said direction of the legislator as it is reflected by section 63.

15. My colleague, Justice Englard, is of the view that in our matter we are to adopt the entity theory and accordingly to tax the interest of a partner in a partnership that is transferred to another with capital gains tax. In this context he mentions that section 63 does not directly address the question that arises in this case. In addition he notes that there are a line of provisions in the Ordinance which conceive of the partnership, explicitly or implicitly, as a separate business unit. So too, my friend explains that there is case law which determines that the law of the partnership is as the law of a separate business.

As said, I agree with the view of Justice Englard according to which section 63 itself does not provide a direct answer to the case we are dealing with. However, it is to be reiterated that section 63 is the only section in the Ordinance which deals with partnership taxation and it can point in the direction of the aggregate theory.

As for the other sections which point, according to the view of my colleague, to a different approach, my view is that they cannot serve as a reference for such an approach. The provision of section 63(a)(2) to which my colleague refers, is merely a technical provision. My colleague wishes to conclude, from the provisions of sections 63(b), 131(a)(5) combined with 131(c) and (d) and 224(a) of the Ordinance, which in part exclude the partnership from their application, that from this it can be inferred, ostensibly, that the rest of the provisions which apply to an association of persons also apply to a partnership. In my opinion, we cannot learn from these provisions to our matter. The provisions, primarily deal with technical matters and not the question of tax liability. And even if it can be concluded from them that the partnership is an association of persons, the significance of this is not that it is a matter of an association of persons of a corporation type to which the laws which apply to a corporation apply.

As for the case law which Justice Englard brings in support of his position, it is to be emphasized that this case law amounts to a single judgment (ITA 118/90 *Lev Hagalil Partnership v. Income Tax Assessor, Tiberias* [14]) which is not from the study halls of this court. In this, I do not wish to express an opinion as to said judgment on its merits in itself, as it is not up for discussion before us. I will only clarify that that judgment focused on a specific determination and not a general one, according to which a partnership is an ‘association of persons’ as to section 181B of the Ordinance and therefore it was determined in it that that section applies to the partnership. This construction was done using careful language and with the awareness that this is not an easy determination and that it needs to be reconciled with the provisions of section 63 of the Ordinance. I would like to reiterate that the accepted

approach in Israeli case law as to taxation of partnership, an approach which has existed for some time, consistently and unequivocally follows the aggregate approach.

16. The direction of the legislator, as it is reflected in section 63 of the Ordinance, is also supported by the provisions of the general law, from which one can learn that one can find a broader common denominator between a partnership and the business of a private person than between a partnership and a corporation. A limited liability company is a very sophisticated legal personality. According to section 4 of the Corporations Law 5759-1999:

> 'A corporation is a legal personality with the capacity for any right, duty and operation which is consistent with its character and nature as an associated body.'

This section emphasizes that a corporation has the legal capacity which comes very close in degree to the legal capacity of a person made of flesh and blood. The independent entity of a limited liability corporation has powerful expression in that there is a clear-cut and impassable partition (apart from the exceptional cases of lifting of the veil) between its creditors and its shareholders. Moreover, even in the inner circle, between it and its shareholders, the latter do not owe the corporation anything apart from the capital they committed to invest in it (the principle of limitation of liability). The situation of partners in a partnership is different. According to section 20 of the Partnership Ordinance [New Version], 5735-1975 (hereinafter: 'the Partnership Ordinance') every partner is liable, jointly with the other partners and severally, for all the liabilities that the partnership is liable for. Indeed, according to section 20(b), an enforcement order will first be issued against the partnership and only in the situations listed in the section will be issued against a partner. However, the principle by which first one turns to the partnership and only later to the partners, does not dull the distinction between the status of partners and the status of shareholders in a company. In the inner circle, among the partners and the partnership, section 34(1) establishes that every partner is liable for covering the losses of the partnership at a rate proportional to the capital sum that he agreed to sign to. Here too, the distinction between a partnership and a corporation is clear. As said above, a shareholder in a limited liability corporation does not owe it anything beyond the capital that he committed to invest in it. On the other hand, the liability of the partner for the losses of the partnership is not static, but it stands in direct relation to the amount of the loss and to the proportion of his share in the partnership. In summary, even if we assume that some of the characteristics of the partnership grant it the status of an entity within the legal world, there is a great distance between this status and the status that is granted to a limited liability company.

17. On the other hand, the partnership is close in essence to a business run by an individual. The real distinction between it and a sole proprietorship is that the partnership is managed by several persons. Indeed, for considerations of efficiency the Partnership Ordinance grants the partnership certain capacities that are not granted to an individual

managing a business. While the sole proprietor does not have an entity separate from the individual himself, a registered partnership has the capacity to sue and be sued (section 66(a) of the Partnership Ordinance). So too, the partnership, as distinct from each of the partners separately, holds the partnership assets (section 31 of the Partnership Ordinance). These capacities enable efficient management of a business which is managed collectively by a number of owners. It is easy to understand the discomfort that would be caused, for example, if it was necessary to register the partnership assets in the names of the partners themselves. In such a case, whenever there would be a change in the composition of the partnership the immediate need would arise to change the registration of the ownership of assets which require registration. As said, these capacities were granted to the partnership so that the partnership business could be managed more efficiently. However, they do not create a substantive distinction between a private business and a partnership like the one that exists between a partnership and a limited liability corporation (for additional considerations see Y. M. Edri and Y. Eden in said article [29] p. 317).

18. My colleague, Justice Englard, presents a different position. In his view, an interest in an ‘active business’ of a partnership is similar, at its core, to the concept of a share in a business corporation, as in the two cases it is a matter of a unique economic entity that is separated from those holding it. In that, in his view, a partnership is distinguished from a business run by an individual, as to whom it is difficult to separate between his private assets and liabilities and those of his business. My colleague Justice Englard further adds that imposing a tax only on the tangible assets from the ‘active business’ of this entity, does not reconcile with the economic reality.

From an economic standpoint, there is great logic in the position of my colleague, according to which a one is to examine a business in an overall and coherent manner, as a ‘going concern’, and not to split it artificially to its various components. There is therefore much rationale behind the claim that in terms of the economic reality, there is a similarity between the taxation of the sale of the shares of a shareholder in a corporation and taxation of the sale of the share of a partner in a partnership. But similar economic logic applies as to a ‘going concern’ managed by an individual. Also as to the sale of a business of a private individual, as opposed to his other private assets, there is logic in determining the value of the sold interest in accordance with the value of the sold business as a whole business unit and not as a sale of each of the assets included in it separately. Indeed, a situation in which an individual sells his business, is very similar to a situation in which two partners sell their interests in the partnership business. For example, Reuven manages a photo developing business. Shimon and Levi also manage a similar photo developing business but they manage it as a partnership, Reuven, Shimon and Levi decide to retire and sell their business – Reuven sells his interests in his business while Shimon and Levi sell the interests in their joint business. Is there a real rationale for a distinction, in terms of the tax laws, between the manner of determining the liability in capital

gains tax between Reuven and Shimon and Levi? In the case of Reuven as the sole owner of the business, it is a matter of a live and active business which can be related to separately from its owners. The entire difference between a partnership and such a business is in the number of people managing it. Ostensibly, there is no real reason to claim that the fact that a number of people manage a business and not an individual constitutes an appropriate criteria which justifies a distinction in the manner of taxation between the two cases.

19. My colleague, Justice Englard seeks to distinguish between his approach as to transfer of an 'interest in a partnership' and adoption of the 'going concern' approach also as to a sole proprietorship. He suggests a distinction which focuses on the likelihood of blending of assets. According to his approach, it is difficult to distinguish for an individual between private assets and business assets. On the other hand, in a partnership, due to the conflict of interest between the partners, identification of the business assets is easier. This distinction between a partnership and the sole proprietorship, is difficult in my view. Blending of assets is a factual matter. In fact, it is possible that there is a business managed by an individual in which the distinction between the business and the other personal affairs and accounts of the business owner is meticulously maintained, and there may be a partnership where the line of separation between the partnership business and the private affairs of the partners is not maintained. In any event, in a corporation, blending of assets is a cause for retroactive 'lifting of the veil', to the extent that it is proven that such blending occurred. If we apply these grounds to our matter, with the necessary changes, as of course there is not any veil partitioning between a person and his business, then the situation of blending of assets justifies that the business of an individual not be considered a separate business unit for tax purposes, however, it does not justify a distinction, to begin with, between the manner of taxation of a partnership and the manner of taxation of a sole proprietorship.

20. To summarize what has been stated in paragraphs 14-19 above, it can be said that the approach of the legislator of the Ordinance, as reflected in its section 63, is to see the interests of the partner in the partnership as similar to the interests of a private individual in his business. As I have sought to show, indeed there are lines of similarity between the interest of an individual in his business and the interest of a partner in the business he shares with others, a similarity on which a similar treatment of the tax laws in the two cases is based. From hence the conclusion, that when a partner transfers his interests in a partnership, he is similar to an individual who transfers an interest in his business, and will be viewed as transferring his interest in each of the assets of the partnership business. The 'going concern' or 'active business' approach, which my colleague Justice Englard seeks to apply, as to transfer of interests in a partnership – without my expressing an opinion as to whether it constitutes the lex ferenda – if examined, ought to also be examined as to the transfer of the business of an individual who manages his business separately from his other private matters.

In any event, be the *lex ferenda* what it may, in its current version the

Income Tax Ordinance is not laid out for such a radical change without causing damage to the fundamental principles on which it is founded. It is proper, therefore, that the initiative for the revolution in tax laws which apply to a partnership and those who are partners in it, as my colleague suggests, and to the extent that it should be so, come from the legislator. It is to be presumed that in the event of such a change in the law, the legislator will ensure a comprehensive and coherent arrangement which will properly address all the consequences which stem from this. It is not proper that a change of such magnitude, will be the product of case law, as there is a real concern, as will still be clarified below, that it will leave in its wake more questions and queries than those it seeks to resolve.

B. Harm to the distinction between regular income and capital income

21. The Income Tax Ordinance, similar to additional legal systems, distinguishes between the taxation of regular income and the taxation of capital gains. Indeed, the general tendency existing in many countries as well as in Israel, is to bring together the two taxation regimes, and today the tax rates which apply to regular income and to capital gain are even identical. However, the tax regimes have not been completely united and the difference between taxation of capital gain and taxation of regular income still stands in several ways, some of which I will mention below. First, the international rules of taxation of regular income differ from the international rules of taxation of capital gain (see for example sections 2,5,89(b) of the Ordinance). While the application of the personal tie is very broad in the taxation of capital gains (sections 89(b)(1) of the Ordinance) it is very limited in the taxation of regular income. Second, while there is no arrangement which enables the spreading out of regular income, as the legislator was aware of the fact that the capital gain was accumulated over a number of years and not only at the date of implementation, and therefore established a spreading out arrangement in section 91(e) of the Ordinance, which enables spread of the capital gains up to a period no longer than four tax years or the period of ownership of the asset, whichever is shorter. Third, the laws for deduction of regular expenses are different from the laws of deduction of capital expenses. While regular expenses are deductible to the extent that they were expended in the generation of the income of the taxpayer (section 17 of the Ordinance) capital expenses are not deductible. Fourth, while it is not possible to deduct depreciation of earned income , it is possible to deduct depreciation of depreciable capital assets. Fifth, the laws of offset of regular losses are different from the laws of offset of capital losses (see: sections 28, 92 of the Ordinance).

22. Taxation of the sale of a share in a partnership as the sale of an overall interest in a partnership as an asset, ignores the character and classification of the assets in the partnership's ownership and taxes all these assets as though they were capital assets which influence the value of the overall interest being sold. As long as the distinction between taxation of regular income and taxation of a capital asset stands as is, it is not appropriate to blur the borders between the two types of incomes. Such blurring may incentivize evasion of tax, and lead to unreasonable

consequences.

My colleague Justice Englard, does not see any difficulty in this. In his view, just as a share, which aggregates within it capital and earned assets, is taxed as capital so too the interest in a partnership. According to his view the aggregate approach specifically may create difficulties, as it requires the application of different laws on different assets within the partnership.

According to my view, there is no doubt that blurring of the realms between earned and capital income which stems from applying capital taxation on the transfer of an interest in a partnership will drag unwanted consequences after it, among them consequence of tax evasion. To this the situation that existed in the United States following the approach of the case law there to tax the transfer of an interest in a partnership with capital taxation serves as a thousand witnesses. This is the place to emphasize that the tax reductions which are caused as a result of the blurring of the boundaries between earned and capital income constitute tax reductions which result from a judicial determination, namely from the determination (as in my colleague's version) according to which an overall interest in a share in the partnership is transferred. Therefore, it is ostensibly a matter of tax reductions which were done lawfully and which cannot be dealt with via anti-planning norms. The result is unsatisfactory in two senses. Not only is it a matter of a tax reduction that will hold from a legal standpoint, but it is a matter of a tax reduction that is the product of the Court's case law.

I also do not share my colleague's position, that the aggregate theory creates a difficulty in light of its distinction between capital and earned taxation. The aggregate theory, is a simple approach which is aligned with the existing solutions and existing laws and applies them as they are on the sale of assets in the process of sale of an interest in a partnership. There is no need, in its framework to invent new solutions and no difficulty arises in implementing solutions. All that is needed is to apply the regular law to each and every asset. Just as the law will apply to an individual business owner, so too it will apply to a partner in a partnership as to his share in the partnership assets. As to the 'difficulty' which my colleague Justice Englard mentions with the aggregate theory according to which it leads to application of the international taxation tie on only some of the assets and not on all the assets, there is no difficulty in this. It is natural that in the sale of assets of various types different laws apply. More than once it will occur that capital and earned assets are sold, and on each type different laws apply, including the laws of international taxation as to the taxation tie which justifies taxation.

23. My position that the approach of my colleague will lead to a blurring of boundaries between earned and capital incomes can be exemplified in the following way. Take a case where the taxable income of a partnership all of whose assets are current assets, was, during each of its three years of operation, negligible. In the fourth year the partnership earned a profit. At the end of the fourth year the partner, who has no additional income beyond the partnership, sells his share in it. According to the approach which sees in this sale the sale of an interest

in an asset, then the partner is entitled to demand the spread of the profit that he earned from the sale over a period which is not to exceed four years, and thereby significantly reduce the effective tax he bears, in light of the fact that he had no income in the past years. It is clear that the profit was not earned over the years, but it stemmed from the partnership business over the last year, which increased the value of his interest in the partnership. This unwanted consequence stems from the application of section 91(e) of the Ordinance which is suited to 'natural' capital assets for a sale that by its nature and character is not a capital sale. In earned assets the 'compression effect' that the spreading out arrangement comes to overcome does not exist (See D. Glicksberg 'Averaging Property Betterment and Spread of Capital Gains' [30] at 371).

My colleague Justice Englard takes issue with this example, saying that the reasons which justify the spread of the profit over four years with capital assets are also valid as to an interest in a partnership. So too, he comments that in many cases, the presumption at the foundation of the arrangement of spread of the profits, according to which there is an even yearly growth in the value of the capital asset in a manner that justifies attribution of equal parts to the tax years in the spread period, does not match the reality. My view is different. When it is a matter of natural capital assets, the match between the presumption at the foundation of the arrangement of spread of capital gain and reality is great and therefore, in this context, the presumption is reasonable. On the other hand, with an asset of a 'partnership interest' the degree of matching between this presumption and the reality is minimal and therefore is not reasonable. Moreover, and this is the main point, my colleague's approach grants the taxpayer the possibility of controlling the substance of the transferred (this in total contrast with the existing situation as to natural capital assets). If the taxpayer wishes, he will transfer his share in one unit as a 'partnership interest' including undistributed profits, and will be taxed on this in an overall manner as capital gain. In this last way, he has the choice to turn an earned asset into a capital asset. This choice, which may benefit the taxpayer, is of course not given to the taxpayer where it is a matter of natural capital assets. It turns out, therefore, that according to the approach of my colleague an unwanted opening was created for tax evasion.

It should be mentioned that the consideration of blurring of the boundaries between taxation of capital income and earned income, was one of the main considerations that drove the American legislator to establish section 751 (quoted above) in a law, alongside a provision which recognizes the sale of a share of a partner in a partnership as the sale of an interest in a partnership. Establishing a legal rule according to which the sale of a share in a partnership is the sale of an interest taxed as a capital gain, will lead to the problematic reality that existed in the United States prior to the statutory arrangement that came to address it.

24. It will be noted that the case that I mentioned above serves only as an example of the unwanted consequences as a result of the fact that due to the sale of a 'partnership interest' there has resulted a blurring in the distinction between capital income and regular income. There are

additional examples of this. Such blurring could lead to unwanted consequences in terms of tax laws, in light of the difference between the provisions in the Income Tax Ordinance as to taxation of regular income and the provisions as to the taxation of capital gain, some of which I discussed in paragraph 21 above.

C. Implementation problems

25. A 'partnership interest' is a special asset. This asset has characteristics that are not characteristics of 'natural' capital assets. The asset changes from time to time, in accordance with the change in the assets which make it up. Its value changes in accordance with these changes. Its value also changes in accordance with the economic results of the partnership business. Applying section E of the Ordinance, that deals with the taxation of capital gains which grow from the sale of a capital assets, on a 'partnership interest' raises significant difficulties. Section E is designated for dealing with 'natural' capital assets. Its provisions are adjusted to such assets. It is not built for dealing with capital assets of the 'partnership interest' type. Applying its provision on a 'partnership interest' will encounter substantial difficulties.

26. In order to understand these difficulties, it is appropriate to explain the way in which the Ordinance taxes capital gains. Section 91 imposes a capital gains tax on the actual capital gains that the taxpayer gained, at the same rates as his regular income, when the capital gains is regarded as income at the highest level in the ladder of his existing income. The Ordinance establishes a number of definitions and formulas for calculating the actual capital. Put simply, the actual capital gain is the actual rise (after neutralizing the effects of inflation) in the value of the capital asset from the date of its purchase until the date of its sale. In the terminology and technical definitions of the Ordinance 'actual capital gain' is defined in section 88 as the 'amount by which the consideration is greater than the balance of the original price'. The 'inflationary amount' is defined as '(1) the part of the capital gain which is equal to the amount by which the balance of the adjusted original price is greater than the balance of the original price. . .' From hence, that in order to calculate the actual capital gain, we need the definitions of 'the balance of the original price' and 'the balance of the adjusted original price' and of 'the consideration'. These terms are defined in section 88 of the Ordinance as follows:

> The balance of the original price' – the original price of the asset after the deduction of depreciation amounts;
>
> 'The balance of the adjusted original price'– the balance of the original price . . . multiplied by the index on the day of the sale divided by the index on the day of the purchase . . .;
>
> 'consideration' – the price that is to be anticipated from the sale of the asset by a willing seller to a willing buyer when the asset is free of any encumbrance which comes to guarantee a debt, a mortgage or other right which is intended to guarantee payment;. . .'
>
> 'The original price' is defined in section 88 as follows:

> ''Original price' –
>
> (1) For an asset that is bought – the amount the that taxpayer spent for the purchase of that asset; (2) For an asset received in a barter – the consideration at the time of the barter;
>
> . . .
>
> (5) For an asset that the taxpayer created – the amount that the taxpayer spent for creating the asset.
>
> (6) For an asset that reached the taxpayer in any other way – the amount that the taxpayer spent for the purchase of that asset;
>
> And all with the addition of expenses spent by the taxpayer for improving the asset or holding it from the day of purchase until its sale, as long as they were not deducted in the past in calculating the taxable income of the taxpayer.

It is found, that in order to calculate the capital gains tax liability, the 'balance of the original price' is to be calculated and subtracted from the 'consideration' and thereby the 'capital gain' is reached. The 'balance of the original price' is to be subtracted from the 'balance of the adjusted original price' and thereby the 'inflation amount' is reached. The tax will be imposed on the 'actual capital gain', meaning, the difference between the capital gain and the 'inflation amount'. At the center of the calculations, is the value of the 'original price' when, as said, it not possible to calculate the capital gains tax liability without first calculating the 'original price' of the asset being sold.

27. Applying said provisions to the sale of a 'partnership interest' entails many difficulties. What, for example, is the 'original price' of the 'partnership interest'? Is it the amount that a partner invested when he joined the partnership or perhaps it is the accumulation of the 'original prices' of all the partnership assets? What is the 'balance of the original price' of the 'partnership interest'? Can we say that it is the 'original price' of the interest deducting the depreciation on the interest, when it is difficult to view the 'partnership interest' as a depreciable asset? Does it stem from this that depreciation and 'balance of the original price' of the partnership interest is identical to the 'original price'? Or perhaps we would say that 'balance of the original price' is the 'balance of the original price' for each and every partnership asset? How will the adjustment for inflation be made and the balance of the adjusted original price be calculated? These questions clarify the difficulty in applying Chapter E of the Ordinance on the 'partnership interest'. Such an application in fact is not possible without statutory intervention which will establish adjustment provisions which will enable application of Chapter E of the Ordinance on a partnership interest.

My colleague, Justice Englard, does not relate to all these questions, whose resolution is necessary in order to implement the provisions of Chapter E of the Ordinance on the transfer of a 'partnership interest'. However, he comments that calculation of the 'original price' of the partnership interest does not raise a special problem. According to him, this is to be calculated similarly to the manner of calculation of the

'original price' of a share in a corporation. I do not share the approach that this is necessarily the only or appropriate solution. Usually, the original price of a share is the sum that was paid for its purchase or the market value of the share at the date of its purchase and changes that occurred in the corporation's assets between the date of purchase and the date of sale do not influence the original price. On the other hand, it is not at all clear that assets that a partner brought into a partnership during its lifetime do not influence the 'original price' of the partnership interest. The opposite, it is very possible that it is appropriate that additional investments and assets that the partner invested in a partnership will influence the original price of the partnership interest. Therefore, the determination is necessary as to the degree of effect of these additional investments by the partner and a determination as to the manner of its calculation. The Income Tax Ordinance does not provide a clear cut answer to this.

28. Generally, my colleague is of the view that the absence of adjustment provisions is not a determinative factor when a question of a fundamental character is in the mortar. In his view 'Were that special problems will arise with the acceptance of the proposed approach, then the hand of the legislator is poised to complete that which requires completion.' (paragraph 41 of his judgment). As said above, my view is, that the approach of my colleague will lead to a revolution in the area of tax law of partnerships, a revolution which the Income Tax Ordinance is not set up to deal with. It will be emphasized, it is not a matter of a regular question of construction which the judge dealing with is meant to decide according to the various construction options open before it. In its present formula, the Income Tax Ordinance lacks any provisions which enable applying capital taxation on the transfer of a 'partnership interest'. In order for the matter to be possible, 'creative case law' of the Court is needed, ab nihilo. On the other hand, the aggregate approach which is reflected in section 63 of the Ordinance and the application of this approach does not raise, as previously mentioned, any vagueness. I prefer the approach, according to which one must operate within the law which supplies satisfactory answers for its implementation, rather than the approach according to which the court will determine the general policy, the principle, in the topic of partnership taxation and thereby force the legislator to be dragged after it and complete what needs completion and repair that which needs repair. As I clarified above, my view is that even if it is proper to change the existing situation relative to the taxation of a partnership – without establishing this – it is appropriate to leave to the legislator the task of shaping general policy as to taxation of a partnership in general and taxation of the transfer of the partnership interest in particular and to develop this policy in a detailed and comprehensive arrangement which will enable its implementation. It is not appropriate in my view, that this court place a preference on one of the two paths in the matter of partnership taxation, with the knowledge that the legislator must come on its heels and disassemble the mines that it leaves in its wake.

29. The difficulties in applying Chapter E on the 'partnership

interest' in the present statutory situation, in which the adjustment provisions do not exist, can be exemplified with three examples. The one, two partners who set up a partnership and each invest 100,000 NIS in it. The partnership purchases a truck in the amount of 200,000 NIS. During the course of the year the partnership accumulated an income of 100,000 NIS which was not distributed. According to what was said in section 63 of the Ordinance, each partner will pay tax according to his share in the income (under the assumption that the average tax rate which applies to the taxpayer is 50%, his share in the income is 50,000 NIS). If he sells his share in the partnership for the sum of 150,000 NIS, he will have a capital gain of 50,000 NIS (150,000-100,000). The outcome is that he pays a double tax. In light of what is said, the need is created for a provision which will adjust the 'original price' to the fact that the partnership incomes were not distributed and therefore the 'original price' is to be increased by the undistributed profit or the consideration is to be reduced at the same rate. (See Y. M. Edri and Y. Eden, **Ibid**, [29] at p. 322). Such an adjustment provision, was established by the Israeli legislator in section 64a(a)(7) in regards to a 'family corporation'. Similar to a partnership in the taxation of a 'family corporation' as well there is an arrangement of lifting of the veil. In order to avoid double taxation of the members of the corporation, upon the sale of their shares in the corporation section 64a(a)(7) establishes that:

> 'In the sale of a share of a family corporation an amount equal to the part of the sum of the profits that accumulated in the corporation during the period of the benefit and it did not distribute, as per the part of the share in the rights to corporations profits, will be subtracted from the consideration, in the matter of section 88 both as to the seller and as to the buyer.'

Such adjustment as said is also established in American law, which as said, taxes the sale of a share in a partnership as the capital sale of the interest in the partnership. Section 1001, which is found in Chapter O of the IRC, which deals with calculation of the profit for the sale of the capital assets, establishes that the profit or loss is the amount realized over the adjusted basis. The chapter contains provisions for calculation of the adjusted basis, in addition to provisions which impact its calculation, which are spread in the various chapters including chapter K. Section 705, which is found in Chapter K, deals with calculation of the adjusted basis of the interest of the partner in the partnership. The section adds to the adjusted basis the share of the partner in the partnership incomes, in order to avoid the double taxation which we pointed out above. A similar adjustment provision is absent from the Ordinance as to the taxation of the transfer of the share of a partner in a partnership. In its absence, the taxation of a share in a partnership as an interest in a partnership will lead to an unwanted consequence of double taxation.

As to said example, my colleague Justice Englard responds that it would be possible to solve the problem that arises in light of the lack of an adjusting provision in our matter by way of the purposive

interpretation of the law which will avoid double taxation. It is appropriate to emphasize in relation to this, first that we are not dealing with the interpretation of an existing statutory provision but in creating an arrangement ex nihilo by this court. Second, preventing the double taxation can be done under the circumstances in one of two ways – the one by increasing the 'original price' by undistributed profits; and the second, by reducing the consideration by the same rate. Each of these ways may have a different impact on taxation in the future. Which of the two ways should the Court undertake? Is it not a matter for the legislator to regulate?

30. A **second** example, exemplifying the implementation problems that will be created as a result of the determination that in transferring a share in a partnership an interest in a partnership is sold, is as follows. The partnership spends 100,000 NIS that is not deductible. The next day one of the partners sells his share in the partnership for 50,000 NIS. Should we say that he had a capital loss of 50,000 NIS (150,000-100,000)? It is clear that the answer to this is in the negative, as otherwise the selling partner will be able to deduct a non-deductible expense. In actuality, this partner has not experienced a capital loss or a capital gain – he received his investment back at the same value. In order to avoid the indirect deduction of the non-deductible expense, an adjusting provision is needed which will reduce from the 'original price' the expenses expended by the partnership and which are not deductible. The adjusting provision which resolves this anomaly is found in section 705 of the IRC The section reduces from the adjusted basis the partner's share in the partnership's non-deductible expenses in order to prevent this indirect deduction. Such a provision is necessary to the extent that the rule is adopted that the sale of an interest of a partner in a partnership is taxable with capital gains tax for the sale of the interest in the partnership. But an adjusting provision of this type is absent from the Ordinance. In its absence, the rule according to which the sale of a share in a partnership is like the sale of an interest in a partnership will lead to an unwanted result of indirect deduction of a non-deductible expense.

31. A **third** example, three partners set up a partnership with an investment of 100,000 NIS each. During the course of the tax year, the partnership received one intake in the amount of 90,000 NIS, which is not taxable, a gift or other intake which is tax exempt. To the extent that later, the partner sells his interest in the partnership in the amount of 130,000 NIS, he will be taxed for the capital gain of 30,000 NIS. We find that the partner was taxed for an intake that is not taxable. In order to avoid this result, an adjusting provision is necessary which will increase the original price by the sum of the intakes which are taxable or are tax exempt, or which will reduce the consideration by the same rate. Such a provision is found in section 705(a)(1)(b) of the American IRC. The section increased the adjusted basis of the partner at the proportion of his share in the non taxable incomes of the partnership. Such a provision does not exist in the Ordinance. In its absence adoption of the rule, according to which the sale of the interest of the partner in the partnership is the sale of a capital gain of an interest in a partnership, will

lead to the unwanted result of the taxation of a partner for non-taxable income.

My colleague Justice Englard is of the view that a tax exempt intake will not be taxed by force of the core principle which prohibits collection of a double tax. In this subject, first, it is not necessary, as a one and only solution, that a tax exempt intake, which turns to a partnership asset and is included in its assets, will not be taken into account in determining a capital gain with the sale of an interest in a partnership. Second, even if it is a matter of a double tax, I will turn to what is said in the latter part of paragraph 29 which is appropriate, with the necessary changes, in our matter as well.

32. These examples, of course do not exhaust the spectrum of unwanted results which may result from adoption of said rule lacking suitable adjustment provisions. They exemplify, that in its present state, Chapter E of the Ordinance is not adapted to the taxation of the special asset of a 'partnership interest'. Indeed I clarified above that in those legal systems which chose to adopt a rule according to which the sale of a share in a partnership is to be taxed as the sale of an interest in a partnership, such as the American and Canadian legal systems, the relevant tax law includes clear provisions which adjust the taxation arrangement which applies with taxation of capital gains to the special asset of an interest in a partnership.

My colleague, Justice Englard notes that in particular the American experience is counter evidence to the claim that imposing liability on the transfer of a share in a partnership as an interest in a partnership is not implementable absent specific adjusting provisions. He reminds in this context, that the case law took this step, without waiting for a detailed statutory arrangement. As I noted above, comparative law enables us to learn from the experience of others and to avoid problematic situations they got into. Indeed, in the United States the case law preceded the statutory arrangement. However, as I detailed above, this fact created difficulties which required statutory intervention. From this experience one can learn that even if according to one view or another the lex ferenda is to tax transfer of a share in a partnership as the transfer of an interest in a partnership – without expressing an opinion that it is so – the right way is to direct a recommendation to the legislator to anchor a full and coherent statutory arrangement in this vein. This is not to be done by way of case law which does not suit the practiced legal provisions.

Conclusion

33. The dispute as to the appropriate way to tax the transfer of the share of a partner in a partnership is legitimate. In this complex matter there are views in one direction and another. Different legal systems take different approaches. As I sought to show, Israeli law chose to impose a tax in such a case for the transfer of a share of the partner in each of the partnership assets and not for the transfer of a 'partnership interest'. The principle which arises from section 63 of the Ordinance, the provisions as to the distinction between a regular income and a capital income, and the statutory provisions which establish the way to taxation of capital gains – all these point clearly in this direction. This was also the practice

until now. In my view, this situation is not to be changed other than by the explicit word of the legislator.

34. If my view were to be heard, the appeal would be granted, the judgment of the District Court would be overturned, and the decision of the appellant the subject of the appeal to the District Court would be upheld. So too, I would impose on the respondents the appellant's costs in both courts, in the amount of 25,000 NIS.

President A. Barak

I join the opinion of my colleague Justice Or. I accept his rationales. I seek to draw the attention of the legislator to the matter before us. It is appropriate for it to be regulated – whether by adoption of my colleague Justice Englard's model, or by adoption of my colleague Justice Or's model or by the adoption of a third model – by a comprehensive and thorough act of legislation.

It was decided by a majority of opinions as per the opinion of Justice Englard.

27 Iyar 5761
20 May 2001