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Global Tax Alert

Israeli Tax Authority releases draft circular for comments on payments to a parent company under recharge agreements for grant of stock-based compensation

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Executive summary

The Israeli Tax Authority (ITA) recently released for consultation[1] a draft circular on payments to a parent company under recharge agreements for the grant of stock-based compensation (SBC) to the employees of its subsidiary (the Draft Circular).

The purpose of this Draft Circular is to outline the ITA's position as to the intercompany charge payments between the Israeli company that employs the relevant employee to which the SBC is being granted and the parent company that issues the relevant capital instruments, and its classification as debt repayment versus dividend distribution.

For this analysis, the considerations set forth by the ITA are whether the payment is conditioned by the vesting of the instrument, the fair market value (FMV) of the instrument at the time of grant, the date on which the recharge agreement was signed (compared to the issuance date of the capital instruments), and whether the SBC costs were included in the cost base in accordance with the *Kontera Case* ruling.

This circular also aims to clear Reportable Position no. 70-2019 that was published last year which created uncertainty with respect to such intercompany charges. This Draft Circular corrects this Reportable Position.

Due to the significant impact of the *Kontera Case*, multinationals with operations in Israel should closely review this Draft Circular and examine its potential impact on their recharge payments and overall SBC costs. Those with recharge payments and agreements not in accordance with the conditions of this Draft Circular, as well as those not in compliance with the *Kontera Case*, should consider either aligning themselves with the ITA position or managing the risks involved, including the impact on the tax provision.

Detailed discussion

The background of the Draft Circular addresses to the cases in which SBC is issued to an employee of an Israeli company (the Employing Company) for capital instruments of the (direct or indirect) parent company (the Granting Company), and the Granting Company charges the Employing Company for the payment of such capital instruments that were issued (the Intercompany Charge). A reference is also made to the *2018 Supreme Court Kontera Case*,[2] where it was ruled that expenses incurred by an Israeli Research and Development (R&D) subsidiary of a United States (US) parent relating to employee stock option plans should be included in the cost base for calculating the cost plus remuneration, and where there was no reference to the treatment of the Intercompany Charge, if and as exists between the Granting Company and the Employing Company.

The Draft Circular then determines under which circumstances the payment by the Employing Company to the Granting Company for the participation in the payroll expenses will be classified as a debt repayment, and in which cases it will be considered a dividend distribution and therefore may trigger withholding tax accordingly. It is clarified that the mere recharge payment should not be viewed as a deductible expense by the Employing Company, and such expense shall be recorded in accordance with the relevant GAAP, regardless whether an Intercompany Charge exists, and will (or will not) be tax deductible in accordance with the Israeli Tax Ordinance (ITO).

In order for a payment to the Granting Company to be considered as a participation in payroll expenses (rather than a dividend), it has to be not higher than the amount of expenses recorded in the Employing Company's financial statements at the time of grant, and it has to meet the following conditions:

1. The payment to the Granting Company is conditioned by the vesting of the capital instruments. In other words, the charge will be recorded and recognized only once the capital instrument is vested.
2. The payment to the Granting Company for any vested capital instrument is based on its FMV at the time of grant, according to the accounting records of the expense.
3. The payment to the Granting Company is according to a recharge agreement between the companies that was signed prior to the grant of capital instruments.
4. The entire SBC expense was included in the cost base for purpose of Section 85A of the ITO (*Transfer Pricing in International Transactions*), according to the *Kontera Case*.

It is clarified that the abovementioned conditions will be analyzed per capital instrument and per employee, rather than as a whole.

The Draft Circular then stipulates that any payment that does not meet these conditions will be classified as a dividend, even if it was paid to a group company that is not the direct or indirect parent of the Employing Company.

When all those conditions are met, but the recharge agreement provides that the payment to the Granting Company will be the intrinsic value at the realization date of the capital instrument, the payment to the Granting Company at the realization date up to the FMV as it was at the grant date according to which the accounting expense was recorded (or had to be recorded) will be considered as participation in payroll costs, and any additional amount will be considered as a dividend.

A company that has a recharge agreement with the Granting Company and the payments thereunder meet all relevant conditions under this Draft Circular, which are therefore classified as debt repayment for the participation in payroll expenses, is exempt from reporting reportable position no. 70-2019, which generally classifies such participation as a capital investment, and any following payment as a dividend (or capital reduction, as the case may be).

The Draft Circular also provides several examples to demonstrate the application of its provisions.

Impact

This Draft Circular, together with the *Kontera Case*, should serve as an indication of the high scrutiny by the ITA of multinationals operating in Israel and specifically those with R&D centers in Israel.

Those multinationals should closely review this Draft Circular and consider its potential impact on their recharge payments and overall SBC costs, and monitor upcoming developments and publications on this matter. Those with recharge payments and agreements not aligned with the conditions of this Draft Circular, as well as those incompliant with the *Kontera Case*, that may face reclassifications of recharge payments into a dividend, should consider either aligning themselves with the ITA position or managing the risks involved, including the impact on the tax provision.

It is important to emphasize that this is still draft for discussion and there is no certainty when and if this circular will become final. Nevertheless, it is expected that field assessing officers will use this Draft Circular to present this position in tax audits.

Endnotes

1. Comments are due by 17 May 2020.
2. See EY Global Tax Alert, *Israeli Supreme Court rules stock based compensation to be included in cost base for transfer pricing*, dated 2 May 2018 (the *Kontera Case*).

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