

*Israel***Options Not Deductible for ‘Cost Plus’ Method: Israel High Court**

Multinationals with Israeli subsidiaries face a sharp increase in tax liabilities after a court ruled that equity compensation schemes must be included in intra-group pricing calculations using a method that measures comparable but uncontrolled manufacturing costs.

The unanimous 29-page decision was delivered by the Supreme Court April 22 by a panel of three justices in an appeal against district court verdicts in which Kontera Technologies Ltd. and Finisar Israel Ltd., — local research and development subsidiaries of foreign companies — unsuccessfully challenged assessments by the Israel Tax Authority.

The transfer pricing calculation, which uses the specific “cost plus” method, involves costs that aren’t deductible. The method measures the comparable, uncontrolled cost of manufacturing a product, plus an “appropriate” gross profit margin, according to Organization for Economic Cooperation and Development international guidelines.

The Supreme Court upheld the verdicts against both companies, rejecting their argument that stock options granted under Section 102 of Israel’s Income Tax Ordinance should be excluded from their cost-plus transfer pricing calculation of the profit margin paid by the parent company for services from the subsidiary.

The judges addressed “the appellants’ claim that the district court verdict reflects a tax policy that is incorrect and illogical, and is liable to frustrate the development of the high-tech industry in Israel,” responding that “this court does not examine the wisdom of the tax policy in Israel and its task consists of interpreting the existing and actual law, and not determining which law is desirable in the eyes of one taxpayer or another.”

**Impact for ‘Hundreds’ of Subsidiaries** The decision could affect hundreds of Israeli companies operating as subsidiaries of multinationals, allowing the tax authority to revisit and increase tax assessments for the past four years, said Eran Lempert, a tax partner at Yigal Arnon and Co. in Tel Aviv.

Stock options are a popular form of employee compensation, and granting them under Section 102 allows them to be taxed at 25 percent when exercised, instead of 50 percent.

“To attract a high quality workforce, you need to grant them options. It’s a very competitive market. Now

the cost of that is going to be much higher for the employers,” Lempert said in an April 26 interview. “It’s a dramatic decision. It’s going to increase costs for those R&D centers.”

“You can implement strategies and ways to avoid that decision by adopting different transfer pricing methodologies and have different inter-company agreements, but for the relevant tax year, it makes Israel much less attractive,” he said. In the long term, taxpayers will be able to mitigate the impact of the ruling, but for the current year and tax returns already filed, it will be hard to address the issue retroactively, he said.

**Eye Toward U.S. Reform** The verdict will increase pressure on Israeli policymakers to improve the tax climate for high-tech companies which provide about half of the country’s industrial exports. It comes as Israel grapples with the effect of U.S. tax reforms that have reduced Israel’s competitive advantage, causing some multinationals to re-think their investment strategy.

The country also faces a severe skills shortage, creating a job market in which sought-after employees seek generous stock options as part of their compensation. Section 102, which allows employees to enjoy preferable tax treatment of options, disallows the company from deducting them against its corporate tax.

“The whole industry works on these options,” said Daniel Paserman, partner and head of tax at Gornitzky and Co. in Tel Aviv. “The companies are all competing for employees. There is a shortage of high-tech employees in Israel. I don’t know if they are in a position to suddenly come to them and ask them to pay 50 percent tax instead of 25 percent.”

“I don’t think companies will not do deals in Israel as a result of this,” Paserman told Bloomberg Tax in an April 26 interview.

The Israeli start-up industry remains “interesting and appealing,” he said. “I’m now doing a very big deal in Israel and we just had a conversation with the purchaser. We went over all the obstacles and they accept that these are costs to take into consideration in their calculations of the bid offer for the target.”

However, he notes it’s “not a deal breaker.” Paserman said in certain cases it might change the numbers dramatically, “but I don’t think it’s a killer.”

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