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New Ruling - Capital Gain Treatment for Shares issued under Section 102

A new precedential ruling of a district court on option plans granted to employees provides more certainty and flexibility to Israeli companies and their employees on awards granted under section 102 of the ITO.

Section 102 of the Israeli Income Tax Ordinance (“**Section 102**” and the “**ITO**”, respectively) allows Israeli residents who are employees and officers of a company to receive, under certain conditions, favorable tax treatment for compensation in the form of equity awards. Section 102 includes two alternative tracks for the tax treatment of equity awards issued to and registered in the name of a trustee for the benefit of the grantee. Section 102 provides significant beneficial tax treatment to the employees: first, Section 102 allows for a postponement of the taxable event for the employee, who will be taxed upon the earlier of the following: (i) the sale of the options (shares) by the trustee; or (ii) the transfer of such options to the employee. Second, under the capital gain tax route, pursuant to Section 102, employees of private companies enjoy a favorable tax treatment of 25% capital gains tax (rather than marginal tax rate which can be up to 50%).

A new tax ruling, *Shohat v. Tsfat Tax Assessor*, by Judge Irit Hod of the Nazareth District Court (the “**Court**”), illuminates various aspects of Israeli employee option plans and under Section 102. Notably, the ruling addresses three significant issues (1) the nature of the Israeli Tax Authority’s (the “**ITA**”) preliminary approval of the option plan; the (2) eligibility of certain classes of shares for favorable tax treatment, and (3) classification of a “controlling shareholder.”

1. An Option Plan Approval is not Technical -

The ITO provides that in order to enjoy the ITO's beneficial tax treatment, the company must antecedently file the option plan with the ITA and receive its approval that the plan satisfies the requirements of Section 102. The ITO further provides that following the lapse of 90 days from its filing, an option plan would be deemed approved if the ITA failed to reject it. The ITA argued that the ITA's approval of an option plan is technical in nature, a fortiori, when the approval is a result of lack of response by the ITA. The Court ruled, however, that the approval of an option plan is substantive. The Court reasoned that the plan's approval should give comfort and certainty to both the company and the employee. Moreover, the Court ruled that even a plan that was not actively approved by the ITA but instead approved due to the lapse of time would be deemed materially approved. The Court further elaborated that the practical implication of the fact that a plan is "substantively approved" is that in most circumstances it prevents the tax assessor from challenging the plan. The Court qualifies however that the ITA may challenge a plan that contradicts, or significantly deviates, from the provisions of Section 102.

2. More Flexibility in Designing Options Plans –

The company adopted an option plan according to which employees were granted non-transferable, non-voting shares. The shares provided the employees with certain dividend rights and would become dormant upon the termination of employment. The ITA claimed that these shares are "virtual" and that the payment classified as a dividend is, in fact, an "annual bonus", which is to be subject to ordinary income taxation. Nonetheless, the Court reviewed Section 102 and the general provisions of the corporate law and concluded that companies have the prerogative to determine which rights are attached to each class of shares, including its transferability. Hence, the Court recognized that the shares granted under the plan fall within the scope of Section 102. The Court reasoned that the shares, although provide only dividend rights, qualify for beneficial tax treatment as they fulfill the purpose of Section 102, which is to help companies reinforce the commitment of their employees to its success.

3. Controlling Shareholder Classification

To qualify for beneficial tax treatment, an individual must be an employee or an officer of the company who is not a "controlling shareholder". The definition of "controlling shareholder," for the purpose of Section 102, includes, inter alia, the rights to receive at least 10% of the profit or the possession of at least 10% of the issued equity. The ITA argued that the employee held 22.7% of all issued class A shares and therefore the employee should be classified as a "controlling shareholder". The Court rejected the ITA's position and determined that "controlling shareholder" holdings should not be determined per class of shares, but rather by the total issued shares. In this case, the employee's rights to dividends did not amount to more than 10% of the company's total issued and outstanding shares.

Another question that was brought before the court is what is the appropriate tax rate for dividend distribution to an employee who received his shares under Section 102, when the distributing company enjoys a beneficial tax treatment (under the Israeli Encouragement of Capital Investment Law–1959, the “Encouragement Law”). The Court ruled that the employee should be taxed at a 25% rate as a capital gain pursuant to Section 102 (and not at a 15% rate pursuant to the Encouragement Law).

This Court ruling is one of the most significant cases to address Section 102. At this point, it is difficult to anticipate the implications of this ruling, while providing comfort to both companies and employees, it deviates drastically from ITA’s common practice. **We note that recently both the taxpayer and the ITA appealed this judgement and both appeals are currently pending before the Supreme Court.**

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