

The Israel Tax Authority Published a New Circular on Recharge Agreements for Stock-Based Compensation in International Transactions

Overview

On January 27, 2021, the Israel Tax Authority (the “**ITA**”) published a new circular titled “*Payments to a Parent Company for the Grant of Stock-Based Compensation to its Subsidiary’s Employees (Recharge Agreements) in an International Transaction*” (the “**Circular**”). The Circular presents the ITA’s position as to the tax classification of recharge payments where a subsidiary (the “**Employing Company**”) compensates its parent company (or another company within the group) (the “**Granting Company**”) for granting its shares to the employees of the Employing Company as stock-based compensation (“**SBC**”).

The main question addressed by the Circular is under what circumstances should a recharge payment be classified as a reimbursement of the Granting Company’s costs or, alternatively, as a dividend distribution from the Employing Company to the Granting Company (which may trigger a withholding tax liability). The purpose of the Circular is to provide guidelines on the ITA’s view with respect to the said classification

The Circular provides that recharge payments would be considered as reimbursement of the Granting Company’s costs (and not as dividend) to the extent all following conditions are met:

1. The payment to the Granting Company is only with respect to vested SBC;
2. The payment to the Granting Company is based on the value of the vested SBC, as determined by the Employing Company under generally accepted accounting principles for purposes of reporting the expense in its financial statements (usually the fair value on the grant date);
3. The payment to the Granting Company is in accordance with a recharge agreement that was executed prior to granting the SBC; and
4. All expenses incurred in connection with granting SBC were included within the cost base for transfer pricing purposes (according to Section 85A of the Israeli Income Tax Ordinance (“**ITO**”).

The Circular provides that any payment that does not meet the above requirements would be classified as a dividend distribution (or a capital reduction, as the case may be), even if paid to another member of the group which is not the direct parent of the Employing Company.

The Circular also clarifies that recharge payments should not be considered as tax-deductible expenses of the Employing Company. Rather, the costs associated with the SBC would be deductible only if allowed pursuant to the general provisions of the ITO, regardless of the existence of a recharge arrangement.

Finally, the Circular clarifies that an Employing Company that makes recharge payments that meet all the conditions and requirements of the Circular is not required to follow Reportable Position 70/2019 (*Stock-Based Compensation Recorded as a Capital Transaction*).

Key Takeaways


The Circular impacts cross-border recharge arrangements involving Israeli companies. While reimbursement of costs is generally not a taxable event, a dividend distribution to a foreign company is considered a taxable event under Israeli tax law, and may trigger withholding and reporting obligations. Because recharge payments would be considered by the ITA as reimbursements only when meeting the strict rules of the Circular (including the requirement for a written and signed recharge agreement executed before the SBC is granted), companies that make recharge payments should make the necessary changes in order to comply with the Circular. Although ITA circulars merely represent the opinion of the ITA and are not binding upon taxpayers, they are an important source that taxpayers should take into account when dealing with tax issues that may be challenged by the ITA and when managing their risks.

In addition, the Circular may affect the amount of expense Israeli companies may claim with respect to SBC issued to employees under Section 102 of the ITO. Section 102(d) allows the Employing Company a deduction equal to the lesser of (i) the ordinary income recognized by the employees with respect to the grant, and (ii) the recharge amount charged by the Granting Company with respect to such grant. Failure to meet the requirements of the Circular – thereby causing the company's recharge amounts to be treated as a dividend – may mean that the company will be considered by the ITA as not having paid a recharge, thereby eliminating the allowed deduction altogether.

Finally, the Circular significantly increases the tax burden on Israeli companies that provide services to their foreign parents on a cost-plus basis. Depending on the circumstances, such companies are not allowed to deduct the cost of the SBC for tax purposes or are limited in the amount they are allowed to deduct, but in either case are required to include the entire cost in the cost base for transfer pricing purposes. In cases where the Circular disallows the deduction for recharge payments, the total deductions of such companies will be less than their cost basis (for transfer pricing purposes), resulting in higher taxable income and more taxes due in Israel (in addition to the withholding liability on the dividend). This will be true even if such companies fail to meet only a technical condition in the Circular such as the requirement to sign a recharge agreement prior to granting the SBC.

In view of the above, we recommend that multinational corporations with Israeli subsidiaries review their recharge arrangements and consider the Circular's provisions when entering into a new recharge agreement.

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