

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

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration [here](#).

Also available is our [EY Global Tax Alert Library](#) on ey.com.

Executive summary

The Israeli Tax Authority (ITA) has published the final circular (the Circular) regarding payments to a parent company under recharge agreements for the grant of stock-based compensation (SBC). This follows a draft circular (the Draft Circular) that was published by the ITA in March 2020.¹

The purpose of this Circular is to outline the ITA's position with respect to the intercompany 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 SBC and its classification as reimbursement for participation of the parent company in payroll costs of the subsidiary versus dividend distribution. This Circular sets forth the ITA position where the expenses recorded for the grant of SBC were included as an expense/cost for purposes of Section 85A of the Income Tax Ordinance (ITO), in accordance with the *Kontera Case*.²

In order for an intercompany payment to be classified as a reimbursement for payroll expenses, the Circular requires the payment to be up to the payroll expense recorded in the financial statements for the grant of the SBC, to be final and not contingent on work, and agreed upon in advance.

This Circular also aims to clear Reportable Position no. 70-2019, published in 2019, which created uncertainty with respect to such intercompany charges. This Circular corrects and clarifies this Reportable Position where the SBC expense is included for purposes of Section 85A of the ITO, according to the *Kontera Case*.

Due to the significant impact of the *Kontera Case*, multinationals with operations in Israel should closely review this 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 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 tax provision.

Since there is no transition provision, this Circular potentially also applies to past recharge payments.

Detailed discussion

The background of the Circular addresses 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).

The Circular mainly addresses service companies that are remunerated on a cost-plus basis, where the SBC costs are included in the cost base for calculating the cost-plus remuneration, as was ruled in the 2018 Supreme Court *Kontera Case*, but at the same time can apply to Israeli companies that serve as distributors on a Buy/Sell model.

The Circular then determines under which circumstances the payment by the Employing Company to the Granting Company will be classified as a payroll expense reimbursement, and in which cases it will be considered a dividend distribution (or capital reduction, as relevant). 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 of whether an Intercompany Charge exists, and will (or will not) be tax deductible in accordance with the Israeli Tax Ordinance.

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 meet all the following conditions:

1. The payment is only for vested SBCs.³
2. The payment for any vested SBCs is based on the value recorded in the financial statements (usually its fair market value at the time of grant), in accordance with the relevant GAAP.

3. The payment is made in accordance with a recharge agreement between the companies that was signed **prior** to the grant of the SBCs.
4. The entire SBC expense was included in the cost base/expenses for the purpose of Section 85A of the ITO (*Transfer Pricing in International Transactions*), according to the *Kontera Case*.

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

A reference that was made in the Draft Circular with respect to cases where the recharge payment is for the intrinsic value at the realization date, which provided that the payment up to the FMV of the instrument at the grant date (as recorded in the financial statements) will be considered as payroll expense reimbursement, where any additional amount will be considered as a dividend, was omitted in the final Circular that was published.

A company that has a recharge agreement with the Granting Company and the payments thereunder meet all relevant conditions under this Circular, which are therefore classified as payroll expense reimbursement, 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 Circular also provides several examples to demonstrate the application of its provisions.

Impact

This Circular, together with the *Kontera Case*, will likely have a significant impact on multinationals operating research and development centers and other service companies in Israel.

Those multinationals should closely review this Circular and consider its implications on their recharge payments and overall SBC costs. Those with recharge payments and agreements not aligned with the conditions of this Circular, as well as those non-compliant 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 their tax provision.

Endnotes

1. See EY 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](#), dated 4 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.
3. Also relevant for instruments that vest in tranches.

For additional information with respect to this Alert, please contact the following:

EY Israel, Tel Aviv

- ▶ Sharon Shulman sharon.shulman@il.ey.com
- ▶ Lior Harary-Nitzan lior.harary-nitzan@il.ey.com

Ernst & Young LLP (United States), Israel Tax Desk, New York

- ▶ Lital Haber lital.haber1@ey.com

About EY

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

© 2021 EYGM Limited.
All Rights Reserved.

EYG no. 000706-21Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com