2 May 2018
Global Tax Alert
News from Transfer Pricing

Israeli Supreme Court rules stock based compensation to be included in cost base for transfer pricing

Executive summary

On 22 April 2018, the Israeli Supreme Court ruled on two appeals made by Kontera Technologies Ltd. (Kontera) and Finisar Israel Ltd. (Finisar) and counter appeals by their assessing officers, where both cases addressed the Israeli tax treatment of stock based compensation (SBC) expenses in contract research and development arrangements, which are typically remunerated on a cost plus basis. The Israeli Supreme Court ruled in favor of the Israeli Tax Authorities (ITA), including a secondary adjustment.

The Supreme Court ruling upholds two factually similar District Court decisions of Kontera and Finisar from 2015 and 2016, and confirmed 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, notwithstanding the fact that such expenses were specifically disallowed as a tax deduction for Israeli tax purposes.[1]

This Alert summarizes the key points of the Supreme Court decision.

Detailed discussion

The judges accepted the ITA's position that SBC expenses recorded in the financial statements are integral to the business operation, and therefore considered as employment compensation that should be included in the cost plus base calculation.

In addition, while the Court concurred that the SBC expenses should generally be deductible for tax purposes, such were disallowed in the cases at hand since the companies elected to apply the "capital gain track" available under Section 102 of the Israeli Tax Ordinance, by which the employees are eligible to a reduced capital gains tax rate upon exercising the SBC. In this context, it was noted that a deduction could be allowable to the extent that under Section 102, the SBC is treated as employment income taxed at marginal rates, and not as a capital gain.

Moreover, according to the Supreme Court ruling, the adjustment to the price of services provided by the Israeli subsidiary (additional consideration) should have created an intercompany balance, which should bear arm's-length interest, taxable by the Israeli company.

Lastly, the Supreme Court accepted the ITA's appeal to the District Court decision and determined that in the case of deviation where the adjustment leads to tested party results outside the range of comparable company results, the markup should be adjusted to the median according to Section 2(c) of the Israeli transfer pricing regulations.

The Supreme Court asserted that the burden of proof, which presumably should have been with the ITA, should be transferred to the taxpayer, as the transfer pricing documentation did not match the facts and circumstances of the case.

Implications

Multinational groups that operate R&D centers (or other service centers) in Israel which are remunerated on a cost plus basis should evaluate the Israeli Supreme Court decision and its potential impact on their set of circumstances, including special attention to potential past exposures, interest and penalties.

Additionally, multinational groups should take a close look at their transfer pricing documentation to ensure it accurately reflects their specific facts and circumstances.

Furthermore, multinationals should consider the impact of their previous tax return filing, including restating according to the new Supreme Court decision. In this respect special attention should be given to tax returns that were filed after the District Court decisions.

Endnote

1. See EY Global Tax Alert, *Israeli District Court rules on the treatment of stock based compensation costs under a cost plus arrangement*, dated 7 January 2016.

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

EY Israel, Kost Forer Gabbay & Kasierer, Tel Aviv

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

Ernst & Young LLP, Israel Tax Desk, New York

- Rani Gilady rani.gilady1@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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. For more information about our organization, please visit ey.com.

Transfer Pricing Group

EYG no. 02601-181Gbl

1508-1600216 NY
ED None

ey.com