

Client Update

New Notice of the Israel Tax Authority Regarding Stock-Based Compensation: Amendment of Tax Returns following the Supreme Court Ruling in the *Kontera* and *Finisar* Cases

December 2018

Dear Clients and Friends,

On December 16, 2018, the Israel Tax Authority (the "ITA") published a notice that companies remunerated under the Transaction Net Margin Method, on a cost-plus basis, that did not include stock based compensation charges ("SBC") in their cost-base must file amended tax returns.

Background

On April 22, 2018 the Israeli Supreme Court ruled in the appeals of *Kontera Technologies Ltd.* and *Finisar Israel Ltd.* concerning the inclusion of employee SBC charges within the cost base for cost plus arrangements.

The Supreme Court ruled that Israeli subsidiaries operating on a cost-plus model must include the accounting expense related to the SBC in the cost base.

The ITA Notice

According to the ITA notice, in light of the Supreme Court ruling, Israeli companies remunerated under a cost-plus basis that granted SBC to their employees, but did not include the SBC in the cost base, are required to file amended returns. Tax audits will be initiated against companies that do not amend their tax returns, which may potentially result in a higher "plus" margin (based on the median within the interquartile range) and penalties; this is subject, *inter alia*, to the applicability of the TNMM model and the range selected by the tax payer.

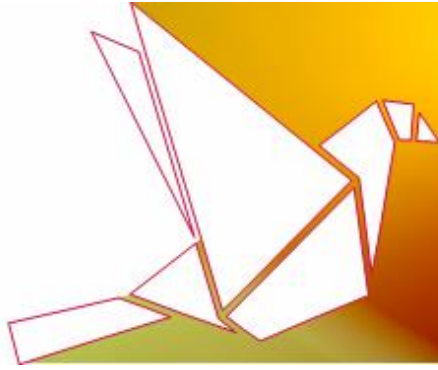


Important Notes to Consider:

- 1) Partial Relief by Claiming a Corresponding Tax Deduction by Implementing a Recharge Agreement.** Publicly-traded companies may be eligible for a tax deduction that fully or partially corresponds to the SBC income inclusion, provided that the parent company has charged the Israeli subsidiary for the cost of the SBC. In order to implement such charge, a Recharge Agreement should be put in place. Recharge agreements present various issues related to the amount, timing and other aspects of the recharge. Careful consideration should be given to these matters to avoid adverse tax results.

- 2) Secondary Adjustment.** The ITA's notice does not expressly address tax aspects of the so-called secondary adjustment arising from the increase of taxable income to the Israeli subsidiary, but such adjustment should be considered. The secondary adjustment may normally be treated as either a deemed dividend from the Israeli subsidiary to its non-Israeli parent, thereby triggering Israeli withholding tax, or alternatively, as a deemed loan from the Israeli subsidiary to its non-Israeli parent resulting in accrual of interest income by the Israeli subsidiary due to the deemed interest. In the *Kontera* case the ITA agreed a deemed loan was a secondary adjustment.

- 3) To file or not to file?** The ITA's position is not obvious and presents legal difficulties. Also practically, while the ITA promise to initiate tax audits against companies that do not amend their tax returns, there is no guarantee that the amended tax returns will not be challenged by the ITA. Companies should consider the amendment of the tax returns according to the status of their tax years (e.g. open, closed, under audit), the tax return submission date (e.g. relatively to the district/supreme court judgements), whether the returns provided disclosure re SBC, and according to other circumstances concerning the legal obligation to amend financial statements and tax returns. Additionally, the option of amending past reports in later years should be examined, in order not to restart the statute of limitations period. Other economic factors may be considered, as, in hindsight, certain economic elements may have changed.



To read the Hebrew version of the Guidance as published by the ITA, [click here](#).

Since the fines to be imposed by the ITA are significant, we recommend companies that have not included the SBC charges in their cost basis seek legal advice regarding their situation. Our tax department has vast experience dealing with such cases and we would be happy to assist you.

Please do not hesitate to contact us with any questions or if you require any clarification regarding any of the matters above.

Sincerely,

Herzog Fox & Neeman

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