Client Update

New ITA Circular | Performance-based Vesting of Employee Equity Awards

December 2018

Dear Clients and Friends,

On December 5, 2018, the Israeli Tax Authority (the "**ITA**") published a Circular, which sets forth its position regarding the taxation of equity-based compensation, which is subject to performance based vesting (the "**Awards**"). Awards that do not comply will be disqualified from beneficial tax treatment unless the company takes action, as further detailed below.

The purpose of the circular is to determine the performance conditions, under which the allocation of Awards will be deemed to meet the provisions of Section 102 of the Income Tax Ordinance (New Version), 5721-1961 (**"Section 102"**) and in specific the beneficial tax routes, as well as determine the grant date for the purpose of Section 102.

This client update provides a summary of the Circular.

Introduction

It is a common practice among companies to incentivise their employees by granting Awards such as options, shares and restricted share units. The receipt of the Awards is subject to certain terms which at times include continued engagement with the company and at times include achievement of certain milestones or goals either of the individual, the company or the market (the "**Vesting Conditions**").

Asia House, 4 Weizmann St., Tel-Aviv 6423904, Israel I Tel: (972)-3-692-2020 I Fax: (972)-3-696-6464
Twitter: @hfnlaw I Blog: unfolding.co.il I hfn@hfn.co.il I www.hfn.co.il

Section 102 does not include any reference to Vesting Conditions. The only determination included in Section 102 as a condition to receive tax benefits is a limitation on the holding period of the Awards or underlying shares by a trustee prior to being sold to a third part (a period of two years under the trustee capital gains route and one year for the ordinary income route) (the **"End of Period"**). Despite the language of the law, the ITA have issued a Circular which addresses performance based vesting of Awards as further detailed below.

<u>Circular and its Conditions</u>

The following is a summary of the conditions set forth in the circular:

1. **The grant of equity-based compensation which is subject to performance based vesting under Section 102**

   In order for the grant of Awards to be considered an allocation under the provisions of Section 102 - Allocation through a Trustee, it must comply with the following conditions:

   i. All the terms of the grant, including mainly the exercise price, expiration date and vesting schedules, were reviewed and approved by the company's board of directors.
   ii. The performance-based or market-based Vesting Conditions must be fixed, measurable and predetermined as of the grant date.
   iii. The grant was made under an equity benefit plan which allows performance-based vesting, and was submitted for approval with the ITA.
   iv. The Awards were timely and appropriately deposited with the trustee pursuant to the instructions of the ITA.
   v. The plan or grant documents do not include a put or call right other than a call option which was approved by the ITA.

2. **The date of grant from which the End of Period shall begin**

Generally, the grant date is the date on which the company's board of directors resolved to grant the Award and set its terms. On such date the number of shares underlying the Awards is determined (the "**Target Amount**") as well as the criteria under which the Awards will vest.

For the avoidance of doubt, if the number of exercised shares granted to the employee upon exercising the Awards is greater than the Target Amount set on the grant date, the difference between the Target Amount and the amount of shares actually granted to the employee will be deemed a new grant.

3. **Exit-based Vesting and IPO-based Vesting**

Some companies grant Awards which vest upon the occurrence of an exit event (i.e. the sale of the company) or when the company's shares are listed for trading on a stock exchange (IPO) (an "Exit Event").

According to the Circular, such Awards should not be considered equity-based compensation, but cash-based compensation granted as a benefit in the framework of an employee-employer relations and the income deriving thereof should be classified as ordinary work income under Section 2(2) of the Ordinance, and taxed as a bonus to the employee upon the occurrence of the qualifying event.

For companies that have granted Awards which are either vested upon an IPO or Exit Event or only exercisable upon an IPO or Exit Event the Circular determines a process to apply the beneficial tax route. The Circular grants a 180 day grace period during which the companies can change the vesting conditions of their Awards and file a request to "redeposit" their Awards with the trustee pursuant to the trustee routes of Section 102. The "redeposit" will re-start the applicable holding period and the calculation of the End of the Period, however will retain in full the tax treatment of the Awards under the applicable tax route. The

companies DO NOT need to apply for a special tax ruling, they only need to file a notice with the Professional Department of the ITA and with their Assessing Officer.

Please note that the Circular includes additional terms and conditions which were not fully detailed herein.

To read the Hebrew version of the Circular as published by the ITA - Click here

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

KEY CONTACT

Shachar Porat | Partner, Head of Employee Equity Compensation Practice

Tax Department

☎ +972 3 692 5530

porats@hfn.co.il