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CLIENT UPDATE



A New Reportable Position regarding Recharge Payments for Share-based Compensation

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General

This month, the Israel Tax Authority ("ITA") published its 2019 list of reportable positions requiring mandatory disclosure. The Israeli Income Tax Ordinance ("ITO") requires a taxpayer to report any position taken in its annual tax return that is contrary to the published ITA's positions, if the tax benefit resulting from such position exceeds NIS 5 million for that taxable year, or NIS 10 million in the aggregate over four taxable years. Failure to report a contrary position as part of the annual tax return will be treated like a failure to file the tax return. The ITA started publishing the reportable positions subject to mandatory disclosure in 2016 and has been expanding the list every year.

Recharge for Share-Based Compensation

In the 2019 list, the ITA added reportable position 70/2019 referring to share-based compensation charge-back reimbursement payments ("SBC" and "Recharge", accordingly). Recharge (also known as "charge-back") is the payment by a subsidiary to its parent corporation for equity of the parent that the subsidiary grants to its employees. It is a common transaction in which the subsidiary pays the parent cash for the benefit accruing to the subsidiary's employees from the SBC.

In the new reportable position 70/2019, the wording of which is not entirely clear, it seems that the ITA's view is that if the SBC (treated according to the Israeli Accounting Standard No. 24 or IFRS 2) was recorded on the Israeli subsidiary's financial statements as equity instruments (equity-settled share-based payment transactions) rather than as a liability, the transaction between the parent corporation and the

subsidiary should be classified as an equity investment in the subsidiary rather than an intercompany debt. As a result, any Recharge payment for the costs associated with the SBC from the subsidiary to its parent would be deemed a dividend, and therefore would be subject to withholding tax.

While not explicitly limited to a situation of a foreign parent and an Israeli subsidiary, it seems that this is what reportable position 70/2019 attempts to address because of the reference to withholding tax. Obviously, any issue of recharacterizing a payment as dividend could equally apply to the reverse situation of an Israeli parent with foreign subsidiaries.

Position 70/2019 presents certain challenges and if its purpose is to deter foreign parents from recharging Israeli subsidiaries for SBC, then in our view that would be inconsistent with the law. The ITA's position is not aligned with the provisions of Section 102(d) of the ITO that allow the employing company (the Israeli subsidiary) to deduct as an expense some of the benefit recognized by the employee from the SBC in the year in which the tax was paid on the employee's income. Such deduction is limited to the lower of (i) the employee's income from the SBC taxed at ordinary rates or (ii) the amount the employing company was recharged by the granting parent company. Moreover, while the parent records the SBC in its equity, this does not rule out the possibility of having a "subsidiary debt" on the assets side of the Parent's balance sheet and the subsidiary recording a liability to the parent. In addition, the Recharge is a transaction subject to Section 85A of the ITO, the legal source for Israeli transfer pricing rules governing international transactions between related parties. The Recharge for shares made available by a parent company to its subsidiary may be mandated under the arm's length principle of Section 85A. Lastly, recharacterization of the Recharge as a dividend may be inconsistent with the way the parent company would treat this payment under its domestic tax rules (including in countries with which Israel has concluded tax treaties), and thus any Israeli withholding may not be allowed as a foreign tax credit and result in a double taxation.

Summary

The wording of the new reportable position is not entirely clear. If it is intended to limit Recharge mechanisms for SBC, it would be inconsistent with the ITO provisions governing transfer pricing, the deductibility of certain SBC-related expenses and obligations to avoid double taxation under tax treaties. **The Recharge payment is not a dividend** and should not be recharacterized as one. Multinational enterprises should review the accounting treatment of the Recharge in the subsidiary's financial statements and documentation of the Recharge mechanism.

Our firm has extensive experience in advising multinational corporations on transfer pricing matters and in all the aspects of share-based compensation and in representing such corporations in disputes and tax appeals with the ITA

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