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A New Tax Circular regarding Recharge Payments for Stock-Based Compensation

January 28, 2021

On January 27, 2021, the Israeli Tax Authority ("ITA") issued a new circular on recharge payments for stock-based compensation. **Circular 1/2021** titled ***"Payment to a Parent Company for Grants of Stock-Based Compensation to the Employees of its Subsidiary (Recharge Agreements), as part of an International Transaction"*** (the "**Circular**") sets forth **the position of the ITA** on the classification of recharge payments to the parent company. As discussed below, the ITA's view is that recharge payments will be classified as a dividend, if such payment does not meet the conditions specified in the Circular. The Circular follows a Reportable Position 70/2019 published a year ago (see our client update).

Recharge or chargeback is the payment by a subsidiary to its ultimate parent corporation for stock-based compensation ("**SBC**") granted to the employees of that subsidiary. The subsidiary pays the parent for the benefit accruing to its employees from the SBC in the form of rights to the shares of the parent company. The Circular first provides that the reimbursement payment to the parent for the SBC would be deductible only to the extent allowed under the provisions of the Israeli Tax Ordinance (the "Ordinance")[1]. The Circular then focuses on the classification of the recharge payment to the parent and examines whether it should be deemed a dividend.

The Circular provides that a recharge payment **will not be classified as a dividend, if all of the following conditions are met**:

1. The payment to the parent company is only with respect to SBC that has vested[2].
2. The payment is based on the value recorded as an expense in the financial statements according to acceptable accounting principles (typically the fair market value of on the date of grant).
3. A recharge agreement was executed prior to the grant of the SBC.
4. The cost of the SBC to the employer-subsidiary is included in the cost basis or as an expense for the purpose of determining the arm's length pricing for transactions of such subsidiary according to Section 85A of the Ordinance (the equivalent of Section 482 of the Internal Revenue Code).

Our View

The ITA's position in the Circular clearly intends to **limit the outbound recharge payments** for SBC. In our view the **positions set forth in the Circular are inconsistent with the language of Section 102(d)** of the Ordinance governing the deductibility of the expenses relating to SBC and specifying that the deductible amount also depends on the recharge amount. Section 102(d) of the Ordinance generally allows for a tax deduction of the lower of (i) the income taxed as ordinary income to the employee or (ii) the recharge amount. This means the charge back is a condition for the deduction and limiting it may have an impact on the deduction available to the company. This should only be done by legislation and not an ITA circular.

Moreover, the recharge agreement in an international transaction and the amounts charged should be at arm's length. **In its 2004 paper** on *Employee Stock Option Plans: Impact on Transfer Pricing*, the **OECD took the view that recharge payments should be allowed either upon grant of the SBC or upon the receipt of the shares** (i.e., vesting in the case of an RSU and exercise in the case of an option). In the latter case, therefore, the recharge amount would be based on the fair market value of the share at such time rather than the fair value at grant. Both alternatives – accounting for the expense at grant or fair market value at vesting / exercise – reflect arm's length transactions and therefore should be consistent with Section 85A of the Ordinance. **The Circular, on the other hand, is in effect restricting the taxpayer to just one alternative, and without legislative action is inconsistent with Section 85A.** Furthermore, the ITA's position is therefore also **inconsistent with the arm's length standard embodied in Article 9 of tax treaties** (Article 11 of the US –Israel tax treaty).

In addition, the Israeli courts (for example, in the *Broadcom decision*), relying on the OECD **generally not interfere in agreements between the related parties other than in rare cases** Transfer Pricing Guidelines and general contract law, have already ruled that the ITA should.

In our opinion the parties have the right to determine their payment mechanism, as long as it is determined in accordance with the arm's length principle and supported by applicable transfer pricing documentation. The recharge payment is generally not a dividend and should not be classified as such.

We note that the **ITA's circulars are not binding on the taxpayers or the courts**. However, it is expected that the ITA will focus on this issue, and we recommend companies review their recharge arrangements. The ITA position in the Circular is also not provided on a prospective basis, and it seems the ITA would consider using it as "existing law" when auditing open years.

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

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[1] Section 102(d) of the Ordinance generally provides that the deductible amount is the lower of the employee's ordinary income and the recharge amount paid to the parent company.
[2] The Circular mentions that the recharge payment cannot occur prior to the vesting of the SBC but does not restrict the actual payment from being made later than that. That means that the recharge payment may also occur upon the exercise of stock option or the sale of shares even if vesting was earlier.

Contact Information

Eldar Ben-Ruby Partner Tax Group Leader	**Meir Akunis** Partner Tax Group	**Shaul Grossman** Partner Tax Group	**Keren Shitrit** Partner Tax Group
Dr. Michael Bricker Partner Tax Group	**Omri Davidov** Partner Tax Group	**Nathalie Anvar Hammer** Partner Tax Group	**Maor Hakak** Partner Tax Group

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