How To Structure Employee Stock Options In Israel

By **Barbara Klementz** (July 3, 2018, 10:43 AM EDT)


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I hope most of you have seen the April 2018 Israeli Supreme Court ruling in the Kontera Technologies Ltd. and Finisar Israel Ltd. v. Israeli Tax Authority cases, which confirmed that stock-based compensation has to be included in the cost base of Israeli subsidiaries of multinational companies. As a result of the decision, we have already seen a flurry of activity as many companies are evaluating how to obtain a tax deduction for awards granted to Israeli employees.

As a reminder, for companies with a cost-plus arrangement with their Israeli subsidiary, the decision means that the income of the Israeli subsidiary is effectively increased by the amount of the stock-based compensation, plus the mark-up. To mitigate the tax due on this increased income, it will be crucial for most companies to deduct at least a portion of the equity award income.

The problem is, however, that a tax deduction for equity award income is available in Israel generally only for awards granted under a trustee plan. Many companies have already set up a trustee plan to grant awards in Israel because trustee awards can provide for beneficial tax treatment for the employees and, thus, most Israeli employees push hard to receive trustee awards.

So let's look more closely at the requirements of a trustee plan and the corresponding tax benefits.

Trustee Plan Requirements

As the name indicates, a trustee plan has to be administered by an Israeli trustee which has to hold the awards and underlying shares for the duration of the holding period (more on this below) and which will satisfy the applicable tax withholding and reporting obligations. Most companies enter into a "supervisorial" trust arrangement with the trustee, which means the awards and shares are not physically held by the trustee. Instead, they are held by the existing broker (e.g., in the U.S.) and the Israeli trustee works with the broker to ensure the awards/shares are not sold before the holding period ends.

There are a number of companies in Israel which can act as a trustee for this purpose, and several are very familiar with U.S.-style equity plans and can work with the brokers that generally administer the plans. The fees vary by trustee and usually depend on the number of grantees in Israel and the number of transactions.

Further, to implement a trustee plan, an Israeli sub-plan to the parent plan will need to be adopted and filed for approval with the Israeli Tax Authority, or ITA.

Once the initial filing has been made, companies must report each grant to the trustee within 45 days of the grant date. This can be done by sending the trustee a copy of the board resolutions approving the grants.

There are two possible tracks for a trustee plan: the capital gains track and the ordinary income track. Almost all companies we work with opt for the capital gains track because only this track also provides tax benefits for the employee.

Capital Gains Track

Under the capital gains track, employees will be taxed at sale on the sale proceeds minus any price paid by the employee to acquire the shares (i.e., exercise price for options, purchase price under an employee stock purchase plan, or ESPP, nil for restricted stock units, or RSUs). For public company awards, the tax treatment at sale is bifurcated: the value of the shares underlying the award at grant minus any price paid by the employee to acquire the shares is taxed as ordinary income at the employee's marginal tax rate. Any appreciation in value between grant and sale is taxed as capital gain at a rate of approximately 25 percent.

The employer will be able to claim a tax deduction for the ordinary income portion, provided the employer is charged for this cost. The tax deduction can be claimed only once the shares have been sold.[1]

To qualify for the capital gains track, the trustee must hold the shares for a minimum of 24 months from the date of grant for options and RSUs and 24 months from the purchase date for ESPP.

For RSUs, the ordinary income portion is equal to the value of the underlying shares at grant. Because this typically will equal the amount that has to be included in the cost base, companies will be able to offset the additional tax burden with a corresponding tax deduction. However, a timing issue remains because the tax deduction is available only in the year of sale, while the additional tax burden is created in the year of grant.

For options, given that the exercise price will in almost all cases be equal to the value of the shares at grant, there typically will not be any ordinary income portion at grant and, hence, no deductible amount.[2]

For ESPP, the ordinary income portion is equal to the value of the shares at grant minus the purchase price. However, offering an ESPP under a trustee plan usually is not very beneficial to the employees. Furthermore, because the 24-month holding period for an ESPP starts running on the purchase date, employees have to hold the shares for a longer period of time than the shares subject to options and RSUs.[3]

Ordinary Income Track

Under the ordinary income track, the entire gain at sale (i.e., sale proceeds minus any price paid by the employee to purchase the shares) will be taxed as ordinary income and, thus, deductible to the local entity, provided it is charged for this cost.[4]

To qualify for the income tax track, the trustee must hold the shares for a minimum of 12 months from the date of grant for options and RSUs and 12 months from the purchase date for ESPP.

Given the treatment of the entire gain as ordinary income and the 12-month holding period, this track is obviously not popular with employees and rarely implemented.

Conclusion

To maximize the tax benefits for both the company and the employee, granting RSUs under the capital gains track of a trustee plan is (and will be) the preferred approach for most companies that are interested in seeking a tax deduction. As noted above, a timing issue remains because the tax deduction cannot be taken until the shares are sold (even though the deductible amount will be limited to the value of the shares at grant). In order to claim the tax deduction, the local entity has to be charged for the deductible amount pursuant to a written reimbursement agreement.

One additional wrinkle to consider for U.S. parent companies is that the amount that can be charged to local entities should not exceed the value of the shares at vesting. Any amount charged in excess of this value could be considered as a taxable dividend under Section 1032 of the U.S. Internal Revenue Code. Therefore, the charge-back amount should be limited to the lower of the value of the shares at grant and the value of the shares at vesting. If the stock price drops between grant and vesting, this will reduce the value of the reimbursement amount and, thus, of the deductible amount in Israel.

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[1] For awards granted by a private company, the entire sale proceeds (minus any price paid for the shares) are treated as capital gain, which means no deduction is available.

[2] Note that, to determine the value of the shares at grant under a trustee plan, companies will need to look to the prior 30-trading day average price of the shares. Therefore, if the exercise price is determined based on the closing price on the grant date (or prior day closing price), a small discount could exist.

[3] It used to be possible to obtain tax rulings for ESPP granted under a non-trustee plan in Israel whereby the ITA would agree to allow companies to treat the discount at purchase as ordinary income and take a tax deduction for this amount. While it is still possible to get the ITA to agree that the discount at purchase should be treated as ordinary income, in recent years, the ITA has refused to allow a tax deduction for this amount.

[4] It may be problematic for U.S. issuers to charge the local employer for an amount that is greater than the market value of the shares at vesting.