Israeli Supreme Court rules ESOP expenses should be included in cost-plus compensation

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In brief

The Israeli Supreme Court has upheld two recent District Court decisions requiring a US-parented Israeli subsidiary that provided R&D services to the US parent company to include in its costs in determining its revenue, under a cost-plus formula, option expenses relating to US parent company options granted to the Israeli company's employees (*Kontera Technologies Ltd v. Tel Aviv 3 Assessing Officer and Finisar Israel Ltd v. Rehovot Assessing Officer, April 22, 2018*).

In detail

Facts

In both appeals, the Appellants are Israeli companies that provided R&D services to their US parent company (Parent Company) for a service fee determined on a cost-plus basis (Service Fee). A service agreement was executed between the Israeli companies and their Parent Company (Service Agreement).

Set out below is a review of the background of each District Court case being appealed and the arguments presented by the Appellants and the Income Tax Authority (ITA) before the Israeli Supreme Court. Thereafter, we set out the judgment issued by the Supreme Court for both cases.

Kontera case

Background

Further to a Service Agreement dated January 1, 2005 between the Appellant and the Parent Company, R&D services were to be performed by the Appellant for the Parent Company in consideration for the Parent Company compensating the Appellant with a Service Fee, computed based on the Appellant's expenses (Costs) plus a profit margin of seven percent of expenses.

In 2009–2010, the Parent Company granted stock options to employees of the Appellant. The employee stock ownership plan (ESOP) was governed under the capital gain tax regime of Section 102 of the Israeli Income Tax Ordinance (Ordinance). This regime provides that upon an employee's sale of shares received from the exercise of the options, the gain generally is taxed at a beneficial capital gain rate of 25 percent (instead of being taxed as employment income), while the employer is not entitled to a tax deduction for the value of the option benefit (except for part of the gain which may be taxed to the employee as regular employment income – detailed rules apply).

In 2010, the Appellant and the Parent Company amended the Service Agreement (Service Agreement Amendment) retroactively stating that commencing from January 1, 2008, the expenses of the options granted to the Appellant's employees shall not be included in the total Costs upon which the profit margin is applied.

In accordance with Israeli Accounting Standard 24, the option expenses were recorded in the Appellant's financial statements as an operating expense. However, the option expenses were not deducted for Israeli tax purposes.

The ITA issued tax assessments for years 2009–2010, contending that the option expenses should have been included in the Costs in computing the Service Fee. Since the Costs did not include the option expenses, the effective rate of the profit margins when including the option expenses were not seven percent (as set out in the Service Agreement) but rather were only 1.73 percent and 0.97 percent in 2009 and 2010, respectively. The ITA contended that this resulted in the Service Fee not being at arm's length as required under Israeli transfer pricing rules of Section 85A of the Ordinance.

District Court decision

The District Court held in its decision of December 2015 that the Appellant should have included the options expenses in the total Costs in computing the profit. The reasons given by the Court included the following:

- The options were granted to employees to motivate them to invest in their R&D performance efforts on behalf of the Appellant and also indirectly for the benefit of the Parent Company. Therefore, the option costs were expenses incurred in the Appellant's generation of income, even though the options were issued by the Parent Company.
- In the original 2005 Service Agreement, the Appellant and Parent Company agreed to include the option expenses in the total Costs in computing the profit. In the 2010 amendment to the Agreement, the parties agreed to neutralize the option expenses, claiming that this was the customary market practice also in related-party transactions. However, the District Court stated that the Appellant did not provide support for its position. The District Court said that the original 2005 Service Agreement reflected that at the time the Agreement was entered into, the customary practice was to include the option expenses in Costs, while the 2010 amendment primarily was intended for the purpose of reducing the Israeli corporate tax liability of the Appellant under the cost-plus formula.
- The Israeli accounting standards require option grants to be recognized as an expense and this standard was used as well in the preparation of the Appellant's financial statements.

The Appellant alternatively argued that if the District Court determined that option expenses must be included in the Costs, then the option expenses should be deductible for tax purposes. The District Court rejected this argument and explained that the Appellant had chosen to apply the capital gain taxation route of Section 102 — which on the one hand provides a beneficial capital gains tax rate for its employees, but on the other hand does not allow a deduction for tax purposes. The Appellant did not select the employment income tax route under Section 102, which would have taxed the gains as employment income and allowed the Appellant to have a corporate tax deduction. The Appellant's election of the capital gain route was its own decision driven by economic reasoning it adopted at the time of the option grants, the District Court said, and the Appellant cannot later reverse its prior election. Therefore, the District Court held that no deduction for tax purposes was allowed for the option expenses.

Appellant's arguments before the Supreme Court

The Appellant made the following main contentions:

- The Appellant argued that the District Court's ruling requiring option expenses to be included in Costs contradicts Section 85A of the Ordinance, which allows the ITA to intervene in a transaction only if the pricing terms of the transaction deviated from the arm's-length standard determined under transfer pricing principles. The Appellant contended that since it provided transfer pricing documentation to the ITA based on comparable transactions between unrelated parties evidencing that it was customary to not include option expenses in Costs, the burden of proof showing that the Service Fee was not at arm's length had shifted back to the ITA, which failed to support its contrary position.
- Regarding the Service Agreement Amendment, the Appellant argued that the purpose of the amendment was only to clarify the original Service Agreement and not to make new changes. The Appellant argued that this is supported by the fact that the parties never included the option expenses in Costs even before the amendment was executed. Moreover, even if the parties' original intention was to include the option expenses, the parties had the right to agree to amend the Service Agreement in

order to exclude such costs in subsequent years.

- As an alternative position, the Appellant argued that if the option expenses must be included in Costs, the option expenses should be deductible for tax purposes in the year the options were granted. The Appellants contended that the capital gain route under Section 102 only disallows a deduction for the expense arising at the time of the exercise and sale of the underlying shares, while it may be argued that a deduction for the expense at the time of the grant should be permitted. Otherwise, requiring its inclusion in Costs for determining the Service Fee without allowing a corresponding tax deduction results in double taxation.

ITA's arguments before the Supreme Court

The ITA argued that the District Court ruling was correct in requiring the option expenses to be included in the Costs. The ITA contended that the Service Agreement Amendment was not a clarification but rather a change by the parties intended to reduce the Appellant's Israeli tax liability.

The ITA also argued that the Appellant's first transfer pricing study presented in the audit process in fact was supportive of the ITA's position that option expenses are to be included as operating expenses. The ITA contended that the Appellants later submission of a second transfer pricing study was based on methodology not relevant and the findings of this second report contradicted the findings set out in first report.

Since by not including the option expenses in the Costs the Service Fee income materially fell outside the interquartile range (4.5 percent–15.3 percent) as set in the Appellant's transfer pricing study, based on the rules of the Israeli tax regulations that address such deviations, the ITA argued that the cost-plus percentage should be adjusted upwards and set at the median of the comparable results (9.1 percent), rather than at the seven percent rate set in the Service Agreement. The District Court earlier had rejected this ITA contention to raise the percentage rate.

Finisar case

Background

In 2004, the Appellant and the Parent Company entered into a Service Agreement whereby R&D services were to be performed by the Appellant for the Parent Company in consideration for the Parent Company compensating the Appellant for all of its Costs plus a profit margin of two percent. The profit margin was increased to eight percent in 2007.

In 2005–2007, the Parent Company granted stock options to the Appellant's employees. The option plan for Israeli tax purposes was governed under the capital gain tax regime pursuant to Section 102 of the Ordinance (similar to the *Kontera* case).

In 2005, the Appellant and the Parent Company included the option expenses in the Costs in computing the Service Fee. However, the Appellant did not include the option expenses in the years 2006 and 2007. The Appellant deducted for tax purposes in 2005–2006 the option expenses, but no deduction was taken in 2007.

The ITA issued tax assessments for years 2005–2007, contending that the options expenses should have been included in the Costs in computing the Service Fee.

District Court decision

The District Court held in its decision of January 2016 that the Appellant should have included the option expenses in the Costs in computing the Service Fee under the cost-plus formula. The reasons given by the Court included, the following:

- The Appellant treated the option costs as an expense in its financial statements. The District Court explained that although the accounting treatment of costs does not necessarily mean the same should apply for tax purposes, in this case weight should be given to the accounting treatment since the Service Agreement expressly stated that the Service Fee is to be determined in accordance with generally accepted accounting principles.
- Similar to the *Kontera* ruling, the District Court held that although the options expenses are costs incurred in the Appellant's generation of income, they are not deductible for tax purposes further to the capital gain trustee route under Section 102 of the Ordinance.
- The District Court added that since the Appellant should have included the value of the options in the Costs, the Appellant's Service Fee was understated. Therefore, the District Court held that the Appellant should recognize deemed interest income on the difference between the Service Fee amount that the Parent Company should have paid to the Appellant and the amount that it actually paid to the Appellant. Imputed interest should be computed based on the Section 85A transfer pricing rules; therefore, additional tax should be assessed on this income.

Appellant's arguments before the Supreme Court

The Appellant made the following main contentions:

- The transfer pricing study submitted by the Appellant documented situations of companies that did not include the option expenses in the Cost basis. This was sufficient to shift the burden of proof onto the ITA, which (the Appellant argued) did not meet this burden. Therefore, the ITA should not be allowed to intervene in the parties' transaction.
- The value of the options constituted an indirect cost. According to Israeli transfer pricing rules, only direct costs that the Appellant pays should be taken into account when determining arm's-length compensation under a cost-plus formula.
- As the Appellant operates in a sector carrying high risk, it is possible that the employee options may end up having no value in being unrealizable; therefore, the options may not generate any income for the employees. Thus, as an alternative argument, the Appellant argued that the option costs in any event should not be included in Costs at least until such time that they are exercised and the employees generate profit.
- The District Court's ruling results in a double tax event. Firstly, the Appellant is being required to include the option expenses in Costs while at the same time not being able to deduct the option expenses for tax purposes. The second tax event is that the employees are being taxed on capital gain at the time they sell the shares exercised from the options.
- The facts that the option expenses were included in the Appellant's financial statements and that the Service Agreement stated that profits should be based on generally accepted accounting principles do not mean that the same treatment should apply for tax purposes.
- Since the Parent Company intended to bear the costs of the options, requiring these costs also to be included in the cost-plus formula results in a duplication of the costs to the Parent Company.
- Israeli tax law should give weight to the Service Agreement, which stated that Costs did not include option expenses.
- Regarding the secondary adjustment, the Appellant argued that even if there is a deemed understatement of the Service Fee, this should not be viewed as a loan from the Parent Company. Moreover, if option expenses must be included in the Costs, in any event the Appellant will be assessed for interest and inflationary linkage on the additional tax due to the ITA. Consequently, also requiring imputed interest income, which will result in an additional tax liability, would not be appropriate.

ITA's arguments before the Supreme Court

The ITA rejected all of the Appellant's arguments and requested that the Supreme Court uphold the District Court's ruling requiring that the option expenses be included in the Costs and that there should be a secondary adjustment.

The Supreme Court judgment

Overview

In the introductory section of its ruling, the Supreme Court provided a comprehensive overview of the objectives of transfer pricing rules and why they are important when there are related-party international transactions. The Court explained that for related-party transactions, there is an inherent concern that the pricing set by the parties may not be in line with arm's-length pricing due to a group's desire to achieve an overall beneficial tax result, especially for international transactions when parties are subject to different tax regimes. The Court provided an overview of the different methodologies set out in the Israeli transfer pricing tax regulations, including the Net Cost Plus Markup which was applied by the Appellants.

Burdens of persuasion, proof

The Supreme Court also provided an extensive discussion regarding (1) the burden of persuasion and (2) the burden of bringing proof, as set out in Section 85A of the Ordinance. The Court explained that under Section 85A, the taxpayer has the burden of persuasion to establish that the price and terms of its transaction were in line with the price and terms of the market. The Court rejected the Appellants arguments that the burden of persuasion rests on the ITA and not on the taxpayer.

The taxpayer in this first stage also has the burden of bringing proof. Therefore, if the ITA requests supporting documentation for a transaction and the taxpayer meets this burden of bringing the proof — i.e., it produces the required documentation and the transfer pricing study— then the burden of bringing the proof shifts to the ITA. The ITA then is required to support its position as to what should have been

the pricing and terms of the transaction at market terms.

However, if following the ITA's initial request for documentation the taxpayer did not meet its first burden of bringing the proof — i.e., the taxpayer did not succeed in establishing a market study that relates to similar types of transactions in an appropriate manner — then the burden of bringing the proof shall not transfer over to the ITA. This also means that the taxpayer will not have met the burden of persuasion imposed upon it under Section 85A.

In this regard, the Supreme Court upheld the findings of the District Court supporting the ITA, i.e., that the transfer pricing studies submitted by the Appellants did not support their positions. Even though transfer pricing studies were delivered to the ITA, they were not deemed sufficient to allow a transfer of the burden of bringing proof to the ITA. The Court emphasized that delivering documents in itself it not enough; rather, the documentation must sufficiently establish the claims of the Appellants that the price and terms of the transactions were set according to the price and terms that would be accepted when there would be negotiations between unrelated parties acting based on market considerations. The Court held that the Appellants did not satisfy this burden.

Inclusion of option expenses as Costs

The Supreme Court saw two main issues in the question of whether option expenses should be included in Costs when using a cost-plus compensation formula. The first issue, considered the principal question, is when from an economic perspective the option expenses should be viewed as a part of the integrated costs incurred by the Appellants in providing its R&D services. The second issue is whether unrelated parties entering into similar transactions customarily include the option expenses in the Costs under a cost-plus formula.

Regarding the first issue, the Court upheld the District Court's conclusion that option expenses meet the criterion of Section 17 of the Ordinance and should be classified as expenses incurred in the Appellants' generation of income. The Court stated that equity incentives such as options are a commonly accepted form of benefit-in-kind remuneration that incentivizes employees to work towards the success of their employer company. Therefore, the options were granted to the Appellants' employees to incentivize them to provide the best possible R&D services to their employer and also indirectly to the Parent Company, with the goal that the value of the Parent Company shares would increase in value as it succeeds. Therefore, from an economic perspective, the options were an expense in the Appellants' generation of income and should be viewed as a Cost for purposes of the cost-plus formula.

Notwithstanding the foregoing, the Supreme Court noted that the fact that option costs are included in the Costs does not in itself mean that the ITA may intervene in the parties' agreements as expressed for the transaction. Such intervention shall be allowed only in the circumstances in which a taxpayer did not meet the burden of persuasion to show that the price of the transaction, including the value of the options, was compatible with the customary market price in similar transactions. The Court stated, however, that the case at hand is among those situations in which the taxpayer did not satisfy the bringing of proof burden; consequently, in any event, it has not met the burden of persuasion, which rests on the taxpayer further to Section 85 of the Ordinance.

The Court explained that in both of the Appellants' cases, the thesis argued by the Appellants that the option expenses should not be included in the Costs was not compatible with the transfer pricing studies submitted by the Appellants, since the profit ranges of the companies that the Appellants requested to draw a comparison to in their case did take into account the value of the options. Therefore, for both Appellants, the Court affirmed the rulings of the District Court that the option expenses should be added to the Costs.

Observation: The Court did not directly address whether or not parties at arm’s length would share ESOP expenses but, rather, focused on the transfer pricing studies submitted by the Appellants. Further, it is unclear if the Court’s analysis would have been impacted if (i) the transfer pricing studies would have been presented after making appropriate economic adjustments for option expenses for the Appellants and the comparable uncontrolled companies presented therein; or, (ii) if it would be demonstrated in any other manner that not charging SBC is arm's length. Therefore, this raises the question of how the Court would rule if the factual situation, supported by the relevant analyses, is different than those of the Appellants.

With regard to *Kontera,* the Supreme Court accepted the ITA's appeal requiring that the cost-plus formula percentage should be increased to 9.1 percent rather than the seven percent set in the Service Agreement.

Deduction of option expenses for tax purposes

The Supreme Court stated that although the general deduction rule in Section 17 of the Ordinance generally allows costs incurred in the generation of income to be deductible for tax purposes, the special rule of Section

102 that disallows the deduction for option costs under the capital gain trustee route overrides the general rule. Furthermore, even if it can be argued that a deduction should be allowed under the Ordinance, this inappropriately would provide the Appellants with a double benefit: having gains from the sale of shares taxed to the employees at a special 25-percent tax rate, while also allowing the Appellants the benefit of a deduction of the option expenses. The Court viewed such an outcome as incorrect.

Secondary adjustment — imputed interest income

With respect to *Finisar*, the Supreme Court upheld the District Court's ruling requiring a secondary adjustment, and noted that the current trend in tax law also is to assess a taxpayer for imputed income. Although the District Court found that the transfer pricing rules of Section 85A should determine the amount of deemed interest income, the Supreme Court ruled that the imputed interest rate set under Section 3(i) of the Ordinance (regarding a taxpayer receiving a loan with interest at below-market rate) may be used for this purpose (e.g., the 2018 rate is approximately 3.5 percent).

Conclusion comment by the Court

In a final comment, the Supreme Court noted that the Appellants also had argued that the rulings of the District Court reflected tax policy that was not correct nor wise, and that such rulings might impede the development of the high-tech industry in Israel. The Court commented that its role is not to examine the wisdom of Israeli tax policy but rather to interpret the current laws and not to determine the law that is desirable for one taxpayer or another.

The takeaway

In recent years, the question of whether option expenses need to be included in Costs for a company providing services under a cost-plus basis remuneration formula has been a contentious issue in ITA assessments. This Supreme Court decision has upheld the two recent District Court rulings that required option expenses to be included in the Costs without any tax deduction allowed for the option expenses based on the specific facts in those cases, including the relevant transfer pricing analyses. The Supreme Court also has accepted the concept of a secondary adjustment being assessed when an Israeli company's revenue has been understated. Therefore, multinational companies with Israeli affiliates should review their factual circumstances and consider necessary steps that may be applicable.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing and International Tax Services – Israel

Doron Sadan, *Tel Aviv*
+972 (3) 795 4460
doron.sadan@il.pwc.com

Vered Kirshner, *Tel Aviv*
+972 (3) 795 4510
vered.kirshner@il.pwc.com

Transfer Pricing Global, Americas, and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
Americas Transfer Pricing Leader
+1 646 471 1957
horacio.pena@pwc.com

Paige Hill, *New York*
US Transfer Pricing Leader
+1 646 471 5192
paige.hill@pwc.com

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