Tax Alert: Cost-Plus Taxpayers? Amend Your Tax Return, or Else…

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Summary

On December 13, 2018, the Israeli tax Authority (the "***ITA***") issued a public letter (the "***Letter***") following a recent supreme court ruling, where employees' stock option expenses were deemed to be included in the pool of cost for cost-plus based taxpayers (e.g., R&D centers). The uniqueness in the Letter is that the ITA's demand from the relevant taxpayers to amend their previous years' tax returns so that such taxpayers' income will reflect the inclusion of stock-based compensation's expenses in the pool of cost. The Letter includes an explicit warning that the relevant taxpayers who will not amend their previous years' tax returns are exposed to not only higher income tax adjustments, but also to penalties, in certain cases.

Background

Although the accounting standards (FAS 123R, IFRS2, and the Israeli standard 24) classify stock-based compensation as part of the wage and salary expenses of a taxpayer, from the Israeli tax perspective, these expenses are not necessarily deductible. The Israeli tax rules enable companies, when granting their employees stock options, to choose between three tax tracks: (i) the trustee capital gain track;[1] (ii) the ordinary income track; or (iii) a non-trustee track. In general, the capital gain track levies a capital gain tax rate (25%) on the employee, once the options are exercised, but at the corporate level, these expenses are not deductible. In general, exercise, for purposes of the capital gain track, is the earliest of when (i) the employee receives the stock from the trustee or (ii) when the stock were sold.[2] On the other hand, the ordinary income track and the non-trustee track levy wage tax (up to 50% including social security and health tax), but the stock option expenses are deductible at the corporate level. The common practice in the technology industry is to choose the capital gain track.

For multinational enterprises, implementing the cost-plus (as referred in the Israeli transfer pricing regulations as the markup on total cost under the Comparable Profit Method (CPM or TNMM as referred in the OECD Transfer Pricing Guidelines) was a triple win: (i) from a management reporting, R&D centers are considered as cost centers' business unites, which derive their income solely from the provision of R&D services to another affiliate in the multinational group; (ii) from transfer pricing perspective these R&D centers usually do not own any intellectual property (IP) and therefore, the use of the cost-plus under the CPM/TNMM seems as the most appropriate method; (iii) from finance perspective the cost-plus provides fairly accurate forecasts and it is a simple method to monitor. Since there was no definite clear rule in Israel that stock-options expenses must be included in the cost-plus base, many companies took the tax position of granting stock options to their employees under the capital gain track and yet, excluding these accounting expenses in computing their cost-plus base income.

Eventually, this issue came into court. Kontera Technologies Ltd.[3] (Kontera) and Finisar Israel Ltd.[4] (Finisar) are both Israeli R&D centers of U.S. headquarter-based companies. Both companies

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[1] Pursuant to the Israeli tax law in Israel, in order for an employee to be eligible for the capital gain track, among other things, the options need to be deposited with a trustee, and the options need to be held with the trustee for at least 2 years from the grant date.
[2] Certain pre-ruling can be obtained from the ITA to defer the tax even further, in some cases of M&A or IPO.
[3] C.A. 974/16, Kontera Technologies Ltd. v. Pkid Shuma T"A 3.
[4] C.A. 1728, Finisar Israel Ltd. v. Pkid Shuma Rehovot.

implemented the wide spread transfer pricing model among R&D centers - the cost-plus model and granted their employees stock options under the capital gain track.

On April 2018, the Israeli supreme court ruled in favor of the ITA, and adjusted Finisar and Kontera's income to include the value of the stock options that were stated in their financial statement, for accounting purposes, even though such expenses are not deductible for tax purposes. As a side effect, the court also determined that the markup should be adjusted upwards, since the recorded profit, lacking the inclusion of the options expenses, resulted in a profit margin that was outside the applicable range. In addition, the court also increased Kontera's and Finisar's taxable income by determining a higher margin, equal to the median point as presented in Kontera's and Finisar's transfer pricing reports. The court accepted the ITA's argument that once the stock options expenses were added to the pool of cost, Kontera's and Finisar's recorded profit resulted in a profit margin lower than the arm's length range as presented in their transfer pricing reports, and as such, should be adjusted the median point in the range.

Impact

In light of Kontera and Finisar court rulings and the ITA's Letter, there are three main scenarios, relevant taxpayers should consider prior to amending their tax returns:

1. *Corporates to bear the additional tax burden*. Naturally, materiality considerations should be taken into account, but in certain cases, the tax impact can significantly increase the corporate's effective tax rate.

   Employees to bear the additional tax burden. Companies may change the track pursuant to which they structure their stock options plans and to use to the 'ordinary tax' track so the stock options expenses will be deductible for tax purposes. Such approach would result in a significantly higher tax rate on the employees, once the options are exercised. We note that such change cannot be executed retroactively, with respect to awards that have already been granted. However, for future plans and with respect to equity incentive plans that support the ordinary tax track (which most Israeli plans allow), companies may change their election from capital gain track to ordinary income track. Cost plus taxpayers, may also want to consider applying some changes, or reviewing their transfer pricing methods, to mitigate the tax burden. There are few alternative transfer pricing methods that need to be considered according to the specific facts in each case:

   a. ***Time & Material***. Based on the comparable uncontrolled price (CUP) method, where the R&D center's revenue is determined based on comparable hourly rates performed by its employees.
   b. ***Actual Cost.*** Also based on the CUP method, where comparable unrelated agreements are used, which compensate service providers only n their actual costs, plus a markup.
   c. ***Profit Split.*** Although R&D centers typical have no *legal* ownership in IP, backed by BEPS, taxpayers (and tax authorities) may imply that certain R&D centers may own economic IP.