PEARL COHEN

Venture Lending What You Need to Know

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Introduction

The recent frightening developments in the economy, which may be found to be exaggerated, concerns many in the high-tech industry. Companies are required to cut on costs, investors are sitting on the fence and waiting for the crisis to demolish their investments, creditors are starting to sharpen their sword, vendors are getting edgy on the credits they provided to their clients, lawyers are searching their ways back from the exit dream to the neon light – all-nighters office job, banks raising their interests rates, inflation is picking up, and the cost of living soars. Well, it is always a good idea to refer to cost of living, whether in economy spikes or economy downturns.

Recently, as investors fear for their investments and companies seek funds to continue to grow (or at least to keep them above water), we are facing a spike in the alternative financing vehicles – the debt financing.

Venture financing

While it is not a new tool, and it is a pretty common way to raise money, recently we experienced growth in the establishment of venture financing funds and venture funds that adopt hybrid investment tools (part debt part equity). In parallel, we experience a growing number of companies that are using venture financing, for variety of reasons.

The reasons for using venture financing vary. It avoids negotiating company's valuation (and it is not something most CEO's want to do these days), it saves the company from a potential down round (in downturn economy), and it provides investors with opportunities that are less risky than the traditional venture investment. Specifically, it puts the investors/creditors in a higher priority vis-à-vis the shareholders in case of liquidation, it provides the creditors with interest income, and, if the venture financing is structured properly, it provides the creditors with the opportunity to become a shareholder, if they want that, in better terms.

The tax issues that arise in venture financing are important, and often times are overlooked by borrowers. It is out of the scope of this circular to discuss how some companies found themselves in bankruptcy, or in liquidation, because of overlooked tax issues in venture financing. We will try to outline a few important issues to be carefully addressed in any venture financing, but there are many more that needs tax counsel attention.

Taxation of Interest in Israel

Pursuant to the Israeli tax law, interest paid by an Israeli resident (in this circular we will focus on Israeli companies) on loans is considered taxable income, and if the interest is paid to a non-Israeli lender, then the interest is considered as income sourced, and taxable to the foreign lender, in Israel.[1] Israeli tax law imposes tax on interest generated from loans, in various rates, which might be as high as the marginal tax rate. For example, interest paid to a "Significant Shareholder" (i.e., shareholder holding 10% of the corporation) is subject to the highest marginal tax rate (currently 47%) or as low as 15% for loan that does not bear linkage. Furthermore, there are some tax exemptions provided for interest; however, they are mostly unavailable when the loan is given to a corporation.

1 Section 4A(d) of the Israeli Tax Ordinance.

Thus, when a non-Israeli tax resident lends money to an Israeli company, the payment of interest will be taxed in Israel, by way of withholding tax, when the interest is paid. It should be mentioned that in dealing with convertible debt instruments, such as convertible loans, interest is accrued over the life of the instrument and when the instrument is ultimately converted (if converted) to shares, there is accrued interest that is treated as paid to the lender (by issuing the lender more shares to compensate for the accrued interest component); namely, the convention of the convertible instrument is deemed by the Israeli Tax Authority as a repayment of the loan principle and the accrued interest to the lender, and then the lender immediately uses this payment to buy shares in the company. Therefore, the withholding tax obligations is triggered at the convention.

Some relieves from Israeli tax on interest are available under Israel's tax treaties network. For example, under the U.S.-Israel tax treaty a reduce rate of 17.5% tax is imposed on interest, and lower rates available to U.S. financial institutions; under the UK – Israel tax treaty the withholding tax rate is limited to 15%; and under the Germany – Israel tax treaty the withholding tax rate is limited to 5%, with some exemptions to certain kinds of loans. However, as mentioned above, as the Israeli withholding system does not account for reduced tax rates, such relieves will only be available if the Israeli tax officer approves the reduced tax rate via a withholding certificate.

Gross up of Israeli Taxes

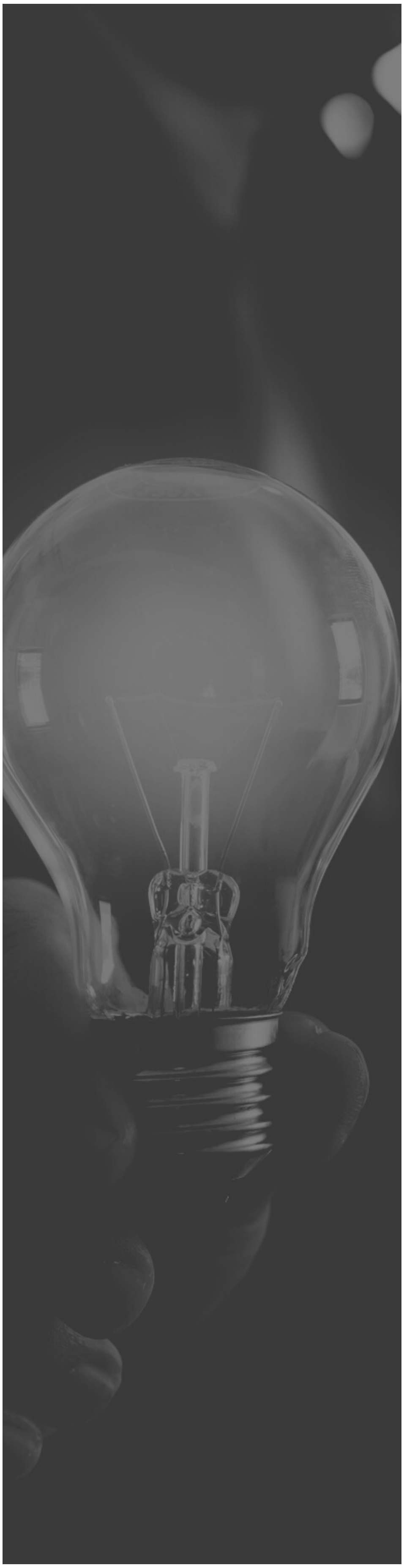
The withholding tax imposed in Israel on interest payment reduces the return on the investment for the lenders and therefore lowers the attractiveness of such instruments to foreign lenders.[1] Therefore, many foreign lenders require, and the borrowers agree, to "gross up" any withholding tax that is imposed upon repayment, so that the tax is actually being born by the borrowing company rather than the lender, and the lender becomes indifferent to the Israeli tax consequences.

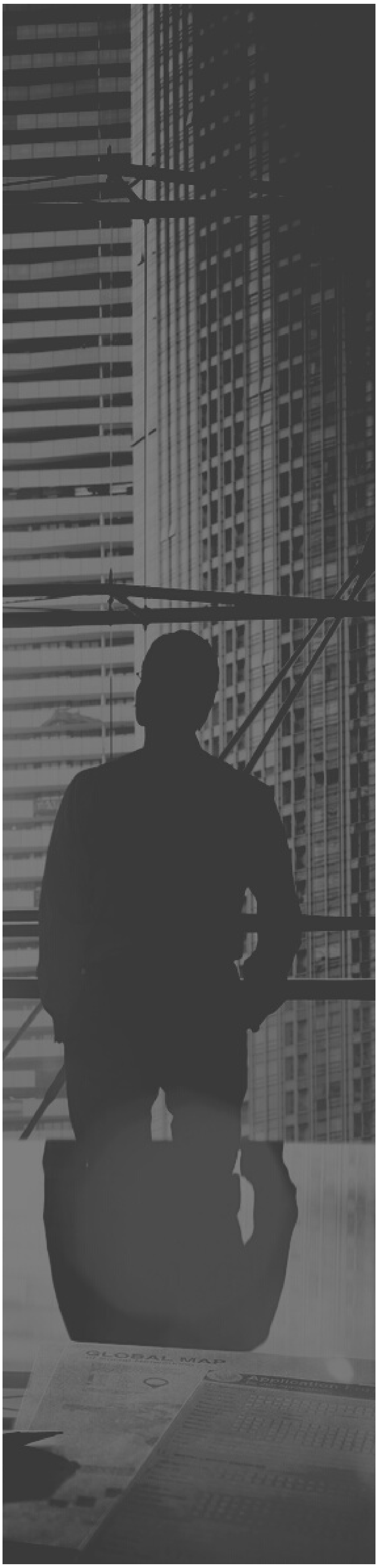
In essence, the gross up mechanism increases the cost of the loan to the borrower since the borrower needs to pay the tax on the interest and the overall amount of the loan will have to be increased to account to such payment. For example, if an Israeli company borrows USD 1 million for one year, with an interest rate of 10% per annum, then by the end of the year, it will have to pay back the lender USD 1 million as the principal and an addition $100,000 as interest for a total of USD 1.1 million. When making the payment, the company must withhold tax form the portion of the interest at a rate 5% (treaty reduction), making the actual net payment to the lender come up to $1,095,000. The $5,000 is then remitted the Israeli Tax Authority.

[1] We note that the United States exempts certain non-US lenders from tax in the U.S. on certain "portfolio interest." Germany exempts (very generally) non-German residents from tax on interest sourced in Germany.

However, if a gross-up mechanism is implemented, then the net payment to the lender will be USD 1.1 million (since the interest is paid in full without any deduction) and the company has to increase the overall payment by an amount that after deducting it for withholding tax peruses, will leave a net payment of USD 1.1 million. In our case in order for the lender to receive $100,000 net interest, the company's withholding amount is $5,265 (and not $5,000). This way, a payment of $105,265 as interest payment with a withholding tax are of the 5% comes out to a net interest payment of $100,000 and allows for a net payment of $1.1 USD to the lender, as if no withholding tax was imposed.
Consequently, the gross up mechanism, makes the loan more expensive to the borrower; not only does the borrower have to bear the cost of the original withholding tax ($5,000 in our example), because the overall payment is increased, the amount by which it has increased is also part of the interest payment, and thus, subject to withholding tax, which increases further the cost of the tax.

Since the gross-up mechanism can be very costly to borrowers, and since many lenders condition the loan on a gross up of the taxes, one of the major considerations to consider when agreeing for a gross up feature is the interest withholding tax rate; namely, if the lender is a non-Israeli tax resident, then it might be eligible for a relief under a tax treaty. Accordingly, the borrower may apply to the Israeli Tax Authority for a reduced withholding tax rate. That way the borrower can reduce the loan cost, while the lender is indifferent since it received the same net payment.





It also demonstrates the impact the residency state of a lender. For instance, if an Israeli borrower receives a loan form a German lender, it can theoretically reduce the withholding tax rate to 5% instead of the default 25% and thus reducing the cost of a gross up mechanism by 80%, making the financing by way of a loan from a German lender much more attractive than a loan form a lender that is a tax resident of a country that does not have a tax treaty with Israel, or a lender that is a tax resident of a country that has a less favorable interest provision in its tax treaty with Israel.

Needless to say, that the terms of the financing loan, including any gross up mechanism, are set in the loan agreement, giving both sides certainty as to the allocation of the risks involved in the loan, and in this context the overall cost of the loan to the borrower (including gross-up costs).

Gross Up and Loan Assignment

Another aspect that is often overlooked by Israeli borrowers that seek financing from non-Israeli resident and that agree to a gross up feature is the impact of the ability of the lender to transfer or assign the loan to another entity.

Many venture lending firms or venture lending fuds, bundle loans and sell them to other debt funds. Thus, it is customary to find an assignment provision in loan agreements, allowing the lender to assign its rights and obligation under the loan agreement to a third party. Such provision allows the lender to sell the loan and transfer it to third parties. Usually, the assignment of the loan to a third party does not entail any changes to the terms and conditions of the loan, and therefore, the borrower should be indifferent. However, if taxes are grossed up, such an assignment might increase the cost of the loan to the borrower.

For example, an Israeli borrowing company might agree to a gross-up feature, because the rate of withholding applicable to the lender is 5%. If the lender assigns the loan to a Caman Island lender, a country with whom Israel has no tax treaty, or even to a U.S. or UK lender, then, the cost of the gross-up increases dramatically (Because there is no withholding reduction available to interest paid to a Cayman Island resident then the withholding rate increases to 25%, (or in the case of a U.S. assignee – 17.5% and for a UK assignee - 15%) which means that the gross-up becomes tremendously high compared to what the borrower expected when receiving the loan and agreeing to the gross up. It significantly adversely affects the borrower, that it might not have agreed to a gross up feature, had it known that the cost will be as high.

Accordingly, it is recommended that when an Israeli borrower considers taking a loan from a non-Israeli tax resident and agrees to a gross up mechanism, it should limit the amount of gross up cost by limiting the rate of tax to be subject to the gross-up feature. This will ensure that cost of the gross up will not exceed its anticipated cost due to assignment of the loan agreement to third parties.