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Client Alert

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Israeli "Cost Plus" Dilemma – Several Suggested Solutions

As you may know, in the last year the Israeli Tax Authority has won three major court cases on a transfer pricing issue relating to equity awards. The courts generally upheld that Israeli subsidiaries which are remunerated by their parent company on a "cost plus" basis must include the stock-based GAAP expenses in the cost basis, but cannot deduct the same expenses for tax purposes.
Two of the three cases are up for appeal in November, with the appellants petitioning the Supreme Court to change the ruling of the lower courts. However, in the likely event that the decisions will be enforced by the Supreme Court, every Israeli R&D subsidiary which grants options or RSUs under the capital gains track to its employees, will be required to charge its parent company for the equity award expenses, without the ability to deduct an expense for tax purposes. This is already creating excess Israeli tax liabilities for multinationals.

Following these rulings, several solutions have been proposed as a mechanism for mitigating the Israeli tax issue explained above. Three possible courses of action are suggested below:

a. Replace "Cost Plus" intercompany agreements with hourly fees:

Assuming that the subsidiary carries out R&D, customer support, marketing services etc., the Parent could reimburse the subsidiary for its services based on a per-hour charge (calculated on the basis of actual time spent, or based on a monthly retainer). The relevant details of the arrangement should of course be backed up by a transfer pricing study, and can be adjusted for relevant criteria (i.e. seniority of the developer, skills, etc.). Implementing this type of intercompany agreement would cause the costs of the subsidiary to no longer be relevant in determining its taxable income, thus alleviating the tax issue caused by the courts.

b. Grant ordinary income track awards to Israeli employees:

Under the ordinary income track, the awards must be deposited with a trustee for a minimum one year holding period. The employee will be subject to ordinary income tax when the underlying shares are sold, and the local subsidiary will be eligible to receive a deduction for tax purposes. The amount of the deduction is equal to amount of income taxed in the hands of the employee, provided that the cost of the award is charged back to the issuing company. Also, if the employee sells the underlying shares before the one-year holding period has elapsed, some of the deduction may be disallowed.
The use of ordinary income awards by "cost plus" subsidiaries can be advantageous, even though there may be certain timing issues –the cost is recorded at grant and vesting but the deduction will only be allowed in the year when the shares are sold; in addition, from an HR perspective, there is a disadvantage for Israeli employees which will likely wind up paying more tax than under the capital gains track.

c. Transfer the IP to the Israeli subsidiary:

The Israeli government has recently announced that it intends to grant tax benefits to multinational companies which transfer IP into Israel. The idea is to have the R&D subsidiaries in Israel own all or part of the group intellectual property (patents, copyrights, software licenses), resulting in part of the group's income from its products moving to Israel. In other words, the intent is no longer

for the Israeli company to provide services to other group members, but to record income from either end customers or intercompany royalties.

The proposed legislation, which is in very initial stages, states that a company which earns preferred income from IP it owns (such as royalties or income from sales or SaaS), will be eligible for very low corporate tax rate (6% or 12%) and that dividends to a foreign parent company will be subject to a reduced 4% or 5% rate.

Also, if the IP is sold to the Israeli subsidiary, then the purchaser can amortize the cost of the IP over eight years, thus reducing the effective Israeli income rate to a minimum.

Although the proposed bill is very complex and many of the provisions are still unclear, we believe that the proposal could present a lucrative planning opportunity for deliberating their global IP tax strategy in light of the BEPS recommendations. We will fill you in with additional information as it becomes available.

This client memo is intended to provide general information and should not be viewed as tax advice.

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