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# Israel Tells Firms to Amend Tax Returns for Stock Options

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By William Hoke

The Israel Tax Authority (ITA) has issued letters informing companies they must amend prior tax returns to comply with a Supreme Court decision earlier in the year on the taxability of employee stock options.

In April, the Supreme Court rejected two related challenges to the ITA's authority to require the inclusion of stock options in the cost base for intragroup research and development services (*Kontera Technologies Ltd. v. Assessing Officer Tel Aviv* (CA 943/16) and *Finisar Israel Ltd. v. Assessing Officer Rehovot* (CA 1728/16)). The taxpayers in each case had applied the comparable profits method — the equivalent of the OECD's transactional net margin method — using the markup on service costs as the profit-level indicator without including the value of stock-based compensation (SBC) in the services cost base.

*Calcalist*, a financial newspaper in Israel, reported December 23 that the ITA recently sent letters to Israeli subsidiaries of multinational companies advising them to amend their tax returns to bring them into line with the *Kontera* rulings, as the April court decisions are collectively known. *Calcalist* said the letter warned companies failing to amend their returns that they could end up paying higher taxes on audit, as well as possible fines and penalties.

Yuval Navot, a tax lawyer with Herzog, Fox & Neeman, said he couldn't recall any other case when the ITA advised companies to file amended returns after a Supreme Court decision. Boaz Feinberg, a tax lawyer with Zysman, Aharoni, Gayer & Co., agreed. "Usually, following a Supreme Court decision, the ITA would send a circular with interpretation as to the outcome of the decision, but I must admit that this is the first time I [have] seen a notice reminding companies to amend their tax returns," Feinberg said.

Navot, who wrote an analysis of a lower court decision on the *Kontera* case for *Tax Notes*, said the ITA's position on filing amended returns to deal with the SBC issue is not clear and could entail legal difficulties. "There are some parameters that should be taken into account, such as the tax returns' submission date relative to the District Court or Supreme Court rulings, whether the returns provided any disclosure regarding non-inclusion of SBC costs in the cost base, and whether or not the company was audited or is currently under an audit," Navot said.

Companies that do file amended returns should consider amending prior years' accumulated increases in net income because of the SBC inclusion in the next tax return to avoid restarting the statute of limitations period for past years for which returns were already filed, Navot said. "In such amended returns the possibility of corresponding tax deductions should be considered, which is available mostly to public companies that offered [restricted stock units] or restricted shares to Israeli employees," he said. "Publicly traded companies may be eligible for a tax deduction that fully or partially corresponds to the SBC income inclusion, provided that the parent company charged the Israeli subsidiary for the cost of the SBC."

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It may also be possible in the amended returns to consider SBC that did not ultimately vest either for employees who did not complete their required work term or when benchmark financial results were not satisfied, Navot said.

In the *Calcalist* article, the newspaper quoted a tax lawyer who said the ITA's demand that past tax returns be amended is not legally valid before the Supreme Court's decision was published. Feinberg said his interpretation of the lawyer's comment is that the legal status of the issue changed with the Supreme Court's decision and that the ruling should not be applied retroactively.

Feinberg said he doesn't agree with that position because the Supreme Court had ruled in an earlier case that its decisions apply retroactively unless there was a valid claim of reliance on a previous legal status that was in effect at the time a return was filed. "In [this] situation — and it is emphasized in the ITA's notice — the legal status that was confirmed by the Supreme Court was the ITA's original [position] on the situation, which was published and known to all taxpayers and their advisers," Feinberg said. "This could have been different — and [applied] only prospectively — if there was a previous reverse precedent that taxpayers could have relied on. But, [for] this issue, this is not the case."

Navot said the ITA warned companies that fail to amend their tax returns that they could face a higher "plus" margin based on the median within the interquartile range. "In a cost-plus methodology, taxpayers are not required to adhere to the median within the interquartile range and thus companies that will amend their tax returns may select a lower margin," he said. "On the other hand, there is no guarantee that the amended tax returns will not be challenged by the ITA."

While the ITA's letter does not expressly address tax aspects of the so-called secondary adjustment arising from the increase of taxable income to the Israeli subsidiary, Navot said the potential impact of such an adjustment should be considered by companies filing amended tax returns. "The secondary adjustment may normally be treated as either a deemed dividend from the Israeli subsidiary to its non-Israeli parent triggering Israeli withholding tax or, alternatively, as a deemed loan from the Israeli subsidiary to its non-Israeli parent resulting in accrual of interest income by the Israeli subsidiary due to the deemed interest," he said. "In the *Kontera* case, the ITA agreed with a deemed loan as a secondary adjustment."

Navot said the ITA will most likely waive penalties for companies that file amended returns to comply with the *Kontera* decision.

Feinberg said the ITA's letter put companies on notice that they could face stiff fines if they don't file amended returns. "The notice stipulated that a company that would not file an amended return may have fines imposed on it," he said. "Nothing in the notice is leading [anyone] to believe that the ITA would give any kind of special treatment to a company that would file an amendment."

The ITA's notice specifically says that a company that doesn't file an amended return might be hit with a special "deficit penalty," which could equal between 15 percent and 30 percent of the increased tax liability, Feinberg said.

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