



Tax Update

August 2016

New ITA Ruling Regarding Taxation of Holdback Payments and Reverse Vesting Mechanism
in the Context of Mergers & Acquisitions

Dear Clients and Colleagues,

We write to inform you that the Israeli Tax Authority (the "ITA") has recently published a draft circular ("**Draft Circular**") on the tax treatment of holdback payments and reverse vesting mechanism in the context of merger and acquisition transactions.

According to the Draft Circular, subject to certain conditions as will detail below, the sale of shares to which holdback payments and reverse vesting mechanisms apply would be subject to a capital gains tax rate of 25% (30% in case of controlling shareholders). This is in contrast to the ITA's previous position which attributed consideration for continued employment of founders and key employees as employment income taxable at a marginal rate (up to 50%).

The following is a summary of the conditions set out in the Draft Circular:

Reverse Vesting

In general, the mechanism aims to ensure that founders and key employees of a company will continue to work for the company and act for its benefit by imposing restrictions on their shares for a certain period of time, which restrictions shall be removed (in stages or at one time), subject to their continued employment with the company. The following summarizes the conditions that were set out in the Draft Circular which, if fulfilled, will result in the classification of the sale of the shares under the reverse vesting mechanism as a capital gain and not as employment income:

1. The mechanism was established in advance and in writing at the time of incorporation of the Company (or near such date) and/or as a result of a substantial investment in the company (an investment of at least 5% of the company's issued shares following the investment).
2. In the event of exercise of the mechanism, the agreement provides that only the company and/or the other shareholders of the company are entitled to purchase the shares from the selling founder/key employee for no consideration or for their par value, all as agreed in advance and in writing on the date of the signing of the agreement.
3. The shares of the founders/key employees are classified as equity and are ordinary shares which entitle the holders to the same rights as the other holders of the company's ordinary shares, and the gain from the sale of which would be classified as a capital gain.

Holdback Consideration

In general, holdback consideration is a mechanism in which part of the consideration from the sale of the founders/key employees' shares shall be paid to them in stages during a defined period of time following the closing date of a transaction, subject to their continued employment with the company.

The following summarizes the conditions that were set out in the Draft Circular which, if fulfilled, the consideration paid to the founders/key employees pursuant to the holdback arrangement that is part of the share purchase transaction will be classified as capital gain and not as employment income:

1. The shares of the founders/key employees are classified as equity and are ordinary shares which entitle the holders to the same rights as the other holders of the company's ordinary shares, and the gain from the sale of which would be classified as a capital gain.
2. The founder's/key employees' held the shares that are being sold in the transaction for at least 6 months before the signing date of a transaction agreement.
3. The holdback consideration is not additional consideration to the consideration set in the transaction but, rather, an integral part of the consideration for the company's shares, and the price paid for them is the same as the price per share paid to the other shareholders.
4. The founders/key employees enter into a new employment agreement that will come into effect no later than the closing date of the transaction; or continue to work under their existing or amended employment agreement under which they will receive an appropriate salary that is not lower than their salary before the closing of the transaction.
5. The acquiring company shall attribute the holdback payment in its financial statements as a payment for the acquisition of shares in the framework of the transaction (and not as an employment salary payment), and it will not claim the holdback payment as an expense for tax purposes.
6. The founders/key employees shall report the sale of their shares and, to the extent that the consideration is paid entirely in cash, they will pay a full tax advance for the entire consideration (including the holdback consideration). If, ultimately, the founders/key employees do not receive a portion of the holdback consideration, they will be entitled to amend their tax returns and receive a tax refund. In transactions in which the shareholders' consideration is, in whole or in part, in shares or in other rights, various tax deferral mechanisms under the Income Tax Ordinance may apply.
7. For the removal of doubt, the company, its shareholders, the founders/key employees will not be permitted to claim any expenses pursuant to the holdback mechanism including for professional fees.

It should be noted that if the share price paid to the founders/key employees is higher than the share price paid to other entitled shareholders of the company (excluding interest or profits of the holdback consideration), such difference will be subject to employment income taxable at a marginal rate (up to 50%).

Please contact us with any questions regarding the foregoing.

Sincerely,

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