

NEWSLETTER – OCTOBER, 2011

ADDITIONAL FAST TRACK APPLICATIONS FOR CAPITAL GAINS TRACK EQUITY GRANTS

The Israel Tax Authority (ITA) has recently published two additional application forms for “fast track” approval in connection with options granted under the “capital gains track” defined in Sections 102(b)(2) and (3) of the Israeli Income Tax Ordinance (ITO) with respect to:

- **Repricing Options**
- **Net Exercise of Options**

This is in addition to the existing “fast track” application available for grants of RSUs under the “capital gains track”.

Re-pricing Options

The reduction of the exercise price of an “out-of-money” option, or the exchange of such an option for a new option with a lower exercise price, is generally deemed to be a new grant for the purposes of Israeli taxation, with the exchange or termination of the existing grant triggering an immediate tax event, to the extent that such grant is vested on the date of exchange or reduction in exercise price. In order to avoid triggering an immediate tax event in such circumstances, it is established practice to request a ruling from the ITA.

The fast track application is intended to expedite the process of obtaining pre-approval from the ITA to implement the re-pricing. Curiously, the fast track application form refers solely to the circumstances of reduction of the exercise price, and not the exchange of existing option for new options, which on a substantive tax level leads to the same result. It is unclear at this stage whether this omission was deliberate or if the ITA intended that the fast track form will apply to both alternative practices for re-pricing options.

Net Exercise

The ITA has consistently maintained the position that implementation of a “net exercise” mechanism for exercise of options granted under the “capital gains track” requires a pre-ruling to confirm compliance with the requirements of the “capital gains track” in order to confirm the proper tax treatment in light of the fact that the “netted out” options are being substituted for the actual payment of the options’ exercise price.

The fast track form standardizes and simplifies the application process, **but may be used solely for companies**: (a) that are resident in Israel, (b) whose shares are publicly traded and (c) whose equity plan provides for a net exercise mechanism. As a result, it appears that the availability of the “fast track” in this instance will be limited to Israeli public companies whose plans permit a net exercise, and will not be available to non-Israeli companies who make grants to Israeli employees under a compliant “capital gains track” plan.

The net exercise arrangement is intended to arrive at the same tax result as if the employee had actually paid the exercise price and received a larger number of shares. However, the fast track application provides that in the event that the underlying shares are not sold within 10 days of the net

exercise (or the *later* of 10 days of the net exercise or completion of the 24 month trust period, in the event of an exercise following termination of employment), the calculation of both the capital gains and employment income components of the gain will be less favorable.

With respect to both forms of fast track application, the ITA has clarified that the tax arrangement will only come into effect upon issuance of an actual approval by the ITA. In our discussions with ITA officials, the officials indicated that applications for fast track approval may be followed by a request from the ITA for a meeting with the applicant's advisors. If this proves to be the actual *modus operandi* of the ITA, the practical significance of a fast track application process will, unfortunately, be limited.

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Please direct any queries you may have regarding issues relating to equity grants to:

Ben Sandler

bens@arnon.co.il

+972-523-665219