



**YIGAL ARNON & Co.**

L A W F I R M

## Legal Update – Tax – Reverse Vesting and Holdback Arrangements - New ITA Draft Circular (August 2016)

On July 12, 2016, the Israeli Tax Authority (the "ITA") published a Draft Circular (the "**Draft Circular**") which sets forth its position regarding the application of capital gains treatment with respect to the sale of shares that are subject to the so called "reverse vesting" or "holdback" arrangements.

### Reverse Vesting

#### The Mechanism

In general, in order to incentivize a founder to remain involved in a company, it is a common practice to have the founder enter into an agreement, under which the founder's shares in the company are subject to repurchase by the company (or other founders) if the founder ceases his or her involvement in the company within a specified number of years. The shares may also be subject to other limitations and restrictions that are removed gradually over the time of the founder's involvement in the company. This right of repurchase and imposition of restrictions is known as "Reverse Vesting". Prior to the issuance of the Draft Circular, there were concerns that the sale of shares that were at any time subject to Reverse Vesting would be taxed at ordinary income tax rates.

#### Tax Arrangement

The Draft Circular clarifies that the proceeds of a sale of shares that are or have been subject to Reverse Vesting (whether such shares were subject to sale to a third party, the company or other shareholders) will be taxed as capital gains (as opposed to ordinary income), if the following conditions are met:

- a. The Reverse Vesting mechanism was put in place in advance and in writing at the time of incorporation of the Company (or close to such time) and/or in connection with a substantial investment in the Company (for this purposes a substantial investment is regarded an investment in which the company issues shares comprising at least 5% of its issued share capital (post issuance)).
- b. In case where the "reverse vesting" mechanism is triggered, the agreement provides that only the company or the other shareholders may purchase the shares from the selling founder/key employee, and they may only do for no consideration or in consideration of the shares' par value.
- c. The shares 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.

### The Mechanism

This mechanism is designed to preserve key employees of a target company following an acquisition. For that purpose, the purchaser may often wish to hold a portion of the consideration paid to such key persons for their shares, and consequently make payment of such portion contingent on the person's continued employment over a period of time. Prior to the Draft Circular, there were concerns that such mechanisms resulted in ordinary income treatment on the payment of the "held back" consideration since such payment was contingent on the continued employment of the key employee.

### Tax Arrangement

The Draft Circular clarifies that consideration paid to a former founder or key employee pursuant to a holdback arrangement that is part of a share purchase transaction will be subject to capital gains treatment up to the share price, if the following conditions are met:

- a. The shares 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.
- b. The shares which are being sold as part of the transaction have been held by the founder (or other key person) during a period of at least six months prior to signing of the transaction.
- c. The consideration paid under the holdback arrangement is an integral part of the consideration paid for the shares (as opposed to additional consideration) and is based on the value of the company as agreed among the parties.
- d. The price per share paid to the founders or key employees is equal to the price per share paid to the other shareholders holding the same class of shares. If the price per share paid to the founders or key employees is higher than the price per share paid to the other shareholders, the excess will be considered employment income and will be taxed accordingly.
- e. The founders or the key employees enter into a new employment agreement or continue their employment under an existing or amended agreement, under which they will be paid adequate compensation for their employment that may not be lower than their compensation prior to the transaction. Such payment must be in addition to payment for the shares.
- f. The holdback payment is recorded in the purchaser's financial statements as a consideration for shares rather than as salary. The purchaser shall not claim such payment as an expense for Israeli tax purposes.
- g. The founders are required to report the sale of their shares to the ITA and to pay the tax with respect to the entire consideration paid for their shares, including the amount that is being held-back by the purchaser. If the holdback consideration is eventually not paid to the founders, then the ITA would refund the relevant portion of the tax plus interest and linkage differences.

**Our tax department has a wide experience handling, planning and advising on matters relating to the issues discussed above. For further information please contact Ofir Levy ([ofir@arnon.co.il](mailto:ofir@arnon.co.il)) or Eran Lempert ([lempert@arnon.co.il](mailto:lempert@arnon.co.il)) from our tax department.**