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Q&A

Please provide a brief overview on how an ESOP in a start-up is usually structured in your jurisdiction (of particular interest: virtual or real participation programs, market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights).

General

ESOP in Israel is extremely common practice. Most high-tech and startup companies attract their employees (and talent) by providing lucrative equity incentives in the form of options, RS or RSUs under an ESOP. On the side of employees and officers, equity packages are a major consideration for employment in startup and high-tech companies, and in recent year 'traditional industries' are starting to implement similar plans in order to attract talent.

Section 102

Due to its widespread use, Israeli legislators have provided three decades ago a specific legislation to address incentive plans for employees under the Israeli tax ordinance – also commonly known in Israel as "Section 102". If a company adopts an incentive plan for its employees and officers under Section 102 (and follows the specific rules thereunder), the employees and officers will be entitles to preferential capital gains tax treatment once they sell their shares.

Therefore, Israeli companies usually adopt a Section 102 Plan ("102 Plan"), which provides for real equity in the company (option or shares).

I will provide some more details regarding the Section 102 process, benefits and limitations below.

Vesting

It is common practice for options to have a vesting period of 3-4 years, with a 1 year 'cliff' (followed by monthly or quarterly instalments).

Exercise price

In private companies, there is no FMV requirements for exercise price (for Israeli employees and officers). It is not uncommon to provide options with $0.01 exercise price, after the company has been valued with a much higher PPS. With publically traded companies, the value is at least the FMV.

Rights.

Before conversion of the options, option holders have no rights as equity holder.

Once the grantee converted options under the 102 plan ("102 Options" and "102 Shares", respectively), they are held by a special trustee ("102 trustee") and all voting rights are given by way of POA to a company position (usually the chairman of the board). In effect, the 102 Shares are mere economic value incentives. 102 Shares are entitled to dividend and benefit from an exit/M&A as all other shares.

It is extremely uncommon for 102 Shareholder to be entitled to preemptive rights, ROFR/O or similar rights (except tag along). This is usually covered under the articles, that provides for a specific threshold % that entitles only major shareholders (3-5% and up) to such rights.

Termination of Employment

In case of termination of employment, most grantees have 3 months to decide if to exercise the vested options. If they do not, the options terminate.

Please provide an overview of the respective tax situation an employee finds him-/herself in when he/she participates in a real/virtual equity investment program (applicable taxes and approximate tax burden (a) at the time of the investment and (b) at the time when revenues therefrom are received).

Options/Shares granted to grantees under the 102 Plan (capital gains track) allow grantees to benefit from a capital gains tax of 25% instead of income tax that can reach up to almost 50%.

In order to be entitled to the benefits of a 102 Plan reduced tax rate:

- The company must adopt a plan and approve it with the tax authorities (automatic approval within 30 days of submission).

- The company must appoint a special 102 trustee to holder the options/shares (that ensure the tax payment in case of sale/dividend).

- A block period applies to the options/shares of 2 years from the date of grant, and if

such clock period is breached (expect in case of drag-along/exit), the 102 shares lose their beneficial tax treatment.

- All grants must be notified to the tax authorities 45 days from approval by the board.

102 Options/Shares are only taxed when they are transferred from the 102 Trustee (usually this happens only in case of an exit).

All other grants not under Section 102 are deemed as income tax.

Are there any tax advantages for an employee if the revenues based on the equity investment are reinvested in start-ups or other companies?

There are no tax benefits for ‘investor founders’. The tax rate is fix 30% (or 25% if the individual holds less than 10%) on the profit of the founder (upon dividend or sale), like any other individual investor.

Are there any tax advantages for the company if an ESOP is established in the company?

No.

Please highlight one pro and one con of the legal set up with regard to ESOPs in your jurisdiction.

Pro: Incentivizing employees with capital gains in case of exit (rather than income tax).

Con: Lockup period of 2 years effects early exits.