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## **Israel Tax Authority Draft Circular – Attribution of Income to R&D Centers and New “Safe Harbor” for Knowledge Transfer Following an Acquisition by an International Group**

### **Client Updates**

On February 27, 2025 the Israel Tax Authority (the “**ITA**”) published a draft policy circular (the “**Circular**”) regarding the attribution of income to R&D centers in Israel.

According to the ITA, the Circular is designed to remove barriers for multinational high-tech companies operating in Israel and to attract new companies to the country. The goal is to increase tax certainty, providing a clear and consistent framework for the taxation of companies. The Circular applies to both multinational companies currently operating R&D centers in Israel and those planning to establish new centers through the acquisition of Israeli companies.

The Circular is open for public comments until March 23, 2025.

### **1. Guidelines on Attribution of Income to R&D**

#### R&D Centers Covered by the Circular

The Circular addresses the circumstances under which an Israeli company provides R&D services to an affiliated company outside of Israel, with compensation based on the profitability margin method (setting a margin based on expenses), where the Israeli company is compensated for all its costs plus the margin.

The Circular applies under the following conditions:

- The ultimate parent company is a foreign company, a resident of a treaty country, holding (directly or indirectly) both the Israeli company and the company receiving the services.
- The income and activity of the Israeli company are limited to providing R&D services, with no other activities or assets unrelated to R&D services, particularly intellectual property.
- The income from providing R&D services qualifies as preferred income under the Encouragement of Capital Investment Law, and the company meets the requirements for reduced tax rates.

The Circular outlines internal procedures regarding how the ITA will handle assessments for companies managing such R&D centers. Notably, it specifies that if the ITA wishes to apply a different transfer pricing method, it must obtain approvals from senior officials within the Tax Authority before raising the issue with the taxpayer and before issuing assessments at various stages of the audit. Furthermore, for groups with

annual revenues exceeding 10 billion NIS, approval from the Director of the Professional Division is required at the early stages of the assessment process, and the approval from the Director of the Tax Authority is required in later stages.

#### Private Tax Rulings Regarding Compensation for R&D Services with Limited Risk

A company that meets the conditions outlined in the Circular, as mentioned above, may request an advance tax ruling stating that the price for R&D services provided to an affiliated party is in line with market terms. If the Tax Authority determines that the proper method for income attribution should be based on profit splitting, a tax ruling will only be issued after obtaining approval from the Director of the Professional Division.

#### APA Arrangements

The Circular highlights another tool available to taxpayers - the possibility of initiating an Advance Pricing Agreement (APA) procedure. This Process aims to reach an intergovernmental agreement regarding transfer pricing, combining agreements between treaty countries with the tax network of the taxpayers. The Professional Department of the Tax Authority encourages taxpayer to consider this route when necessary, as it offers an additional way to gain certainty regarding the pricing of R&D service transactions.

### **2. Private Tax Ruling for Israeli Company Acquisition by an Internal Group, IP Transfer, and Limited Risk R&D Services**

The Circular introduces a "safe harbor" mechanism designed to allow an Israeli company acquired by an international group to transfer its intellectual property outside of Israel and transition to providing limited-risk R&D services. This process is subject to receiving approval from the Tax Authority regarding the transfer pricing method, margin rate, and compensation of the sale of the IP.

This mechanism, which aims to provide tax certainty during the knowledge transfer, is relevant under the following conditions:

1. The acquired company, prior to the acquisition, operated as a preferred technological enterprise under the Encouragement of Capital Investment Law, with technological income, and held qualifying intellectual property.
2. The funds used to acquire the company must come from outside of Israel or from profits subject to Israeli tax. The acquisition must be financed by the acquirer's own equity.
3. The ultimate parent company and/or significant shareholders in the parent company must not be significant shareholder in the acquired company prior to the acquisition, and vice versa.
4. The Israeli company must sell all its rights to the IP within 30 days of the acquisition of the shares in the acquired company.

5. The acquired company must continue providing R&D services to the acquiring company for the ongoing development of the sold IP for the entire duration of the approval period.
6. The value attributed to the sold IP must be at least 85% of the transaction value in the share purchase deal, which includes payment for other rights, additional liabilities, and bonuses to employees, adjusted for cash and cash equivalents, and including tax implications.
7. The workforce size and labor costs related to providing R&D services after the IP transfer must not decrease by more than 20% compared to previous years, during the entire approval period.

A company that meets the cumulative conditions of the Circular may request a private tax ruling from the Transfer Pricing and Valuation Departments within the Professional Division of the Tax Authority. This ruling will confirm the market conformity of the margin rate and the compensation for the IP, for a period of up to 8 years.

According to the Circular, the procedure will be valid between 2025 and 2028, with a review by the ITA in 2028.

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