

March 3, 2025

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

### **Client Updates**

Dear Clients,

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

According to the ITA, the Draft Circular is designed to remove barriers for multinational high-tech companies operating in Israel and to attract new companies to the country. The goal of the Draft Circular is to increase tax certainty, providing a clear and consistent framework for the taxation of Israeli companies that serve as R&D centers. The Draft 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 Draft Circular is open for public comments until March 23, 2025.

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

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

The Draft Circular addresses Israeli companies that provide R&D services to an affiliated company outside of Israel, where such Israeli companies are compensated based on the profitability margin method (i.e., the Israeli company is compensated for all its costs plus a margin, (TNMM/CPM) methodology).

The Draft 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 R&D 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 Law for the Encouragement of Capital Investment, 1959, and the Israeli company meets all the requirements

to be eligible for reduced tax rates under the said law.

The Draft Circular outlines internal procedures regarding how the ITA will handle assessments for Israeli companies serving as R&D centers. Notably, the Draft Circular specifies that if the ITA wishes to apply a different transfer pricing method with respect to the R&D services provided by the Israeli company, the ITA must obtain approvals from senior officials within the ITA 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 of the ITA is required at the early stages of the assessment process, and the approval from the Head of the ITA is required in later stages.

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

A company that meets the conditions outlined in the Draft 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 arm's length. If the ITA 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 of the ITA.

#### APA Arrangements

The Draft Circular highlights another tool available to taxpayers – the ability to initiate an Advance Pricing Agreement (APA) procedure. This process seeks to reach an intergovernmental agreement regarding the transfer pricing that should apply to transactions between related parties in the participating countries.

The Professional Department of the ITA encourages taxpayers to consider this approach when appropriate, as it provides an additional avenue for obtaining certainty regarding the pricing of R&D service transactions.

## **2. Tax Rulings – Acquisition of Israeli Company by an International Group, IP Transfer, and Limited Risk R&D Services**

The Draft 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 ITA regarding the transfer pricing method, margin rate, and compensation for the sale of the IP.

This mechanism, which aims to provide tax certainty to foreign multinational that wish to extract IP from Israeli companies they acquire, is relevant under the following conditions:

1. The acquired company, prior to the acquisition, operated as a Preferred Technological Enterprise under the Law for the Encouragement of Capital Investment, 1959, had income that qualifies as Technological Income, and held qualifying intellectual property.
2. The funds used to acquire the company must originate from outside of Israel or from profits already subject to Israeli tax. Additionally, 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 acquired company must sell all its rights to the IP within 30 days following the acquisition of the shares of 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 throughout the entire duration of the approval period.
6. The value attributed to the sold IP should be at least 85% of the sum of the total consideration in the share acquisition transaction plus excess balance sheet liabilities and off-balance sheet liabilities to the Innovation Authority and employee bonuses, less cash and cash equivalents, and this should be grossed-up according to the relevant corporate tax rate .
7. Throughout the approval period, the workforce size and labor costs associated with providing R&D services after the IP transfer must not decrease by more than 20% compared to previous years.

A company that meets the cumulative conditions of the Draft Circular may apply for a tax ruling from the Transfer Pricing and Valuation Departments within the ITA's Professional Division. This ruling will validate the market conformity of the margin rate and the compensation for the IP, for a period of 8 years.

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

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This update is intended to provide general and concise information only. It does not constitute a full or complete analysis of the issues discussed, nor does it constitute legal opinion or legal advice and should not be relied upon.

## Key Contacts



**Daniel Paserman**  
Head of Tax



**Shlomo Aviad  
Zider**  
Mediator, Partner



**Shirin Gabbay-  
Metzger**  
Partner



**Adi Haya Raban**  
Mediator, Partner



**Dr. Assaf Y.  
Prussak**  
Partner