רשות המסים בישראל

Draft Circular XX/2025 Attribution of Income to R&D Centers

1. Introduction

1.1. Multinational corporations operating in Israel play a significant role and make a substantial contribution to the high-tech industry, which is a key pillar of the Israeli economy. In many cases, foreign multinational companies choose to operate in Israel through a local subsidiary (hereinafter: "**R&D Center**" or "**the Israeli Company**"), which is engaged in providing routine research and development services under a limited-risk model (hereinafter: "**R&D Services**") for a related foreign entity, which aside from providing R&D Services, no additional activities are conducted in Israel by the Israeli Company, while the foreign entity bears the research and development risks, provides the funding, and has the ability to control and manage these risks. As the transaction between the Israeli Company and the foreign entity constitutes a cross-border transaction between parties with a special relationship, it is subject to the provisions of Section 85A of the Income Tax Ordinance (New Version), 1961 (hereinafter: "**the Ordinance**").

1.2. This circular will review various tools that can assist the Israeli Company in obtaining tax certainty in Israel, ensuring that the R&D services transaction is in accordance with market conditions as required under Section 85A of the Ordinance. In this circular, we will update the public on a framework for obtaining a tax ruling in cases where an Israeli company is acquired by a foreign company, its intangible assets are sold, and it is subsequently transformed into an R&D service provider, as well as with respect to an internal control mechanism related to tax assessments for certain R&D centers. The objective of these measures is to reduce instances of double taxation while ensuring the appropriate payment of taxes in Israel.

2. Audit Procedures in the Tax Assessment Process

2.1. In most cases, based on accumulated experience, the transfer pricing method used by the Israeli Company to report the international transaction in which it provides R&D services is a method that compares profitability ratios, as specified in Regulation 2(a)(2)(a) of the Income Tax Regulations (Determination of Market Conditions), 2006 (hereinafter: "**Transfer Pricing Regulations**"), and the profitability ratio is determined according to alternative (3)(a) of Regulation 1 of the Transfer Pricing Regulations (the method and profitability ratio will be collectively referred to in this circular as a "**Cost-Based Markup**").[1]

2.2. In cases where the taxpayer meets the conditions outlined in Sections 2.4–2.10 of this circular, and during the assessment process the Assessing Officer determines that a different transfer pricing method that is not a Cost-Based Markup[2] should be considered, a representative from the professional department will be involved in evaluating the potential change in transfer pricing method before presenting the argument to the taxpayer.

2.3. Should the Assessing Officer seek to issue a discretionary assessment that includes a change in the transfer pricing method and a different profit attribution to the Israeli Company due to this change (hereinafter: "**Transfer Pricing Adjustment**"), and the taxpayer meets the conditions outlined in Sections 2.4–2.10 of this circular, the assessment must be approved by a senior director in the Professional Division[3] and issuing an assessment by formal order must be approved by a senior department director in the Professional Division[4] (hereinafter: "**Director of the Professional Division**") with respect to the Transfer Pricing Adjustment. If the consolidated financial statements of the Ultimate Parent Company[5] (as reflected in its consolidated reports) indicate annual revenue exceeding ILS 10 billion in the tax year under review, and the Assessing Officer considers changing the transfer pricing method to a method other than a Cost-Based Markup, the

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[1] For companies that operate as R&D centers, it is common to apply the Transactional Net Margin Method (TNMM) with a Markup on Total Costs as the PLI.

[2] It should be clarified that a request for documentation or explanations does not constitute a change in the transfer pricing method and does not require prior approval from the Professional Division.

[3] or a higher-ranking official in the Professional Division.

[4] or a higher-ranking official in the Professional Division.

[5] It should be clarified that the Ultimate Parent Company is an Ultimate Parent Entity as defined in Section 85C of the Ordinance, but it must be an entity that is not transparent for tax purposes. It should also be clarified that the consolidated financial statements of an investment fund will not be considered as the statements of an Ultimate Parent Company.

Head of the Professional Division must approve the examination of such a change before raising the issue with the taxpayer.[6]

Issuing a discretionary assessment for a Transfer Pricing Adjustment must be approved by the Director of the Professional Division, following consultation with the Deputy Director for Planning and Economics and the Professional Advisor to the Director of the Tax Authority. Additionally, issuing a formal assessment order for a Transfer Pricing Adjustment must be approved by the Director of the Tax Authority. This procedure will be in effect for years 2025–2028. The continuation, termination, or modification of this procedure will be reviewed by the Tax Authority in the year 2028.

2.4. The Ultimate Parent Company is a foreign company, resident in a reciprocating country, that is the head of the group and holds full ownership, directly or indirectly, in both the Israeli Company and the company to which the Israeli Company provides R&D services (hereinafter: "t**he Service Recipient**").[7]

2.5. Israeli residents or former Israeli residents[8], even when considered together, do not hold more than 10% of the control rights either individually or with others9 in the Ultimate Parent Company[10], from the date of the establishment of the Israeli Company until the assessed tax year. However, in cases where the full ownership rights of the Israeli Company were acquired, the aforementioned examination will be conducted starting from the date of acquisition.

[6] It should be clarified that the approval mentioned will be granted the first time the Assessing Officer believes the transfer pricing method should be changed, and no additional approval will be granted in Stage B if approval has already been given in Stage A.
[7] In certain cases, the Ultimate Parent Company will be the Service Recipient.
[8] Israeli residents in the 10 years preceding the year assessed.
[9] Control rights and "together with another" as defined in Section 88 of the Ordinance. It should be clarified that the examination will also include indirect holdings through an entity or in another manner.
[10] If the Ultimate Parent Company is a company whose shares are listed for trading on a stock exchange, either in Israel or abroad, shareholders from the public (i.e., those who purchased their shares through the stock exchange) will not be considered Israeli residents unless they hold a position or have a vested interest in the company, even if some of these shareholders are Israeli residents.

2.6. The income and business of the Israeli Company consist solely of providing R&D services to the Service Recipient, and it does not have any activities and/or assets unrelated to the provision of R&D services, and specifically intangible assets (IP).[11]

2.7. According to the agreement between the Israeli Company and the Service Recipient, the Israeli Company is reimbursed for all of its costs plus a markup.

2.8. The income of the Israeli Company from providing R&D services is considered preferred income as defined in alternative (5) of the definition of preferred income in Section 51 of the Capital Investment Encouragement Law, 1959 (hereinafter: Encouragement Law), and it meets all the required conditions to qualify for reduced tax rates under the aforementioned law.

2.9. In the annual tax return submitted under Section 131 of the Ordinance, the Israeli Company declared in Form 1385 that, in accordance with the provisions of Section 85A of the Ordinance and the OECD Guidelines, the profit attribution method for providing R&D services should be the Cost-Based Markup method, which is also consistent with its financial statements.

2.10. The Israeli Company will attach to the annual tax return, submitted under Section 131 of the Ordinance, a copy of the R&D services agreement, a full market conditions study [Transfer Pricing Study] as required under Section 85A of the Ordinance and the Transfer Pricing Regulations. It should be clarified that the market conditions study will include, among other things, an analysis of the DEMPE functions (supporting the selected transfer pricing method) as well as a matrix of comparable companies that were either accepted or rejected for determining the cost-based markup.

2.11. The provisions outlined in Chapter 2 of this circular will also apply to assessments in which the Assessing Officer has already begun discussions, whether in Stage A or Stage

[11] It should be clarified that the holding of another Israeli company, directly or indirectly, by the Ultimate Parent Company (in addition to the R&D center company), which engages in other activities, will not affect the fulfillment of this condition.

B, provided that from the publication date of this circular until the statute of limitations applicable for the assessment, whether under Section 145 or Section 150 of the Ordinance, more than 6 months remain.

3. **Request for a private tax ruling in the case where an Israeli company is acquired by a foreign corporation and becomes a company providing R&D services with limited risk after the acquisition**

3.1. In many cases, an Israeli company engaged in the development of intangible assets, which is a Preferred Technological Enterprise as defined in the Encouragement Law and owns the intangible assets while bearing all the development risks associated with them (hereinafter: "**(the) Acquired Company**"), is fully acquired by the Ultimate Parent Company or a company owned by it (hereinafter: "**(the) Acquiring Company**"). Shortly after the acquisition, the Acquired Company sells its intangible assets to the Ultimate Parent Company or another foreign company fully owned, directly or indirectly, by the Ultimate Parent Company (hereinafter: "**the Service Recipient Company**")[12], and then the Acquired Company becomes a company providing R&D services to the Service Recipient Company.

3.2. An Acquired Company, which meets the conditions outlined in sections 3.3-3.10, will contact the Valuation and Business Restructuring Department and the Transfer Pricing Department in the Professional Division for a private tax ruling.[13] If it adheres to the principles outlined below, it will receive a tax ruling confirming that the transfer pricing method applicable to the Acquired Company for R&D services is a Cost-Based Markup method, specifying the markup rate, and that the compensation attributed to the sale of the Acquired Company's intellectual property to the Service Recipient Company is in line

[12] In certain cases, the Ultimate Parent Company will be the Service Recipient Company.
[13] The tax ruling issued will be joint between the Valuation and Business Restructuring Department and the Transfer Pricing Department within the Professional Division.

with market conditions. This will be valid for a period of 8 years (hereinafter: "**IP Sale Approval Period**").

3.3. The Acquired Company, prior to the acquisition, was a preferred technological enterprise, its income was technological income, and the intangible assets it owned included a preferred intangible asset as defined in the Encouragement Law.[14]

3.4. The Israeli company carries out the declarations mentioned in sections 2.2-2.7 of this circular after the acquisition and throughout the entire IP Sale Approval Period.

3.5. The Acquiring Company may be a foreign resident company or an Israeli resident company. However, the source of the funds for acquiring the Acquired Company must be outside of Israel or from profits that have been taxed in Israel, and the acquisition must be made using the Acquiring Company's own equity.

3.6. The Ultimate Parent Company and/or its material shareholders are not material shareholders in the Acquired Company prior to the acquisition. Additionally, the Acquired Company and/or its shareholders are not material shareholders in the Ultimate Parent Company.

3.7. The Acquired Company sold all of its rights to the intangible property it owned prior to the acquisition to the Service Recipient Company, and within 30 days from the date of the share exchange[15] related to the acquisition of the Acquired Company's shares.

3.8. The value assigned to the intangible asset (hereinafter: "**TPIP**")[16] in the transaction should be at least 85% multiplied by the summing of the total gross consideration in the share acquisition of the Acquired Company[17] [18], together with excess liabilities and subtracting of liabilities related to the Innovation Authority or employee bonuses and cash and cash

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[14] It should be clarified that in cases where the company does not have taxable income, the examination will be conducted as if it had taxable income under Section 1(2) of the Income Tax Ordinance.
[15] Closing date
[16] TPIP (Arm's Length) Transfer Price of the intangible asset being sold.
[17] The total consideration will include both the payment for the purchase of shares and the payment for other rights (such as options), and will be calculated according to the principles outlined in the Income Tax Circular No. 15/2018 regarding "Business Restructuring in Multinational Groups."
[18] In cases where the Acquiring Company previously held rights in the Acquired Company, the total consideration will be adjusted to 100%.

equivalents ("**NIP**")[19] divided by 1 minus the applicable tax rate[20], as presented in the following formula.

3.9. Throughout the entire period of approval under the IP Sale Track, the Acquired Company

$$\mathbf{TPIP} = \frac{(NIP)}{(1-t)}$$

will serve as the provider of R&D services to the Service Recipient Company, in relation to the continued development of the intangible asset being sold.

3.10. The scope of the workforce and the cost of employing the workforce engaged in providing R&D services in the Acquired Company after the acquisition shall not decrease by more than 20% compared to the scope and cost of employing the workforce that was engaged in developing the intangible asset being sold, based on the two tax years preceding the acquisition year[21] throughout the entire approval period under the IP Sale Track. If the reduction rate exceeds 20%, it will only be permissible if the reduction rate in the Acquired Company is lower than the reduction rate within the group.[22]

3.11. As part of the request for a tax ruling, the Acquired Company will submit the required documents as specified in section 85A(d) of the Ordinance, both regarding the provision of R&D services and the pricing of the IP. It should be clarified that during the review of the request, the Director may request additional documents.

3.12. This procedure will be valid for the years 2025-2028. The extension, cessation, or modification of the procedure will be reviewed by the Tax Authority in 2028.

[19] The value derived from the formula described, after subtracting cash and multiplying by 85%, will be referred to as NIP.
[20] Represented by the letter "t" in the formula.
[21] The labor cost will be adjusted according to the consumer price index from the comparison year (the two tax years preceding the acquisition year) up to the examined year.
[22] The average reduction rate in the Ultimate Parent Company and its wholly-owned subsidiaries, either directly or indirectly.

4. **<u>Issuing private tax rulings that determine that the compensation received by an Israeli company providing R&D services with limited risk to a related foreign entity is in accordance with market conditions</u>**

4.1. Section 85A(d)(1) of the Ordinance stipulates that a party to a transaction involving a special relationship may request prior approval from the Director to confirm that the agreed price for a specific transaction is in line with market conditions. Section 85A(d)(4) outlines the deadlines for the Director to notify the applicant of the decision, and Section 85A(d)(5) specifies that if the Director does not respond within the specified timeframes, it will be deemed as an implied approval that the transaction was conducted under market conditions.

4.2. Research and Development centers that meet the conditions outlined in Section 2 of this circular are entitled to request prior approval from the Director for a preliminary tax ruling, confirming that the price they received for providing R&D services to a related party is in line with market conditions. If, during the review of such a request, the handling authority determines that the appropriate income allocation method should be based on a profit split, a tax ruling will not be issued without approval from the Director of the Professional Division.

5. **<u>APA Arrangements</u>**

5.1. A taxpayer who is a resident of Israel and enters into a transaction with a resident of a reciprocating country may request to reach a bilateral agreement regarding the determination of transfer prices (Bilateral Advanced Pricing Agreement – "**BAPA**") incorporating a binding agreement between reciprocating countries and an agreement between the tax authority and the taxpayer. The advantage of such an agreement is that the tax authority of the treaty country is part of the agreement, and it is binding on both countries. The taxpayer has the right to request a bilateral or even multilateral advance pricing agreement (APA). In this type of agreement, tax authorities establish the pricing for future transactions between related parties in each of the countries by setting appropriate criteria (method, comparison data, assumptions, etc.). It should be clarified that since APAs are based on the mutual agreement procedures outlined in tax treaties, taxpayers submitting requests for such arrangements are not bound by the timeframe specified in section 85A(d)(4) of the Ordinance. The Professional Department encourages requests for such agreements when the taxpayer believes there is a need for them. This alternative provides additional certainty for companies involved in research and development regarding the pricing of R&D service transactions.

Sincerely,
Israel Tax Authority