2 November 2025
Income Tax Circular No. 8/2025 – Israel Tax Authority
Subject: Attribution of Income to Research and Development Centers

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1. Introduction

1.1 Multinational companies operating in Israel have significant importance and contribute greatly to the high-tech industry, which is a central pillar of the Israeli economy. Often, foreign multinational companies choose to operate in Israel through a local subsidiary (hereinafter: "R&D Center" or "the Israeli Company"), which, according to its reports, is engaged in providing routine R&D services with limited risk (hereinafter: "R&D Services") for a related foreign corporation that bears the risks of research, development, and financing, and has the ability to control and manage these risks. Since the transaction between the Israeli company and the foreign corporation is an international transaction with special relationships between the parties, the transaction is subject to the provisions of Section 85A of the Income Tax Ordinance (New Version), 1961 (hereinafter: "the Ordinance").

1.2 This circular (hereinafter: "the Circular") presents an internal control tool for conducting assessments for some R&D centers, as well as a framework for issuing a tax ruling in the case of the acquisition of the Israeli company by a foreign company, the sale of its intangible assets, and its transformation into a company providing R&D services. The purpose of the circular is to increase certainty in the Israeli tax environment, establish uniform policy, prevent double taxation, and ensure proper tax payment in Israel.

2. Change in Transfer Pricing Method within Assessment

2.1 Sections 2.2–2.5 of the circular apply where the transfer pricing method reported by the Israeli company, as part of its self-assessment, for the international transaction regarding the provision of R&D services, is a method that compares the profitability rate, as stated in Regulation 2(a) - 2a of the Income Tax Regulations (Determination of Market Conditions), 2006 (hereinafter: "Transfer Pricing Regulations"), and the profitability rate is according to Alternative 3(a) as stated in Regulation 1 of the Transfer Pricing Regulations (the method and profitability rate together are referred to in this circular as "Expense-Based Margin")[1].

2.2 Examination of a change in the transfer pricing method for the R&D service transaction to a method other than the expense-based margin[2] (hereinafter: "Change in Transfer Pricing Method") for a taxpayer meeting the conditions listed in Section 2.4 of the circular, will be accompanied by a referent from the professional division of the Tax Authority[3] before the claim is presented to the taxpayer. Issuance of an assessment according to best judgment under Section 145 of the Ordinance ("Stage A Assessment") will be approved in writing by a senior manager in the professional division[4], and issuance of an assessment by order under Section 152 of the Ordinance ("Stage B Assessment") will be approved in writing by a senior

[1] For companies operating a research and development center, the commonly applied method is transactional net margin method or markup on total costs inside the PLI.

[2] For the avoidance of doubt, a request for the provision of documents and 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 authority within the Professional Division.

[4] Or a higher-ranking authority within the Professional Division.

department manager in the professional division[5] ("Head of the Professional Division").

It should be emphasized that the requirement for such approval pertains solely to a change in the transfer pricing method, and not to the various components for which compensation will be provided, the level of the margin, or any other issue that may arise during the tax assessment process.

2.3 The assessment of a change in the transfer pricing method by the Assessing Officer, with respect to a taxpayer that meets the conditions specified in Section 2.4 of this Circular, and in cases where the total consolidated revenues of the ultimate parent company[6] (hereinafter: "the Ultimate Parent Company"), as determined in accordance with generally accepted accounting principles for the reviewed tax year, exceed NIS 10 billion[7], shall require prior written approval from the Head of the Professional Division before such position is presented to the taxpayer[8].

In such cases, the issuance of an assessment in Stage A, with respect to a change in the transfer pricing method, shall be approved in writing by the Head of the Professional Division, following consultation with the Deputy Director of Planning and Economics and the Professional Advisor to the Director of the Tax Authority. The issuance of an assessment in Stage B shall be approved in writing by the Director of the Tax Authority.

2.4 <u>The conditions under which a change in transfer pricing method will be accompanied as stated above are the fulfillment of all the following conditions:</u>

2.4.1 The ultimate parent company is incorporated outside Israel and is a resident of a foreign country that is a party to an international agreement, as defined in Section 214A of the Ordinance. The ultimate parent company is the head of the group and holds all rights, directly or indirectly, both in the Israeli company and in the company to which the Israeli company provides R&D services ("Service Recipient Company").[9]

2.4.2 Israeli residents or former Israeli residents, directly or indirectly, even if all are examined together, do not hold 10% or more of the control means alone or together with another[10], in the ultimate parent company[11] at any time from the establishment of the Israeli company until the assessed tax year. If all rights in

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[5] Or a higher-ranking authority within the Professional Division.

[6] For purposes of this circular, the ultimate parent company is a final parent entity as defined in section 85C(a) of the Ordinance, which is not tax-transparent. An investment fund shall not be regarded as the ultimate parent company.

[7] With respect to translation rules, see Professional Position Paper No. 02/2024: Encouragement of Capital Investments Law – Special Preferred Technological Enterprise – Translation Rules.

[8] For the avoidance of doubt, such approval shall be granted only the first time the Tax Authority believes that the transfer pricing method should be changed, and no additional approval shall be granted at Stage B if approval was already provided at Stage A.

[9] In certain cases, the ultimate parent company will be the entity requesting the services.

[10] Means of control and "together with another," as defined in section 88 of the Ordinance. It is clarified that this examination shall also apply to indirect holdings through a corporation or otherwise.

[11] If the company is publicly traded on a stock exchange in Israel or abroad, the assessment shall take into account (in the numerator) only shares held by Israeli residents or former Israeli residents who are officeholders or interested parties.

the Israeli company are acquired or registered for trading, the examination will be from the date of acquisition or registration for trading, as applicable. For this purpose, "former Israeli residents" are individuals who were previously residents of Israel, and who, if they were to return to Israel, would not be entitled to the status of a "Returning Resident – Veteran" as defined in Section 14(a) of the Ordinance.[12]

2.4.3 The chosen profitability rate according to Alternative 3(a) in Regulation 1 of the Transfer Pricing Regulations is a measure of operating profit divided by gross and operating costs (markup on total costs as PLI).

2.4.4 The Israeli company's income derives from providing R&D services for a foreign resident.

2.4.5 In the annual tax report submitted under Section 131 of the Ordinance, the Israeli company declared in Form 1385 that according to Section 85A of the Ordinance, the most appropriate profit attribution method for the R&D service transaction is expense-based margin, and the Israeli company applied it for calculating its income.

2.4.6 The Israeli company shall attach to its annual tax return filed pursuant to Section 131 of the Ordinance a copy of the R&D services agreement, as well as a full transfer pricing study as required under Section 85A of the Ordinance and the Transfer Pricing Regulations.
For the avoidance of doubt, the transfer pricing study supporting the selected transfer pricing method (including the DEMPE functional analysis) shall include, among other elements, an analysis of the functions performed and the comparison matrix of comparable companies that were accepted or rejected for purposes of determining the cost-based margin, provided that the tax return under Section 131 of the Ordinance is filed after the publication of this Circular.

2.4.7 An Israeli company seeking to apply the provisions of Chapter 2 of this circular will attach an explanation to the tax adjustment report under Section 131(c) and/or notify in writing at the beginning of the assessment process the supervising assessor and the team coordinator that it meets all the conditions listed, a declaration that may be checked by the assessor.

2.5 For the avoidance of doubt, nothing in the above constitutes a determination or statement that expense-based margin is not the correct model for profit attribution under Section 85A for an Israeli company providing R&D services that does not meet the provisions of Section 2.4 of this circular.

2.6 This procedure will be valid for reports of open tax years for assessment until the tax report submitted at the end of the 2029 tax year. Extension, termination, or change of the procedure will be examined by the Tax Authority in 2029.

3. Increasing Margin Based on Expenses Above 14%

3.1 Where an Israeli company meets the conditions in Section 2.4 of this circular and the assessor seeks to determine in Stage A or Stage B assessment that the expense-

[12] If this condition is not met, it will be possible to submit a request to the Professional Division for an individual tax ruling to apply the provisions of Section 2 of this circular despite not meeting said condition. Such a request will be examined based on the specific circumstances of the case.

based margin should be higher than 14%, a referent from the professional division[13] will approve in writing the issuance of Stage A assessment, and the head of the professional division[14] will approve in writing the issuance of Stage B assessment.

3.2 This procedure will be valid for reports of open tax years for assessment until the tax report submitted at the end of the 2029 tax year. Extension, termination, or change of the procedure will be examined by the Tax Authority in 2029.

4. Path for Specific Tax Rulings in Cases of Acquisition of an Israeli Company by a Foreign Corporation and Transition to a Limited Risk R&D Service Model, Including Sale of Intangible Assets of the Acquired Company

4.1 This chapter deals with Israeli resident companies engaged in developing a preferred intangible asset ("Target Company" as defined in Section 51K of the Encouragement of Capital Investments Law, 1959), which are acquired by a foreign ultimate parent company or other companies under its direct or indirect ownership ("Share Acquisition Transaction").

4.2 Often, a related action to the acquisition of rights in the target company, which is performed shortly after the acquisition, is the sale of the intangible asset[15] of the target company ("Sold Intangible Asset") to the ultimate parent company or another foreign company under its full ownership, directly or indirectly ("Purchaser of the Intangible Asset"). After the sale, the target company provides R&D services to the purchaser of the intangible asset as part of a change in the target company's business structure.

Where the conditions in Section 4.3 below are met and the consideration attributed to the sold intangible asset is equal to or greater than the result of the calculation in Section 4.4, the consideration attributed to the sold intangible asset will be deemed to meet market conditions as required by Section 85A of the Ordinance.

To obtain approval and certainty as stated in Section 4.2 above, the target company will apply for a tax ruling ("the Decision") from the Valuation and Business Model Change Department in the professional division of the Tax Authority. The decision will confirm that the consideration attributed to the sold intangible asset meets market conditions as required by Section 85A of the Ordinance. Additionally, the decision will confirm that the profit attribution method for R&D services related to further development of the sold intangible asset will be expense-based margin for a period starting from the closing date of the share acquisition transaction and ending at the end of the seventh tax year thereafter ("Approval Period in the IP Sale Track").

4.3 The decision will be given subject to fulfillment of <u>all</u> the following conditions:

4.3.1 The target company's personnel will provide R&D services after the acquisition to the purchaser of the intangible asset and/or other companies in the ultimate parent group, directly or via another Israeli company in the group[16].

[13] Or a higher-ranking authority within the Professional Division

[14] Or a higher-ranking authority within the Professional Division

[15] Including all transferred activities associated with it.

[16] For the avoidance of doubt, a tax event resulting from the transfer of the R&D service activity from the Target Company constitutes a separate event from the sale of the intangible property being sold, and is **not** included within the formula set forth in Section 4.4

4.3.2 If, prior to the acquisition date, the Target Company met the conditions prescribed under the Encouragement of Capital Investments Law with respect to its classification as a Preferred Technological Enterprise, its income was technological income, and the intangible property being sold included a preferred intangible asset[17], even if the company did not claim benefits under the Encouragement Law, and following the closing date it was classified as a Special Preferred Technological Enterprise.
For this purpose, "Preferred Technological Enterprise," "Technological Income," "Preferred Intangible Asset," and "Special Preferred Technological Enterprise" shall have the meanings assigned to them in Section 51KD of the Encouragement of Capital Investments Law.

4.3.3 At the closing date, the target company met the provisions of Sections 51K(2), 51L of the Encouragement Law, including obtaining approval from the National Authority for Technological Innovation as required by Section 51L of the Encouragement Law.

4.3.4 The tax rate on the real capital gain from the sale of the sold intangible asset is 6% under Section 51K(2) of the Encouragement Law.

4.3.5 The target company will meet the conditions in Section 2.4 of this circular throughout the approval period in the IP sale track.

4.3.6 The purchasing entity will be a foreign resident company or an Israeli resident company, provided that if it is an Israeli resident company, explicit approval is obtained in the decision. A condition for approval for an Israeli resident purchaser is that the source of funds for the acquisition comes from capital outside Israel or profits taxed in Israel, and the acquisition is made from the purchaser's own capital.

4.3.7 The purchasing company will hold all rights in the target company after the acquisition.

4.3.8 The ultimate parent company and/or its significant shareholders do not control (holding over 50% of any rights as defined in Section 88 of the Ordinance) the target company before the acquisition. Also, the target company and/or its shareholders are not significant shareholders in the ultimate parent company. For this purpose, a "significant shareholder" shall have the meaning ascribed to it in Section 88 of the Ordinance.

4.3.9 The target company sold all its rights in the sold intangible asset, which it owned before the acquisition, to the purchaser of the intangible asset within 180 days from the closing date, with the sale agreement effective from the closing date.

4.3.10 From the closing date, profit attribution to the target company will be according to the limited risk R&D service provider model for further development of the sold intangible asset.

4.4 The minimum value attributed to the sold intangible asset for the purpose of implementing this circular:

$$85\% \times (A - B + C + D)$$

Where:

[17] It is clarified that in a case where the company has no income, the examination shall be performed as if income had existed pursuant to Section 2(1) of the Ordinance.

A = Total consideration in the share acquisition transaction of the target company[18, 19]

B = Cash and cash equivalents

C = Total liabilities: loans, severance pay provisions, advance income, preferred share debt component

D = Obligations for payments to the Innovation Authority and/or bonuses to employees and service providers, even if not recorded in the company's financial statements.

The parameters for calculating the formula will be taken from the closing balance sheet of the target company.

4.5 The application for a decision will be submitted to the Valuation and Business Model Change Department in the professional division. As part of the application for a tax ruling, the target company will submit the required documents as stated in Section 85A(d) of the Ordinance, to determine that the transfer price of the sold intangible asset is at market value, and that the transfer pricing method for R&D services related to further development of the sold intangible asset should be expense-based margin. The application will include the supporting documents detailed in the appendix attached to this circular. It is clarified that the manager may request additional documents during the review of the application. The tax ruling will be subject to the timeframes stated in Sections 85A(d)(4) and 85A(d)(5) of the Ordinance.

4.6 The profit from the sale of the sold intangible asset will be classified as business capital gain under Section 28(b) of the Ordinance.

4.7 It is clarified that this track does not prevent a taxpayer who meets the above conditions from claiming that the value attributed to the sold intangible asset is lower, either in its self-assessment or by applying for a specific tax ruling outside this track. Such a claim will be examined according to the specific circumstances and facts of the case. Also, a taxpayer who does not meet the above conditions may apply for a specific tax ruling to determine that the value attributed to the sold intangible asset is at market conditions as stated in Section 85A(d) of the Ordinance.

4.8 For the avoidance of doubt, nothing in the above constitutes any determination or statement regarding the value of the sold intangible asset or the profit attribution method, where the target company does not meet the conditions in Section 4.3 of this circular and claims that the R&D service activity related to further development of the sold intangible asset should not be according to the expense-based margin method.

5. Issuance of Specific Tax Rulings Determining that the Compensation Received by an Israeli Company Providing Limited Risk R&D Services to a Related Foreign Corporation is at Arm's Length

[18] The total consideration shall also include consideration for the acquisition of shares as well as for other rights (such as options), and shall be calculated in accordance with the principles set forth in Income Tax Circular No. 15/2018 titled "Business Restructuring in Multinational Groups."

[19] In a case where the acquiring company held rights in the acquired Israeli company prior to the transaction, the total consideration shall be normalized to 100%.

5.1 Section 85A(d)(1) of the Ordinance states that a party to a transaction between parties with special relationships may apply to the director for prior approval that the price of a specific transaction, as agreed between the parties, is at arm's length. Section 85A(d)(4) of the Ordinance sets the deadlines for the director to notify the applicant of the decision, and Section 85A(d)(5) of the Ordinance states that if the director does not respond within the specified deadlines, it will be deemed as implicit approval that the transaction was made at arm's length.

5.2 Israeli companies providing R&D services to a related party that is not an Israeli resident, whether or not the services meet the conditions in Chapter 2 of this circular, may apply to the professional division for prior approval from the director in a tax ruling that the transaction price is at arm's length as stated in Section 85A of the Ordinance. If the application for a tax ruling is submitted in the years 2025–2029 and there is no agreement between the company and the person handling the application, the applicant will have the option to withdraw the application.

6. APA Arrangements

6.1 A taxpayer entering into a transaction with a related party who is a resident of a treaty country may request to reach a bilateral or multilateral agreement regarding transfer pricing ("Advanced Pricing Agreement – APA"), which combines a binding agreement between the tax authorities relevant to the transaction and the taxpayer, subject to and in accordance with the provisions of the tax treaty between the countries. The advantage of such an agreement is that the Israel Tax Authority and the other relevant countries are part of the agreement, and it is binding on both the taxpayer and the countries.

In such an agreement, the tax authorities agree on the transfer pricing of the transaction or future transactions between the related parties subject to the application in each country, by determining appropriate criteria (method, comparables, assumptions, etc.). It is clarified that since APA arrangements rely on the mutual agreement procedures in tax treaties, applications for such arrangements are not subject to the timeframes stated in Sections 85A(d)(4) and 85A(d)(5) of the Ordinance.

The Israel Tax Authority encourages the regulation of transaction prices through the APA process. This is an additional option available to R&D companies for obtaining certainty regarding the pricing of R&D service transactions.

Best regards,
Israel Tax Authority

Appendix – Required Supporting Documents for a Tax Ruling Application as Detailed in Section 4 of this Circular

1. Sellers' valuation used for the share acquisition transaction.
2. Presentation for buyers (road show).
3. Acquisition model – detailed business forecast of the target company used by the purchaser for the share acquisition transaction.
4. Presentation to the purchaser's management for approval of the share acquisition transaction (FGNG) of the target company.
5. Target company's balance sheet at the closing date.
6. Share purchase agreement (SPA) of the target company, including full appendices.
7. Excel file detailing all consideration in the share acquisition transaction – cash, exchange of rights, deferred or contingent amounts, etc.
8. Full details of liabilities at the closing date: debts, employee bonuses, exchange of unvested options, etc.
9. Consolidated financial statements of the target company for the three years preceding the closing date.
10. Solo financial statements of the acquired group companies for the three years preceding the closing date.
11. All transfer pricing market studies (TP studies) conducted for the target company before and after the acquisition date.
12. Agreements between the target company and related parties preceding the closing date.
13. Detailed calculation of the formula in Section 4.4, including references to relevant sections in the supporting documents attached to substantiate the values in the formula.

As stated in Section 4.5, additional documents may be required.