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Global Tax Alert

Israeli Tax Authorities address issues regarding issuance of Utility Tokens, blockchain technologies and cryptocurrencies, including related tax benefits

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Executive summary

Recently, the Israeli Tax Authorities (ITA) published a Tax Circular explaining its position towards the tax implications of "digital tokens" issued for the provision of services or products under development (Utility Tokens) as part of Initial Coin Offerings (ICOs)/Token Generation Events (TGEs), including the tax aspects associated with such services or products (the Tax Circular). A previous Tax Circular presented the ITA's view that a virtual currency (such as Bitcoin, Ethereum, etc.) is an "asset" within its meaning in the Income Tax Ordinance, and therefore subject to capital gain tax rules upon disposal (unless the activity generating such income constitutes a business, which case the income is treated as a business income, with the relevant income tax and value added tax (VAT) implications).

The regulated tax regime, as outlined in the Tax Circular, demonstrates Israel's invigorative approach towards blockchain technologies and cryptocurrencies. Together with the Israeli research and development (R&D) environment and the new Innovation Box regime,[1] this Tax Circular positions Israel as a principal location for multinationals that are seeking for new opportunities in the virtual era.

Building a better working world

Under the Tax Circular, the ITA generally determine the revenue recognition method for funds received as part of such ICO, and allow the deferral of such recognition, according to the relevant and applicable accounting rules, up until the occurrence of particular events, for example, the actual provision of the services or products developed.

The Tax Circular also establishes the tax treatment for Utility Tokens issued to employees, directors and service providers as part of an ICO; the VAT implications that apply, with the distinction between Israeli and foreign residents; and applies the same rules to back to back structures, in which a wholly-owned subsidiary company issues the Utility Tokens, and transfers the funds received and their corresponding liabilities (to provide the services/products) to that Israeli parent company.

Most importantly, the Tax Circular allows for companies that carry out such ICOs to potentially enjoy the tax incentives available for qualifying companies, including those provided under the Base Erosion and Profit Shifting (BEPS)-compatible new Israeli Innovation Box regime, which offers a corporate income tax (CIT) rate of 12% for qualifying companies with global consolidated revenue below ILS10b (approx. US$2.5b), or of 7.5% if located in Jerusalem or in certain northern or southern parts of Israel; or a CIT rate of 6% for qualifying companies with global consolidated revenue below ILS10b.

This positive approach indicates the ITA acknowledgement of the rapid technological changes and the impact it has on technology multinationals, which may view Israel as a favorable destination for the execution of innovative blockchain technologies, using the hundreds of R&D centers currently operated there, while benefiting from the exceptionally attractive tax incentives it has to offer.

Israel is an international innovation center in all aspects of blockchain technologies and cryptocurrencies, and is currently one of the first jurisdictions to introduce its regulatory tax environment towards blockchain technologies and cryptocurrencies. As such, multinationals are encouraged to look carefully at this Tax Circular and examine its opportunities and implications.

Detailed discussion

Income tax and VAT implications

In the Tax Circular, the ITA generally determine the revenue recognition method for funds received in return for Utility Tokens as part of an ICO, according to the relevant and applicable accounting principles, and allow the deferral of revenue recognition in certain circumstances. The Tax Circular includes references to certain types of business models, including the provision of services or sale of products in return for the issued Utility Tokens, and the grant of a perpetual right to obtain services from the issuing company. Other specific models will be considered by the ITA Professional Department. In certain cases, such as in the case that the development failed, the revenue should be recorded immediately upon such failure.

The Tax Circular also refers to the taxation of Utility Tokens issued to employees, directors and service providers, and allows two alternative tracks – the first defers the income recognition until the date in which the Utility Token is exercised, based on the Utility Tokens' value at such date, and the second triggers an immediate tax at the date in which it the Utility Token is allotted, according to the Utility Tokens' value at this date.

With respect to VAT, the Tax Circular distinguishes between services and products, and determines the revenue recognition method (cash vs. accrual basis) in accordance with the Israeli VAT law, with several exceptions (for example, income from the provision of services will be reported on an accrual basis if the consideration of the ICO was paid in digital tokens). In this regard, the ITA also distinguish between the identity (foreign or Israeli resident) of the party who participated in the ICO and the party that eventually acquired the product/consumed the service, and allow the issuing company to retroactively amend its invoices, as relevant.

Lastly, the Tax Circular stipulates that the same rules will apply to back to back models, in which an ICO takes place by a wholly-owned foreign subsidiary of an Israeli company, and all funds and liabilities are transferred to that the Israeli parent company.

Integration with Israeli tax incentives, including those provided under the new Innovation Box regime

While the standard CIT rate in Israel is currently 23%, and the dividend withholding tax (WHT) rate ranges between 25%-30% (unless reduced by a treaty), Israel grants tax benefits that might dramatically reduce the said tax rates. Such incentives include:

- For Preferred Enterprises – a reduced CIT rate of 16%, or, if located in Jerusalem or in certain northern or southern parts of Israel, the tax rate is further reduced to 7.5%, with a dividend WHT rate of 20% (unless further reduced by a treaty).

- For Preferred Technological Enterprises under the BEPS-compatible new Israeli Innovation Box regime[2]:
  - For qualifying companies with global consolidated revenue below ILS10b – a CIT rate of 12%, with a reduced tax rate of 7.5% as above, with a dividend WHT rate of 20% (unless further reduced by a treaty).
  - For qualifying companies with global consolidated revenues over ILS10b – a CIT rate of 6%, with, for companies held by foreign resident companies holding at least 90%, a dividend WHT rate of 4%, if certain conditions are met (unless further reduced by a treaty).

One of the requirements for this regime is that the company invests at least 7% of its revenues in R&D expenses.

In order to encourage technology companies to invest in the development of blockchain technologies and cryptocurrencies in Israel, the Tax Circular provides that such activity may be entitled to the said tax benefits, if the relevant conditions are met at the time the income is recognized. In addition, if such income is not recognized, it shall not be considered as part of the revenues for the 7% R&D expenses requirement. It is noted that the ITA Encouragement Law Department will examine cases in which a distortion has occurred as a result of the revenue recognition principles.

Implications

Israel's progressive approach towards blockchain technologies and cryptocurrencies and its regulatory tax environment, together with the Israeli R&D ecosystem and the new Innovation Box regime, provide an opportunity for multinationals that are seeking to expand their operations in the virtual era. Companies should carefully review this Tax Circular and examine the potential consequences and benefits.

Endnotes

1. For more information regarding the Israeli new Innovation Box regime, see EY Global Tax Alert, *Israeli's new IP regime formally comes into effect as of 1 January 2017*, dated 18 May 2017.
2. The CIT may vary based on the Nexus formula as defined under the new Innovation Box regime.

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