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Global Tax Alert

New Israeli Innovation Box Regime: An update and review of key features

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Executive summary

The new OECD[1] BEPS[2]-compatible Israeli Innovation Box regime (the "Technological Enterprise" regime) was first launched on 1 January 2017, following by Regulations that were released on 28 May 2017. On 5 November later that year, the Israeli Tax Authority (ITA) published a detailed Tax Circular on the new intellectual property (IP) box regime and its implementation, as well as on its compatibility with other incentives provided under the Israeli tax law. Since then, several ITA rulings were published that can provide additional insights on the applicability of the new Innovation Box regime.

In addition, for innovative companies that do not meet the criteria set forth in the legislation, the Israeli Innovation Authority (IIA) published, on 20 May 2019, the conditions that are needed to be satisfied for such enterprises to qualify for this regime and enjoy its tax incentives. Such approval can be granted for enterprises that will establish an innovation level that is similar to or higher than the level of innovation that is accepted worldwide in the main technological field of the company. The request should be filed with the IIA within 90 days of the beginning of each tax year, and **for tax years 2017-2018 – within 90 days from the day on which the conditions were published** (i.e., **until 18 August 2019**).

This Alert summarizes the key features of this regime and addresses frequently asked questions (FAQs) regarding it, based on our practice.

Building a better working world

Detailed discussion

Overview and objectives

In this new IP box regime, which is fully compatible with BEPS Action 5 on Harmful Tax Practices,[3] and approved by the OECD as a non-harmful IP regime, the Israeli Finance Ministry acknowledged that in a post-BEPS era, technology multinationals may view Israel as a location to consolidate IP and substance due to the hundreds of research and development (R&D) centers currently operated there.

Accordingly, the innovation box applies to multinational companies that will convert their existing R&D centers into IP hubs or establish new ones. The tax incentives will also apply to existing Israeli companies that will qualify for the new regime.

This Innovation Box regime is complementary to the existing Preferred Enterprise regime. However, the more historical tax incentives under the Approved and Beneficiary Enterprise regimes cannot be provided in conjunction with the incentives under the Innovation Box regime.

In addition, the Israeli Government provides extensive grants and incentives for R&D and Innovation activities, as well as for employment, that can be provided in parallel to the tax incentives as detailed below.

The key features of this regime, as well as the recent IIA update for innovative companies to qualify under the legislation are outlined below.

Key features and FAQs

<table>
<tr><td rowspan="3">Corporate Income Tax (CIT), dividend withholding tax (DWHT) rate and capital gains tax (CGT) rates</td><td></td><td>CIT</td><td>DWHT</td><td>CGT</td></tr>
<tr><td>Preferred Technological Enterprise</td><td>6%
7.5%/12% if global turnover < $2.5B</td><td>4%
If at least 90% of the company is held by a foreign company
20% otherwise;</td><td>6%
12% if global turnover < $2.5B</td></tr>
<tr><td>Preferred Enterprise</td><td>7.5%/12%, based on location in Israel</td><td>20%
May be reduced under applicable tax treaties</td><td>Standard CIT 23%</td></tr>
<tr><td>Types of IP that are covered</td><td colspan="4">Patents; Copyright protected software; Plant breeders' rights; Other rights as determined by the Finance Minister; Other R&D driven IP that was approved by the Israeli Innovation Authority, only to the extent the taxpayer is part of a group with global turnover under ~US$53m[iv] (NIS211m) and that the taxpayer does not itself earn more than ~$8m (NIS32m) per year; while not yet in force in Israel, generic IP may also qualify following a recent approval by the OECD.

Taxpayer can either be an owner or part owner of the qualifying IP asset, or hold a right in the qualifying IP asset.</td></tr>
<tr><td>Types of income that are qualified</td><td colspan="4">Royalty income such as license fees, software and product sales, sale of related products, related service fees, SaaS, R&D services (limited to 15% of the total income), compensation income (other than capital gain), income from R&D driven IP that was approved by the IIA, and other types of income to be determined by the Finance Minister.</td></tr>
</table>

Required conditions for applicability	The incentives under the Innovation Box regime can be granted for companies that meet the following conditions:
	• 7% of the last three years' turnover* was invested in R&D (as recorded in the financial statements (FS)), or ~$20m (NIS75m) R&D expense per year; and,
	• One of the following conditions are met:
	    • 20% of the employees are in R&D that their payroll is paid and recorded solely as R&D expense in the FS, or 200 R&D employees per year
	    • Venture capital investment of at least ~$2m (NIS8m) was made in the company
	    • Average annual growth over three years of 25% in sales, with a minimum turnover of ~$2.5m (NIS10m) in each of these years, as well as in the current year
	    • Average annual growth over three years of 25% in employees, with a minimum of 50 employees per year in each of these years, as well as in the current year
	Companies not meeting the above conditions may still qualify under the discretion of the IIA in the Economy Ministry. These conditions require the enterprise to prove that its innovation level is similar to, or higher than, the level of innovation accepted worldwide in the main technological field of the company in different categories, during the three-year period prior to the tax year. The request should be filed within 90 days of the beginning of each tax year, and for tax years 2017-2018 – within 90 days from 20 May 2019 (i.e., until 18 August 2019); and,
	• 25% or more of the sales of the enterprise, directly or indirectly, are at a market of at least 14m residents
	* The company's turnover from its business activity, including from marketing and manufacturing activity, and excluding rental and financial income, consideration from the sale of assets, etc. Software companies providing advertising services can also exclude income that is paid to marketing space owner, based on a Decree published by the Finance Minister with the authority given to him by the law.

The nexus formula

The proportion of income that may benefit from the IP regime (“the nexus ratio"):

$$\frac{🟢\ \text{qualifying expenditures} * 130\%}{🟢\ \text{qualifing expenditures} + 🔴\ \text{overall expenditures}}$$

Treatment of R&D expenditures as qualifying/overall	R&D performed in Israel (in-house or outsourced)	🟢
	R&D performed outside Israel via branches	🟢
	R&D performed outside Israel via related parties	🔴
	R&D performed outside Israel via Externally Provided Workers (EPW)	🟢
	R&D performed outside Israel via third parties	🟢
	R&D outsourced from related Israeli entities (performed in Israel or abroad)	🟢

Based on a clarification provided by the ITA in its tax circular, the same treatment should apply to R&D expenditures under cost sharing arrangements

How to transfer IP into Israel?

Effect on Israel's nexus formula:

$$\frac{🟢\ \text{qualifying expenditures} * 130\%}{🟢\ \text{qualifing expenditures} + 🔴\ \text{overall expenditures}}$$

	Base case IP sale / license	IP sale / license (previously developed in Israel)	Transfer of trade*
Transferor's R&D: qualifying	◌	🟢	🟢
Transferor's R&D: non-qualifying	◌	N/A	🔴
Acquisition costs (FMV) or royalties	🔴	◌	◌

In other words, an acquisition of IP or a transfer of trade into Israel can result with the importation of qualifying expenditures into the nexus formula, that together with the 130% factor, can significantly increase the nexus ratio.

* For a transfer to be considered a transfer of trade, the following should be shifted to the enterprise: the economic rights, the contracts with client and suppliers, the liabilities and the business strategic management of the R&D or manufacturing processes that are related to the transferred business

Ability to leverage acquisition of IP and use it as a repatriation strategy?	The entire acquisition of the IP can be leveraged with debt as Israel does not have thin cap limitations. Arm's-length interest incurred is generally deductible with no interest deductibility limitations, subject to the appropriate withholding tax. The leverage may also be provided in the form of a capital note (an interest free loan for a minimal period of five years, that is not subject to transfer pricing rules in Israel), which may allow tax free repatriation from Israel. The acquisition of IP into Israel can also serve a repatriation strategy, especially with respect to "trapped earnings" (earnings that were tax exempt under historical tax regimes).
Full amortization of acquired IP	Over eight years
Is it discretionary or non-discretionary?	This regime is non-discretionary; a qualifying company should be eligible for the tax incentives provided to qualifying income based on the nexus ratio.
Are rulings available?	Rulings are available (though not mandatory) to confirm the conditions for the qualification of the enterprise as a Technological Enterprise, the qualifying income, the application of the nexus formula, the treatment and valuation of a marketing IP (based on various exceptions provided by the ITA in its tax circular), among others. 10-year stability ruling can be provided to a company if, *inter alia*, the enterprise acquired IP at a value higher than ~$140m (NIS500m)
Are there any exit implications?	There is no claw back of tax benefits

Implications

Israel's progressive approach towards the Israeli R&D ecosystem and the new Innovation Box regime, provides an opportunity for multinationals that are seeking to align ownership and control over intangibles with value creating functions in a post-BEPS world.

Companies should review this new legislation and examine the potential benefits and consequences.

Endnotes

1. Organsiation for Economic Co-operation and Development.
2. Base Erosion and Profit Shifting.
3. OECD BEPS Action 5: Countering on Harmful Tax Practices more effectively, taking into account Transparency and substance.
4. Currency references in this Alert are to US$.

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