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Tax Policy Could Undermine Israel's IP Outreach

By Matthew Kalman

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- Innovation authority introduces licenses to allow more flexible use of research
- Tax authority demands full capital gains payments on licensed transfers

Israel's tax authority is coming under criticism from tax advisers for undermining efforts to encourage more multinational investment in Israeli technology companies.

The independent and publicly-funded Israel Innovation Authority (IIA) has loosened restrictions on grants, allowing Israeli companies to license IIA-funded intellectual property, or know-how, instead of selling it. That should make companies more attractive to foreign investors but so far the tax authority refuses to play ball, tax practitioners warn.

"It's not good for the Israeli economy or for the high tech industry when you have two branches of the Israeli government not speaking with the same voice. The tax authority damages these transactions and investment by multinationals," Daniel Paserman, partner and head of tax at Gornitzky and Co. in Tel Aviv, said by phone Oct. 28.

The tax authority assesses any IP transferred outside Israel as liable for full capital gains, even if licensed on a non-commercial basis for further research and development, or to another subsidiary within the same multinational. Israeli companies want taxes on the licensing deals to be lower.

The IIA doesn't deal with capital gains or any other tax. Instead of demanding the upfront repayment of up to six times the grant, plus interest, for the sale and transfer of all the IP to foreign ownership, it is now charging a low license fee plus a royalty that's payable only when there is income.

But the tax authority said it would employ different criteria from the IIA when assessing such transfers. The IIA examines such deals "to fulfill its mission, which is essentially to encourage investment in Israel," a tax authority spokesperson said.

"However, the tax authority examines granting the use of know-how, and intangible assets that have been developed, in transactions between related parties in the same multinational corporation in accordance with the nature of the transaction and its value, and all based on tax legislation arising from the Income Tax Ordinance, regulations and other taxation rules," the spokesperson said.

Accordingly, the Israel Tax Authority first examines the classification of the deal granting the right to use intangible assets from the perspective of the true commercial significance of the deal between the transacting parties.

Such transactions will be examined not according to IIA criteria but "in accordance with the Income Tax Ordinance, regulations and its rules," a tax authority spokesperson said by email Oct. 31. Tax assessments will be based on its determination of "the market value" of each deal, the authority said.

New Rules

New IIA regulations introduced in September allow companies receiving research grants to license that knowhow to companies within the same group. Permits must be granted by the IIA research committee and are limited to multinationals with a turnover of $2 billion or more. The development must benefit the Israeli economy.

Before 2017, the IIA didn't allow the IP it funded to be licensed for use outside Israel. Local companies that received IIA grants, or multinationals acquiring them, had to transfer the IP abroad, paying an exit fee up to six times the original grant plus interest.

"This could kill a deal. That is now something that is going to be resolved with these new regulations," said Raz Tepper, partner and head of the high tech department at Fischer Behar Chen Well Orion & Co. in Tel Aviv.

The IIA first introduced licenses last year to incentivize companies to keep their IP at home.

"When there was an acquisition of an Israeli company the buyer would immediately transfer all the IP out of Israel," said Hillel Levin, head of intellectual property at the IIA. "Alternately, they just wouldn't invest in these kind of companies."

"We wanted to find a compromise," Levin said. "The amount paid back on a one-time return can be miniscule compared to the amount of income that the Israeli economy will receive from having activity in Israel and paying taxes from that activity and from the tax on salaries."

The decision is "very positive," said Ofer Granot, a tax and incentives partner at Herzog Fox and Neeman law office in Tel Aviv. A multinational considering buying an Israeli company that is IIA-funded can share its know-how within the group at a fraction of the previous cost and without paying a one-time fee in advance that it might never recover, he said.

"For the Israeli economy, it's great," Granot said Oct. 29. "The multinational now doesn't have to take the know-how outside. The Israeli company can keep the know-how and share it with the group."

This is "significant" for Barry P. Levenfeld, partner at Yigal Arnon and Co. law firm in Jerusalem. "This should contribute to easing of uncertainty in a situation that's fairly common of a global company wanting to incorporate an Israeli company's IP in its products," he said.

Anat Even-Chen, an associate in technology practice at Barnea & Co. law firm in Tel Aviv, noted that multinational corporations have better capabilities for development outside of Israel. “It’s either leaving the know-how in Israel and letting it die, or taking the things that were accumulated and maybe developing something else. We won’t do that if we have to pay six times the grant. But if we just have to pay royalties out of sales up to the original grant, that will only increase the level of return for the Israeli government,” he said.

Tax Authority Not on Board

However, the tax authority doesn’t differentiate between license or sale and so far has demanded capital gains tax on the full value of such transfers. Assessments for 2017 have not yet reached the courts, but practitioners said similar cases in the past indicated the direction of tax authority policy.

“From their perspective it’s still a sale. I don’t think this will change their approach,” Paserman said. He added that the tax authority “is a step behind” because they are always looking at collecting taxes and not at enhancing the Israeli economy. “It increases the cost of making transactions and investing in Israel. In general the atmosphere is not positive. They are not encouraging multinationals.”

The new license “will have no real effect on the tax policy and treatment” and “contradictory approach” of the tax authority, Granot said.

“Companies will not seriously think of maintaining a big portion of their IP in Israel when in some cases companies know they will be faced with these innovative arguments from the tax authority. It’s a real challenge,” he said. “The tax authority has to give more thought in order not to give the impression that we are a hostile business environment and not turning from startup nation to tax-up nation.”

To contact the reporter on this story: Matthew Kalman in Jerusalem at correspondents@bloomberglaw.com

To contact the editors responsible for this story: Penny Sukhraj at psukhraj@bloombergtax.com; Vandana Mathur at vmathur@bloombergtax.com