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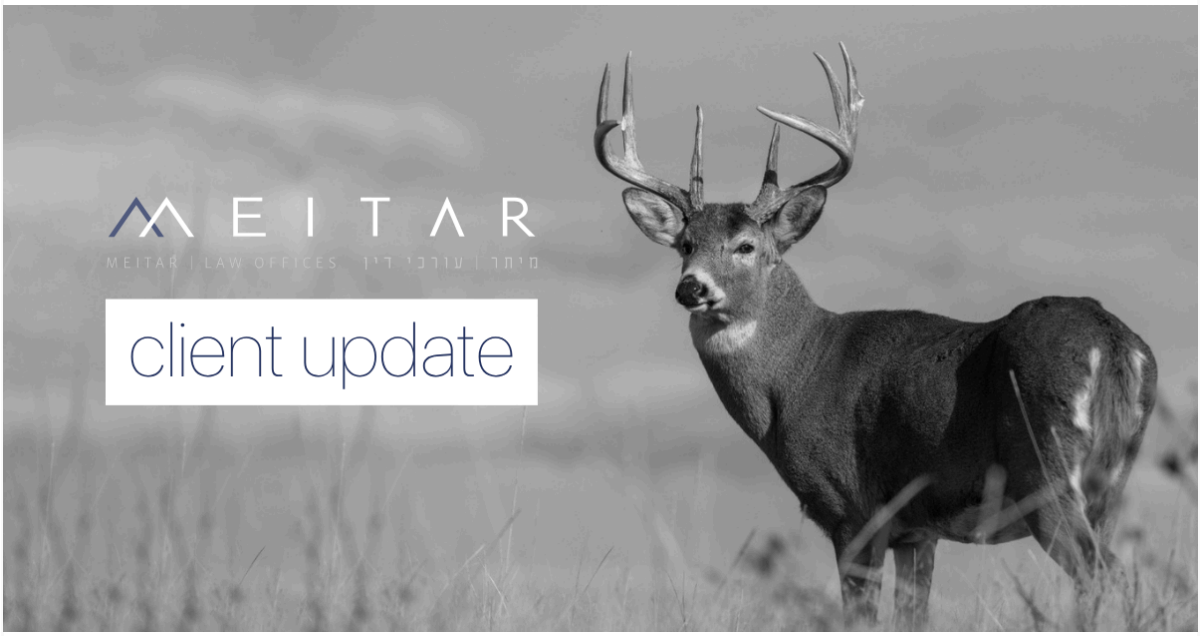

Significant Changes in the Taxation of the Israeli High-Tech Sector

November 5, 2025

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On November 2, 2025, the Ministry of Finance, the Israel Tax Authority (the "**ITA**"), and the Israel Innovation Authority announced in a joint press conference a reform initiative affecting the approach to tax policy which is primarily focused around key tax issues within the high-tech industry (the "**Reform**"). The Reform is expected to be implemented through a combination of legislative measures and the issuance of ITA circulars, aimed at supporting and maintaining Israel's attractiveness as an international hub by providing tax benefits and increasing the level of certainty for taxpayers.

The Reform is directed at various entities in the high-tech ecosystem – high-tech companies, investors, and employees who are returning to Israel after an extended stay abroad.

The purpose of this client alert is to outline and summarize the most relevant measures that have been enacted or proposed.

1. High-Tech Companies

1.1 As part of the Reform, on November 2, 2025, the ITA issued Income Tax Circular 8/2025 – Attribution of Income to Research and Development Centers (the "Circular").

The Circular aims to provide broad tax certainty for multinational corporations operating in Israel in three areas: (a) limitations on changing transfer pricing methods within audit proceedings; (b) a safe harbor for valuing intangible intellectual property sold following the acquisition of an Israeli company; and (c) an expedited procedure for transfer pricing rulings in respect of R&D services. The Circular is primarily relevant to large multinational groups.

The main provisions which were introduced under the Circular include:

- **Restriction of the tax assessor's discretion in changing transfer pricing methods from Cost-Plus method and when determining a markup exceeding 14%:**
  - The Circular establishes a procedure under which an examination aimed at changing or rejecting a transfer pricing method of an Israeli company (that otherwise complies with the Circular's provisions) that provides services to non-Israeli related entities within a multinational group (whose ultimate parent company is non-Israeli), change to a transfer pricing method that is not cost-plus (TNMM/CPM) shall be conducted (at least) with the participation of a professional division referent within the ITA. The issuance of Stage A or Stage B assessments on this matter shall require prior written approval by senior officials in the professional division. Where the Israeli company is part of a multinational group with annual turnover exceeding NIS 10 billion, a higher-level professional division approval will be required.
  - In addition, the Circular instructs that the tax assessor may not increase the cost-based markup of a company that complies with the Circular beyond 14% without prior written approval (at least) from a professional division referent and, for Stage B, written approval by the Head of the Professional Division.
- **Provision of tax rulings in cases of acquisitions by non-Israeli corporations and transition to a limited-risk R&D service model combined with the sale of the target company's intellectual property:**
  - The Circular establishes a dedicated track for obtaining a tax ruling (the "**Ruling**") for Israeli target companies ("**Target Company**") which, following their acquisition by a multinational group, intend to transfer their intangible assets to a non-Israeli group entity.
  - The Ruling will include in its scope and affirm that the portion of consideration allocated to the transferred intangibles — being at least 85% of the total transaction consideration for the acquisition of the Target Company (less cash, liabilities, and other parameters) — reflects arm's length value as required under Section 85A of the Israeli Income Tax Ordinance (New Version), 1961 (the "**Ordinance"**), and that the applicable transfer pricing method for the post-acquisition limited-risk R&D activity shall be cost-plus (TNMM/CPM).
  - The Ruling will be granted subject to various conditions, including that the Target Company met, prior to acquisition, the requirements of a "Technological Enterprise," and following the acquisition is classified as a "Special Preferred Technological Enterprise" under the Law for the Encouragement of Capital Investments, 1959 (the "**Encouragement Law**").
  - It should be noted that the Circular does not require that the purchase price determined in the transaction to acquire the Target Company be grossed up for corporate tax purposes. This approach is consistent with the recent District Court decision in **Administrative Appeal 59306-01-23 Hexadite Ltd. v. Tax Assessor Tel-Aviv 3**, which held that when inferring value from a comparable transaction using

the Acquisition Price Method, the basic assumption is that the price determined between two unrelated parties reflects a complete bargained-for exchange taking into account all relevant economic considerations, including tax considerations. Therefore, the consideration for the sale of the intangible asset should not be increased to account for the corporate tax applicable to it.
    - Moreover, the capital gain (not including the linkage adjustments) from the sale shall be treated as business capital gain for loss offset purposes.
    - The Ruling effectively constitutes a safe harbor. Companies may assert a lower value for the sale of intangibles either in their self-assessment or through a private tax ruling obtained from the ITA.
- **Provision of private tax rulings affirming that a remuneration method of Israeli limited-risk R&D service providers is based on arm's length:** The Circular extends the applicability of Section 85A(d) of the Ordinance to allow the withdrawal of tax ruling applications (submitted between 2025–2029 years) if no agreement with the ITA is reached.
- **Encouragement of APA arrangements** :The ITA encourages taxpayers to utilize the arrangements of Advance Pricing Agreements (APAs) as an additional means of achieving tax certainty for related-party transactions. Such arrangements are concluded between the ITA and foreign tax authorities, and allow taxpayers to determine in advance the transfer pricing method for future transactions.

1.2. Taxation of Marketing Intangibles of a Preferred Technological Enterprise: In addition to the Circular, a forthcoming ITA directive is expected to clarify the attribution of income to marketing intangibles — an issue that has arisen in recent audit discussions, since income attributed to such intangibles is subject to the standard 23% corporate tax rate, while income attributed to technological intangibles enjoys preferred rates.

1.3. Following our client update on Pillar Two, the important issue of potential tax benefits to offset the effective corporate tax increase (likely in the form of an R&D tax credit) remains under discussion, and draft legislation has not yet been published.

1.4. Facilitation of Corporate Reorganizations: The current measures complement the recent relief enactments introduced in Amendment No. 279 to the Ordinance (March 2025), which expanded tax-free restructuring possibilities. See our prior client update.

2. The investors

Reform in Investment Funds Taxation. Under current law, uncertainty exists concerning the tax treatment of investment funds (including venture capital funds) and non-Israeli investors in Israel. The uncertainty relates to whether income should be classified as capital gain or business income, and to the question of whether a permanent establishment exists in Israel for non-resident investors. For three decades, this uncertainty has been addressed through applications for a private tax ruling establishing the tax consequences for investors and fund managers under specific criteria. However, this mechanism did not adequately serve other non-Israeli investors and involved heavy administrative burdens in order to obtain the aforementioned private tax rulings. Under the Reform, this matter is proposed to be resolved comprehensively through the Investment Fund Tax Regulations, published for public comments on November 2, 2025 (the "**Regulations**"), which will define a unified

taxation mechanism for general partners and limited partners in such funds.

A preliminary review of the Regulations indicates, among other things, the following:

Capital gains exemption for a qualifying investment in a technological company:

- The Regulations distinguish between **investments in securities**, a "**qualifying investment**", and a "**qualifying investment in a technological company**." The latter refers to investment in a "technological company" (as defined therein) where at least 75% of the amount invested constitutes consideration for newly issued shares of the technological company (as opposed to secondary purchases). **With respect to capital gains from a qualifying investment in a technological company, a broad exemption from capital gains tax will apply to all investors** – including those investing directly and those investing through a partnership or fund. **This measure, ensuring capital gains exemption treatment for any non-resident investor investing in a qualifying technological company, represents a substantial and welcome improvement**.

Classification of Fund Investments as Capital Gains

- The Regulations explicitly state that income attributed to an eligible limited partner (who is not involved in the management of the partnership) from the taxable income or capital gain of a partnership, from the sale of a security (of any type), shall be considered as capital gain – without distinction between Israeli and non-Israeli resident investors. The classification as capital gain applies only to investors through partnerships and not to direct investors such as angel investors.

Capital gains exemption to non-Israeli residents for investments through partnerships

- **Non-Israeli resident limited partners will be exempt from Israeli capital gains tax on profits attributed to them by a partnership from the sale of securities, even where the gain is connected to a PE in Israel.**
- **Non- Israeli resident managing partners** will be exempt on their fund-level investment income, provided their investment commitment in the partnership does not exceed 10% of total commitments. If it exceeds 10%, the managing partner may elect a rate of 10% tax on its share of profits from the sale of securities of Israeli companies, or of foreign companies whose majority of assets are situated in Israel ("**Qualified Israeli Securities**"), attributable to the portion of its investment exceeding 10%.

Taxation of interest and dividends:

- The Regulations distinguish between investments made through a "**qualified private investment fund**" and other investments. Investments not made through such a fund will be eligible to the capital gains exemption, as detailed above, but not the relief on interest and dividends.
- Non-Israeli resident limited partners in a qualified private investment fund will be exempt from Israeli tax on interest and dividends from qualifying investments in a technological company.
- Non-Israeli resident limited partners in a qualified private investment fund that are either pension funds in a treaty country or state-owned corporations in their country of residence shall be exempt from Israeli tax on interest and dividends from all qualifying investments (technological or not) or, alternatively, subject to 5% tax on interest from qualifying investments in non-technological companies, if the company deducted the interest expenses for tax purposes.

Taxation of carried interest:

- **Israeli managing partners** will be subject to a **reduced tax rate** of up to 27%, plus 3% surtax, on their total carried interest income derived from all of the partnership's investments – generally consistent with the average effective rates under the current regime.
- **Non-Israeli managing partners** will be subject to a 10% tax rate on their share of the partnership's profits derived from Qualified Israeli Securities – this represents a reduction from the current applicable 15% rate. The Regulations omit the current refund mechanism that applies in cases where no foreign tax credit is available.

Transitional arrangements:

The above measures will apply to investments made after the Regulations' publication date. Funds that previously obtained valid tax rulings may continue to rely on them for investments made through December 31, 2032. Carried interest will be subject to a mixed regime combining the current rulings' regime and the Regulations, based on the ratio of investment amounts during each of the relevant periods, to the fund's total investments. It should be noted that this allocation mechanism creates a degree of uncertainty throughout the term of the fund, as the total amount of the fund's investments might only become known upon its liquidation.

The Regulations do not include transitional provisions for other cases that are otherwise expressly governed by them, such as investments by non-Israeli residents made outside the framework of a fund with a tax ruling.

VAT on management fees and carried interest

Separately, an amendment to the VAT Law will be enacted, providing that management fees paid to a partnership will be subject to VAT at the full rate (18%) with respect to the proportional share of Israeli investors, and to VAT at a zero rate with respect to the proportional share of non-Israeli investors in the fund. This is consistent with the practice previously applied by the VAT authorities.

The amendment refers to specific regulations to be enacted with respect to VAT on carried interest; however, the Regulations published to date do not include provisions on this matter, and those are expected to be published separately in the near future.

3. Human Capital

Encouraging Aliyah and Return of Israeli Expatriates via Favorable Tax Treatment of Stock Options: Until now, employees who were granted stock options for work performed abroad and exercised them after returning to Israel were required to pay Israeli tax on the entire gain, including the portion accrued while they were non-residents. This situation has sometimes deterred Israelis from returning or caused them to delay their return. Under the Reform, the ITA intends to issue a circular stipulating that returning residents may elect to allocate back such income over a period of up to six years, so that the portion attributable to their period abroad will not be subject to Israeli tax. In addition, it will be possible to apply the capital gains tax route under Section 102 of the Ordinance to options granted during their employment abroad and benefit from the reduced tax rate available under

that regime.

4. <u>Summary and Initial Implications</u>

The “Reform” in the taxation of the high-tech sector is a welcome initiative aimed at addressing several issues that have hindered the enticement of foreign investors to Israel, deterred multinational companies from expanding their activities in Israel, and, in some cases, discouraged returning residents and new immigrants from relocating to Israel.

However, in most areas, the Reform does not alter the fundamental principles underlying the existing tax frameworks applicable to the high-tech industry but rather modifies the manner in which they are implemented (for example, by introducing administrative constraints on assessment procedures or replacing advance approvals with regulations).

Beyond the guiding principles outlined in the Reform, its success will depend on the determination and speed with which it is implemented. A prompt adoption of the necessary measures (through legislation, regulations, and professional circulars) and the establishment of clear, simple, and easily applied mechanisms are essential for the Reform’s success and for maintaining and enhancing the performance of Israel’s high-tech sector.

Our firm has vast experience in advising multinationals companies, investment funds, and other foreign investors, as well as returning residents, including with respect to various tax aspects and applications for tax rulings and other arrangements with the Israel Tax Authority.

Join us for a webinar on Recent Changes in the Taxation of the Multinational Companies on November 13, 2025, at 11:00 AM (Israel time).

For registration click here

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