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## CLIENT UPDATE

# The IIA / OCS New Licensing Rules

The Israeli Innovation Authority (previously known as the Office of the Chief Scientist of the Israeli Ministry of Economy) ("IIA" / "OCS") has published important new rules regarding use of knowhow that was funded by the IIA.

The new rules enable IIA-funded companies to license IIA-funded knowhow to foreign corporations subject to IIA approval, payment of a reduced fee and certain reporting obligations. Until now, any license concerning IIA-funded knowhow (which was broader than a license to market, distribute or sell products) required payment of a lump sum transfer fee to the IIA that could reach up to six times the amount of the IIA funding of the company - as much as the fees to transfer the knowhow abroad.

The new licensing rules relieve the restrictions on global business activity of IIA-funded companies, enabling more technological and commercial cooperation. The purpose of the new rules is to make it easier for IIA-funded companies to exploit their knowhow on a global basis, to share it with foreign corporations (including their foreign affiliates), and to create new business opportunities.

The new rules are also meant to incentivize foreign corporations that acquire or invest in IIA-funded companies to maintain the technology of the Israeli companies in Israel, while being able to share the technology globally (within the group or with other parties) at a reasonable cost.

The new rules affect M&A, investment and commercial transactions which involve IIA-funded companies or companies that hold IIA-funded know-how. The new rules also provide an opportunity for IIA-funded companies to reexamine the structure of their operations in order to share their know-how with non-Israeli partners or group companies.

The new rules are not easy to implement, in particular if the transaction is between related parties, or if the consideration is not monetary or fixed. However, the new rules are just a starting point, and not a bad one. The IIA already stated it will adjust the new rules along the way if necessary, either by amending them or agreeing to practical arrangements. HFN is working with the IIA to create a special IIA licensing regime for multinational corporations that will relieve MNCs even further in order to incentivize them to maintain their technology in Israel.

It is therefore highly recommended to consider the implications of the new rules, both regarding future transactions as well as regarding restructuring possibilities of on-going operation of IIA-funded companies. Also note that the new rules may bear various tax implications that need to be carefully considered.

Should you require any further information or clarification regarding the issues discussed in this circular, please do not hesitate to contact us.

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# The IIA / OCS New Licensing Rules – In a Nutshell

## The IIA Approval

- ***The IIA may approve any grant of "permission" (license) to non-Israelis*** to use IIA-funded know-how or any rights therein.
- ***Complete sale/assignment of IIA-funded know-how*** (including license in which the owner is effectively excluded from using the know-how) ***or the grant of manufacturing licenses to non-Israelis will continue to be subject to the rules that currently exist.***
- ***The new rules do not exempt various kinds of permissions to use IIA-funded know-how that are currently subject to IIA approval but do not trigger IIA payments*** (such as integration, maintenance and support etc). However, we expect that such transactions will continue to be without payments to the IIA.
- ***The IIA may require guarantees from the company or from the licensee*** for the payment of license fees to the IIA as a condition to the approval of the license.
- ***Each grant of license, even if regarding the same know-how approved in the past, is subject to the new rules*** - i.e., it will require IIA approval and payment of license fees to the IIA.
- ***The IIA may update its approval for a grant of license*** if the company receives new funding for a project whose know-how was included in license previously approved by the IIA.
- ***IIA approval for a grant of license or full payment of the license fees to the IIA does not release the company from the rules of the IIA.*** The company will continue to be subject to the limitations and obligations under the R&D Law, including royalty payments obligation (if applicable) and limitations on transfer of know-how unless the company sells/assigns its IIA-funded know-how to others with the IIA approval.

## IIA License Fees

- As a condition to receiving the IIA approval for a grant of license, the IIA-funded company will be required to make certain license fees payments to the IIA as detailed below.

- ***The minimum amount*** – will be no less **than the relevant IIA funding** that had been received (including interest).
- ***The maximum amount*** – will be no more than **6 times the relevant IIA funding** that had been received (including interest).

Past royalties paid by the company to the IIA and previous payments paid to the IIA for other grants of licenses regarding the same know-how will be set off from the fees charged.

- ***There are no refunds for fees paid if the grant of license or the conditions thereof are cancelled or changed.***
- ***Calculation of IIA License Fees -***

The Total Transaction Amount	IIA Fees
Paid in one installment	The <i>Repayment Amount</i> subject to <i>Depreciation</i> .
Paid in installments – two options:	
<ul style="list-style-type: none"> <li>• Where <i>Repayment Amount</i> &gt; IIA funding, including interest</li> </ul>	<i>IIA Participation Ratio</i> X Any payment for the license
<ul style="list-style-type: none"> <li>• Where <i>Repayment Amount</i> ≤ IIA funding, including interest</li> </ul>	<i>Minimal Ratio</i> X Any payment for the license

Total Transaction Amount = The total payments the IIA-funded company is expected to receive, directly or indirectly, for the grant of the license, as determined by the IIA.

If the consideration for the license is not monetary or fixed, if there are "special relations" between the parties or if the consideration is not arm's length – the IIA may (usually interpreted as "must") determine the Transaction Amount based on an Economic opinion.

Repayment Amount = IIA Participation Ratio X Total Transaction Amount

Depreciation = The amount is depreciated over 7 years, down to the amount of the IIA funding received (including interest), starting at the end of the third year from the completion of the relevant IIA-funded project.

$$\text{Minimal Ratio} = \frac{\text{IIA funding including interest}}{\text{Total Transaction Amount}}$$

$$\text{IIA Participation Ratio} = \frac{\text{The IIA funding under the relevant projects}}{\text{RD expenses of the company connected with the relevant knowhow + relevant IIA funding}}$$

**Note:** if the IIA Participation Ratio is > 50% → the company will not pay more than 50% to the IIA from each payment it receives.

### **Exclusion of certain payments from the IIA License Fees calculation**

- ***Based on the nature of the payments*** - The IIA may agree that certain amounts that are paid for the license **will not** be taken into account for the calculation of the Total Transaction Amount or the IIA Participation Ratio.
- ***Based on timing of the payments*** - The IIA may agree that amounts that are expected to be paid seven years or more after the date of the grant of the license **will not** be taken into account for the calculation of the Total Transaction Amount.
- Amounts that were excluded for the purpose of calculation of the IIA license fees may still be subject to royalty payment obligations to the IIA.

### **If the Repayment Amount is lower than the IIA Funding**

- ***If the company fully paid the IIA License Fees and the Repayment Amount is lower than the relevant IIA funding (including interest)*** – the IIA may require the company to pay the IIA the difference within 14 days.
- ***If the IIA determines that the company is not expected to repay the full amount of the relevant IIA funding (including interest)*** – the IIA may require the company, subject to a hearing, to immediately pay the full amount of the IIA funding (including interest).

### **Exchange of licenses without payment of IIA License Fees**

- The IIA may approve the exchange of licenses without any payment to the IIA, if a license is exchanged for a license in another know-how, which the IIA determines benefits the Israeli economy substantially more than the license that is granted to the relevant non-Israeli.

- In such case, the know-how received in the exchange will be deemed IIA-funded and will be subject to the limitations and obligations under the R&D Law, including the obligation to pay royalties.
- The IIA may retroactively cancel the approval for any exchange if the know-how received in Israel in the exchange is not used within 4 months from the date of the approval.

### **Reporting obligations**

- The company must submit an annual report to the IIA signed and approved by a certified accountant starting from the receipt of the IIA approval until the end of the period of the license.
- The IIA may exempt the company from the submission of the annual report, permanently or for a limited period, in the following cases: (i) the license was canceled, (ii) the company paid to the IIA the full IIA license fees, or (iii) the IIA is convinced that there will be no additional payments for the license.

### **Tax notes**

- **Sale / License** - IIA approvals are reviewed by the Israeli Tax Authority ("ITA"). Now that the new licensing rules are published, it be critical to apply for the proper IIA approval (for a transfer of knowhow or for a license of knowhow) and to draft the application to the IIA properly (even in the case of application for a transfer of knowhow), in order to reflect the true nature of the transaction and to avoid any arguments from the ITA in this regard based on the IIA approval.
- **Transfer Pricing** - the information that will be provided to the IIA regarding the consideration in licensing transactions may be used by the ITA and has an obvious implication on transfer pricing matters.

*This publication is intended as a general guide only. It should not be regarded as legal advice and should not be relied upon. The readers should seek specific professional advice in applying the applicable law to any specific situation.*

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