Bloomberg Tax
Transfer Pricing Report

Multinationals Face Tougher Israeli Intercompany Pricing Audits

By Matthew Kalman

Posted Nov. 8, 2018, 8:46 PM

- Israeli circular codifies transfer pricing rules based on OECD guidelines
- Could mean bigger tax bills for some multinationals

The Israel Tax Authority is maintaining its strict approach to the tax treatment of intellectual property transferred abroad following the purchase of an Israeli company by a multinational.

Israeli entities of multinational groups transferring valuable intangibles to their foreign affiliates face more onerus intercompany pricing audits as a result of a Nov. 1 circular.

According to practitioners, the circular gives the tax authority the ability to assert more value to a company's transfers, leading to higher transfer pricing assessments and thus bigger tax bills.

The principles of transfer pricing are used when individual units of a multi-entity company are treated as being separately run. Transfer pricing often uses comparables—real-world examples of similar transactions between unrelated parties—to decide how to value an intercompany transaction.

Business Restructurings

"A multinational purchaser has the ability to force the transfer of assets at a much lower price than the market value because the companies are related," said Boaz Feinberg, a partner and head of tax and financial regulation at Zysman, Aharoni, Gayer and Co. in Tel Aviv, told Bloomberg Tax.

"This is why the tax authority says it can intervene," Feinberg said. "The whole purpose of transfer pricing is to make sure that the relationship between the companies does not affect the actual price of what is transferred."

The circular defines such a transfer as "a change in business model" that essentially changes the function of the acquired company, stripping it of its value, altering its relationship with the parent, and triggering a tax event equal in most cases to the value of the acquisition with attendant tax liability.

"Where the conditions created or imposed between related parties due to the material change in the existing arrangements differ from those that would have been determined between parties with which no special relationship exists, the price must be determined according to the price and market conditions," the circular says, citing the OECD guidelines on transfer pricing.

The circular addresses the methods for identification and characterization of business restructuring and suggests the acceptable transfer pricing methodologies to value functions, assets and risks that could be taxable. Where the transfer of assets is preceded by an acquisition of shares, the total purchase price will usually be applicable—unless the taxpayer can prove otherwise.

Impact on Investment

The Nov. 1 circular codifies a policy first approved by the Tel Aviv District Court in 2017 precedent-setting case against Microsoft Corp.

Microsoft had acquired Gteko Ltd., a startup, for $90 million.

The court rejected Microsoft's $26.6 million valuation of Gteko Ltd.'s intellectual property. The court agreed with the tax authority that without the IP, Gteko was essentially worthless, and thus upheld the tax authority's demand for an additional $28 million in taxes.

The decision, which cast a shadow over multinational acquisitions of Israeli companies, is yet to be tested in Israel's high court but its adoption as formal policy has significant implications for future deals, affecting the structure and pricing of mergers and acquisitions of local technology companies, practitioners said.

"You can see the effect," said Daniel Paserman, partner and head of tax at Gornitzky and Co. law firm in Tel Aviv. "We have multinationals that we represent that have ceased doing this kind of investment in Israel for the last couple of years because of these issues with the tax authority. There's a lot of uncertainty. They say the environment is not positive and they get hit by the tax authority so they are more cautious about investing in Israel."

Acquiring Start-Ups

The policy effectively allows the authority to tax the transaction twice, Paserman said by phone Nov. 4. The founders and investors are taxed for the capital gain on the sale of their shares to the multinational, and then the Israeli company is taxed on the deemed dividend with the subsequent transfer of the IP or other assets to the foreign group.

"It's problematic because it makes all the deals more expensive," he said. "If I'm a multinational looking at the overall price and I'm considering the likely cost of my investment in Israel, I should now add this additional layer of taxes which makes these transactions more expensive."

"Multinationals don't like this situation," he said. "Long term, it might deter startups or investors from investing in Israel. They will think it better to establish foreign entities and not Israeli entities because of all these obstacles and problems."

Microsoft Case on Appeal

While acknowledging that the bid to stop multinationals transferring revenue-producing assets and activity to lower-tax jurisdictions “is a huge issue,” the Microsoft-Gteko verdict was a “bad example” that may not be upheld on appeal, Feinberg said.

Miscrosoft closed Gteko and transferred its employees before transferring the IP, which it argued represented only a fraction of the original purchase value of the company, Feinberg said by phone Nov. 4. That was unusual, as was the difference between the valuation of the IP and the company’s shares.

Microsoft declined a request to comment.

“It was a bad case because the gap between the premium on the shares and the price they paid for the IP was enormous,” he said. “It seemed to be unfair. Legally, Microsoft might have a good claim, maybe it will be reversed in the supreme court. It’s not a simple case.”

The Nov. 1 circular also sets out guidelines for the possible licensing of IP that would leave the know-how in the Israeli company and reduce the immediate tax liability. The conditions are very strict and hard to fulfill, Feinberg said, but they offer an alternative route. “It’s an opening,” he said.

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