



March 2020

Broadcom Case – The ITA did not file an Appeal to the Supreme Court

Reading Time: 3 minutes

In a precedential ruling of Broadcom Semiconductors (formerly Dune) case, which was granted after four years of complex legal proceedings, the District Court accepted the taxpayer's position in its entirety. The ruling holds meaningful tax implications for acquisitions of Israeli companies. The taxpayer's victory over the Israeli Tax Authority (herein: "**ITA**") is particularly impressive given the fact that in a previous, similar ruling regarding **Gitko** and Microsoft case the same court panel adopted the ITA's position and rejected the appeal.

Within this memorandum, we would like to comment and shed light on a few important issues that should be addressed regarding future acquisitions of Israeli companies, and ITA's assessments, which are issued in relation to them.

In short, Broadcom purchased Dune's shares at a value of approximately 200 million USD. Following the acquisition of its shares, Dune engaged in three inter-company agreements with a few companies within Broadcom. The first agreement was a **license agreement** in exchange for royalties; the second was a **services agreement** in consideration for "cost plus" basis fees; and the third was a **marketing and support** agreement for products development via a "cost plus" basis payment.

According to the ITA, after the acquisition, Dune underwent a "**business model change**", from a business venture that owns profitable intellectual properties to a "risk-free" company that operates at a "cost plus" model and develops intellectual property in favor of related foreign companies. Under these circumstances, according to the ITA, Dune should have been considered as an "**empty corporate shell**" that "**emptied out**" its own assets in favor of the group's members. Therefore, the transaction should be reclassified, so that the company shall be taxed for the sale of its "**FAR**" (Functions, Assets and Risk). The FAR should be valued based on the price of the share purchase transaction aforementioned, subject to a few minor computational adjustments. **The court rejected the ITA's thesis and accepted the appeal, which was filed and conducted by our office.**

The court's decision regarding the "FAR" sale

In recent years, the ITA has been reciting three magic words - "**business model change**". According to this approach, whenever an Israeli company is acquired by an international group and shifts its business model to a "cost plus" model, it transfers its own "FAR".

Furthermore, in the judgment, the court determined that "*I do not believe that the words "business model change" are some kind of magic words, where it is sufficient simply to utter them in order to give rise to a change of the classification of the Transaction that was made between the parties*". This is a significant announcement for startups and a warning sign for the ITA which is committed to carefully reviewing every transaction. The Court firmly stated that a "business model change" is a legitimate business action "*that could be beneficial*" and certainly is not an automatic cause for issuing a sale assessment.

The court's decision regarding the FAR valuation

The Court ruled that the assessment regarding the deemed "FAR" sale must be canceled, making disputes related to the FAR valuation irrelevant. However, the court saw fit to express its position about valuation aspects by way of obiter dictum, including:

- **Payments to the Chief Scientist** - The Court held that the payment to the Chief Scientist should be added to the consideration paid for the shares (which is generally the starting point for the FAR's valuation), since the court refers to it as "a type of fine" for transferring knowledge outside of Israel.
- **The function's "discount rate"** - The Court held that cases in which FAR is considered to have been sold, the ITA's thesis that the post-transaction company activity is less risky should be taken into account for valuation purposes. Therefore, in order to value the functions left in the Israeli company, a reduced discount rate should be taken into account. As a result, the value of the functions left in the Israeli company will increase, and accordingly the "FAR" value (and its taxation) will be lower.
- **Reduction of control premium** - The ITA refuses to recognize payments given for control premium when it deals with a purchase of 100% of the shares. However, the court accepted our position that the purchase price should be additionally reduced by the value of the control premium also in such cases, provided that it has been proved that the control premium was taken into account in the purchase price.

Of course, the short list above is not exhaustive and additional issues are currently being discussed in various court proceedings, including cases that our firm is conducting in courts.

For further information please contact:



Daniel Paserman
Adv. (CPA), TEP, Head of Tax
✉ paserman@gornitzky.com



Shlomo Aviad Zider
Adv. Partner
✉ shlomoz@gornitzky.com