The Medingo-Roche Case: The District Court Dismissed the Israel Tax Authority's Argument of the Sale of "FAR" Following a Business Restructuring

On May 8th, 2022, the Tel Aviv District Court (the Honorable Judge Yardena Seroussi) accepted the tax appeal filed by our firm in the matter of Medingo Ltd., a subsidiary of Roche, one of the world's leading healthcare corporations. Medingo's tax appeal was filed against the Israel Tax Authority's argument of the sale of FAR following a "business restructuring". As a result of this court ruling, the Israel Tax Authority's demand to collect tax in the amount of over NIS 185 million was dismissed.

Medingo was set up in 2005 and was engaged in the development of the "Solo," a wireless insulin pump for diabetes patients. In May 2010, Roche Group acquired the entire share capital of Medingo for US $160 million, together with a payment in the amount of US $19 million according to the agreed milestones.

In line with standard practice after the acquisition of an Israeli start-up company by a multinational, about six months after the share transaction, four agreements were signed between Medingo and Roche Group: a license agreement for granting a right of use in the Israeli company's intellectual property in consideration of the payment of royalties; as well as three service agreements – R&D, manufacturing and marketing – in consideration of Cost Plus 5%.

The Assessing Officer argued that the engagement in the agreements shortly after the transaction for the purchase of the shares should be viewed as a "Business Restructuring", as a consequence of which Medingo should be deemed to have sold to Roche Group its core functions, assets and risks ("FAR"), and that this transfer is subject to capital gains tax. The Assessing Officer sought to derive the value of the sale of the FAR based on the consideration that had been paid in respect of the purchase of the shares, and determined that taxable income of approximately NIS 480 million and a tax liability of approximately NIS 120 million (before interest and linkage differentials) should be attributed to Medingo. In addition, interest income for the following years was attributed to Medingo in the amount of tens of millions of New Israeli Shekels, by virtue of a "secondary adjustment."

Medingo denied the Assessing Officer's arguments, and it argued that not only had the company not been emptied out, but, rather, under the auspices of Roche, and with its encouragement, Medingo had achieved growth in all respects: it was Medingo's management that had outlined and managed its R&D, manufacturing and marketing efforts; the number of Medingo's employees grew significantly (from 89 employees in 2010 to 147 employees in 2012); it became profitable for the first time in its history; and the court was also presented with evidence attesting that the ownership of Medingo’s patents had been strictly protected, and that a separation had been made between the “old” IP (which remained owned by Medingo) and the “new” IP, which was registered under Roche’s name. In addition, Medingo pointed out the erroneous application of the OECD Guidelines by the Assessing Officer , which show that not every change in the company’s risk-reward mix is compensable, and that when the business restructuring is consistent with engagements in which unrelated parties would have engaged under similar circumstances, then there is no reason for the court to intervene in the intercompany understandings or to award additional compensation. Medingo also argued that in actual fact, it had sold its intellectual property to Roche Group in November 2013, and this is the date of the tax event.

In her judgment dated May 8, 2022, the Honorable Judge Yardena Seroussi adopted the Appellant’s position in its entirety, and ruled that the circumstances of the case should not be deemed to be the sale of FAR that would amount to the divestment of an asset which is taxable. As noted by Judge Seroussi, her judgment continues along the path that was paved by the Honorable Judge Borenstein in the **Broadcom** case, and she reiterated his determination that “business restructuring” is not “*a magic word, where it is sufficient to merely utter it in order to bring about a change of the classification of the transaction that had been made between the parties*.” In her judgment, Judge Seroussi ruled, based on the testimonies and the evidence that had been brought before her, that the Medingo's operations had continued, and even with greater intensity, in accordance with the provisions of the intercompany agreements, and that Medingo had continued with operations, including the R&D, manufacturing, marketing and management functions.

Below we will emphasize a few key points which were laid down in the judgment, and which are likely to have significant implications for cases involving a “business restructuring”:

- The question of whether a transaction between related parties complies with the arm’s-length principle should be examined according to two stages: at the first stage, the nature of the transaction should be examined (license, services, sale or other) and whether the transaction would also have been made between unrelated parties. In this regard, the Honorable Judge Seroussi referred to the position of the OECD Guidelines, that there should be no intervention in the nature of the transaction in contravention of the agreements, other than in exceptional circumstances, in which the agreements are fundamentally implausible or where they do not allow, in any manner whatsoever, the determination of a price in accordance with the arm’s-length principle. At the second stage, it should be examined whether the price that was paid is consistent with the market conditions; however, the pricing of the transaction cannot indicate the nature of the transaction, but, rather, at the very most, whether there is cause to increase the royalties and to modify the terms and conditions that were set forth in the Agreement.

- An additional indication that a transaction between related parties is consistent with the arm’s-length principle is that prior to the intercompany engagement, none of the parties had any realistically available option that was viewed as being preferable from a business point of view – “*with hindsight, and on paper, it is “convenient” to propose alternatives; however, on many occasions, the reality on the ground in real-time is totally different*.” In this context, the Honorable Judge Seroussi clarified in her judgment that a “realistically available alternative” means solely an alternative whose preference is not subject to any doubt whatsoever. In addition, the court discussed the fact that the examination of the available alternatives should be done from the point of view of both parties to the transaction.

- The Assessing Officer’s arguments with respect to the “removal” of functions from Israel in the framework of the intercompany agreements must be backed up by facts on the ground. The Assessing Officer’s reliance solely on the intercompany agreements is not sufficient in this context, and the Assessing Officer should not have made a petitio principii argument – that solely because these are related companies, then the matter involves a sale, and not the granting of a license and R&D services (without examining the transaction on the merits and the parties' subsequent conduct, as would have been the case, had the parties been unrelated). Likewise, the parties' intention (if any) to remove the operations from Israel in the coming years does not create a tax event in and of itself, because this determination is subject to actions and not intentions.

- Insofar as pertains to the Assessing Officer's argument of the outlining of the business strategy by Roche, the court discussed the fact that the Assessing Officer had not been sufficiently precise in the distinction between Roche as a shareholder and Roche as the purchaser of operations. Medingo's management has always been subject to a shareholder which has outlined the company's strategy. In other words, the fact that Roche took part in outlining Medingo's policy does not necessarily lead to the conclusion that the management function has been removed from Medingo. This is a fortiori true given that Roche has vast experience in the pharma industry, and it makes sense that Medingo would seek to take advantage of the extensive know-how in Roche's possession.

- As was also done in the **Broadcom** case, it would appear that the court attributes weight to the growth in the number of employees since the signing of the intercompany agreements, as well as the growth in the company's revenues and the turnaround from being a loss-making company to a profit-making company.

- The fact that patents that were developed up until the Roche period were registered in Medingo's name, whereas patents that have been developed thereafter have been registered in Roche's name, attests to a separation that was made by the parties between the "old IP" and the "new IP," as well as that from an economic point of view, the old IP was not permanently transferred in the framework of the license agreement, and was not mixed in with the new IP, as the Assessing Officer is claiming. This is also shown by the fact that Roche was required to purchase the old IP at the expiration of the term of the license agreement in order to continue to make use thereof.

- With respect to the question of whether the risks were transferred or not, it is necessary to focus on the risk of the failure of the product, a risk that remains, first and foremost, with Medingo, as distinct from the risk of the loss of the investment, which is borne by the shareholders. The Honorable Judge Seroussi also found that the reduction of the risks (and the accompanying opportunities) in and of itself does not show the sale of the operations, and that businesses can change their business model, even without it constituting a sale.

Please feel free to contact us with any questions that you have on this matter.




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