Business Model Change Tax Assessments – Recent Court Update

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Israel – the holy start up nation – is an important technology hub. Many innovative start-ups and initiatives attract substantial capital investments from all over the world. Multinational companies acquire Israeli companies at various stages, in a rapid pace - almost on a weekly basis. Following such acquisition, the acquired Israeli company is usually transformed into an R&D center, often compensated on a cost-plus basis.

In recent years, the Israeli Tax Authority has argued that the Israeli company underwent a "business restructuring", from a business venture that owns its own IP and may benefit from materializing its potential, to a "risk-free" company

Sometimes, the legacy IP of the acquired company remains under the ownership of the Israeli entity, while new IP developed under the R&D service agreement is owned by the foreign multinational. Sometimes the existing IP is sold to a foreign entity which is part of the group (since many multinational corporations prefer to concentrate the group's entire IP under one ownership). In addition, the Israeli entity is likely to provide additional services to the foreign group, such as, marketing, manufacturing, etc.

In recent years, the Israeli Tax Authority (ITA) developed a theory, according to which such post acquisitions inter-company transactions/ engagements, constitute a taxable "business model change". Namely, the ITA argues that the Israeli company underwent a "business restructuring", from a business venture that owns its own intellectual property and may benefit from materializing its potential, to a "risk-free" company that operates as an R&D center developing intellectual property in favor of related foreign companies, limiting its profits to the mere profit set in the cost-plus engagement. Therefore, the ITA argues that the Israeli target company should be considered as an "empty corporate shell" that "emptied out" its Functions, Assets and Risk ("FAR") in favor of the group's

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members. Hence, the ITA reclassifies such post-acquisition transactions as a deemed taxable sale of the company's FAR. Commonly, in order to evaluate the FAR, the ITA uses the price paid for the shares, and applies few minor computational adjustments.

Moreover, during past years, the ITA added another layer to the assessment and argued that as there was a deemed sale of the FAR, and no consideration was actually paid for it by the foreign multinational, the unpaid compensation assessed by the ITA is an "imputed inter-company debt", which should carry arm's length interest. This assessment by the ITA is referred to as a "Secondary Adjustment", since the ITA's claim in this regard depends on the initial adjustment of the deemed FAR sale.

Thus, in most cases the ITA charges the Israeli company for the taxes that should have been paid according to the ITA's position in respect of the deemed FAR sale (the initial adjustment) and also for deemed "imputed interest" (the secondary adjustment).

For a few years already, the ITA has issued numerous tax assessments based on the "business model change" theory, claiming for a sale of the Israeli company's FAR to the multinational corporate group that has purchased its shares. Many cases were settled; however, four cases

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reached the stage of a court judgment.

The first case was the Gteko – Microsoft case, published in 2017. In that case, Microsoft Inc. purchased an Israeli start up called Gteko for approximately 90 million USD. Thereafter the Israeli company transferred all its employees to Microsoft Israel and sold its IP to Microsoft Inc. for approximately 26.5 million USD. The court accepted the ITA's assessment and ruled that the company was indeed emptied and all its FAR was sold out.

The Gteko ruling astonished the hi-tech industry, and real fear rose among companies and investors that Gteko's outcome will jeopardize the attractiveness of purchasing Israeli target companies.

After the Gteko case, however, additional three cases were brought to the Israeli court after the ITA issued FAR assessments, accompanied by "secondary adjustment" assessments. Our firm represented the taxpayers in all three cases, while in two the court ruled in favor of the taxpayer, but the third case was ruled in favor of the ITA and an appeal is currently being considered.

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The first case was the Dune – Broadcom case, published in 2019. In that case, Broadcom purchased an Israeli target company named Dune Semiconductor Ltd., for a value of approximately 200 million USD. Following the acquisition of its shares, Dune engaged in three inter-company agreements with few companies within Broadcom: a license agreement for Dune's existing IP in exchange for royalties; an R&D services agreement for consideration calculated on a "cost plus" basis, while the IP developed as part of those services belongs to Broadcom; a marketing and support agreement for products development as part of the R&D services. According to the ITA, after the acquisition, Dune underwent a change in its "business model", from a business venture that owns profitable intellectual properties to a "risk-free" company that operates for the benefit of a foreign multinational and its revenues have been limited to the royalties and the "cost plus" based compensation. 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 - as the ITA claimed in the Gteko case. Therefore, the ITA reclassified the transaction and determined a capital gain tax for the sale of Dune's "FAR". The ITA valued Dune's allegedly sold FAR based on the price of the share purchase transaction, subject to a few minor adjustments. The court rejected the ITA's thesis and accepted Dune's appeal on the assessment - determining that the engagement in the inter-company agreements did not constitute a "sale of FAR". This was an impressive precedential ruling, particularly given that the judge in this case was the same one who wrote the Gteko judgement where the ITA's position was accepted. The ITA did not appeal to the Supreme Court.

A few months ago, on May 8th 2022, the Medingo - Roche case judgement was published. Medingo Ltd. was established in 2005 and engaged in the development of the "Solo," a wireless insulin pump for diabetes patients. In 2010, Medingo's entire share capital was acquired by Roche, one of the world's leading healthcare multinational corporations, for around 180 million USD. In line with the standard post-acquisition practice described above, after the share transaction, four agreements were signed between Medingo and Roche group: a license agreement for Roche's use of Medingo's IP in consideration of royalties payment; as well as three service agreements - R&D, manufacturing and marketing support and consultation - in consideration for fees calculated

on a cost plus basis.

As in the cases of Gteko and Dune, the ITA argued that the engagement in the agreements shortly after the transaction for the purchase of the shares should be viewed as "business restructuring", as a consequence of which Medingo should be deemed to have sold its' FAR to Roche, and be liable for capital gain tax. The ITA sought to derive the value of the sale of the FAR based on the shares transaction consideration and - in addition - imposed deemed interest income for the following years by virtue of a "secondary adjustment".

Medingo denied the ITA's arguments and 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.

The court adopted Medingo's position in its entirety and ruled that the circumstances of the case should not be deemed as a sale of FAR and that even if the business model of Medingo had changed - such change is not taxable. As noted by the court, the Medingo judgment continues along the path paved in the Broadcom case, and it reiterated its 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".

There are a few key points laid down in the Medingo judgment, which are likely to have significant implications for cases involving "business restructuring". Due to the limited scope of this article, we would shortly mention only a few principles:

> **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 determined. At the second stage it should be examined whether the transaction's consideration is consistent with the market conditions**

- 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), also considering whether such transaction would also have been made between unrelated parties. In this regard, in accordance with the OECD Guidelines, there should be no interference 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 transaction's consideration 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 or profit margin, or to modify specific terms set forth in the agreements.
- 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 viewed as preferable from a business point of view. In this context, the court clarified in its judgment that a "realistically available alternative" means solely an alternative whose preference was undoubtable at the time, without hindsight. In addition, the court emphasized that the examination of the available options should be done from the point of view of both parties to the transaction.
- The ITA's arguments with respect to

the "removal" of functions from Israel in the framework of the intercompany agreements must be backed up by proven facts. The ITA's reliance solely on the intercompany agreements is not sufficient in this context, and the ITA should not have made a petitio principii argument – that simply because the companies are related, then the matter involves a sale, and not 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).

The court determined that the classification of the transaction as sale of IP or FAR is immaterial, as in this case both parties determined the transaction's value based on the DCF methodology. Therefore the core of the dispute was around the valuation and the judgement did not address the classification issue whatsoever

- A distinction should be made between "old IP" (which existed prior to the transaction) and "new IP" (to be developed), including the legal ownership thereof, and its formal registration.

The ITA did not file an appeal to the Supreme Court. The last judgement was published on October 25th 2022 - the CA case. Memco, a startup established in the early 1990's, was indirectly acquired by CA Inc. as part of a purchase of another multinational company in 1999. Memco's name was then changed to CA Israel, and while it maintained its own (legacy) IP, it also provided R&D services to the parent company, as well as other intercompany services such as sales and marketing of CA Inc.'s products in Israel.

A decade later, CA Israel sold its remaining legacy IP to CA Inc.. The ITA argued that CA Israel sold not only its IP but also all of its cyber-sector FAR, and valued the "deemed consideration" at five times higher than the price actually paid for the IP.

The court determined that the classification of the transaction as sale of IP or FAR is immaterial, as in this case both parties determined the transaction's value based on the DCF methodology. Therefore the core of the dispute was around the valuation and the judgement did not address the classification issue whatsoever. The court ruled in favor of the ITA, as it was not convinced that the expected income from the IP, estimated as part of the DCF valuation, was as limited as assumed by CA, despite the fact the court was also not comfortable with the high growth rates used in the "overly optimistic" estimation of the ITA. The court also confirmed the "secondary adjustment"; however, the court noted its dissatisfaction since it questioned the authority of the ITA to impose such secondary adjustment. The court mentioned that if it were not for a Supreme Court decision that previously maintained a secondary assessment (the Kontera case) - CA Israel's appeal in this regard might have been accepted and thus called for the Supreme Court to re-examine the matter.

The taxpayer is considering appealing to the Supreme Court nowadays, so perhaps we still have not heard the last word in this matter.

It seems that the Medingo case had a highly cooling effect on the 'business model change" theory, as developed and implemented by the ITA. Some assessments based on this theory are still pending in different stages, but in some cases the ITA already withdrew this claim and even canceled the assessment. However, further to the district court ruling in the CA case regarding the valuation of IP that was actually sold, the ITA might focus more on the pricing of inter-company transactions rather than on such transactions' reclassification. Only time and judges will tell. ■

THERE IS
ALWAYS
A WAY

Some see a conflict

We see Common ground

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