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Global Tax Alert

Israeli Court rules in favor of taxpayer on business restructuring

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Executive summary

On 9 December 2019, the Israeli Central District Court (the Court) ruled on the classification of a business restructuring concerning a post-acquisition set of agreements that included the license of Intellectual Property (IP) in return for royalty, and the provision of Research & Development (R&D), marketing and technical support services on a cost-plus basis, made by the acquired Israeli company to its US parent and other group entities. After the same Court and Judge ruled in favor of the Israeli Tax Authority (ITA) in the well-known *Gteko Case*[1], which discussed a post-acquisition one-time sale of IP, the Court made a clear distinction between the two cases with the focus that the business restructuring in the *Gteko Case* resulted with a "contentless shell corporate", whereas the instant case led to the growth of the company and its elevation following the business restructuring. In addition to the above, the Court made important comments with respect to the valuation of a one-time sale of IP, especially with respect to control premium. The implications of this ruling can be very significant for multinationals acquiring Israeli technology companies and performing a business restructuring thereafter.

The case, *Broadcom Semiconductor Ltd vs. Kfar Saba Assessing Officer*, was decided in favor of the taxpayer. The Court ruled that the change of business model in which a company transitions from being a company that develops for itself into a company that provides its acquirer with such services on a cost-plus

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basis and is entitled to royalties based on the sale of products that combine its IP does not necessarily lead to the conclusion that the company essentially sold an asset. The general claim of the ITA according to which any business restructuring and change in the composition of Functions, Assets and Risks (FAR) results in a capital gain is not acceptable, and while a careful analysis and comparison of pre- and post-FAR is a proper approach, it must be done in a measured way rather than in a broad and automatic manner. Subject to the Israeli Transfer Pricing (TP) rules, the ITA can intervene in the transaction and determine a different compensation rate than the one determined by the parties (which the Assessing Officer did not argue in the case at hand). However, if there is no concrete indication that the transaction itself is different than the one presented (i.e., a sale of assets), there is no room for such intervention. Beyond what is required, the Court commented on various valuation items that were litigated by the parties, and generally agreed with the taxpayer that the value of inventory, workforce and Control Premium should be deducted from the purchase price, but noted that the value of such Control Premium should be supported by a "real-time" document to prove it was in fact included in the purchase price.

Multinationals conducting Israeli acquisitions should carefully review the decision and its specific differences from the *Gteko Case*, to evaluate its potential impact on prior transactions and the important highlights to keep in mind towards future acquisitions and business restructurings.

Detailed discussion

Broadcom Semiconductors Ltd (the Company), previously known as Dune Semiconductors Ltd, is an Israeli company operating in the production and marketing of router switching components and high-speed switches designed for broadband communications infrastructure. Broadcom Ltd was 100% held by Dune Networks Inc., a US company (the Parent Company). In 2002, the Company entered into a license agreement with the Parent Company for the right to use the Parent Company's IP (the Concept) in return for a royalty. It was agreed that any IP that was developed prior to the agreement will remain under the ownership of the Parent Company, while any new IP that will be developed will be owned by the Company. In addition, the Company and the Parent Company engaged in a license agreement with a third party for the joint development of the IP, owned by the Company (the JDA).

In November 2009, Broadcom Corporation (Broadcom), a US publicly traded company acquired 100% of the shares of the Parent company for US$200 million[2] (before adjustments). As the Company was supported with $5.1 million in grants from the Israeli Innovation Authority (previously known as Office of Chief Scientist) (IIA) during 2003-2009, it approached the IIA with the request to transfer the IP developed by it, and that was supported by the IIA, to outside of Israel. The IIA approved this request, subject to a payment of $15.4 million. The representations made by the Company to the IIA, in which it described the transaction as the "sale" of the IP rather than a mere license transaction, was later used by the ITA in Court to substantiate the claim that even the Company itself viewed it as a sale.

Following the acquisition, the Company entered into three agreements with Broadcom and its affiliates (the Transaction). In February 2010, the company entered into a marketing and technical support agreement with Broadcom Singapore Pte Ltd on a cost-plus basis, with a markup of 10%. In March 2010, the company entered into an R&D services with Broadcom on a cost-plus basis, with a markup of 8%, with a retroactive effect as of 1 January 2010. On the same date, the company entered into a licensing agreement with Broadcom International Ltd, a Cayman Island entity (Broadcom Cayman), to use, develop, design, sell, offer to sell and distribute the products deriving from the IP and technology owned by the Company. Based on a TP analysis performed for 2010, the royalty rate was determined to be in the range of 14.1% and 14.7% of Broadcom Cayman's turnover.

In August 2012, as part of a global restructuring in the Broadcom group, the Parent Company was merged into the Company, which resulted with the direct holding of Broadcom of the Company. In November 2016, following Broadcom's acquisition by Avago Technologies (Avago), the Company sold its IP to Avago in return for $73 million, while up to this point, the royalty payments made to it by Broadcom Cayman totaled to $124 million.

The main dispute between the parties was on the classification of the Transaction as a whole, where the ITA argued that following the Transaction, the Company turned from a company engaged in R&D, manufacturing (via subcontractors), marketing, distribution and sales, into a company whose sole activity is the provision of R&D services to its acquirer. The result of such transition, in which the company separates from its business, transfers it to others and turns to a service-provider company, with a considerable reduction of the risks and rewards it had with its business, constitutes a "business restructuring" that is classified as a sale which should be subject to tax accordingly. The ITA argued that the value of FAR transferred should be determined based on the purchase price, with the relevant adjustments to separate between the assets left in Israel and those which were transferred as part of the business restructuring.

Main issues discussed

A. Business restructuring / FAR transfer

A change in a business model that has benefits for the company, in a way that increases its activity, income and profit, as well as its workforce (which the Court significantly emphasized), even if it includes the substitution of one function with another, a risk with reward and vice versa, does not mean that the company conducted, upfront, a transaction that economically represents the transfer of an "economic value" or an "asset". As such, not every business restructuring will justify a reclassification of the transaction, and as long as there is no concrete indication that the business restructuring reflects a different transaction, significantly broader than the one presented by the parties, there is no room for intervention other than in the transaction price in accordance with TP rules, if and as required. As such, while the ITA can generally use the "reclassification" tool to reclassify one transaction to another (based on the broad definition of the terms "asset" and "sale" under the Israeli Tax Ordinance), the general rule is that the contractual agreements should be respected, and therefore the intervention in the transaction itself should be limited and will be appropriate only in "rare" cases.

B. Separation between "old" and "new" IP

With respect to the ITA's argument according to which the Company could not technologically, economically and legally separate between the "old" and "new" IP, the Court accepted the Company's position and confirmed that there is no such conceptual and principal difficulty as the Company was maintaining a clear separation between the two, even if mainly for data security reasons (such as it joint developments with unrelated parties, e.g., the JDA), while the "old" IP remained on the Company's servers in Israel, to which Broadcom's employees did not have access.

C. Valuation of the transferred FAR

In addition, the Court commented on certain valuation items litigated between the parties, as they devoted significant amount of evidences and arguments to the valuation of the IP, if it would be considered as being sold. Thus, while the main item discussed in the ruling is the reclassification of the Transaction as a sale, the Court made some very important comments that are relevant to the cases of a one-time sale and the importance of a real-time documentation of items included in the Purchase Price Allocation (PPA), as well as a proper fallback analysis.

While the PPA includes important information on the examined business, and in the absence of any other document (such as TP analysis to determine the market price and conditions), it can provide insight on the way the parties, especially the acquirer, viewed the economic potential embedded in the different components of the business. However, the main difference between a TP analysis and a PPA, which is meaningful, is that the latter does not take into account the benefit created to the selling company from the transaction.

The Court accepted the ITA's approach according to which the payments made to the IIA should be added to the purchase price, that the tax value of net operating losses is the one that appears in the PPA rather than in the tax return for the relevant year as this was the value viewed by the parties, and with respect to the valuation of the distribution and manufacturing functions that moved to outside of Israel.

On the other hand, the Court accepted the taxpayer's position on the valuation of the R&D center (specifically, the risk factor rate to determine the weighted discount rate), and that the value of inventory, workforce, and control premium should be deducted from the purchase price, but noted that the value of such control premium should be supported by a "real-time" document to prove it was in fact included in the purchase price.

D. Reliance on OECD guidelines

Unlike the position held by the taxpayer, the Court confirmed that for Israeli tax purposes, the ITA can refer to the Organisation for Economic Co-operation and Development (OECD) guidelines in its business restructuring arguments and that the FAR analysis methodologies can be used for reclassification and valuation purposes, although it should be done in a measured manner, rather than broadly and automatically, which is also the approach that arises from the OECD guidelines.

E. Burden of proof

The Court accepted the ITA's position according to which in the case of reclassification of a transaction (unlike in the case where the assessing officer intervenes in the acquisition price), the burden of proof is on the taxpayer to prove what is the transaction that took place and which assets were sold as part of it, especially as the taxpayer is the one that possesses this information.

Implications

Multinationals involved in acquisitions of Israeli companies should closely review this decision and its impact on post-acquisition business restructuring performed, with a focus on its differences from the *Gteko Case*. Companies should take notice of the lessons learned from the case as they may apply to future acquisitions, such as the importance of the Companies officers' ability to explain and prove to the Court the business reasons behind the acquisition and combination and its growth thereafter.

In addition, even though the main items discussed were the reclassification of a license agreement into sale, the decision includes very important comments on the valuation of a one-time sale of IP, especially with respect to a control premium, that should be carefully considered with respect to pending cases and future acquisitions.

Companies should also notice and understand the emphasis and use made by the parties and Court to various presentations, documents and records prepared by the acquirer and the target (PPA which details all relevant components, TP analysis, IIA letters, internal IP records, etc.) in order to be well prepared for potential controversy. As such, companies with pending cases should review their documentation and prepare their cases accordingly, especially as those cases tend to reach Court.

Endnotes

1. Israeli court ruling 49444-01-13 *Gteko Ltd. vs. Kfar Saba Tax Assessor* (6.6.2017).
2. Currency references in this Alert are to the US$.

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