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ITA CIRCULAR ON TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS

05/11/2018

On November 1, 2018, the Israeli Tax Authority ("**ITA**") issued a new circular in the area of transfer pricing applicable to multinational companies operating in Israel. **Circular 15/2018** titled ***"Business Restructuring in Multinational Enterprises"*** (the "**Circular**") sets forth the view of the ITA as to how to analyze a business restructuring for transfer pricing purposes and for the determination of the arm's length price. As discussed below, the ITA's view is that a business restructuring can occur if certain functions, assets and risks are shifted between affiliated companies, even if no legal transfer takes place, and this can result in two levels of taxation of the deemed transfer.

A Business Restructuring. The Circular explicitly refers to and relies on the OECD Guidelines, particularly chapters VI (Intangibles) and IX (Business Restructurings), and on the Central District Court holding in the matter of *Gteko*. The Circular defines a business restructuring as a transfer of functions, assets or risks ("FAR"), typically from an Israeli company, to a related party in the multinational enterprise, the result of which is the termination of the business activity in the Israeli company or the material change to that activity. In determining whether a business restructuring occurred, the Circular follows the OECD Guidelines and requires a FAR analysis (comparing the pre-change FAR to the post-change FAR), a review of the contractual arrangements between the parties (provided the parties' conduct is consistent with such agreements) and of the realistically available alternatives the parties have. The typical scenario would be the case of a foreign multinational acquiring the shares of an Israeli company and following that acquisition changes the business model of the Israeli company (for example, to a limited risk distributor or an R&D service provide compensated on a cost plus basis).

Intangibles and Economic Ownership. The Circular provides that often the business restructuring happens by transferring intangibles and specifies a non-exhaustive list of intangible assets such as patents, know how, trade secrets, trademarks, and licenses. The Circular further suggests that intangibles assets need not be transferable on a stand-alone basis nor need they be identified on the financial balance sheet and may be part of the goodwill or going concern. In this respect, the Circular makes it clear that what matters is the economic ownership, even if legal ownership was not transferred, and adopts the DEMPE (development, enhancement, maintenance, protection and exploitation) analysis for economic ownership of intangibles. The Circular further makes the argument that certain intangibles can be identifies and transferred separately as independent assets, while others (such as goodwill) cannot be transferred absent a transfer of additional assets.

Synergies, Workforce. The Circular specifically refers to the value of synergies achieved through the efficiencies of an acquisition and states that the position of the ITA is that these are not intangible assets by themselves but something that affects the value of other intangibles. In *Gteko*, the court determined that synergies should be integral to the value of the other assets and kept the question whether they could be a separate asset unanswered. The Circular does not explain how the value of such synergies should be divided between the parties (the acquirer and the target company) since the ITA often argues that the synergies belong to the Israeli target company, in contrast to the OECD Guidelines that foresee an allocation based on the contribution of each party to such synergies. The Circular states that the value of synergies should be taken into account in determining the value of the transferred intangibles. Similarly, the Circular determines that market specific characteristics are not an intangible and do not belong to any of the parties (implicitly meaning that these will reduce the value of any transferred FAR). As to workforce in place, the Circular cites the holding of *Gteko* and determines that it is a valuable function the transfer of which could lead to the transfer of intangibles. Although employees cannot be "sold" it is possible to attribute to the employing company an asset on the basis of the ability to transfer the entire workforce and foregoing valuable functions. This determination can be helpful where, unlike in the Gteko case, the employees keep on working in the target company.

Sale versus License. The Circular acknowledges that a business restructuring may be facilitated through a sale of intangibles or through a license. Documenting the transaction as a right of use will not determine whether the transfer of intangibles is a sale or a license transaction and the classification will depend on the substance of the transaction looking at characteristics such as whether there is a time limit on the license, whether the transferred rights are exclusive, whether the transferee has the right to make changes and transfer the rights to third parties, and who has the rights in newly developed intangibles subsequent to the transaction. The Circular emphasizes that the classification will not depend on the form of payment – whether it is lump sum payment or installments.

Best Method and the Acquisition Price. In determining the arm's length price for the business restructuring, the Circular establishes the CUP (comparable uncontrolled price) as the preferred transfer pricing method if there is a comparable transaction that happened in time proximity to the change in business model, for example the acquisition of the shares or activity of the transferring company. The Circular acknowledges that material adjustments may be required in such cases in order to determine the arm's length price. In employing the acquisition price method the Circular requires to include in the acquisition price all consideration paid for all the equity rights including assumed liabilities, earn out payments (that depend on future performance), holdback amounts and retention bonuses. This is not entirely in line with the *Gteko* holding that explicitly excluded holdback amounts and retention bonuses from the acquisition price. The ITA are also of the position that the acquisition price may not be reduced for synergies and control premium while *Gteko* left this open for synergies and explicitly excluded the control premium from the purchase price, as also inferred from example 26 of the OECD Guidelines (interestingly, the Circular cites and translates this example in exhibit A and nevertheless ignores the ratio of that example). The Circular also ignores market changes that may have occurred after the equity acquisition and seems to refer primarily to the acquisition price. The Circular follows the OECD Guidelines in making clear that the purchase price allocation made for accounting purposes has limited significance and is not determinative for transfer pricing purposes.

DCF Valuation. In case there are no comparable transactions the Circular refers to valuation techniques. First, there should be an indicative valuation for the business activity using relevant multipliers (EV/Revenue, EV/EBIDTA, EV/EBIT) and available public information on companies from the same industry. Then, the income method using DCF should be applied to determine the value of the activity prior to the business restructuring and the value of the FAR remaining and not transferred following the business restructuring – the difference is the value of the FAR transferred or eliminated. DCF is indeed also the valuation method preferred by Israeli courts in corporate law disputes.

Tax Audit – Secondary Adjustment and Documentation. Finally, the Circular refers to the "secondary adjustments" required as a result from a classification of a transaction as a business restructuring and reviews the consequences the business restructuring could have for companies benefitting from the special corporate tax regimes under the Encouragement of Capital Investments Law. Typically such secondary adjustment will take the form of an inter-company notional loan or a notional dividend which shall result in an additional tax liability in Israel. The ramification of a “secondary adjustment” can be severe: imposition of corporate tax (currently, up to 23%) on the Israeli company on the deemed sale of assets, followed by a deemed dividend withholding tax on a grossed-up value of the distributed assets.
Importantly, Exhibit B of the Circular lists the documentation that will be reviewed in a tax audit including the PPA, intercompany agreements, pre and post change transfer pricing studies, etc. Interestingly, the ITA will also seek to review documentation that may not be in possession of the company. For example, on the buyer's side, business models, buyer’s board minutes and presentations, etc.

The Takeaway – multinationals involved in the acquisition of Israeli companies should closely review the Circular and its impact in the context of post-acquisition changes in the business model and the valuation methodologies used to support those changes. The Circular reflects the views of the ITA that have come up and are likely to keep on coming up in tax audits following cross-border acquisitions which are now anticipated to occur whether there were business model changes or not. The ITA’s current approach to these cases, following their success in *Gteko*, is very aggressive. While in the past many of these tax audits were concluded with a reasonable compromises, since the *Gteko* case the ITA is taking a more hardline approach which resulted in quite a few cases of pending before the courts and some mutual agreement proceedings between competent authorities. Not all views expressed in the Circular are with merit and there is a significant risk that the Israeli approach could result in double taxation in cases in which other countries disagree with it.

The prudent approach every potential multinational should be taking is to analyze these factors prior to concluding an acquisition and, if changes are planned, to factor the potential risks and costs that could be associated with these changes into the pricing of the transaction. Post-acquisition, there may be different ways to achieve the same goals with differing tax consequences, which should be discussed and reviewed prior to "diving in" to the integration process.

Our firm has vast experience in advising on business model changes, setting the proper documentation and manuals to support it and in representing international and domestic clients in transfer pricing controversies with the ITA and the Israeli courts

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