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Tax Implications of Post-Acquisition IP Transfer The Recent Gteko Ruling

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Last week's District Court decision in Gteko vs. Tax Assessor of Kfar Sava (the "Gteko Decision")[i] provides both a warning light as well as guidelines for multinational corporations who acquire Israeli high-tech companies. The issue before the court was whether an Israeli company could, soon after being acquired by a foreign company, transfer its intellectual property ("IP") and claim that the value of such IP should be determined as a stand-alone asset.

The Gteko Decision is extremely significant because it was the first time that the position of the Israeli Tax Authority ("ITA"), as published on July 8, 2010, with respect to "*a change in the business model*" of a technology company was tested in the courts. The court held in favor of the ITA's approach that the value of the transferred assets should reflect the entire entity value of the selling company, and was therefore significantly higher than as reported by the seller.

However, the decision is also significant insofar as it can serve as guidance on what post-acquisition structuring and planning may be available in order to mitigate the exposure that the ITA will recharacterize a transaction.
The case involved Gteko, Ltd ("Gteko"), an Israeli company that was established in 1992, developed software that was used as a platform for building software solutions, and by 2006 had entered into contracts with a number of large electronics manufacturers. Gteko employed approximately 150 people, most of whom provided customer service, and

a small number of whom, engaged in the research and development (R&D) of the software.

In November 2006, Microsoft Corporation ("Microsoft") acquired 100% of Gteko's stock (the "Stock Acquisition") for $90 million (before certain adjustments) with the goal of integrating Gteko's technology into Microsoft's products (with the expectation of achieving certain synergies). Shortly thereafter, Gteko employees ceased working for Gteko and became employees of Microsoft Israel ("MS Israel"), an Israeli subsidiary of Microsoft. Concurrently, Gteko and MS Israel signed an intercompany services agreement, on a cost plus basis, for MS Israel to provide manpower services to Gteko so that Gteko could continue providing customer service to its existing customers.

On July 1, 2007, in accordance with its global IP policies, Microsoft acquired Gteko's IP from Gteko in an asset transaction (the "Asset Transaction"). Gteko reported $26 million as the consideration for this transaction, claiming that the $26 million was the fair market value of the IP. This determination was based on the purchase price allocation ("PPA") that had been prepared in connection with Microsoft's Stock Acquisition in November 2006.

The ITA took the position that the Asset Transaction involved a transfer of significantly more (almost all) of Gteko's assets and not just the IP as Gteko claimed. Given the proximity in time between the Stock Acquisition and the Asset Transaction, the ITA effectively argued that Gteko's assets could not have "evaporated," and that the emptying of Gteko's assets and workforce should not be respected since it left Gteko as a shell with no economic substance. Instead, the Asset Transaction should be treated as a sale of the entire business, not just the IP, and that the value of the transferred assets should not be significantly lower than the entity value of the Stock Acquisition.

It is worth noting that the facts in the Gteko Decision differ from the typical controversy encountered by Israeli companies, especially in the high-tech sector, when acquired by a foreign company. In most transactions, only the IP is transferred from the target to the acquirer, while all of the employees remain within the purchased Israeli company and the potential dispute with the ITA focuses on the value of the IP.

In the case of Gteko, however, the focus is less on the value of the IP and more on the substance of the Asset Transaction and scope of the assets that should be treated as transferred. Since a vast majority of Gteko's employees transitioned to become employees of MS Israel soon after the Stock Acquisition, the marketing functions and the R&D functions of Gteko were effectively transferred to MS Israel. The evidence demonstrated that all of the R&D resources that were transferred from Gteko were diverted toward the development of a new Microsoft product, as had been the purpose of Gteko's acquisition in the first place. Further, Gteko confirmed

that without the Gteko workforce, Gteko's IP had almost no value. Therefore, although employees cannot be "sold," the court treated Gteko's workforce in place as an asset of Gteko with great economic value.

In addition, the court acknowledged that the entity value at the time of the Stock Acquisition may include the value of certain "synergies" for Microsoft, with the result that the value of the assets transferred upon the Asset Transaction may be lower. However, the court attributed only a limited value to the "synergy" component from Microsoft's perspective, noting that it is not sufficient to prove the value of the 'synergy' to the acquiring company, but also to prove that this value would not apply for other purchasers. Absent such negation, the synergy value will be attributed to the purchased company.

The court decision also incorporates the principles of the Israeli transfer pricing rules even between two Israeli companies who have a joint foreign owner. Under such transfer pricing rules, it is the taxpayer who bears the burden to prove the nature and scope of the transaction (even if the taxpayer has provided the assessing officer all the documents required by the regulations for determining fair market value).

The analysis and argumentation by the ITA to a great extent relied on internal documentation of Microsoft prior to the acquisition of Gteko.
In light of the Gteko Decision, we believe that taxpayers can mitigate the exposure that the ITA would recharachterize the nature or scope of a change in business model by the following:
(i) the activity and economic substance of the target should be retained in the target, including and in particular, the workforce in place and other aspects of the going concern value;
(ii) existing contracts of the target should be maintained and not assigned to the acquirer (or an affiliate of the acquirer) so that the target does not become an empty shell without any economic substance;
(iii) to the extent feasible from a business perspective, sweeping IP migration should be avoided, and the target's IP should be made available to other members of the acquirer's group through specific limited licenses or cost sharing arrangements.

Furthermore, to the extent that the purchase price of an Israeli technology company reflects a premium on account of unique synergies between the company and the specific acquirer, such synergies should be carefully documented in a way that would demonstrate both their existence with the actual purchaser and their absence for other potential purchasers.

Finally, it is worth noting that recent amendments to the Encouragement of Capital Investments Law (Amendment No. 73) have extended and expanded certain tax benefits to technological enterprises. These amendments are intended to encourage the retention of R&D and IP centers in Israel, and even migration of IP into Israel. It appears that the increase of incentives for IP retention in Israel in cases of acquisition of

Israeli technology companies is consistent with the approach under the Gteko Decision for mitigating the exposure that a change in business model could raise questions as to the nature and scope of the transaction.

Therefore, any contemplated post-acquisition IP transfer should be analyzed in light of both the warning light and guidelines provided by the Gteko decision, as well as the opportunities presented under the new law.

Our firm has gained a lot of experience in advising multinational corporations in the structuring of both the acquisition of local companies as well as the post-acquisition integration of the purchased companies or their IP and in representing such companies in ITA audits regarding change of business model.

[i] The district court is a court of first instance and therefore the decision might be appealed.

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