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CLIENT UPDATE

A new Israeli Court Decision in favor of the Taxpayer on Transfer Pricing Aspects of a Business Restructuring

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Yesterday, December 10, 2019, the District Court ruled in favor of Broadcom Semiconductor Ltd (“**the Appellant**”), rejecting the Israeli Tax Authority (“**ITA**”) assessment that Appellant should be required to pay over NIS 100 million (approximately $29 million) in additional tax for a deemed sale of its Functions, Assets and Risks (“**FAR**”) to affiliated companies (“**the Decision**”). The Decision was issued by the Honorable Dr. Shmuel Bernstein, the same judge who, in 2017, ruled in favor of the ITA in Gteko vs. ITA (“**Gteko Decision**”). The Gteko Decision involved a similar matter, and subsequent to that decision, the ITA has aggressively applied the underlying principles in numerous tax audits and controversies. See our previous client update on Gteko desicion.

Factual Background:

The Appellant is an Israeli company that was established in 2001 to develop manufacture and supply components for routers and fast switches.
In 2002, Appellant entered into a license agreement with its parent company, Dune Networks Inc (“**Parent**”), a U.S. corporation, under which Parent granted the Appellant the right to use certain intellectual property for royalties. It was agreed that intellectual property developed until the date of the agreement would be owned by parent, while intellectual property developed by the Appellant from 2002 and onward would be owned by it.
In addition, the Appellant and Parent entered into a license agreement with Marvel International Ltd, an unrelated third party, for a joint development of the Appellant's IP.
In 2009, Broadcom Corporation (“**Broadcom Group**”) acquired Parent for approximately US$200 million (before certain adjustments) (the “**Acquisition**”).
Following the Acquisition, the Appellant entered into three inter-company agreements, according to which the parties agreed that the Appellant will provide certain services and a license to Broadcom Group, as follows: (1) A marketing services agreement with **Broadcom Singapore Pte Ltd**, on a cost-plus 10% basis; (2) A research and development (R&D) services agreement with Broadcom Group on a cost-plus 8% basis; and (3) A license agreement with Broadcom Cayman, permitting the Cayman company to use, develop, design, distribute and sell products that include the Appellant’s IP rights for five years in consideration for royalties at the rate of between 14.1% and 14.7% of the Cayman Company’s sales turnover (all three agreements are referred herein as the “**Agreements**” and collectively as the "**Transaction**").
Moreover, following the Acquisition, the Appellant gradually increased the number of its employees, increased its revenue and profits, and, at the end of the 5-year term of the license, sold its IP for $73 million to Avago Technologies, an unrelated company that ultimately acquired Broadcom Group.
The main issue before the court was whether the Transaction constituted a business restructuring in which the FAR of the Appellant were sold to Broadcom Group.

Summary of the ITA's Position

The ITA applied its traditional position following acquisitions of Israeli companies by multinationals, and argued that the Agreements had significantly reduced the Appellant’s business operation and profit potential by reducing it to only an R&D service provider, providing such R&D services to only affiliated companies. Therefore, the Transaction should be classified as a sale of all assets of the Israeli company, leaving an "empty shell" in Israel. The ITA applied the acquisition price method and priced the sale of the FAR at the amount of the Acquisition ($200 million) and added a secondary adjustment value.

Summary of The Appellant’s Position

The Appellant argued that the Agreements reflect real transactions, in which the Appellant rendered R&D services and granted licenses to affiliated companies and did not constitute a sale of any FAR. The Appellant claimed that its activity, profitability and number of employees had actually increased as a result of and during the years it operated pursuant to the Agreements. Moreover, when the Appellant subsequently sold its IP, the purchase price was a significant amount, which further demonstrates that its FARs remained within the company.

The Court Decision

In accepting the Appellant's appeal, the Decision addresses many important matters.

1. **Business Restructuring - Distinguishing the Decision from the Gteko**: As the judge was the same in both cases, his comments on the differences between the two cases are particularly insightful. The judge opens his Decision by stating that the facts in this case are completely distinguishable from Gteko's, and therefore, led to the opposite decision. The Gteko case was about a company that became an "empty corporate shall" whose business "crashed" shorty after having been acquired leaving it with no economic value, employees and customers. The Broadcom case is "very different". In the words of the court "*I do not consider the words 'change of business model' to by some kind of magic words the expression of which is enough to change the classification of the transaction between the parties*". In this case, the business activity, revenue, profit and number of employees of the Appellant actually increased (and did not "evaporate" like in Gteko). The Decision makes the important point that each case needs to be examined on its actual specific facts and merits and changes in risks and potential rewards do not automatically mean that there is a transfer of economic value that would be deemed sold.According to Court, the question to consider is whether business model changes might occur under the same conditions while receiving adequate compensation, even had it not been related parties, implementing the arm's length principle.
2. **Review in Hindsight**: The Court emphasizes several times that, like in the Gteko case, it gives significant weight to the outcome of the business model changes and to the fact that in hindsight the Appellant thrived (activities expanded, revenues and profits increased, number of employees increased, more office space was leased) in the years following the Agreements. The Decision explicitly holds that the classification of the business restructuring will be examined against what happened after the transaction. The Court found the increase in the number of employees of the company following the Acquisition to be a significant factor and rejected the ITA's claim that the Appellant's work force should not be considered a significant asset (noted that the opposite argument been raised by the ITA in Gteko Decision).
3. **Reclassification (Section 86 - anti-avoidance) and "different classification" of a Transaction**: the Court explains that the doctrines of reclassification or different classification may be applied to treat a transaction for tax purposes differently that such transaction may be classified under general law, such as contract or corporate laws. The reclassification (which is based on the Israeli equivalent of a general anti-avoidance rule, or "GAAR") requires that the ITA accepts the actual transaction that the taxpayer presented, but at the same time reclassifies the transaction for tax purposes only on the basis it was consummated primarily for the purpose of reducing the tax. In this case, the ITA did not adequately or timely raise the argument that the Transaction was artificial, and therefore the Court rejected it without much discussion. Different classification may be made by reference to a FAR analysis, but the court emphasized that this should not be done automatically or too broadly but rather with restraint.
4. **The Role of the OECD Guidelines on Transfer Pricing:** the Decision makes it clear that the ITA may refer to and rely on the OECD Guidelines and the FAR analysis which are consistent with Israeli tax principles and are relevant for cross-border transactions. The Court holds that they be applied even for transactions that took place prior to the adoption of the relevant chapters in the OECD Guidelines and even in a case where the foreign party to the transaction is not a resident of an OECD country.
5. **Definition of "Asset" and "Sale"**: the Court holds, based on prior case law, which for tax purposes an asset is "*anything of economic value*" including any rights or partial rights in an asset. The transfer of anything of economic value could be a sale, and there is no requirement that there would be a "formal" transfer of ownership in the asset. Since the tax laws attach such a great importance on the economic substance of a transaction, a transfer of FAR could be evidence of a transfer of "something of value" and a deemed sale of an asset. Therefore, a transfer of functions and risks could be a transfer of an asset and each case should be examined on its facts.
6. **Analysis of Functions and Risks**: The court examines the functions and risks of the Appellant and whether they changed as a result of the business restructuring. The court rejects the ITA's position and concludes there was no change in the functions. While the ITA mentions the R&D, marketing and management functions, the court refers primarily to the R&D. The fact that the Appellant conducted R&D activity for itself prior to the change and as a contractor for an affiliate after the change did not mean that the function was transferred. The court notes that the ITA could examine whether the cost plus arrangement was at arm's length but did not do so. The Court emphasizes the importance of any change in the number of employees in this context. The court then dismisses the ITA's point also with respect to management and holds that a change in activity and the Broadcom Group's exercise of some management power does not necessarily mean the Appellant did not exercise any management functions. The Court then reviews the changes in risks and starts by making the point that the Appellant had a new risk of having only one customer following the business restructuring. Another risk was the dependency on the sales by the Cayman licensee. Moreover, reducing risks could be for business reasons. The Court states that reducing risks (and chances) in anticipation that it would eventually increase revenue and profit is not a transfer of FAR that should be classified as a "sale" of an "asset".
7. **Realistically Available Options**: the Court refers to the Chapter 9 of the OECD Guidelines and the 2018 ITA Circular on Business Restructuring and holds that the ITA did not examine at all whether the Appellant had a better available option other than the business restructuring. Therefore, the Court accepts the Appellant's point that the restructuring was the best available option.
8. **Declining Royalty - Old IP and New IP**: the Court acknowledges the possibility to split IP between existing old IP and new IP that is developed under a license agreement and is owned by the licensee. Importantly, the fact that the licensee was a Cayman company, residing in a tax heaven, did not taint the license agreement or the substantive discussion. The Court respects the declining royalty agreement, even if the development of new IP was based on the old IP. In our case, the Court examined the specific circumstances which established a real separation between the IPs, and above all, the fact that the old IP was sold later in 2016 for a significant amount.
9. **Inter-Company Agreements**: The Court repeatedly, throughout the Decision, refers to the inter-company agreements and suggests the ITA could and should have examined them as to whether they were at arm's length. The Court reviews the agreements and give them a lot of weight. Referring to the OECD Guidelines (particularly paragraphs 1.42, 6.34 and 9.168), the Court holds that the agreements and the conduct of the parties are the starting point of any transfer pricing analysis and interference in the contractual arrangements should be only in rare

cases. The case at hand is not such a case. The court further determines that the set of contractual arrangements in this case was not materially motivated by tax considerations, and if the ITA wanted, it could have reviewed whether the intercompany transactions themselves were at arm's length, which it did not.

10. **Double Taxation**: the Court criticizes the ITA for ignoring the possible double taxation resulting from the proposed reclassification as sale of an asset without giving regard to the subsequent sale of the Old IP.
11. **Burden of Proof:** the Court repeated its holding in the Gteko Decision and accepted the ITA's position that the burden of proof remains with the taxpayer to prove the real transaction that took place. This is consistent with a recent Supreme Court holding in another case involving the Broadcom Group.
12. **Valuation (Purchase Price Allocation – PPA)**:

a. Since the Decision was in favor of the taxpayer, the Court referred to the valuation in an obiter. The Court repeats its previous holding that the PPA document is not a suitable tool to determine arm's length price since it is prepared for U.S. accounting purposes and does not necessarily reflect the value of the FAR. Nevertheless, in the absence of other documentation, the PPA may serve as an indication for how both the seller and buyer considered the business potential.
b. The Court determines that a redemption payment to the Innovation Authority for prior grants should be added to the purchase price when the Acquisition Price Method is applied while tax assets for prior NOLs should be deducted.
c. The Court criticizes the ITA for being inconsistent in applying the discount percentage for determining the value of the FAR remaining in Israel under the ITA's own approach and holds a lower discount rate should have been applied if, according to the ITA, the remaining activity was at lower risk.
d. The Court determines that the workforce is a valuable function and that value should be assigned to it.
e. The Court holds that a control premium should be applied to reduce the acquisition price (even if 100% of the company is acquired), but requires real time evidence that the acquirer took such premium into account.

The takeout

The main takeaway from the Decision is that each case should be analyzed according to its specific facts and circumstances. The prevailing ITA approach, which automatically asserts a business restructuring following an acquisition of an Israeli company, will not necessarily be upheld by the courts.
While the ITA is likely to appeal the Decision, it may nonetheless impact pending assessment discussions and tax appeals on these issues.
Furthermore, prospective acquisitions and intragroup changes should be carefully planned, structured, priced and documented taking into consideration the principles of this Decision.
Our firm has extensive 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 and in representing such companies in disputes and tax appeals with the ITA.

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