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Uncertainty Continues:
Buyer Beware - Post-Acquisition Changes and inter-company Agreements by an Israeli Target Ruled to be a Taxable Sale of its Assets

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In a recent decision, the Israeli District Court has ruled that certain changes that were made to the business model of an Israeli company, **Medtronic Ventor Ltd**, shortly after it was acquired by US-based multinational Medtronic Inc, including implementation of various intercompany agreements between it and its US and Irish affiliates, result in a deemed taxable sale of all its assets. The decision of Medtronic Ventor Technologies Ltd vs. Kfar Saba Assessing Officer (TA 31671-09-18) was given by the same district court and the same judge who rendered the decisions in two other key cases on point: *Gteko Ltd. vs. Kfar Saba Assessing Officer* ("**Gteko**"), that was ruled in favor of the Israel Tax Authority (the "ITA"), and *Broadcom Semiconductor Ltd. vs. Kfar Saba Assessing Officer* ("**Broadcom**"), that was ruled in favor of the taxpayer. The decision also distinguishes itself from the District Court case of *Medingo* in favor of the taxpayer. For further information on these cases, see our prior client alerts.

In this client alert, we will discuss the key findings of this case and the impact it may have on other multinationals considering acquisitions of Israeli companies or restructuring of operations.

Background

Acquisitions of start-up companies by established multinational enterprises are common. As would be expected, the purchaser seeks to integrate the business of the acquired company with its more global business and benefit from business, operational and financial synergies. In many cases, the integration process requires certain changes in the business model under which the acquired company operates. This is especially true for small young companies with limited resources.

In recent years, the ITA has been aggressively targeting such post-acquisition changes. The key argument has always been that the acquired company had transferred its functions, assets and risks (its "FAR") to its parent or an affiliate within the multinational group, for no consideration. In these cases, the ITA tends to argue that the FAR transfer is akin to a taxable sale of the business, and no payment was made for the FAR. The ITA then also seeks to make a "secondary adjustment" whereby the acquired company is charged of making a deemed dividend or interest-bearing loan to its foreign parent.

The validity of the ITA's arguments in these cases is highly contentious. In addition, in many cases the ITA's position can lead to double taxation, since the adjustments proposed by the ITA have a direct impact also on the non-Israeli parties to the deemed transaction. For these reasons, taxpayers in recent years have vehemently opposed these positions, whether in direct litigation or in other proceedings such as seeking mutual agreement procedures under applicable tax treaties.

The Medtronic Case

Medtronic Ventor Ltd (the "Company" or "Medtronic Israel"), established in 2004, was an Israeli company that developed a medical device used as an aortic valve, inserted through an aeortic stent for endovascular repair. In 2008, US-based Medtronic Inc. ("Medtronic"), acquired a minority stake in the Company, and in 2009, it acquired the rest of its shares for $325M (subject to adjustments). As a result, the Company became a fully-owned subsidiary in the Medtronic multinational group.

Following the Acquisition, the Company continued to develop its own product, in cooperation with its parent. It entered into inter-company transactions for providing research and development (R&D) services to affiliates in the Medtronic group. It also provided limited-in- time licenses to its IP, including patents it had developed. The respective agreements relating to these transactions were signed in 2010 and 2011 and applied retroactively to 2009. In 2012, the Company ceased its operations.

The ITA argued that immediately after its acquisition, the company engaged in transactions that effectively transferred out of the Company all of its FAR. The R&D services agreement and the license agreement were merely a means to transfer these FAR, and effectively the transaction should be reclassified and treated as if there was a taxable sale of all of the Company's assets. Moreover, since no payment was made for the deemed sale transaction, there should also be a secondary adjustment in the form of an upstream "deemed loan" from the Company to its parent on which interest income was due.

The Court Decision

The Court analyzed the Company's post-acquisition functions and assets, and determined that the Company provided Medtronic a full and complete right to use the Company's assets, while relinquishing entirely to Medtronic the responsibility for the strategic management of its affairs and workforce. Regardless of what the agreements called for, the Court found that Medtronic US essentially "took over" the assets and operations of the Company and absorbed them into its own activity, such that by the time of cease of the Company's business, there was nothing left to transfer.

The court put a particular focus on how strategic management and decisions were carried out. It found that while prior to its acquisition, the Company's management was in charge of strategic planning of its affairs and directed its R&D, following the acquisition, Medtronic's personnel took over all aspects of its management, including the planning of its research and development, marketing activity, growth strategies, budget and decision-making regarding development of new products or discontinuation of existing ones. The Court found the Company's activity was conducted solely for the benefit of Medtronic and was aligned with Medtronic's interests and instructions without any consideration of the interests of Medtronic Israel as such.

Medtronic's intention was to turn the Company into an Israeli innovation center, that performs research and development for a variety of products, in addition to those originally developed by the Company. To achieve this goal, the Company retained existing employees and recruited new employees that seemed fit for those purposes.

Surprisingly, the Court considered this as supportive of the Company's FAR being transferred to Medtronic. Notably, the increase in the number of the employees of the Company following the acquisition did not affect this conclusion, despite this factor being key evidence in both the Broadcom Case, in which the increase in employees supported the conclusion that the taxpayer's FAR remained intact, and the Gteko Case, in which the transfer of all of the taxpayer's employees to other entities after its acquisition, supported the conclusion that it sold its FAR. The Court explained that in this case, the headcount increase and continuation of activity was not indicative of FAR retention, since this new activity was directed and managed by Medtronic, without independent decision-making functions at the Company.

In addition, the Court determined that Medtronic treated the Company's most valuable asset – its IP – as its own. Certain patents were registered in Medtronic's name, without proper support or reasoning. During the development process post-acquisition, the Company took no action in order to keep its ownership of the knowledge it had accumulated, but rather shared it with Medtronic, including for utilization of the IP in Medtronic's new products, for no consideration. Following this process, Medtronic already had all of the knowledge it needed, and there was no need to transfer anything further in preparation for the cease of the Company's operations.

In response to the Company's argument that joint development of IP made perfect business sense and that Medtronic provided significant resources that it lacked, the court noted that the separation between "existing IP" and "new IP" was purely formal in this case. In fact, the court argued that given that the Company did not yet have a proven product, it indicates that Medtronic exploited the initial stage of the IP's development, to adjust it to serve its needs. The focal point in the Company's acquisition was therefore not its existing IP, but its further potential developments that would be owned by Medtronic. In comparison, in the *Broadcom* Case, the taxpayer already had a proven product, and chose to change its business model to licensing while later selling its IP at a significant price. Care was given in the *Broadcom* case to the fact that the new knowledge was not shared between the affiliates. No such separation was found in this case.

The Company also offered that it ceased its operations due to changing market conditions, and the emergence of customer preferences to competing medical devices. The court instead found, based on the testimonies of management, that the discontinuation of activity was promoted by the budgetary needs and business strategy of the Medtronic group. The retroactive signing of the inter-company agreements in proximity to the cease of the Company's operations, without reporting their substance in real time, implies that the agreements do not reflect the business reality but were rather signed in hindsight, to support the Company's position.

For all of the above reasons, the court found that indeed there was a complete transfer of FAR shortly after the acquisition. Moreover, the court accepted the ITA's argument that the valuation of such FAR was equal to the full price paid for the shares at the time of the acquisition, and that there is no justification to deduct components from such price such as a “control premium” (contrary to statements made by the same judge in Gteko and Broadcom Cases) or a value attributed to the creation of future synergies (consistent with the Gteko Case).

Finally, the court also accepted the ITA's argument regarding a secondary adjustment and ruled that indeed the deemed sale created a deemed loan for the same amount, on which deemed interest income should be accrued.

Key Takeaways

The *Medtronic* case is the fourth case on business restructurings to be decided by a district court, following the *Gteko, Broadcom* and *Medingo* cases. The *Broadcom* and *Medingo* cases were not appealed by the ITA, and it remains to be seen if this case will be appealed to the Supreme Court. Some of the findings of this case are surprising, and add uncertainty to the integration process and to the acquisition price. Multinational enterprises will continue searching for the "perfect recipe" that will allow them to engage in integration activities without triggering unwanted tax consequences which may result in economic double taxation. In that context we would like to offer some insights:

- Tax planning for post-acquisition integration should begin already at the acquisition phase. Especially if some of the steps may result in creation of tax risks, or if the business plan is indeed to transfer FAR, advance planning and risk evaluation may impact the transaction structure or at least factor in potential tax costs of restructuring that may take place post-acquisition.
- Contemporaneous documentation of intercompany transactions is a critical point not to be neglected or delayed. The retroactive documentation in *Medtronic*, which was close to the cessation of its activities, enforced the court's finding that there was actually a FAR transfer. By comparison, one of the factors that helped the taxpayer win its case in *Medingo* was that it quickly implemented intercompany agreements that supported and established its business model, and was able to support them with transfer pricing studies, while the ITA failed to show that such arrangements were inappropriate or produce contradicting evidence.
- Another issue to consider is the appropriate transfer pricing method to be chosen for intercompany transactions. It was clear from the current case that the "cost plus" method was indicative of non-risk, parent-company directed, activities.
- Definition of local management's role, in terms of independence, and retention of the ability to make strategic decisions, seems to be a critical factor influencing how courts will approach the functional analysis of Company's post-acquisition activities. Until Medtronic, it was enough to show that key employees remained in their positions and continued to perform the same functions. Now it seems that it

will also be important to show that these functions were performed under independent management, a challenge and easily mustered withing the framework of multinational companies.

- It seems that the court has set a higher standard for joint development of IP. It will be important to have from the outset both the proper policies and documentation, and to adhere to them in practice, if a multinational seeks to draw a distinction between "new IP" and "old IP" and that they can be held separately from each other, even if the new IP is based on the old IP.
- The acquisition price method seems to be the prevailing transfer pricing method accepted by the courts in business restructuring cases. Subtracting the control premium is contentious and in order to support it the Medtronic and Broadcom cases suggest that the acquiring company should document in the pre-acquisition stage that the proposed acquisition price does include such a premium.

Our firm has vast experience in advising multinational enterprises in the structuring of acquisition of Israeli companies, post-acquisition integration of the purchased companies and the transfer pricing aspects of such integration, and in representing such companies in disputes and tax appeals with the ITA.

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