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Israeli Court Decision on IP valuation and transfer pricing

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General

Recently, the Tel Aviv District Court delivered a judgment in the appeal by Western Digital Israel Ltd. (the "**Company**"), pertaining to the income tax assessments concerning the intercompany sale of a specific Error Correction Code technology by the Company to its affiliate within the SanDisk group. Our firm represented the Company in the appeal, which resulted in the court upholding the majority of the Company's arguments and reducing the Assessment Officer's primary adjustment by **73%** (and the secondary adjustment accordingly).

Relevant Facts

The appellant, Western Digital Israel Ltd., is a company engaged in the development, production, and sales of flash memory products. In 2006, the Company was acquired by SanDisk Corporation (which was later acquired by Western Digital). Over the years of its operation, the Company developed a Strong Error Correction Code (SECC) technology for flash memories, designed to potentially increase the products' memory capacity (the "**Technology**").

As of the 2008 fiscal year, the Technology's development was subject to an intercompany R&D cost-plus agreement entered into by the Company and SanDisk Corporation, its U.S. parent. Additionally, the Technology was subject to a licensing agreement with Ramot – the technology transfer company of Tel Aviv University. This agreement was signed as a result of a joint project with the University, pursued during the early stages of the Technology's life, as part of the Magneton Program of the Chief Scientist's Office at Israel's Ministry of Industry and Trade (today known as the Israeli Innovation Authority).

In 2014, the Company sold the Technology to an affiliated company within the SanDisk Group for $35 million, based on a transfer pricing study assessing the value of the Technology.

Dispute

As opposed to the Company's position, the Assessment Officer valued the technology at $136 million, imposing capital gains tax on the difference, along with interest income due to a secondary adjustment classifying the balance as an intercompany debt.

The Assessment Officer rejected the Company's TP valuation, and particularly the assumption that the Company owned a portion of 34% of the Technology immediately prior to the sale, which is the portion constituting the sold Technology. This was based on the assumption that the Technology's features that were developed as of 2008, the effective date of the intercompany R&D agreement, were funded and therefore owned by the U.S. parent, and thus were not subject to the sale by the Company. To this end, the Company performed a technological evaluation, estimating the "weight" (technological significance) of the Technology's features developed prior to 2008. In addition, the Assessment Officer rejected the assumption that the remaining useful life of the Technology sold was 10 years.

During the major part of the proceedings, the Assessment Officer argued that an additional amount of $27 million should be added to the sale price, allocated to a technological component referred to as "Applied Knowledge", that was allegedly sold as part of the transaction (reaching a total value of $163 million). The Assessment Officer even claimed that the lack of distinction between the technology and the "Applied Knowledge" is a main failure in the Company's transfer pricing study. Following the testimonies of the Company's witnesses, who testified that there is no technological and practical basis for the existence of applied knowledge which is distinct from the technology, the Assessment Officer waived this claim.

Court Decision

The court's determination was based on an analysis of the parties' legal rights provided by the relevant agreements and their comparison to the company's real-time documents, including its financial statements and applications filed with the Chief Scientist. The valuation experts of both parties were extensively cross-examined, as well as the Company's past and present officers and the former CEO of Ramot, who testified to the attributes of the flash market, the Technology, the background of the legal agreements and the technological evaluation leading to the 34% estimate.

Contrary to the approach of the court in a similar case (CA Software Israel Ltd. v. Tel Aviv 3 Assessment Officer), which opted to choose between the expert opinions without making any adjustments to balance them, in the case at hand, the court examined the DCF method applied by the experts on behalf of both parties, ordering a specific amendment of the Company's TP valuation according to the court's findings, based on the factual and legal evidence provided. The court upheld the Company's position on the technology's lifespan, the discount rate and the reduction of the routine returns attributable to manufacturing and distribution.

As for the portion of ownership of the Technology by the Company, the court made two determinations: first, the Company should be deemed the owner of the portion of the Technology developed up through the end of 2009, namely, the portion subject of the licensing agreement with Ramot; and second, the Technology's development accumulated linearly, adding an even portion of features each year. Accordingly, the Company's portion was set at 60%, representing an intermediate of the positions of the parties.

As for the secondary adjustment, although the court did not accept the Company's key argument that no tax should be imposed on such a secondary adjustment component, based on the Supreme Court's binding precedent that allowed such an adjustment in one case (Kontera Technologies Ltd. v. Tel Aviv 3 Assessment Officer), the court significantly reduced the interest rate applied by the Assessment Officer from 3% to 2%, based on the rate *de facto* applicable to an intercompany loan provided by the Company.

Future Implications

The court judgment highlights the importance of conducting a real-time, specific, detailed, and evidence-based transfer pricing study. The study made by the Company served as the basis for both the Assessment Officer's tax assessment and the court judgment. Eventually, the court accepted the company's methodology and nearly all of its real-time assumptions.

Our firm is proud to contribute to the developing body of case law on transfer pricing in Israel and to successfully represent multinational corporations in various complex tax disputes, both in court and assessment proceedings.

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