Israeli District Court: Legitimate Post-Acquisition Changes to a Company's Business Model do not Result in a Taxable Sale of its Assets

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In a recent decision by the Israeli District Court in Tel Aviv, the Court has ruled that certain changes that were made to the business model of an Israeli company, Medingo Limited, shortly after it was acquired by Swiss-based pharma multinational Roche, including implementation of various intercompany agreements between it and its foreign group, do not result in a deemed taxable sale of its assets. The decision of *Medingo Ltd vs. the Assessing Officer of Afula* (TA 53528-01-16) adopts many of the principles set forth in the *Broadcom* decision [see our newsletter], and expands upon them in certain ways. 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

In Israel's booming "Start-up Nation" environment, many Israeli companies are acquired each year. In many cases, the purchaser is a multinational company that seeks to integrate the business of the acquired company with its more global business. In many situations, there is a major strategic assumption underlying the purchase that once the Israeli company has access to the broad network of the acquiring multinational, to its resources and experienced personnel, and to its distribution channels, it will be able to significantly expand and improve its business. In many cases, the integration process requires certain changes in the business model under which the company operates. It is only natural that a company that is acquired and becomes part of a multinational group, will operate differently. This is especially true for small young companies with limited resources.

In recent years, the Israeli Tax Authority (the "ITA") has been aggressively targeting such post-acquisition changes. In many cases, some justified and many not, the ITA has argued 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 equivalent to a taxable sale of the business, and since no money actually changed hands, the ITA then seeks to make a "secondary adjustment" whereby the company is charged of making a deemed dividend to its foreign parent, or a deemed intercompany note is created between the company and its parent on which the ITA charges tax on deemed interest income.
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 international parties to the 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 tax treaties.

The Medingo Case

Medingo Ltd (the "Company") was an Israeli company that developed a wireless insulin pump. In 2010, it was acquired by Swiss-based Roche for $160M + earn-out payments of up to $19M. Shortly after its acquisition, it entered into various intercompany agreements with related companies in the Roche Group.
The intercompany agreements were entered into five months after the acquisition, with a retroactive effective dated immediately after the acquisition. They included the followings:

• There were two service agreements, for the performance of marketing and manufacturing services.
• An R&D agreement where the Company agreed to perform R&D services for Roche and agreed that ownership of all future IP will belong to Roche.
• All three above agreements were based on the traditional "cost plus" compensation. In this case, cost +5%.
• There was also a license agreement for the Company's existing IP. Under the license agreement, Roche agreed to pay the company royalties based on of the net revenue from sale of products in which the IP was used (2%).

Approximately three years later Roche purchased the Company's existing IP for NIS 166M.

The ITA argued that shortly after the acquisition, the Company transferred all of its FAR to Roche and claimed this was evidenced by the various intercompany agreements. The value of the FAR transferred was set at NIS 480M – almost the same price paid by Roche for the shares. The ITA argued that the execution of the intercompany agreements devoided the Company of all functions and risks and that should be viewed as have been stripped of all its valuable assets.
The ITA made several arguments regarding the Company:

• The ITA argued that all functions, save for R&D, left the Company and it no longer functioned as an independent company but simply as a contract R&D subsidiary of Roche.
• The company was no longer independently managed, save for day to day activities.
• The company no longer bore any of the risks that an independent company would bear.

The ITA based its argument primarily on its analysis of the intercompany agreements.
In addition, the ITA also argued that the license agreement for the existing IP (in exchange for royalties) should be viewed as a sale of the IP to Roche.

The Company countered with the following arguments:
• The Company argued that it never ceased its activities and continued to perform them in the context of the intercompany agreements. All key personnel continued to work in the company and performed the same functions they did prior to the acquisition. In fact, the company showed an increase in its workforce – from 89 employees in 2010 to 147 in 2012.
• The Company argued that the intercompany agreements did not devoid it of risks. For example, the royalties from the license agreement depended on Roche's sales and the company also bore the risk of any product liability claims from prior sales.
• The changes to the company's business were a reaction to the market conditions and the business strategy of Roche – the company did not have the knowledge or resources that would enable it to market its product in a competitive market and the strategy of working with and entering into the intercompany agreements with Roche presented its best chance for success.

Court Rulings
The Court followed the same principles already stated in the *Broadcom* case, reiterating a company may make changes to the business model in which it operates, and that does not necessarily mean that it has sold its FAR, even if there were changes in functions or risks. The Court even cited what is perhaps the key principle of *Broadcom*:

"I will therefore emphasize that I do not believe that the words "change in business model" are some kind of magic words, the mere utterance of which is sufficient to lead to a change in the classification of the transaction was entered into between the parties."

In following this principle, the court made a few key statements:

• The court adopted the principle from the OECD guidelines that a tax administration should not disregard part or all of a restructuring or substitute other transactions for it unless there are exceptional circumstances. In applying these principles it accepted the Company's position that entering into intercompany agreements such as it did (including the license agreement for the old IP) was quite common and acceptable and at most, the ITA may have grounds to challenge the pricing of those agreements but not the nature of them.
• The court went on to say that when examining changes made to a company's business, what matters is not that changes were made, but whether these changes would have come to fruition, or would be implemented with different compensation, had the parties not been related.
• The Court acknowledged that changes made by the Company and the intercompany agreements were valid business decisions that secured its mid-term future and gave it a better chance of survival. The company was better off being part of the Roche group and having access to Roche's knowledge and resources and this increased its chances of competing in the pharma market.
• The Court made it clear that a multinational that acquired a new company has the right to set policies and expect it to follow them, and by doing so it is not stripping away management from all its power but rather simply exercising its own powers, as a shareholder. The Court made a very important statement:

"It only makes sense that Roche, as a shareholder, will set the Company's policy in accordance with its vast experience in the pharma field, whether or not so mentioned in the inter-company agreements, and it further makes sense that the Company

benefit and take advantage of Roche's expansive knowledge. That does not lead to the conclusion that the Company no longer has any significant functions and that it is no longer responsible for the management of its affairs."

In addition, the Court went on to review the FAR arguments made by both sides, finding decisively in the Company favor:
• The court ruled that the Company continued to perform all of its key functions also after the acquisition. The court did not attribute any importance to the fact that these functions were compensated on a "cost plus" basis.
• The court rejected the argument that Roche "determined the R&D policy and budgeting" and argued that what is most important is the performance of the functions, even if they are performed in accordance of a set policy.
• In analyzing the R&D service agreement, where any new IP was to be owned by Roche, the Court did not see this as indicative of a FAR transfer. It focused on the fact that the R&D functions were still performed by the Company. It did state that this may allow an argument that the pricing of the services is too low, but not that the functions were transferred.
• Similar findings were made also with respect to marketing activities. The ITA's argument that Roche set the marketing policy and was therefore in charge of the marketing function was rejected, both factually and as a matter of importance.
• As discussed above, the Court acknowledged that a parent company may set policies and expect its subsidiaries to comply with them, without this being a transfer of the management function.
• The Court, following the rulings in *Broadcom* and *Gteko*, focused on the change in headcount and noted the increase in almost every department that took place between 2010-2012.
• In its analysis of whether risks were transferred, the court found that the Company continued to bear significant risks, even after entering into the license agreement with Roche. Most importantly, the court acknowledged that indeed the risks that the Company bore after the acquisition were different than those it bore as an independent company, but that in itself did not mean there was a FAR transfer! The court acknowledged that a company can react to changing market conditions and can change the way it operates as a consequence of becoming part of a multinational group, even if this means its risks are now managed differently, so long as this is done for valid business reasons. Changes made, even if they change the way risks are managed, are not a FAR transfer.

Key Takeaways

The *Medingo* case is the third case to be decided by a district court, following the *Gteko* and *Broadcom* cases. The Broadcom case was not appealed by the ITA, and it remains to be seen if this case will be appealed to the Supreme Court. In any event, we do not expect the ITA to yield on this matter and they will continue to carefully scrutinize the operations of Israeli companies that were acquired. In that context we would like to offer some insights:
• Tax planning should begin at the early stages that precede any acquisition. The group seeking to acquire an Israeli should give thought to its integration plans post-acquisition. Continuation of the target as a going concern is definitely the more common situation, and these cases suggest that multinationals should have reasonable flexibility to restructure operations, and implement group policies, without immediate tax cost. That being said, there are also instances where companies are acquired primarily for their IP and without a real desire to continue their operations. In such cases, purchasers should plan for this in advance and perhaps structure the

transaction differently or at least factor in potential tax costs of restructuring that may take post acquisition.

- Proper structuring and documentation of intercompany transactions is a critical point not to be neglected. The OECD guidelines, as well as the court in *Medingo*, make it clear that there would need to be compelling arguments and extraordinary circumstances to move away from the arrangements set forth between the parties and instead create new transactions. One of the factors that helped the taxpayer win its case in *Medingo* was that it had in place fairly quickly 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.
- More than anything else, it is clear that even in today's modern, cloud based "work from anywhere" environment, people still matter. The courts have shown time and again that the key to whether key functions were transferred or not lies with the employees. In every case where the taxpayer showed that the key employees remained in their positions and continued to perform the same functions, the courts have ruled that there was no transfer of FAR.
- The court has recognized that there can be 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. That being said, we believe that any such arrangements will continue to be aggressively scrutinized by the ITA and the key to successfully structuring such arrangements will be to show independent viability of each IP and its applications.
- Finally, any restructuring should also pass the "common sense" prism. When it can be shown that restructuring steps were taken for good business reasons and in line with the group's overall strategy, the tax risks associated with such transactions can be significantly mitigated.

Contact Information

Eldar Ben-Ruby
Partner
Tax Group Leader

Meir Akunis
Partner
Tax Group

Shaul Grossman
Partner
Tax Group

Keren Shitrit
Partner
Tax Group

Dr. Michael Bricker
Partner
Tax Group

Omri Davidov
Partner
Tax Group

Nathalie Anvar Hammer
Partner
Tax Group

For additional information about our firm's Tax group, click here.

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Meitar | Law offices
16 Abba Hillel Silver Road, Ramat Gan, 5250608, Israel | +972-3-6103100

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