

## Client Update | Tax

### Israeli District Court: In an IP/FAR Tax Case the Burden of Proof is on the Taxpayer

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March 2019

Dear Clients and Friends,

The Tel Aviv District Court recently delivered a decision in a tax appeal of *Broadcom* (Tax Appeal 17419-02-18), finding that the burden of proof is on the taxpayer regarding whether a transaction has to be treated as an intellectual property sale (as was reported by the taxpayer) or as a business restructuring in which the functions, assets and risks (“**FAR**”) of the taxpayer were sold (as was argued by the Israel Tax Authority).

#### Background

In 2012, Broadcom acquired the shares of the US parent of an Israeli company for approximately US\$200 million. Less than three months later, the Israeli company sold its IP rights to a related Cayman company within the Broadcom group for US\$59.5 million. On the same date, the Israeli company also signed two other agreements with Broadcom group companies for the provision of research and development services and marketing and technical support services, both on a cost-plus basis.

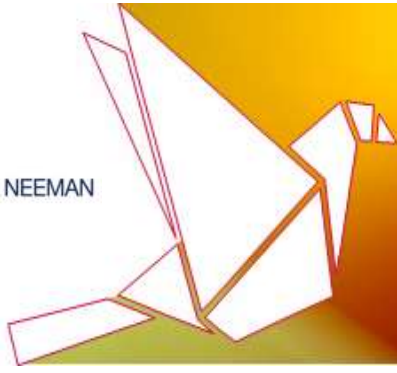
The ITA argued that in substance, the transaction was broader than just an IP sale, and included the sale of the FAR of the Israeli company with an aggregate value of NIS879.5 million instead of NIS230 million as reported. Broadcom argued that the signed agreements factually reflected the real transaction. The ITA did not dispute the value of the IP sold. The crux of the dispute was about what was sold, at what value, and how the sold assets should be taxed.

The ITA priced the sale of the FAR, and added a tax gross-up component and a secondary adjustment value. The ITA argued that a tax gross-up is required to value the FAR since the benchmark value of the shares should be equal to the value of the underlying property (the business activity). The secondary adjustment was classified by the ITA as a loan from the Israeli company to the Cayman affiliate (for the amounts that should have been paid to the Israeli company for the FAR, but were not paid), which in turn triggered taxation of the deemed interest payments.

#### Burden of Proof

The Court rejected the request of Broadcom to shift the burden of proof to the ITA. The Court held that the general rule – that the burden of proof in tax appeals is on the taxpayer – applies also to this case.

- **Reclassification under Section 86 of the Israeli Income Tax Ordinance (the “Ordinance”).** Broadcom argued that the ITA was reclassifying the IP sale transaction by using its power under



Section 86 of the Ordinance. Broadcom argued that according to case law, the use of the reclassification power shifts the burden of proof to the ITA.

The Court rejected this argument. The Court ruled that the Section 86 reclassification takes place only where the ITA accepts the actual transaction that the taxpayer presented, but at the same time reclassifies the transaction for tax purposes only. However, if the ITA *rejects* the transaction as presented by the taxpayer and argues that a different transaction took place, then this is a “different classification” of the transaction – a tax case law doctrine which does not shift the burden of proof to the ITA, since the taxpayer (rather than the ITA) has the best knowledge of the facts.

The Court ruled that in the *Broadcom* case, the ITA did not use its power to reclassify the sale under Section 86. Rather the ITA rejected the presentation of the transaction as an IP sale only, and viewed the transaction as actually a sale of FAR in addition to a sale of the IP.

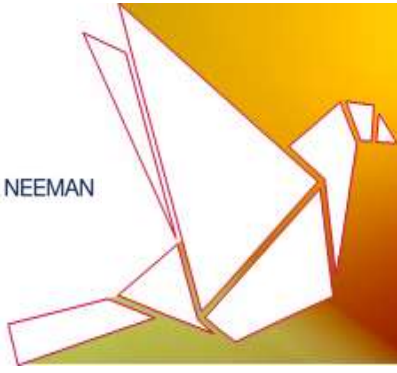
- **Section 85A of the Ordinance (Transfer Pricing rules).** Broadcom argued that the tax assessment was determined under Section 85A of the Ordinance, and as such (and given that Broadcom met all the other relevant requirements), “... the Assessing Officer shall have the obligation to present evidence if the Assessing Officer has made determinations different from the agreements between the parties.”

The Court rejected this argument. The Court ruled that the ITA did not dispute the transfer pricing study the taxpayer provided, but rejected the transaction as was presented by the taxpayer. For this reason, the transfer pricing study is irrelevant for determining the value of the transaction, and therefore Section 85A does not apply.

- **Israel General (non-tax) Law.** Broadcom argued that a different classification of a transaction (based on general legal principles) could not apply, since general Israeli law does not acknowledge FAR as an asset, and does not consider the transfer of FAR as a sale. The Court rejected this argument. The Court did not agree that the general law does not acknowledge sale of activity, including the sale of the ability to carry out functions and to bear the related risks.
- **US Law.** Since the IP sale agreement was governed by the laws of the State of California, Broadcom argued that the classification of the transaction has to be determined based on Californian law. Without deciding whether Californian law is relevant for tax purposes, the Court was not convinced by the expert opinion given on behalf of Broadcom, that under the laws of California the transaction must be classified as an IP sale only. The expert opinion provided that the intention of the parties has to be respected. However, the ITA did not challenge the sale of the IP, but rather argued that other assets were sold also in addition to the IP.

### Concluding Remarks

**The decision of the court in the *Broadcom* case is decisively and broadly written. The Court’s decision will likely encourage the ITA to continue its wide and aggressive use of the “FAR transfer” argument, in particular in the context of M&A transactions involving multinational corporations.**



At the same time, the *Broadcom* decision is not the final word on this matter. It is a District Court decision. It does not constitute a binding precedent, and does not obligate any judge in any other case to follow the decision. Moreover, the *Broadcom* decision does *NOT* mean that the burden of proof is on the taxpayer in any “FAR transfer” case. The “FAR transfer” argument is widely used by the ITA in many cases which are factually different. Depending on the facts and circumstances of each case, the burden of proof may very well be on the ITA, even when following the *Broadcom* decision.

Please do not hesitate to contact us with any questions or if you require any clarification regarding the above.

Yours sincerely,

**Herzog Fox & Neeman**

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