Israel: Court ruling provides insight on Israeli transfer pricing rules pertaining to transfers of intangible property from acquisitions

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In brief

An Israeli District Court ruled that when an Israeli company owning IP is acquired and shortly thereafter its employees and other assets (including IP) are transferred to a related party, the transfer should be viewed as a sale of the entire business activity and the value of the IP should be broadly defined and be derived from the share acquisition price for tax purposes. This court ruling addresses, for the first time, this common type of transaction that occurs in acquisitions of Israeli companies where the employees and assets (including IP) are transferred which creates a capital gain. The Court provides its interpretation of the transfer pricing principles that address how to define the essence and scope of the assets being transferred and how those assets should be priced.

In detail

Facts

Gteko, an Israeli company established in 1992 (the 'Company' or 'Appellant'), provided automated technical support to manufacturers of electronic equipment. The Company developed software which served as a platform on which its technical support services operated (IP).

In 2006, the Company had 150 employees primarily involved in customer support with a small number engaged in the development of the Company's IP.

In November 2006, Microsoft Corporation, a US company (Microsoft US), acquired 100% of the stock of the Company (the Share Acquisition) for approximately USD90M (Share Acquisition Price).

Shortly following the Share Acquisition, Microsoft US transferred the Company's employees to Microsoft's Israeli subsidiary company (Microsoft Israel) (Microsoft US and Microsoft Israel collectively the 'Microsoft Group'). To service the Company's remaining customers, a manpower agreement was entered into between the Company and Microsoft Israel with compensation determined on a cost-plus basis.

In July 2007 (approximately nine months after the Share Acquisition), Microsoft US acquired the Company's IP (IP Transfer) for USD 26.6m (IP Purchase Price). The IP Purchase Price was determined by an unrelated third party valuation company whose services were retained by Microsoft US. The valuation report apportioned the Acquisition Price as of the date of acquisition among the identified IP and other identified assets of the Company. The Company reported the capital gain arising from the sale of the IP which was fully offset against the Company's tax loss carry- forwards.

The Israeli Tax Authority (ITA) issued a tax paying assessment contending that the IP Purchase Price did not reflect the true market value of the IP Transfer and it is unreasonable that there should have been a large differential between the Share Acquisition Price of USD90M and the reported IP Purchase Price of USD26.6M.

The dispute

The differential between the Share Acquisition Price and the lower IP Purchase Price reported for the IP Transfer was the fundamental issue addressed by the Court.

ITA position

The ITA claimed that the IP Purchase Price should have been closer to the Share Acquisition Price than the actual IP Purchase Price declared by the Appellant in reporting the capital gain. The arguments presented by the ITA included the following:

- The IP Transfer extended beyond the sale of the IP alone, and included almost all the assets and activities that had originally been in the Company prior to the Share Acquisition, such that the Company, in essence, was left as an empty corporate shell with no economic content following the IP Transfer.
- The factual evidence reflected that the transfer of the Company's employees to Microsoft Israel was an essential condition to the Share Acquisition, since without obtaining the Company's employee group, the value of the IP by itself was negligible. The transfer of the IP with the Company's employees was intended to direct all of the Company's resources to the Microsoft Group. The remaining minor functions left in the Company post-transfer were only for the purpose of allowing the Company to complete its outstanding customer commitments and was not for preserving or developing independent activities.
- Regarding the value of the IP transferred, the ITA contended (supported by an expert opinion it provided to the Court) that the Company did not prove that the Share Acquisition Price was influenced by synergies unique for the Microsoft Group which would justify a neutralization of its value from the Share Acquisition Price. Furthermore, although synergy is not a distinguishable asset, it influenced the value of all of the assets transferred in the IP Transfer and should have been included in the IP Transfer value.

Company's position

The Company contended that the IP Transfer involved the sale of IP only and this was the transaction that the Company reported as a capital gain. The arguments presented by the Company included the following:

- The ITA has no basis to contend that the IP Purchase Price does not reflect the market value of the IP since the valuation was performed by an unrelated third party valuation expert and was also supported by an expert's opinion that the Company obtained during the appeal process of the ITA assessment.
- The Share Acquisition Price of USD90M exceeded the value of the IP and the Company's other assets since it also took into account synergy benefits that were expected by Microsoft US following the acquisition. Therefore, the synergy value to Microsoft US shouldbe neutralized in determining the value of the Company's IP and assets at the time of the Share Acquisition.
- The transfer of the Company's employees should not be viewed as a taxable event since employees “are not property that can be traded” or “sold”.
- Following the IP Transfer, there remained with the Company an R&D center and distribution activities which were not transferred to the Microsoft Group, thus supporting a conclusion that the IP Transfer transaction was not a sale of all of its assets and activities.

The judgment

The Court rejected the arguments presented by the Company and generally adopted the ITA approach that the IP Transfer should be viewed as wide in scope, which includes the vast majority of the Company's operations and not just the IP ownership. Therefore, the value of the transaction should be closer to the Share Acquisition Price and not as reported by the Company in its tax filings.

The Court provided a comprehensive analysis of Israeli transfer pricing (TP) principles and its objectives and concluded the following:

- Although the Company produced TP documentation attempting to prove the market value of the transaction, further to the TP rules of the Income Tax Ordinance (ITO) and its regulations, the burden of proof remains on the Company since the issue in dispute in this case is not just the valuation but also the essence and scope of the transaction.

- The Court also expressed an important guiding principle that the purchase price allocation (PPA) prepared for the Company was performed for accounting purposes under US GAAP rules and this does not necessarily mean that an analogy may be derived from the PPA for transfer pricing purposes regarding the value of functions, assets and risks being transferred in the IP Transfer between the related parties.
- Even if the Share Acquisition Price was influenced by synergy considerations, this is not proof that another purchaser would not have also had a special advantage that would have similarly influenced a share acquisition price. Therefore, the Share Acquisition Price should not be reduced by the synergy value claimed by the Company in determining the value of the Company's assets acquired. In addition, the Court agreed with the ITA that even if synergy is not an "asset" that can be independently sold, synergy influenced the value of the Company's assets sold in the IP Transfer.
- With regard to defining the essence of the IP Transfer transaction and its scope, the Court accepted the position of the ITA and concluded that the assets sold extended far beyond the actual technology. The Court concluded that the transfer of the employees to Microsoft Israel enabled the Microsoft Group to *de-facto* use the technology, since employees contain the professional know-how and commercial secrets that are connected to the operation of the technology. This approach is supported by the fact that the Company did not receive any separate consideration for the transfer of the employees and the transfer was intended to service the economic interests of Microsoft and not the Company.
- The Court agreed that employees cannot be "sold" and are not assets owned by an employer. However, the Court stated that it has no difficulty, neither from a legal or practical perspective, to attribute to the Company an asset that is expressed in the Company's ability to transfer its employees to another company as one bundled unit (or almost as one unit). Even if the Company was not able to force the employees to transfer to Microsoft Israel, it certainly was able to terminate their employment with the Company. The Company was also able to prevent the employees from making use of the know-how and professional secrets when working for the Microsoft Group. If it would have done so, the Court explained that all of the benefit that Microsoft Group saw in acquiring the Company would have been lost.
- The Court did not agree with the Company's view that the Share Acquisition Price included an economic value that exceeded the IP Transfer value. The Court explained that the value of the difference between the Share Acquisition Price and the IP Purchase Price cannot simply "***disappear or evaporate***" upon the termination of the Company's activities. Therefore, economic value should be attributable to all assets and activities that were acquired by Microsoft in the IP Transfer, even if the assets and activities changed in form following the Share Acquisition. The Court stated that *"the rule is that economic value is maintained, even if it has changed in its form",* which the Court found support for in the OECD/G20 Base Erosion and Profit Shifting Project - Guidance on Transfer Pricing Aspects of Intangible (2014). The Court determined that the Company did not meet the burden of proof that was imposed on the Company to show that this rule of "preservation of value" should not apply in this case.
- The Court concluded that the activity that survived in the Company was intended only to meet Company obligations to its current customers. In fact, a short time after the Share Transaction the customers started to leave the Company, and its operations which previously were very successful quickly ceased.
- Further to the above conclusions, the Court preferred and adopted the valuation analysis contained in the ITA expert's opinion over the valuation presented in the Company expert's opinion (except for allowing minor adjustments for bonuses paid for the preservation of employees, certain contingent salary payments and a minor value for the employees that remained with the Company).
- As a side comment, the Court referred to control premium as having an independent value which should not be attributed to the Company's assets or its activities but is attributable to the

shareholders. Notwithstanding, the Court did not address when to attribute a value to control premium as this was not an issue in the case. Taxpayers should consider value which may be attributed to other items such as NOLs and other tax attributes and value of routine returns post-transfer, among other items that were not directly addressed by the Court.

- The Court also made an important general guiding statement that implementation of Israeli TP rules, and the comparison of a specific transaction to market value transactions, are steps required when dealing with related parties - regardless of whether or not there is a diversion of profits to a lower tax jurisdiction.

The takeaway

In recent years it has been common for purchasers of Israeli companies to transfer the IP of the purchased company to a related company group following the acquisition. The question of how to define the IP transfer and its valuation has been a contentious issue in ITA assessments. The Court for the first time has ruled on this issue and its adoption of the ITA viewpoint may have implications for other acquisitions of Israeli companies where employees and assets (including IP) are subsequently transferred to an affiliate. Acquirers of Israeli should review the ruling and consider its impact on recent and future transactions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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