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Tax News Alert

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Dear Friends and Clients
We are pleased to update you with selected Israeli tax developments for the Second quarter of 2019

Selected Issues:

- The Broadcom Ruling - Innovation on the subject of a change in a business model
- The acquisition of a company that has accumulated losses - the economic equivalence between the fiscal grounds and the commercial grounds
- International - Transfer Pricing During the Corona Crisis

Sincerely,
Artzi, Hiba, Elmekiesse, Cohen - Tax Solutions Ltd.

Tax News Alert No.37 - September 2020

Dear friends,

The Artzi, Hiba, Elmekiesse, Cohen - firm is committed to the highest level of services. We keep our clients and colleagues, in Israel and abroad, fully up to date with respect to recent developments in the Israeli tax law and their implications.

We would like to thank you for using our services and for your kind cooperation which enables us to offer you high level tax solutions. It would be our professional, as well as our personal honor to continue cooperating with you.

The Broadcom Ruling- Innovation on the subject of a change in a business model

A ruling has been handed down recently in the Broadcom case on the subject of a "change in the business model" and the tax implications deriving therefrom, which is a significant and complex matter that has also been related to by the OECD and which has been dealt with by the Tax Authority in recent years. **The Court accepted the appellant's appeal and ruled in its favor**, for reasons that will be detailed below.

The previous rulings and the positions that have been determined on the issue place significant tax exposures in cases in which an Israeli IP company is acquired and there is a change in the array of agreements in a group, which are expressed in the presumption of the sale of the assets and operations in the acquired company (and the determination of the value accordingly).

Abbreviated details of the case:

The appellant is an Israeli company that is engaged in the development and sale of products in the telecommunications market.

The appellant was acquired by the American company Broadcom ("**Broadcom**") for an amount of 200 million Dollars.

A market agreement opposite a company in the Broadcom Group on a cost-plus 10% basis, an agreement for the granting of usage right to the "old IP", which is owned by the appellant opposite another company in the

Group, and a development for the "new IP" opposite Broadcom on a cost -plus 8% basis were signed after the acquisition.

The assessing officer claims within the context of an order that he issued, that **the array of agreements and the circumstances that exist indicate the sale of the array** of the appellant's **functions, assets and risks ("FAR")**, in amounts that are approximately similar (after adjustments are made) to the consideration that had been paid for the acquisition of the shares in the appellant.

The following are the abbreviated claims and insights from the ruling:

1. The testing of the continuity of the activity and the retention of the value of the acquired company: The Judge distinguished between the Broadcom case and the Gteko case, in which he had ruled in the past. In the Gteko case, the Judge mentioned that the acquisition of the Company and the changes that had been made subsequently led to a situation in which the appellant had become "a corporate shell lacking content" such that Gteko's business collapsed shortly after the transaction for the acquisition of the shares. Whereas in the Broadcom case the appellant has proven that following the array of agreements that were made between it and the Broadcom Group, the Company's activity increased and also its revenues and its profits increased. Even the size of its manpower increased and it leased additional floor space.
   In other words – **in the execution of transactions and agreements of this sort, it is necessary to verify the continuity of the acquired company and the retention or even the enhancement of its economic value.** Also, the Judge placed an emphasis on the retention of the size of a company's manpower, and in the case in hand the fact that the appellant's manpower has specifically grown from 90 employees to approximately 200 employees in the years following the acquisition transaction.
2. The sovereignty to change the business model: The Judge hinted that the Taxes Authority has become enamored with the term, however, it is not reasonable that the words "change in the business model" are a magic formula, and that it is enough for them just to be stated in order to bring about a change in the classification of the transaction that has been executed between the parties. Further on it cannot be said that a change in the business model from a model of the continuation of the development of intellectual property, which will be integrated into products and the

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generation of income from their sale, to a model of the continued development of the intellectual property on a cost-plus model, the receipt of royalties in respect of the existing intellectual property (even of the value of the existing intellectual property decreases and disappears) teaches us that at the time of the transaction, the appellant sold "an asset". Further on, the Judge determined that the Company is sovereign to change the model for its operations, even at the price of the reduction of the risks and the opportunities and still this does not constitute a sale. Furthermore, the Judge argues that the fact that the appellant chose to develop the new IP for Broadcom from the time of its acquisition, this does not teach us that it has separated itself from the R&D and the marketing functions that had been operated from itself.

One needs to consider this - A company is entitled to discontinue the development of intellectual property for the purpose of the sale of independent products and to start to develop them for others (including a related third party), whilst receiving royalties in respect of the old IP (i.e. - the splitting of the IP is absolutely possible), and with the knowledge that the value of that IP will reduce over the years, and all this in circumstances in which the considerations that are paid to the Company are appropriate and meet the arm's-length principle.

This is "sensational" news on this issue.

3. The normative source for the analysis of a transaction: The Judge accepts the principle that the Taxes Authority is entitled to analyze transactions in accordance with their economic substance, whilst placing reliance on the OECD's guidelines as a source for interpretation purposes, and he even referred to the Taxes Authority's own words in a circular that it issued on the subject, pursuant to which the case has to be examined with an exact analysis of the FAR for the purpose of classifying the transaction and the consideration therefor, inter alia, with the objective of preventing situations in which there is an inappropriate diversion of profits. However, it would be appropriate for this to be done "in a measured manner and certainly not in an "automatic" and all-encompassing

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4. Royalties versus a capital gain: When the Taxes Authority has been unable to reclassify a transaction, the significance of this is that validity should be given to the agreements that exist between the parties - including the Cost-plus agreements for the provision of marketing and development services (a pricing methodology that was not attacked by the Taxes Authority and thus was approved by the Court) and all that remained for the Taxes Authority to claim are claims regarding "the transaction price" pursuant to the Ordinance, including the royalties rate that was set in the use of the "old IP" transaction (which is something that has not been done in the case in hand).

In the past, we have expressed our opinion that **in the case of the retention of the IP in an acquired company and the granting of a usage right in respect of it "the company will avoid the existence of possible claims regarding the absolute sale of its assets (in which a significant tax exposure is inherent), and the potential dispute is narrowed to a discussion on the royalties rate or on the manner is determined".**

The acquisition of a company that has accumulated losses - the economic equivalence between the fiscal grounds and the commercial grounds

A judgment by the District Court in Tel-Aviv-Jaffa was published on the subject of an appeal by the Nawi Brothers Group Ltd. (hereinafter - **The Company**) against an assessment order, in which it was determined that the Company is not entitled to offset losses that had accumulated prior to its acquisition.

Background

At the beginning of the year 2011, the Nawi Brothers acquired a shell type stock exchange company (by way of a private allocation of 85.5% against the injection of an amount of NIS 47 million into that company), which was "clean" (i.e., without assets or liabilities whose operations had been discontinued about half a year beforehand) which had approximately NIS 153 million of accumulated losses at the end of 2010 (approximately NIS 44 million in business losses carried forward and approximately NIS 109 million in real capital losses on securities carried forward) and new activity and profitability were transferred from a private company that they owned, in the field of

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deferred notes ("the discounting of checks"). In the years 2011 – 2013, all of the accumulated losses were offset against the Company's chargeable income from the discounting of checks.

The assessing officer based himself on a claim of artificiality, and using the special authority that is afforded to him within the framework of the general anti-abuse rules, **he reclassified** the transaction and determined that the accumulated losses (brought forward) cannot be offset within the framework of the Company's activity in the field of the discounting of checks.

It should be mentioned that after the assessment was issued under an order, a partial assessment agreement was signed with the assessing officer for the years 2011 to 2013 pursuant to which the offsetting of the real loss on securities (in an amount of approximately NIS 109 million) from the Company's chargeable income was cancelled, apparently because of the fact that they had not been offset from the Company's capital gains (which did not exist in those years) pursuant to the provisions of the Ordinance, but rather from the chargeable business income .

As a rule, the Court determined that on grounds of the principle of justice in the imposition of tax, the legislator permitted the offsetting of losses against profits from different businesses owned by the same assessee (an individual or a company), however, **"the watershed line in the implementation of this principle is that <u>on the sale of control</u> in a company to new shareholders, who have the ability to direct its operations and who have an economic interest in it".** And therefore, the Court went further and emphasized regarding the acquisition of a company with accumulated losses: **"…that the principle that prohibits the purchase of losses that have been incurred (indirectly) by other shareholders, <u>only applies where there is no fundamental commercial ground for the acquisition of the control in the company and the transfer of new profitable activity into it</u>.** (The emphasis is not in the original). In other words, "the baby will not be thrown out with the bathwater" in every case, because" **in light of this, there is nothing in the fact that the new controlling interests did not incur the losses that have accumulated in the company from the economic perspective and there is nothing in the fact that there is not necessarily a connection between the previous activity and the new activity that has been entered into it, in and of itself, that is necessarily enough to prevent the offsetting of the losses".**

And therefore, the Court determined

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that: **only in a case in which <u>the control is sold in a company, without a fundamental commercial ground</u>, apart from the desire to utilize the losses, distort the balance in the direction of the principal of the prohibition of the purchase of losses that have been incurred by the previous shareholders".**

The Court went further and stated that it had indeed already been determined in a previous judgment that not every purchase of a stock exchange shell with losses is an artificial transaction and that one should even view the "public visibility" that is associated with a stock exchange shell as being a sort of "commercial ground" and in the appropriate circumstances, even a fundamental one. However, the Court determined that every case is to be determined on its own merits and in particular the issue of what the fundamental commercial ground that formed the basis for the acquisition of the <u>specific</u> stock exchange shell was.

The Court determined, that in order to negate a claim of artificiality of a transaction, one needs to weigh up the commercial ground and the fiscal ground therein, and to show that (at least at the level of a reasonable expectation) the transaction is accompanied by <u>a fundamental commercial ground</u> (where the burden of objective proof is placed upon the assessing officer), and at the same time it must also be shown that <u>the importance of the fiscal ground</u> in the transaction (i.e. the tax shield that is inherent in offsetting the accumulated losses, where the burden of subjective proof is placed on the assessee) is of a <u>less</u> fundamental level, and all this is to be measured and examined at the time of the execution of the transaction and not retrospectively.

And in brief, when operating the anti-abuse rules, the assessing officer has to be the first in order and to show that the transaction would not have been executed were it not for the tax advantage (the fiscal ground) and only if he succeeds in doing so is the burden on the assessee to prove (subjectively) that the transaction would not have been executed were it not for the commercial- economic ground therein.

Regarding the fiscal ground (the tax asset that is inherent in the losses), the Court adopted the assessing officer's figures, in the formula for the calculation (the level of the accumulated losses, the corporate income tax rate, the withholding rate in the Company – and all this as was seen at the time of the acquisition!), and reached the conclusion that its level was estimated at approximately NIS 34 million (as compared with just NIS 9 million, as claimed by the Company), which the Nawi brothers hoped for and expected and which constituted a fundamental ground from

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their perspective at the time of the acquisition of the Company.

Regarding the commercial ground in a transaction and its real fundamental nature, the Company claimed and the Court agreed to this and went further that its activity in the field of discounting checks through a stock exchange company afforded that activity, which generally suffers from a negative image (the grey market), appropriate "public visibility", and numerous additional tangible commercial advantages, such as: an influencing customers to use the services of a supervised and audited public company, entrance to the Stock Exchange whilst turning "a new page" without exposing past results, the ability to raise credit from the banks with reduced guarantees, the ability to recruit credit from the capital market and increase the sources of financing, the ability to realize holdings readily and at high values and all this whilst retaining effective control in the Company. Furthermore, the entry into the Stock Exchange with an existing stock exchange shell reduces the Company's time-lines, efforts and costs significantly - which achieves the existence of the commercial ground.

Despite the aforesaid, and for the purpose of the examination of the commercial ground and the fundamental nature thereof, and even in the comparison to the fiscal ground, the Court went into the depths of the business decisions made by the Company and its controlling interests, which they saw at the time of the acquisition, and it examined the commercial grounds regarding the management of the check discounting activity in a public company (with accumulated losses) as compared with a private company (without losses for offsetting), what the commercial ground was in the entry to the Stock Exchange by means of a stock exchange shell by comparison with the alternative paths (such as: the acquisition of a listed public company, an initial offering of a private company and etcetera) and finally the Court also asked whether the Nawi Brothers made a commercial investigation of the acquisition of other stock exchange shells that were available at that time (for example, without losses or with smaller losses).

The Court reached the conclusion that in real time (at the time that the transaction was executed) the Nawi Brothers expected that they would achieve larger profits (regarding the offsetting of the losses), they did not expect to recruit equity in the first years (the issuance of the bonds only took place 4 years later) and also that: <u>in order to prove the existence of "a fundamental commercial ground" in the acquisition of the specific shell, the Nawi Brothers had to prove that</u>

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<u>they took reasonable efforts to try to find additional shells, that did not have losses or which had lower losses, and that it would have been possible to purchase them in that same unique business structure</u>". Hence, the result that the Court arrived as was that the acquisition of the Company was made for a fundamental fiscal ground of the utilization of the accumulated losses and therefore it was artificial.

In our opinion, the economic weighing up that the Court conducted in this case is a comparison between chalk and cheese. How is it possible to compare between a kilogram and a kilometre? The fiscal ground can be measured exactly and (relatively) easily in money terms, whereas the commercial ground and the fundamental nature thereof are examined and measured by a test involving common sense in accordance with economic, commercial, business and moral criteria, market regulations and etcetera- how can we make a real examination of which of the foundations overrules the other? How many further rulings will be written in order to find the magical formula for this unknown? Therefore, maybe this is the place and this is the time to call in the legislator, out of an approach supporting tax stability and to set clear and absolute tax directives for situations in which a company cannot offset accumulated losses.

International - Transfer Pricing During the Corona Crisis

Transaction between entities within a multi-national group form a significant part of global commerce. There are elements that perform centralized functions, such as procurement or intellectual property (IP) management, there are those that perform R&D services and there are distributors of products and services. As is well known, the legislation of transfer pricing provisions in the Income Tax Ordinance was intended, inter alia, to prevent the diversion of profits, which are supposed to be charged with tax in Israel, to another territory, where generally, the tax rate is lower, in a manner that would reduce the Group's overall tax liability.

We would like to quote the Income Tax Department's circular, which deals with transfer pricing, regarding this issue: "*International transactions have especial significance from the tax aspect, in light of the fact that the improper determination of the price between the parties,* ***is likely to divide the overall profit from the transaction such that the part***

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*thereof that it will be appropriate to charge with **taxation in Israel**, **may well not be chargeable in Israel** and it would not be deemed to be profit that has been produced or has accrued in Israel in accordance with the regular principles*".

At the present time, we are coping with an unprecedented crisis in the form of the Novel Corona Virus (COVID-19). In normal circumstances in the market, the transfer pricing policy between entities in a multi-national group leads to a stable and low yield for routine activity that accords with the relative value of the functions that they perform and the risks to which they are exposed, whereas the initiating companies are entitled to the residual profit or bear the residual loss after the entity that bears the lower risk is remunerated.

Since the COVID-19 crisis is an exceptional, exogenous realization of risk, the question arises of the degree to which entities that have a low business risk are required to participate, if at all, in the business change that derives from the crisis, already in the current tax year (2020), in which the crisis has broken out. We believe that there are claims that support this approach, inter alia, **specifically against the background of the business conduct between unrelated companies at the present time**, and that the possibility of a change in the inter-company pricing, at least temporarily, should be examined, with an emphasis being placed on the examination of the implications deriving from the possible change from a long-term perspective. We would mention that the implementation of the **existing** transfer pricing model with the economic analysis (the benchmark) being updated in accordance with the implications of the crisis, would lead to expression being given only to the implications in the results for the coming years since the implementations of the crisis will only appear in the results of the comparative companies in their financial statements for the year 2020, which will be published in 2021. This state of affairs requires changes in accordance with other models, for example the forecasting of the changes that are expected and the implementation thereof already in the current tax year, or for there to be a certain reduction in the pricing.

We will take as an example a company that provides inter-company services, which operates under a profitability policy of Cost-plus 10%, but which is not succeeding in fulfilling the function that it is responsible for as a result

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of the Corona crisis. Is it fair that the Company will continue to report on profitability at a fixed rate without any impact on its results on the assumption that it has not succeeded in reducing the full cost and in certain cases, it is even exposed to an increase in expenses? Is it fair, in the circumstances in the market, that providers of routine services will bear part of the damage that derives from so exceptional an event? Numerous questions arise on this issue, such as: What are the justified commercial reasons – in the circumstances that are relevant to the company that is being examined – which enable a supplier to record a reduced profit (as compared to previous years)? Should the related parties conduct new negotiations on their arrangements, as third parties may do, including opening agreements retrospectively? Do losses of this sort accord with the service or the production function, the asset and the risk profile? Should and how should the supplier be compensated in the coming years when the conditions in the market improve?

In our opinion, in certain cases, it will be possible to support an approach that in the exceptional circumstances that have arisen – on the assumption that they will continue over time in 2020, the results of the parties that are connected to the global crisis event should be adjusted and the profitability target that has been agreed between the parties (the target operating margin) should be diverged from, based on an up to date economic analysis and the general provisions in contract law. In the current state of affairs, at the height of the crisis, it can be assumed at a high level of probability that it would also be possible to come to similar understandings with a third party supplier. We would add that the reduction of the profitability even constitutes the implementation of the existing transfer-pricing model, in accordance with the implications of the crisis, and the selection of a lower profitability rate fits with the model, so long as it is within the inter-quarterly range. Furthermore, an analysis of the losses and the exceptional events that are particular to the company being examined, as the result of the crisis (such as bad debts) should be made.

The crisis even has implications for the analysis of inter-company credit transactions. Thus, for example, it is possible to consider the extension of the payment term timings in respect of inter-company transactions without exceptional interest or indeed, any interest at all being charged, the deferral of the payment times for interest in respect of credit transactions, the

re-examination of the interest rate on inter-company transactions in light of the change in the risk conditions, the increasing of the inter-company credit facilities, the making of new credit available between companies in the Group and the shareholders, since all of these are part of the activities that are required in a crisis. In these cases, it is important to act in accordance with generally accepted transfer pricing principles and to ensure that there is appropriate documentation of the transactions.

We would emphasize **that any change in the model and the attribution of risks between the parties to a transaction** (even where this is done due to the crisis) in contravention of an inter-company agreement and in contravention of the transfer pricing policy (and the transfer pricing works) as applied before the crisis - could endanger the possibility of defending the model in relation to previous years that are not closed and it could certainly lead to a change in the Taxes Authority's approach in relation to the coming years - **and therefore it requires thorough examination and extra care should be paid.** Serious consideration should be given to any change, and if changes are made then this must be documents and very good reasoning given, with full disclosure being given. In certain cases, consideration should even be given to approaching the Tax authority.

The Corona crisis has both short-term and intermediate to long-terms impacts. In the short-term, the Virus' direct impact, the restrictions that it has created and the unexpected costs on at least some of the companies in the Group require adjustments and changes in the transfer pricing policy. In the intermediate to long-term, the impact of the crisis will be examined in the coming years and it is possible that it will lead to a change in the transfer pricing policy, which will find expression in different terms in inter-company transactions and in re-arrangements in international companies, including an expansion in relation to exceptional events and the impact thereof.

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In case you have any questions or need further clarifications, please do not hesitate to contact our International Taxation Team:

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