



## **New Court Ruling Concludes no Sale of FAR in a Change of Business Model**

The District Court recently ruled in favor of Broadcom Semiconductor Ltd. (the “**Appellant**”) in its case against the Israel Tax Authority (ITA), and determined that changes to its business following its acquisition by the Broadcom group, should not result in a capital gain from the sale of FAR (functions, assets and risks). This ruling is contrary to a previous decision handed down by the same judge in 2017, in the Gteko case.

### **Factual Ground**

The Appellant was incorporated in 2001 as a private Israeli company and was fully owned by a US parent company, whose shares were purchased in 2009 by the Broadcom Corporation. Following its acquisition, the Appellant entered into an agreement to provide marketing and support services to a related Broadcom group company under a Cost+10% arrangement, an agreement to provide development services to the parent company for Cost+8%, and a license agreement with another related group company to use the intellectual property of the Appellant in consideration for royalties.

### **Main Arguments for Appellant**

A change in business model justifying an intervention in contractual agreements between the parties and resulting in a sale of activity or intellectual property is appropriate only where the company was emptied from its activity after its purchase. In this case, the exact opposite occurred - the Appellant’s financial situation improved dramatically following its purchase by the Broadcom group. Furthermore, the Appellant did not sell any intellectual property but rather granted licenses and provided R&D services. In addition, some years later the Appellant eventually sold its intellectual property for a significant amount and was taxed for the gain.

### **Main Arguments for ITA**

The ITA argued that according to chapter VI of the OECD guidelines and Section 85A of the Income Tax Ordinance relating to transfer pricing, it should be determined that the entity transferred FAR following the acquisition which resulted in the Appellant changing from a company active in R&D, production, marketing and sales, to a company that only provides R&D services to its parent company. This demonstrates that the Appellant changed its business model, a change that should be reclassified as a sale of an asset.

### **Court Decision**

1. In its decision the honorable judge Dr. Shmuel Bornstein explains that this case is very different from the Gteko case. While the same considerations apply to this case, in the Gteko case the change of business model caused Gteko to become “an empty corporate shell” while the parent company enjoyed all the economic value, so much so that Gteko's business collapsed shortly after the acquisition of its shares.



2. The court criticized the ITA, stating that the words “change of business model” are not magic words that should always cause reclassification of a transaction between related parties. It is very possible to imagine situations where an Israeli company, owning technology with proven value, makes a change in its business model to better its activity, income and workforce. The question is not whether the company changed its business model, but whether this business model would or would not have occurred under the same conditions if the parties were not related.
3. It is, according to the court, a question of transfer pricing, and as such it should be examined under the arm’s length principal.
4. In this case, Broadcom proved that following the agreements entered between the Appellant and the Broadcom group, its activity expanded, as well as its income and profits. The Appellant also increased its workforce and rented more space. Moreover, after a few years the Appellant sold its intellectual property for a substantial amount.
5. The court ruled that the change in business model from a model of developing intellectual property, assimilating it in products and making a profit from selling them, to a model of developing intellectual property for Broadcom under a ‘Cost+’ model in exchange for royalties does not necessarily mean that the Appellant sold an asset to the Broadcom group.
6. The use of the reclassification tool following a functional analysis of change in business model should be made in a restrained manner, certainly not automatically. In cases where the change of business model caused the company to grow, it will be more difficult to interfere in the agreements made between the parties and to determine a different economic substance. In the absence of real indication that the change of business model reflects a different transaction, far wider than the one presented by the parties, there is no room to interfere beyond scrutiny of the price of the transaction according to transfer pricing rules, if applicable.

### **Final Note**

As shown above, the issue of reclassification of a transaction following the acquisition of an Israeli company and the change of a business model is very complex and is dependent on a fact and circumstance test which differs from case to case. The same court ruled in the Broadcom case very differently from its decision in the Gteko case. This is why an accurate analysis should be made in each case.

Our department and firm have extensive experience in representing multinational companies in various transactions including the purchase of local companies, drafting inter-company agreements, advising on the economic terms and representing the companies in tax disputes with the ITA as well as in the courts on a variety of related tax issues, including change of business model. Our team would be happy to answer any questions arising from the latest court ruling.

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