The Tel Aviv District Court recently handed down a decision in the matter of Medingo Ltd. ("the Company") (Civil Appeal 53528-01-16) involving a corporate reorganization. The Company had argued that a change of business model it implemented following its acquisition by Roche, under which it signed intercompany agreements for R&D, services, production, and IP licensing, did not constitute a sale of the Company's operations, and therefore did not constitute a tax event. The decision was based on the guiding principles established by district courts in the past, such as the Broadcom and Gteco cases. In its ruling, the Court dismissed the position of the Israel Tax Authority and accepted the Company's position.

The Facts

Medingo was involved in the development of a unique medical device for diabetics, called Solo. In April 2010, the Swiss pharmaceutical company Roche purchased the Company for approximately $160 million, plus a contingent payment of $19 million. About half a year after the acquisition, Medingo and Roche executed several intercompany agreements for the provision to Roche, with certain services, including R&D services, marketing, production, and product packaging, in a cost plus arrangement (Cost+5%). The parties also signed a licensing agreement for use of the Company's intellectual property that had been developed until that point (**the "Existing Intellectual Property"**). The Company discontinued its operations in 2013. In November 2013, an agreement was signed between the Company and several companies in the Group for the sale of the Existing Intellectual Property in consideration of CHF 42.9 million (approximately NIS 166 million).

The Question in Dispute

Did the four intercompany agreements entered into in 2010, constitute a sale of the functions, assets, and risks ("**FAR**") by the Company, as the assessment officer claimed, so that the value of this sale should be determined based on the consideration paid by Roche for the Company's shares close to such time, or, as the Company argued, is it incorrect to view the intercompany arrangements as a sale of FAR?

The Court's Decision

The Court determined that sole if two considerations were both met would the intercompany arrangements be deemed a taxable sale event:

Do the intercompany agreements themselves constitute a sale of the operations?

The Court established that the intercompany agreements themselves do not constitute a sale of the operations, and that the evidentiary material indicates that "the operations at the Appellant are continuing, with even greater intensity, as set forth in the intercompany agreements." The Court analyzed the fundamentals of FAR as follows:

Functions – The Court established that the Company continued its operations, including functions such as research and development, production, marketing, and management, which remained under its responsibility. Regarding the R&D function, which was central at the Company, it was noted that **the actual location where the R&D function was performed, as opposed to the location from which it was managed, was an important aspect**. The Company managed the R&D budget itself, and at the least, in cooperation with the Group. The R&D agreement was limited in its term, after which it was possible to discuss new terms. It was also established that **even if the products of the R&D operations did not belong to the Company, this did not indicate that the operations were not taking place at its premises and under its responsibility.**

Assets – The position of the assessment officer, who argued that the Existing Intellectual Property had been transferred to Roche pursuant to the intercompany agreements, was dismissed. The Court established that **it is possible to distinguish between the Existing Intellectual Property owned by the Company and the new intellectual property owned by Roche.** The license to use the Existing Intellectual Property was granted for a set term (and in fact, at the end of the term of the agreement, Roche was required to purchase the intellectual property), and Roche was not entitled to transfer it to non-related third parties without the Company's consent.

Risks – Even if after the intercompany agreements were signed, the composition of the Company's operations changed, this would not indicate a sale of its operations. In the words of the Court: **"Minimization of the risks (and the opportunities) themselves would not indicate a sale of the operations. Businesses can change their business mix without this constituting a sale".** After signing the agreements, the Company still had significant risks, such as regarding royalties to which it was entitled, whose amount depended on the sale of products based on its intellectual property, risk stemming from the fact that the Company has a single customer, and risk that products based on its intellectual property would fail and its operations in Israel would be halted (which is what actually happened).

The Court established that the grounds on which the assessment officer based his argument regarding the transfer of functions of "outlining production policy," "outlining marketing policy," and "outlining strategy" were unclear. **The Court distinguishes between the acquiring company (Roche) as the shareholder** – who logically would outline the Company's policy based on its vast experience in the pharmaceutical industry – **and its other hat, as buyer of the operation** – while it is reasonable in this context that the Company would be interested in utilizing Roche's extensive knowledge.

Would the intercompany agreements and change of business structure not have ever happened if they were not a parent company and subsidiary?

In order to answer this question, the Court referred to the guidelines of the OECD, by which in a transaction between related parties, the **characterization and pricing of the transaction** must be examined using the **arm's length principle.**

The essence of characterizing the transaction lies in the question of whether the transaction would have also happened between non-related parties. Pursuant to the guidelines, **there should be no intervention regarding the characterization of the transaction against the agreements except for under extraordinary circumstances, in which the agreements are fundamentally unfounded or do not allow for a price to be determined pursuant to the arm's length principle.** In this case, the Court established that there was no fault in the characterization of the transaction.

The Court established that the assessment officer was wrong in focusing on the terms of the intercompany agreements throughout the entire proceeding, instead of on their characterizations. **The transaction's pricing, it established, cannot indicate whether it constitutes a license or a sale; at the very most, it can assess whether the royalties should be increased or changes should be made to the terms set in the agreement.** This question is related to the characterization of the transaction, not to the consideration. In this case, the agreements secured the Company's future and gave it much higher chances of survival.

In addition, the Court dismissed the Tax Authority's position on the existence of alternatives to the transaction. It commented that in retrospect and on paper, it is easy to suggest alternatives, but often times, the reality in real time is completely different. Therefore, proposing alternatives is nothing more than a guess, as it is impossible to know what the Appellant's situation would be had it not entered into this set of intercompany agreements. The Court emphasized that **the case of substantial temporary alternatives refers only to alternatives regarding which it is clear that they are more worthwhile, in a manner characteristic of the business logic of the transaction.** In the event of a few different temporary alternatives, it is not

possible to necessarily prefer one alternative over another, and the conclusion is not necessarily that the transaction's characterization does not meet the market conditions.

The Tax Department at our office has extensive experience representing multinational companies and Israeli companies regarding issues related to Business Restructuring, and we would be happy to assist you in this regard as well. For additional information:

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