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Medingo – ruling on the concept of post-acquisition business restructurings (Part I: overview)

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On 8 May 2022, the Tel Aviv-Yafo District Court ("the Court") decided on a transfer pricing dispute regarding the concept of post-acquisition business restructurings.[1] In 2010, the Roche Group acquired the full share capital of Medingo. Six months post the acquisition, the parties entered into several agreements, changing Medingo's business model from that of a full-fledged entrepreneur to a low-risk manufacturing, sales and development site. Three years later, Medingo's (pre-acquisition) IP was sold to Roche and its activities were ceased. The Court had to decide whether the (pre-acquisition) IP was transferred/sold to Roche at the time of acquisition or three years later, when Medingo's activities were ceased. This blog comprises of an overview of the case.

Background

Medingo, incorporated in 2005 under the control of Elron Electronic Industry Ltd and operating from its offices in Yokneam (Israel), autonomously it developed and commercialized a unique wireless insulin pump for diabetics ('the Solo'). As it was a relatively small company, it was difficult for Medingo to survive alone in the medical device market. Up to 2010, Medingo was a loss-making company with no profits and even without expected profits in the coming years.

In April 2010, Medingo was acquired by the Roche Group for approx. USD 180 million. Approx. USD 172 million[2] of the purchase price was attributable to the intellectual property ("IP") that Medingo had developed up to that point ("old-IP"). About six months after the acquisition, Medingo and the Roche Group entered into the four following agreements that were effective from June 2010 until years end 2013:

1. **R&D Services Agreement:** On the basis of which Medingo provided R&D services to Roche at a cost plus 5% basis. All IP developed under the R&D services agreement ("new-IP") was wholly and exclusively owned by Roche.
2. **Services Agreement:** On the basis of which Medingo provided Roche with support services in the areas of marketing, technical support and management as well as advice regarding the use of patents. For these services Medingo was remunerated at a cost plus 5% basis as well.
3. **Manufacturing Agreement:** On the basis of which Medingo was remunerated at a cost plus 5% basis as well. It is assumed[3] that the services covered by the agreement consist of standard manufacturing and packaging services.
4. **License Agreement:** Under which Medingo granted Roche a license to use the IP it had developed up to that point ("old-IP"). Roche could, inter alia, manufacture, use, sell, commercially exploit, continue to develop related products and grant sub-licenses to entities in the Roche Group. The licensing fee paid was in the form of royalties at a fixed percentage of sales of the Solo.

The agreements were valid for a fixed period of three years, after which the parties could reconsider the terms and conditions. In this period, Medingo transformed from a loss-making company into a profitable company. It increased its workforce from 89 to 147 employees in 2012. The increase was significant in more or less any department; 56% increase in R&D and production personnel; 150% increase in marketing personnel; 50% increase in engineering personnel; 220% increase in the quality assurance department.

In January 2012, Medingo's employees were notified that the activities in Israel would be terminated at the latest by years end 2013. The Court's documents show that, in 2010, Roche had already announced to a committee that it intended to transfer the activities of Medingo from Yokneam (Israel) to Mannheim (Germany) at some point. However, the Court's documents also show that the decision to move activities from Israel to Germany was not yet final in the middle of 2011. In the course of 2012/2013, the activities of Medingo were terminated. In 2013, Medingo sold the old-IP to Roche for approx. USD 47 million.[4]

[1] Medingo Ltd. v. Assessing Officer Afula, Tel Aviv-Yafo District Court, published May 8 2022.
[2] CHF 178.3 million, f/x-rate 1 January 2010, CHF 1 = USD 0.966.
[3] No information is provided in the court documents regarding the production terms besides the remuneration, which would be a 5% mark-up on costs.
[4] CHF 42.9 million, f/x-rate 1 January 2013, CHF 1 = USD 1.0922.

The Israeli tax authorities ("ITA") rejected Medingo's tax return for 2012 in which it had reported a capital gain for the sale of old-IP for approx. USD 47 million. The ITA argued that this IP was already transferred in 2010 as part of the business restructuring, resulting from the agreements put in place in April 2010. According to the ITA, these agreements should be interpreted altogether, as one. Observing the terms and conditions of the agreements between Medingo and Roche, the ITA argued that Medingo's functions, assets and risks had been transferred to Roche in 2010. To serve the purpose of this contribution we will refer to the 'transfer of a business as a going concern' ("TOGC"). In 2010 the old-IP was valued at approx. USD 172 million. This amount was recognized as taxable income in 2010.

Key questions discussed

The Court addressed the following two key questions in order to resolve the dispute between Medingo and the ITA :

A. Whether the agreements of 2010 should be accurately delineated as a TOGC?
B. Whether the agreements possess commercial rationality? If not, this could result in recharacterization of the agreements.

A. Accurate delineation of the agreements

The agreements contractually involved a restructuring owing to a number of changes in interconnected primary activities.[5] They changed Medingo's business model from that of a full entrepreneur (performing and managing the activities for and by itself at its own risk) to that of a service provider for Roche earning a stable income with a lesser degree of up- or downward potential. The ITA argued that Medingo's ongoing concern (incl. IP) was transferred as a result of this change in business model. According to the Court, such a (contractual) change does not constitute per se a transfer of the functions, assets and risks. The Court analyzed whether any effective transfers of functions, assets and risks were made in 2010.

- The Court noted that no employees of Medingo (e.g. CEO, management, R&D) were fired or transferred to Roche. Medingo continued its activities, including the R&D, production, marketing and management functions. The Court also rejected the ITA's argument that the management of and decision-making authority regarding these functions were transferred from Medingo to Roche . The Court noted that Medingo still carried out the R&D activities in Israel and managed the R&D budget, even though the fruits of these activities were now enjoyed by Roche. In addition, the Court noted that Medingo's workforce increased from 89 employees to 147 employees in 2012 (post the agreements of 2010), and that it went from a loss-making company to a profit-making company. Accordingly, the Court concluded that no functions had been transferred.

- The Court further concluded that the agreements did not constitute a transfer of the legal ownership of the old-IP. For the R&D Services Agreement only granted Roche full ownership/right-to-use the new-IP whereas the License Agreement merely granted Roche the right-to-use the old-IP for a fixed period of three years, after which Roche was no longer entitled to use/exploit the old-IP. The ITA's argument that the old-IP and new-IP should be considered indistinguishable, so that the terms that applied to the new-IP should also apply to the old-IP (i.e., the old-IP was transferred because the new-IP is owned by Roche as per the agreements), was also rejected by the Court. The Court did not see any real impediment to distinguishing the new-IP from the old-IP.

- With regard to the transfer of risks, the Court noted that the agreements changed the business model of Medingo from that of an entrepreneur to that of a low-function/risk service provider. However, the Court stated that such a (contractual) change did not in itself indicate a transfer of the risks. The Court concluded that, although to a lesser extent than before, Medingo still assumed a major part of the risks with respect to its main product (the Solo). According to the Court, the fact that Medingo's only customer was now Roche (and not the external market) merely changed the mix of risks assumed by Medingo, but did not indicate a transfer of all the risks related to the old-IP.

The Court thus ruled that the limited (if any) transfer of functions, assets and risks (related to the old-IP) could not be recognized as a sale of the IP.

B. Did the agreements possess commercial rationality?

The ITA argued that the transaction as structured by the agreements did not meet market conditions because it was not the most attractive option realistically available to Medingo. The Court, however, did not accept this contention, it started by citing the OECD Transfer Pricing Guidelines ("OECD TPGL") that a transaction as structured may only be recharacterized in

[5] Like R&D, manufacturing, supply and marketing.

exceptional circumstances. Furthermore, it observed that it was sensible for Medingo to enter into the agreements in question, given the situation that Medingo was in at the time. Pre-acquisition, Medingo faced considerable obstacles, and chances of survival were not guaranteed. The agreements secured Medingo's future at least in the short term, and gave it a chance to survive/succeed.

The Court noted that it was always convenient to offer alternatives in retrospect and on paper, but that the ground realities are often completely different. In order to determine whether a transaction as structured meets market conditions, only alternatives that are clearly more viable, in a way that they nullify the business logic of the disputed transaction, should be taken into account. In a case where there are several alternatives available and it is not necessarily possible to prefer one alternative over the other, it cannot follow that the transaction as structured does not meet market conditions.

The Court also rejected the ITA's reasoning that the IP was transferred in 2010 because the decision to cease the activities of Medingo in Yokneam (Israel) was already made in 2010. This contention was rejected because the Court was not convinced that Roche had already made the decision to cease the activities of Medingo at the time of signing the agreements in 2010. The Court documents show that the decision to move activities from Israel to Germany was not yet final in the middle of 2011. In the course of 2012/2013, the activities of Medingo were terminated.

Takeway

The contention of the ITA in the Medingo case (described in detail above) that transitional agreements (pending a take-over) could be construed as the 'transfer of a business as a going concern doesn't stand on its own. The TOGC concept has been advocated by the ITA in at least two (somewhat) comparable cases, Gteko[6] (2017) and Broadcom[7] (2019). The gist of these cases shows that a change in business model does not constitute per se a business restructuring for transfer pricing purposes. After the essence of the transaction is accurately delineated, irrespective of its form, the pivotal question to ask is whether the same change would have been made without compensation between unrelated parties. If the answer is 'no,' then the mere change of business model is not compensable. This case brings to the fore (a.o.) that developments in workforce, activities and profitability are crucial aspects that should be considered when answering this question. We are currently putting together our observations and insights on the Medingo case, and we will share our findings in our upcoming blog(s).

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[6] GTEKO Ltd. v. Assessing Officer of Kfar Saba, Central Lod District Court, Published June 7, 2017 "Gteko".
[7] Broadcom Semiconductor Ltd. v. Assessing Officer of kfar Saba, Central Lod District Court, Published December 9, 2019 "Broadcom".