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Medingo – Ruling on the concept of post-acquisition business restructurings (Part II: analysis)

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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 shares 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. The Israeli tax authorities ("ITA") attempted to disregard the agreement and to substitute this for a deemed sale of IP. Medingo/Roche ultimately won the case. In this note, we will share our insights/takeaways. For an overview of the case itself, reference is made to this blog.

Observations/Takeways

Medingo as part of a greater whole

The main issue in Medingo concerned the characterization of the transaction/agreements as a deemed transfer of functions, assets and risks ("FAR"). The case builds on two previous court cases in which the Israel Tax Authority (the "ITA") scrutinized acquisitions of Israeli tech companies (Gteko and Broadcom), whereby following the acquisitions the FAR transferred. A deemed transfer of FAR, as used by the ITA, is or seems to be based on Chapter IX of the OECD Transfer Pricing Guidelines ("OECD TPGL"). This section lays down guidance on the transfer pricing consequences of business restructurings. To serve the purpose of this contribution we will refer to the *'transfer of a business as a going concern'* ("TOGC").

The positions of the ITA in Medingo does not stand on its own. The TOGC concept has been used by the ITA in at least two (somewhat) comparable cases, Gteko[2] (2017) and Broadcom[3] (2019). Gteko was acquired by Microsoft. Shortly thereafter its operations were transferred to Microsoft, whereby the Gteko employees moved to Microsoft's subsidiary in Israel. The Court emphasized substance of form (w.r.t. the agreement/transactions). The post-acquisition transfer of workforce and IP was characterized as a TOGC. The ITA prevailed.

Similar to Medingo, in the Broadcom case (2019), Broadcom's business model changed from that of independent entrepreneur into a service provider post-acquisition by means of several contracts. This change resulted in an increase in Broadcom's activities, renting more office space and an increase in workforce. The Court ruled that such a business model change may constitute a TOGC but should not be concluded (merely) based on the agreement.[4] Broadcom prevailed.

Primary position ITA: Transfer of a business as a going concern

To start off, the ITA took the view that the initial acquisition agreements are economically interrelated and should be examined together, in a broader context. This, in our opinion, is a valid point. The agreements effectively meant a number of changes in interconnected primary activities, changing Medingo's business model from that of a full-fledged entrepreneur performing a range of development, sales/marketing and manufacturing activities to a low-risk manufacturing, sales and development site.[5] The ITA recognized the business model change as a TOGC (incl. IP).

[1] Medingo Ltd. v. Assessing Officer Afula, Tel Aviv-Yafo District Court, published May 8 2022.

[2] GTEKO Ltd. v. Assessing Officer of Kfar Saba, Central Lod District Court, Published June 7, 2017 "Gteko".

[3] Broadcom Semiconductor Ltd. v. Assessing Officer of kfar Saba, Central Lod District Court, Published December 9, 2019 "Broadcom".

[4] The court stated that the question that should be asked is whether such a change would be made without compensation between unrelated parties. If the answer is 'no,' then the mere change of business model is not compensable.

[5] The agreements meant (among other items) that (i) the full-fledged manufacturing activities of Medingo were converted into contract manufacturers activities, (ii) the development activities were converted into contract development activities and (iii) that the-old IP rights were transferred (as in, an exclusive right to exploit the old-IP) from Medingo to Roche.

In essence, and considered as a whole, the agreements could be regarded as a transfer of a broad range of interconnected activities that in a holistic perspective could be regarded as a TOGC. The dominant asset in the TOGC would be the IP of Medingo. All activities are centered around the IP. This is also shown by the purchase price allocation of the acquisition value of Roche. USD 172 million out of USD 180 million was allocated to the IP. The ITA, however, was unable to (even remotely) substantiate this position before the Court. No, and/or very limited functions, assets and/or risks had transferred.

Did the agreements possess commercial rationality?

In its second position the ITA argued that the agreements did not possess commercial rationality. The question that Court needed to answer was whether such change of business model could have been made without compensation between unrelated parties. The fact that the change resulted in an increase of the workforce and the activities of Medingo and changed Medingo from a loss-making company without expected profits into a profitable company, are important indicators. The answer to the question in the case at hand is "no". I.e. the change had an underlying commercial rationality. This reasoning relates to Para 1.142 to 1.148 of the OECD TPGL. These paragraphs clarify that in case of 'exceptional circumstances' agreements can be disregarded/non-recognized. The key question here is whether agreements possess commercial rationality that would be agreed between unrelated parties under comparable economic circumstances.

The advisers of Medingo had a relatively easy task in clarifying the commercial rationality of the agreements. Anyone reading the Court documents can relate to the business drivers for entering into the agreements in question. These are or appear reasonable. The Court agreed with the advisers of Medingo. The Court also concluded that the ITA should (instead) have made a better effort in determining the actual nature of the agreements and applying arm's length pricing to the accurately delineated transactions.

This aligns with Para 1.142 of the OECD TPGL, *"because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult."*

Applying the risk allocation framework

If we would be in the position of the ITA, we probably would have started with applying the framework for analyzing risk in Section D.1.2.1 Chapter I. The contractual terms of the agreement provide the starting point for delineating the transactions between the parties and how the responsibilities, risks and anticipated outcomes were intended to be allocated at the time of entering into the agreements. However, as set out in the OECD TPGL, the evidence of the conduct of the parties may clarify or supplement aspects of the agreements.

Section D.1.2.1 of Chapter I is relevant to determining whether parties assume risks and the consequences for providing funding without assuming risk or performing other control functions. For this reason, an examination of the allocation of risks before and after the agreement is an essential part of the transfer pricing analysis. Such analysis should probably have been prepared and should have allowed the ITA to assess the transfer of the economically significant risks of the Medingo business and the consequences of that transfer for the application of the arm's length principle to the restructuring itself and to the post-restructuring transactions.

A detailed examination of risks was not a topic of the proceedings in the Court documents. Hence, our take on this is a bit speculative. The Court's documents do indicate that the capability and authority to control the economically significant risks associated with the development and manufacturing activities may have remained with Medingo. This seems to contradict with how the (economically significant) risks are contractually
assumed by the associated enterprises. This dichotomy could have been an avenue for the ITA to challenge/adjust the pricing of the agreements, and subsequently, applying arm's length pricing.

Documentation requirements for comparable restructurations

Taxpayers like Medingo/Roche are required to describe any important business restructuring transactions occurring during a year in their TP files (i.e. Master and Local Files) for that year. In addition, in the Local File, taxpayers are required to indicate whether the local entity has been involved in, or affected by, business restructurings during the year or, in the year immediately preceding, and to explain the aspects of such transactions affecting the local entity.

The OECD TPGL states in para 9.33 that taxpayers', as part of their transfer pricing documentation, are recommended to document their decisions and intentions regarding business restructurings, especially as regards their decisions to assume or transfer significant risks before the relevant transactions occur, and to document the evaluation of the consequences on profit potential of significant risk allocations resulting from the restructuring. In describing the assumption of risk, as part of a business restructuring, it is recommended that taxpayers use the framework set out in Section D.1.2.1 of Chapter I.

Next to that, most MNEs (as good practice) generally document (for non-tax purposes) the important reasons driving business restructurings. For example, centralized control and management of manufacturing, research and distribution functions, pressure of competition in a globalized economy, savings from economies of scale, the need for specialization, the need to increase efficiency, lower costs, etc. This is a type of documentation that is likely to be maintained at the group level for non-tax purposes, in order to support the decision-making process of restructurings.

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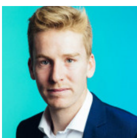

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