Israel Court Says Broadcom Didn't Acquire Assets in Taxable Sale

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By William Hoke

An Israeli court has agreed with a tax appeal by U.S.-based Broadcom Inc., which said it did not buy the assets of Dune Semiconductors after acquiring the Israeli firm for $185 million in 2010.

Henriette Fuchs, a tax lawyer with Pearl Cohen Zedek Latzer Baratz, said Broadcom had initially obtained official permission — and had even paid the government royalties and penalties — to transfer Dune's intellectual property out of Israel before subsequently deciding to keep the intangible assets in the country. Broadcom then entered into several intercompany contracts, which included arm's-length royalties equal to between 14.1 percent and 14.7 percent of revenues, for the provision of services and the use of the IP, she said.

The Israel Tax Authority (ITA) assessed additional tax on Dune on grounds that the agreements effectively resulted in a restructuring of its business that was the equivalent of a taxable sale. *Calcalist*, a local financial newspaper, reported December 12 that the ITA claimed the company owed over ILS 100 million (around $28.8 million) in additional tax. Dune was subsequently merged into another Israeli entity, Broadcom Semiconductors Ltd., which pursued the company's challenge of the assessment before the Central District Court.

Fuchs said the ITA determined that Dune had transformed itself from an independent and active company into one that provided services to the international group that had acquired it. "As a result, the assessor determined that Dune had separated from its [previous] activity, passed it on to others, and was deemed to have generated a taxable capital gain," she said in an email. "According to the tax authority . . . the company transferred its functions, assets, and risks (FAR) to the Broadcom Group and, in its assessment, the tax authorities determined that the price of the share transaction in which the company's shares were purchased was the compass for determining [the value of the sale.]"

The case was heard by Judge Samuel Bornstein, who in 2017 ruled in an unrelated dispute that a subsidiary of Microsoft Corp. owed over ILS 100 million in tax stemming from its acquisition of Gteko Ltd. after buying the networking company's stock for $90 million in 2006 and shortly afterward acquiring its IP assets for $26.6 million. The *Gteko* ruling figured prominently in Bornstein's December 10 decision in the *Broadcom* case.

Yaniv Shekel, a tax lawyer with Shekel & Co. who reviewed a copy of the as-yet-unpublished *Broadcom* decision, said Bornstein ruled that a company can change its business model and not be considered to have sold its assets. "Bornstein said the question that should be asked is whether such a change of contractual terms [under the agreements] would be made without compensation between unrelated parties . . . . If the answer is 'no,' then the mere change of business model is not compensable," Shekel said. "[If] an unrelated party requested compensation, then it would be reasonable to say that something was sold."

Bornstein contrasted the *Broadcom* case with *Gteko,* in which the ITA successfully challenged the valuation claimed for Microsoft's purchase of the company's IP on grounds that the transaction effectively represented the sale of the entire company and was done for an amount significantly below that which would have changed hands if done on an arm's-length basis. Because Gteko's employees were also transferred to Microsoft Israel as part of the original sale, Bornstein rejected Microsoft's claim that the transfer of the company's workforce was not a taxable transaction because employees are not property that can be traded. "The appellant even confirmed that, as far as it is concerned, the value of the appellant's technology, without its staff, is almost nil," Bornstein said in his *Gteko* decision.

Unlike Gteko, which Bornstein said had been left an "empty shell," Dune retained its employees, continued in business, and remained profitable, Shekel said. "Bornstein said that he didn't believe that the economic value that was part of the share transaction simply evaporated and was transferred to the [new] mother company," he said.

Another factor weighing in Broadcom's favor was Dune's sale of IP for $73 million in 2016, Shekel said. "Bornstein said that if another party actually purchased the IP at a later date, how can the authorities claim that it had been sold [earlier]," he said.

Fuchs, who also had access to a copy of the *Broadcom* decision, said Bornstein found that the agreements between Broadcom and Dune were not substantially driven by tax motives but were instead supported by real economic considerations.

Fuchs said many foreign companies looking to acquire the IP of Israeli companies are not interested in acquiring their employees as well. "However, tax saving considerations motivate the sellers of the Israeli company to insist that the transaction be a sale of shares and not the sale of an IP," she said. "After an Israeli company with a nice technical solution is sold to a global company, often quite soon after the acquisition, the business functioning of the acquired company changes, by intent or nature, because the IP of the Israeli company needs to somehow be integrated into the global activities of [the] acquiring group. Sometimes the management or the brains of the Israeli company move abroad, and [research and development] activity in the Israeli company becomes a service to the entire acquiring group as a whole, and the Israeli company might not only service its own IP anymore."

Fuchs said the decision was positive and will provide clarity, certainty, and reassurance for Israeli companies and the international groups that might be interested in them. "The ruling makes it clear that not every transaction reported [to be] artificial by the tax authority is in fact fake, and in today's world, it cannot be that the only transactions that the tax authorities find acceptable are the ones that justify a hefty tax charge," she said.

If an acquired company's intangibles remain in Israel, the Israeli Treasury might come out ahead in the long run, Fuchs said. "The tax it may claim on royalty income from related group companies may be much higher than the tax it can claim on a one-time IP extraction. If the IP is successful, then it could potentially generate more income for the company than a one-time sale would," she said.

Shekel said that while he expects the ITA to appeal, it would be an ill-advised decision. "This has a huge impact on other [pending] cases worth billions of shekels," he said. "I believe they will lose as their position was extreme [and was made] with complete disregard of OECD guidelines and the economics [of the situation]. Except in extreme cases, you should respect the agreements that are actually made."

Fuchs said the ITA is pursuing over 20 similar IP cases involving foreign acquisitions. In one of the largest cases settled so far, an international arbitration panel ruled in 2017 that Hewlett Packard Enterprise Co. reportedly had to pay ILS 1.6 billion in additional taxes related to the outbound transfer of IP after the company's acquisition of Mercury Interactive Corp. in 2006.