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"Reality is wrong. Dreams are for real" (2Pac) – Tupac Shakur

Blog

The valuations attributed by the Israel Tax Authority to R&D centers in Israel, time and time again, reveal large gaps in the tax assessors' perception of reality. Just like the well-known rapper Tupac, the appraisers on behalf of the tax assessors who are tasked with estimating the value of the contracts of Israeli hi-tech companies sometimes assess dreams—not reality.

When it comes to the "change-in-business-model" assessments that the Israeli Tax authority tends to pursue after an exit transaction, the tax assessor is required (in accordance with OECD guidelines) to analyze FAR (Functions, Assets and Risk) in order to determine if a tax event has occurred that could result in a hefty tax. We have already dealt with the analysis of functions and assets in different contexts; Meir Orbach's "Soluto as a Cautionary Tale: the Small R&D Centers on the Chopping Board of the Tech Giants" (Calcalist 25.7.2022) provides an excellent examination of the risks.

Almost every time an Israeli start-up company is acquired by a multinational group and after the transaction becomes an R&D center for that group—a center that provides its services in a "Cost+" model—then, according to the Israel Tax Authority's method, the Israeli company "discards its risks." With the start-up being the R&D center of a "tech giant," the tax assessor believes that the company has reached a state of prosperity, free from all worry or risk.

In this fashion, for example, as part of the huge assessment in the Broadcom case, the tax assessor claimed throughout the assessment discussions and then later also in court that "as part of the change in the business model, the appellant transferred to Broadcom all the risks it had previously borne." The tax assessor listed among them credit and market risks, geographic risks, inventory risks and more—and finally concluded, "Broadcom bears these risks from now on, while the appellant does not bear any risks" (see paragraph 63 of the judgment).

But reality proves otherwise—as Orbach emphasized in his article: "In all the crises of the past, the small development centers were the weak link of the industry in Israel. Those centers that were established on the basis of purchases of small technology companies survived as long as their technology and employees were needed. In times of crisis, however, many of them were significantly downsized or were closed completely. For companies, especially those for which this is their only activity in Israel, it is easier to close a center in Israel than to fire hundreds more workers in Silicon Valley."

This is precisely what the witnesses and experts on behalf of the appellant emphasized in the Broadcom case. Even after the exit, and even after the change in the business model in which the high-tech company becomes a development center for the multinational group that purchased its shares, the Israeli company continues to struggle for its survival. The dependence of the Israeli R&D center on a "single client" threatens to shatter the dream that would then crash on the hard ground of reality.

The district court accepted our argument in full and emphasized in its ruling: "I cannot accept the conclusion of the respondent [tax assessor] also regarding the issue of risks. First, the appellant is right in asserting that following the transaction, it bears the risk arising from the existence of one key client... Second, the appellant surely bears a risk arising from the simple fact that the royalties depend on the sales of products in which the intellectual property is embedded, even if it is a lower risk than the risk it carried before. Third and most importantly, a company that decides to reduce risks (even if this naturally involves reducing risks) does not necessarily act out of non-business considerations or to promote the interests of a related company at its expense."

As Orbach emphasizes, "[t]he closing of the development center yesterday proved how much—despite all the history of the company and the great work it has done for the parent company—there are not many sentiments left when a lean period arrives." One can only hope that in the future the tax officials will carry a deeper "bag of sentiments" for the taxpayers.

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