June 6, 2023

Medtronic case – New Judgment Adopts the Tax Assessor's Claims Regarding a "Business Restructuring"

Client Updates

On June 1, 2023, the judgment of the Honorable Judge Borenstein (Central District Court) was published, in the matter of Medtronic Venture Technologies Ltd. v. Kfar Saba Tax Assessor. The judgment addresses a claim of a "Business Restructuring" (sale of FAR), a claim that the Israel Tax Authority tends to make in cases of acquisitions of Israeli companies by international groups. The judgment joins previous District Court judgments in the cases of Gteko (2017), Broadcom (2019) and Medingo (2022) (our firm represented the taxpayers in the Broadcom and Medingo cases), and it continues the examination of the circumstances in which a change of business model by the taxpayer should be deemed to be a sale of FAR (Functions, Assets and Risks), which is subject to capital gains tax.

The Facts in a Nutshell

Venture Technologies Ltd. ("Venture" or the "Company") was founded in Israel in 2004 and engaged in the development of medical products. In 2008, Medtronic Inc., which stands at the head of an international group that is engaged in the development, manufacture and marketing of medical products ("Medtronic"), purchased 8% of the shares of Venture, and in 2009, Medtronic purchased all of the shares of Venture, according to a value of US $325 million. After the acquisition, Venture engaged, in keeping with standard practice, in a number of inter-company agreements with companies in the Medtronic Group: R&D agreements – pursuant to which research and development services were provided by Venture to the companies within Medtronic Group on a "cost plus" basis; and license agreements – pursuant to which a license was granted to the companies within the Medtronic Group to use the intellectual property owned by Venture for a period of four years in consideration of royalties from the sales. In 2012, the activities of Venture were terminated.

The Tax Assessor claimed that as a consequence of the inter-company agreements, Venture had transferred its FAR to the companies within the Medtronic Group outside of Israel, and, therefore, the engagement between the parties should be classified as a transaction for the sale of FAR, and it should be taxed accordingly.

The Court's Determinations

- The Court decided that the Company did indeed transfer functions, assets and risks to Medtronic,

and it dismissed the Company's Appeal. The Court's conclusion was based on a number of factual determinations, including the following: the Company had given Medtronic a full and complete right to make use of the Company's intellectual property, including the possibility of making changes thereto, almost throughout the entire economic life of the intellectual property; Medtronic had acted in relation to the Company's intellectual property as an owner would act, and the Company did not do anything in order to keep the know-how at the Company; certain patents which had belonged to the Company were registered in Medtronic's name, and Medtronic was the owner of the new intellectual property that had been developed based on the Company's intellectual property; the Company relinquished all decision-making power with respect to its activities and with respect to its future, and it implemented the directives that had been provided by Medtronic, and for Medtronic's benefit; Medtronic decided, based on its own interests, due to its own business, budgetary and other considerations, and contrary to the Company's interests, to terminate the Company's activities in 2012; the R&D agreements and the license agreements were signed shortly prior to the termination of the Company's activities, and these were implemented retroactively; the intellectual property that was owned by the Company permeated the Medtronic Group over time, and it was not sold by the Company, not even upon the closure of its activities.

- The Honorable Judge Borenstein, referred to the leading case law on the issue of "Business Restructuring" and he outlined a spectrum of cases – at the one end, there are clear-cut cases of transferring functions and assets within a short period of time while leaving a corporate shell (as in the Gteko case); and at the other end, there are cases of active companies that continue to grow, maintain and develop their intellectual property (as in the Broadcom case).

In the present case, despite the growth in the Company's personnel and despite Venture's becoming the Group's "center of innovation," the Court found that the circumstances of the case are more similar to those of the Gteko case. In this regard, the Court addressed the fact, inter alia, that the product was at its early development stages, and Medtronic sought to tailor it to its own needs, and that the focus of the transaction was not on the existing intellectual property, but, rather, the future developments that would be under foreign ownership. In addition, the Court also noted that in the Broadcom and Medingo cases, the intellectual property that remained in the hands of the Israeli company was subsequently sold for a significant amount. On the other hand, the Court found that the case is similar to the circumstances of the Gteko case in that Venture had also become a "corporate shell" which is de facto managed by Medtronic, for its own purposes, with the Company's know-how and capabilities "permeated" the Medtronic Group, leaving only "operational" functions within the Company. It should be emphasized that the court arrived at this conclusion despite the fact (and even because of the fact) that the Company apparently became the "center of innovation" of the Medtronic Group and its R&D activities continued.

- After determining that all of the Company's intangible assets had been sold, the Court discussed the value of the FAR that had been sold. In the present case, the two parties both referred to the value of the Company as reflected in the transactions in its shares; however, they disagreed on the question of whether the "comparable transaction" which should be used for the comparison is the transaction in which 8% of the Company's shares were acquired or the transaction which took place a year later, in which the remaining shares were purchased. The parties also disagreed on the question of whether in the framework of the purchase of all of the shares, a "control premium" was priced and should therefore be reduced from the value of the transaction in order to extract

the value of the Company's assets.
The Court adopted the value that had been determined by the Tax Assessor based on the transaction for the acquisition of all the shares of the Company and did not recognize the existence of a "control premium". In addition, the Court viewed the ability to control the Company (in respect of which a "control premium" is allegedly being paid) as being similar to the ability to integrate the Company's intellectual property into Medtronic Group's business plans. Therefore, the Court reasoned that the high value that Medtronic was willing to pay for the Company's shares reflects "synergy," which – as has already been ruled in the Gteko case – is not a separate asset.

- The Court also adopted the Tax Assessor's position with respect to the secondary adjustment and determined that in view of the determinations in the Kontera case (2018), the Tax Assessor is authorized to impose a secondary adjustment.

It can be said that after four District Court judgments on the subject of "Business Restructuring", three of which were handed down by the honorable Judge Borenstein, the legal framework is becoming clearer and guiding principles according to which these cases will be examined by the courts are being formulated. Based on the various judgments, it is evident that significant weight is given to the factual analysis of the circumstances in each case, and, in particular, it is necessary to examine the extent of the group's involvement, the company's independence, the mechanisms for the registration and protection of its intellectual property; and so on.

The Court's judgment emphasizes the importance of the conduct of the international groups following the acquisition of an Israeli company, and the manner in which they develop and implement intercompany relationship and the set of contracts between the companies of the group. Moreover, one can learn from the Court's judgment about the importance of intelligent planning of the transaction and its meticulous implementation, as well as the significance of the tax assessment procedures and their impact on the litigation process in court.

Key Contacts


Daniel Paserman
Head of Tax


Shlomo Aviad Zider
Mediator, Partner


Shirin Gabbay-Metzger
Partner


Adi Haya Raban
Partner


Dr. Assaf Y. Prussak
Partner