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The Tel Aviv District Court Dives into the IP Valuation in an International Transaction between Related Parties

Client Updates

The Tel Aviv-Jaffa District Court (the Honorable Judge Kirsh) recently handed down its judgment in the matter of Western Digital Israel Ltd.

The judgment primarily deals with the question of the value of intellectual property (IP) that was sold by an Israeli company to a related foreign-resident company, in the context of calculating the taxable capital gain in Israel in accordance with the legal provisions regarding international transactions between related parties.

M-Systems (later SanDisk Israel, and nowadays Western Digital Israel) deals, **inter alia**, with portable memory devices. The IP subject of the tax appeal judgment is a technology called Error Correction Code (ECC), which is designed to provide a solution for correcting errors in reading data stored on the portable device.

The IP originated in a collaboration between the Company and Ramot, which is Tel Aviv University's Technology Transfer Company. Over the years, the commercial relationship with Ramot underwent several iterations, and it was eventually agreed that the IP originating from the results of the R&D collaboration up until the end of 2009 would belong to Ramot, and additional results from that time onwards would belong to the Company. In 2008, the Israeli company began to provide services to a related US company on a cost basis, where it was agreed that the deliverables of the service would be the US company's property.

In 2014, the Israeli company sold the ECC IP it owned to a related foreign-resident company, in consideration of US $35 million. The Tax Assessor disputed the value of the sold IP, arguing that its value was US $163 million. The dispute between the parties revolved around the valuation of the IP in its entirety, and around the question of which part of the value of the IP was owned by the Israeli selling company at the time of the sale.

The Company claimed it no longer owned new IP developed from 2008 onwards, concluding that only 34.15% of the IP, as valued by the company, should be attributed to it. However, the Tax Assessor argued that developments from the 2008-2009 collaboration with Ramot were also owned by the Company, claiming for 90% attribution of the IP's value (as valued by the Tax Assessor) to the Company.

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Both parties based the IP valuation on the DCF method calculations. However, the Company sought to quantify the weight of the relevant IP share according to the ratio between the inputs it invested in developing the relevant IP and the total inputs invested in the IP up until the transaction date; Whereas the Tax Assessor claimed such share should be examined by the ratio between the investments of the US company in the Company's activities between 2010 - 2013, and the total **value** of the IP in 2010.

Based on the facts of the case, the court ruled that the IP developed up until the end of 2009 was owned by the Israeli company and, therefore, it formed part of the IP sold in 2014. The court also addressed the question of the weight of the intellectual property as of the end of 2009, and dismissed both the Company's method and the Tax Assessor's method, finding that "the truth is apparently somewhere between the two extremes." With some hindsight wisdom and in the absence of any other clear indication of the weight of early developments in comparison to later developments, it was ruled that the value had grown uniformly over the relevant period, i.e., it was divided equally over the years of development. Accordingly, the court ruled that 60% of the value of the technology at the time of sale should be attributed to the Company.

As regards to the value of the IP, the court examined and concluded on each of the parameters that formed the basis for the DCF valuations, including the technology's lifespan, the expected growth in sales, the discount rate, and the routine returns allocation.

The court ordered the Tax Assessor to prepare a revised assessment according to the court's determinations, while reaching the conclusion that the arm's length consideration in the transaction should have been, according to a "rough calculation," about US $62 million.

The court also addressed the issue of the secondary adjustment imposed by the Tax Assessor, and ruled that the case law in the Supreme Court determines that the Tax Assessor is authorized to include such secondary assessment according to Section 85A of the Income Tax Ordinance; however, on the merits of the case, the court reduced the amount thereof.

Disputes frequently arise between taxpayers and the Israel Tax Authority with respect to the value of assets sold between related parties, particularly in multinational groups. The Supreme Court has already stated that valuations are not an exact science, and the court emphasized so in the present case as well. This is **a fortiori** true in cases that deal with the valuation of intangible assets and intellectual property. When such disputes reach the courts, the question arises as to how the court should decide on the value of the object of sale. This judgment is an exemplary case where the court does not accept either of the parties valuations as is, but, rather, it "rolled up its sleeves" and "dived" into the depths of the parameters comprising the valuations, in order to obtain the result that is the closest possible to a true taxation of the transaction.

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