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Legal Update **July 2017**

FBC Tax Practice

Israeli District Court Accepts the ITA Position and Sets New Acquisition Price for Tax Purposes Between Related Parties

Dear Clients and Colleagues,

We write to inform you about a precedent-setting ruling by a District Court in Israel in a case between Gteko, a subsidiary of Microsoft Corporation, and the Israel Tax Authority ("ITA") regarding a transaction for the sale and purchase of intellectual property assets and its valuation.

In 2006, Microsoft acquired the entire share capital of Gteko for $90 million (pursuant to a "Share Agreement"). At the time, Gteko was an upcoming Israeli start-up company specializing in networking and support software solutions. A short time after the acquisition, all of the employees of Gteko (then, a subsidiary of Microsoft) were hired by Microsoft Israel Ltd.

Less than a year later, Microsoft and its subsidiary, Gteko, entered into an agreement pursuant to which Microsoft acquired Gteko's intellectual property (IP) assets for $26.6 million (pursuant to an "IP Agreement"). The consideration for the IP was based on a valuation determined by an independent valuation company.

In its tax filing following the IP Agreement, and in the litigation that followed, Gteko took the position that the IP Agreement merely involved the sale of its IP, and that the significant difference in consideration in the Share Agreement ($90 million) and in the IP Agreement ($26.6 million) is attributed to the premium that Microsoft expected to gain from synergies between its business and IP assets and the business and IP assets of Gteko. This was Gteko's explanation as to why the consideration in the Share Agreement was higher, as it did not merely reflect the value of Gteko and its IP assets, but also reflected the anticipated value of such synergies.

The ITA, however, argued that the IP Agreement was, in fact, a sale of Gteko's entire business operations and that the $90 million consideration in the Share Agreement (and not the $26.6 million in the IP Agreement) is the true market value of Gteko, regardless of any value that Microsoft

expected to generate from synergies following the Share Agreement.

In addition, the ITA argued that by the time Gteko, as a subsidiary of Microsoft, sold its IP, it was no longer acting as an independent seller but rather putting its parent company's interest first and, therefore, the court must determine the price of Gteko's operations according to its fair market value.

The District Court agreed with the ITA and determined that the transaction that the parties conducted was far more extensive than the deal described by them in the IP Agreement and that between the time of the 2006 Share Agreement and the current status, substantially all of Gteko's business operations, assets and employees were transferred to Microsoft.

The Court determined that the tax implication of the IP Agreement must reflect the real transaction conducted by the parties, so that it should be valued as the sale of substantially all of Gteko's assets for the Share Agreement consideration.

The Court ordered Gteko to pay tax in an amount of approx. NIS 100 million (approx. $28.2 million).

Since different varieties of the structure of agreements between the parties as described above are common in equity investments in Israel, the Court ruling may create significant tax exposure for investors in Israeli companies, and it is a reminder that any investment must be carefully examined prior to signing and executing its agreements.

Please contact us with any questions or clarifications.

We would be delighted to assist you in any way.

Sincerely,

Tax Practice

Fischer Behar Chen Well Orion & Co.

For further information please feel free to contact:

Adv. Anat Shavit	ashavit@fbclawyers.com	+972.3.6944162
Adv. Keren Alon	kalon@fbclawyers.com	+972.3.6944203
Adv. Idan Lange	ilange@fbclawyers.com	+972.3.6944203