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Client Alert

Israel: Substance Over Form - What the NSO Judgment Means for Foreign Investors Acquiring Israeli Companies

This alert is general in nature and does not constitute legal advice

At a Glance

The Israeli District Court held that an Israeli holding company interposed between a foreign private equity sponsor and an Israeli target was an artificial transaction under section 86 of the Israeli Income Tax Ordinance (the Ordinance), so that more than USD 86 million remitted abroad as repayment of shareholder loans was in substance a dividend - a recharacterization worth some USD 8.6 million in Israeli withholding tax, although the amounts actually charged were capped by reference to the Israeli company's distributable earnings. The Court confirmed that acquiring an Israeli company through an Israeli holding company funded by foreign debt may well be legitimate where it serves a genuine economic purpose beyond the tax advantage. What the judgment raises is the evidentiary bar regarding the substance of the Israeli holding company. The investor must be able to prove, from contemporaneous documents, why the Israeli vehicle was chosen.

In February 2014 a Luxembourg company controlled by Francisco Partners fund agreed to acquire all rights in NSO for USD 70 million in cash for 70% of the rights, with the remaining 30% settled by a share exchange at the top of the structure, an aspect whose tax treatment the Court did not address, but it raises an interesting point which we will discuss later. The acquisition was documented as made for an Israeli shelf company incorporated shortly beforehand, said to hold the shares through the Luxembourg company as trustee and recording shareholder loans from it of some USD 70 million at closing, increased by a further USD 17 million in December 2014. Between 2014 and 2018, dividends and upstream loans from NSO exceeding USD 86 million repaid that debt. Neither leg passed through the Israeli company's bank account. The acquisition price moved from the Luxembourg company directly to NSO's selling shareholders, and the repayments moved directly from NSO to the Luxembourg company, recorded in the Israeli company's books alone, and no dividend withholding tax was paid; the rate was agreed at 10% under Article 10.2(b) of the Israel-Luxembourg treaty.

The Court’s Decision

The Court dismissed the appeal. Applying the Gottschel framework, it held that the structure could not be regarded as positive tax planning and was a candidate to be treated as negative planning, expressly leaving open that it might have been found legitimate and framing the matter as essentially evidentiary. The benefit was plain. Had the shares been held directly by a foreign company, nothing could have been distributed without dividend tax, whereas an Israeli-resident shareholder could receive the same amounts tax-free and remit them upstream as interest and principal, moving more than USD 86 million out of Israel without the second tier of the two-tier corporate tax model applying. Once the assessing officer discharged the initial burden, the taxpayer had to show that its asserted commercial objectives, rather than the tax benefit, were the substantive reason for interposing the Israeli company, and it failed. The Court was nonetheless explicit that a foreign parent may establish and fund an Israeli company by loan in order to acquire Israeli shares. Where a substantive economic purpose beyond the tax advantage exists, the transaction is presumptively unimpeachable. The annual charge was capped at the lower of the distributable retained earnings shown in that year's accounts and the amounts transferred, with withholding already made on interest credited against the dividend tax; no gross-up was applied, but that issue was not litigated. An estoppel argument based on a 2019 transfer pricing agreement that had expressly reserved the withholding issue was rejected, as was a treaty non-discrimination claim, and the failure-to-withhold penalty was cancelled for want of fraudulent or deceitful conduct.

Why the Taxpayer Lost

The case was not lost because operating activity of the Israeli holding company began only in 2016; the Court rejected that argument, accepting that consolidating the distribution of products manufactured across group companies takes time. What defeated the taxpayer was the absence of any real-time record of the decision to hold the NSO shares through the Israeli company, together with a quantitative comparison showing the Israeli activity to be economically marginal against the tax saved.

The evidentiary gaps were numerous. The trust agreement was dated the day before the share purchase agreement it refers to, went unmentioned in the 2014 and 2015 financial statements and surfaced only in the 2016 report. NSO itself wrote to the ITA in February 2014 that the acquisition would be made through a foreign company, and the founder confirmed that he learned of the Israeli company only after signing. No board or adviser materials were produced for a decision reflecting an investment of some USD 100 million, including documents the ITA had requested during the audit, and the claim to have screened 35 Israeli cyber targets was wholly undocumented. A regulatory rationale advanced in cross-examination was treated as an expansion of pleadings and, in any event, held to be unsubstantiated. The sponsor's representative in Israel, who negotiated the deal and managed the holding company, was never called, and the taxpayer's expert conceded that he had not reviewed the transaction documents.

The Court accepted that genuine activity existed from 2016, with revenues rising from some USD 4.55 million in 2016 to USD 19.31 million in 2018 and headcount up to 112 in 2021, but looked through revenue to taxable income. Because profit was fixed in advance by a cost-plus arrangement between related parties, cumulative taxable income was only some USD 5 million, tax of under USD 1.25 million against a saving above USD 8.6 million. Where activity is conducted between related parties the group controls where and by whom it is performed, so channelling it into a chosen entity is easily done. Had the acquirer been an established Israeli platform with several portfolio investments and dedicated management, rather than a shelf company, the analysis might have looked very different.

Structuring Considerations and Practical Takeaways

Holding an Israeli target directly through a foreign company may help preserve a potential exemption from Israeli capital gains tax on a future exit, depending on the investor profile and the applicable treaty analysis. An Israeli holding company funded with foreign debt may instead allow a more efficient return of the investment during the holding period, moving value upstream as interest and repayment of principal rather than taxable dividends. The NSO case confirms that the second route remains available in principle, but only where the Israeli company has real economic substance and a genuine non-tax business role from day one.
Document the choice of vehicle, not the choice of leverage. It was never disputed that a target may be acquired with debt, and no operating activity was required on day one; the unanswered question was why this particular entity was interposed, and only a real-time record answers it - investment committee materials, structuring memoranda, tax and regulatory advice, and board minutes identifying the Israeli company and the reasons for choosing it. Keep that record consistent. The holding company's role should appear in the first financial statements and in correspondence with the ITA and the seller, not two years later, and every commercial rationale should be raised at the audit stage rather than at trial.

Test substance quantitatively. The metric that matters is the Israeli taxable profit the holding company is expected to book, measured against the withholding tax avoided, not headcount or gross revenue. Plan for witnesses a decade out, since structuring decisions taken by foreign personnel may have to be proved in court years later, including after an exit, and generic expert evidence that does not engage with the transaction documents carries no weight. Separate accounts, independent signatories and actual routing of funds remain worth the cost. Note also that had the Israeli Holding company been the payor, the generic withholding exemption available to Israeli-resident sellers would not have covered consideration paid in shares. Financing, holding-period distributions, exit taxation, withholding leakage and transfer pricing should be assessed together at the outset.

Open Questions

Two points remain unresolved. Had the investment in NSO been carried at cost rather than under the equity method, and had NSO advanced only upstream loans, arguably no distributable earnings would have appeared and the charge would have been nil - though the ITA would likely have argued that the loans were themselves a dividend in substance; using the Israeli Companies Law distribution limit to measure tax on amounts never distributed as a dividend sits uneasily, and the judgment does not address it. Separately, where Israel recharacterizes interest and principal as dividends, the Luxembourg company should test corresponding relief, such as a Luxembourg participation exemption.

Conclusion

The NSO case is not a rejection of Israeli holding company structures, but a warning that legal form and financial engineering will not survive scrutiny where substance is thin or cannot be proven.
We would be glad to discuss the implications for a specific structure.

For any questions or further clarification on this matter, please feel free to reach out to our team:

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