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Israeli Tax Updates

Quarterly International Tax Update – Israel’s Latest Legislative, Regulatory and Case Law Developments

We are pleased to share our latest Quarterly Tax Update, summarizing key legislative, regulatory and case law developments in Israel that may be relevant to international businesses and investors. We hope you find this information useful and welcome any inquiries or discussions regarding its implications for your operations.

Leveraged Acquisition Through an Israeli Holding Company Held to Be an Artificial Transaction

In 2014, the foreign private equity fund Francisco Partners acquired NSO Group Technologies Ltd., an Israeli company, through OSY Technologies S.à r.l., a Luxembourg-resident group company. Shortly before closing, Q Cyber Technologies Ltd., an Israeli shelf company, was transferred to OSY and used as the acquisition vehicle. The acquisition financing was recorded as long-term shareholder loans from OSY to Q Cyber of approximately USD 70 million and USD 17 million. Between 2014 and 2018, more than USD 86 million was transferred directly from NSO to OSY, without passing through Q Cyber’s bank account. Q Cyber recorded the amounts as loans and dividends received from NSO and as payments of principal and interest to OSY. The dividends from NSO were excluded from Q Cyber’s taxable income under Section 126(b) of the Israeli Income Tax Ordinance (“Ordinance”). No tax was withheld from the principal repayments to OSY, although withholding tax was deducted from the interest component.

The Court examined the arrangement as a whole and accepted the Assessing Officer’s position that it constituted an artificial transaction under Section 86 of the Ordinance, resulting in a tax saving of approximately USD 8.6 million. The payments to OSY were recharacterized as dividends subject to withholding tax at the 10% rate prescribed by the Israel-Luxembourg tax treaty, and withholding tax already deducted from the interest component was credited against the resulting liability. The Court nevertheless cancelled the penalty for failure to withhold tax, finding that the reporting did not involve fraudulent or deceitful conduct.

The Court emphasized that leveraged acquisitions through Israeli holding companies are not inherently improper. The relevant question was whether Q Cyber’s insertion into the structure was supported by a fundamental commercial purpose other than tax reduction. At the time of the acquisition, Q Cyber was a shelf company with no activity, employees or bank account, and its meaningful operating activity began only in 2016. The contemporaneous record also undermined its claimed role: OSY was the named purchaser, purportedly acting as trustee for Q Cyber under an arrangement not mentioned in Q Cyber’s 2014 and 2015 financial statements; NSO’s February 9, 2014 correspondence with the tax authority stated that the acquisition would be made through a foreign company; and one of NSO’s founders testified that he learned of Q Cyber’s involvement only after the purchase agreement was signed. No adequate contemporaneous structuring documents were presented, and no representative of the foreign sponsor was called to explain the commercial rationale. The judgment therefore raises the substantive and evidentiary bar for such structures without ruling them out. An established Israeli holding platform with genuine governance and operational functions may present a different case.

Tax Appeal No. 59924-03-22, Q Cyber Technologies Ltd. v. Kfar Saba Assessing Officer, judgment issued July 28, 2026.

Non-Compete Payment Classified as Ordinary Income

In 2014, Achim Eisenberg Ltd. sold its electron-microscope business to a company in the FEI Group for USD 3.3 million. At the same time, Elia Kahana, the company’s controlling shareholder and key professional figure, entered into a personal undertaking not to compete for three years in consideration for USD 2.2 million. Kahana reported the payment as a capital gain. The District Court held that the non-compete agreement was not genuine and, alternatively, that the payment constituted ordinary income.

The Supreme Court dismissed the appeal but held that the non-compete agreement itself was genuine and served a legitimate business need. The purchaser was entitled to require an express personal undertaking from Kahana. The broad non-compete clause already included in the business purchase agreement, which also restricted the selling company from competing through others, did not make the separate agreement with Kahana redundant. The Court emphasized that commercial parties are not required to rely solely on general obligations arising under the law and that an express contractual undertaking may have independent economic value.

The Court then considered the tax classification of the payment and held that the restriction did not destroy or sever Kahana’s income-producing source. He retained his professional knowledge and relationships, continued working for the company until 2019, and failed to show that market conditions would have prevented him from returning to the field after the non-compete period expired. Accordingly, the entire amount paid for his non-compete undertaking was classified as ordinary income.

Civil Appeal No. 6867/22, Eli Kahana Holdings Ltd., Elia Kahana and Achim Eisenberg Ltd. v. Tel Aviv 3 Assessing Officer, judgment issued September 24, 2026.

Shareholder Withdrawals and Intercompany Balances in a Multinational Group

In a consolidated judgment concerning six tax appeals for the 2015-2017 tax years, the Court considered the tax treatment of transactions involving an Israeli resident who controlled a multinational group and an Israeli transparent company. The principal issue concerned transfers totaling approximately NIS 108 million made to the taxpayer and related companies by a foreign company in which the taxpayer held an interest. In the absence of loan agreements, repayment terms or adequate contemporaneous documentation, the amounts transferred to the taxpayer were not accepted as genuine loans expected to be repaid and were taxed as dividends at the shareholder level.

The Court nevertheless rejected the Assessing Officer’s attempt to attribute additional personal income to the taxpayer, based on his ownership interest, from debit balances recorded between other companies in the group. Even if the failure to repay those balances gave rise to taxable income, that income would arise at the level of the debtor companies and could not automatically be attributed to the controlling shareholder. The Court also held that, once an amount had been taxed as a dividend, it could not also be taxed as deemed interest income under Section 3(i) of the Ordinance.

The judgment also addressed several cross-border issues, including the application of the CFC rules to a dividend received by a Cypriot company, the offset of losses from Canadian real estate activities and the deductibility of financing expenses under related-party loan arrangements. Overall, the decision underscores the importance of loan agreements and supporting documentation for transfers to controlling shareholders, while confirming that intercompany debit balances should not automatically be attributed to the controlling shareholder.

Tax Appeal No. 61448-06-24, Schwebel v. Assessing Officer for Large Enterprises, and consolidated appeals, judgment issued August 12, 2026.

Tax Credit or Grant in Lieu of a Deduction for the Acquisition of a High-Tech Company

Following the draft regulations published in June 2026, final regulations were published allowing an acquiring company that is entitled to a deduction for the acquisition of means of control in a qualifying company under Section 5 of the Law for the Encouragement of Knowledge-Intensive Industry to elect, beginning in the 2026 tax year, to receive a tax credit instead of the deduction.

The credit equals the deduction that would otherwise have been available for the relevant tax year, multiplied by an applicable rate of 12%, 7.5% or 6%, depending on the type of technological income against which the deduction could have been claimed. Eligibility requires the acquiring company to meet, throughout the tax year, the regulations’ definition of an “eligible qualifying company”. An unused annual credit may not be carried forward to the following tax year.

Separately, amounts not utilized by the end of the third tax year following the year in which control was acquired, together with amounts expected to become available only in later years, may be claimed in the fourth year as either a tax credit or an acquisition grant. A company may also irrevocably waive the use of the credit against its tax liability and receive the full amount as a grant. Upon a subsequent sale, the tax basis of the shares in the qualifying company will be reduced by the amount that would have been deductible under Section 5. The regulations apply to deductions that would otherwise be available in 2026 or thereafter, provided that the acquisition is completed by the end of 2026.

Regulations for the Encouragement of Knowledge-Intensive Industry (Temporary Provision), 5786-2026, published August 2, 2026.

Implementation of Tax Benefits for New Immigrants and Returning Residents

Income Tax Circular 07/2026 provides guidance on the implementation of the temporary tax benefits introduced under the Law for the Encouragement of Immigration to Israel and Return to Israel. In determining whether an individual became an Israeli resident during the qualifying period, the relevant date is the date on which the individual’s center of life was actually transferred to Israel, which does not necessarily coincide with the date appearing on an immigrant or returning-resident certificate. Electing an adaptation year does not defer the residency commencement date for this purpose.

The benefit may be claimed during the tax year through a tax-coordination procedure for employees or through reduced advance payments for self-employed individuals, subject to prescribed day-count tests and preliminary limitations. Alternatively, it may be claimed in the annual tax return. The benefit applies only to income from employment, a business or a profession. Where activities are conducted through a transparent entity, attributed profits may be excluded from the benefit, while salary, management fees or consulting fees actually paid to the eligible individual may qualify.

Subject to the conditions set out in the circular, a foreign company deriving Israeli-source income through an eligible individual may also qualify for an exemption, even where the individual’s activities create a permanent establishment in Israel. A temporary departure from Israel during 2028 or 2029 will not, in itself, terminate eligibility, provided that the individual’s Israeli tax residency has not been severed. In cases involving mixed income, the exemption under Section 14 of the Ordinance applies to income attributable to activities conducted outside Israel, while the temporary provision applies to qualifying activities conducted in Israel.

Income Tax Circular 07/2026 concerning the temporary provision under the Law for the Encouragement of Immigration to Israel and Return to Israel, published July 5, 2026.

Income Spreading for Equity-Based Compensation Granted to Employees and Service Providers

Israel Tax Authority Professional Position Paper No. 08/2026 addresses the spreading of income arising from equity-based compensation. For awards governed by Section 102 of the Ordinance, only the capital-gain component may be spread under Section 91(e) of the Ordinance, in equal portions, over a period of up to four tax years ending in the year of realization and not beginning before the year in which the award was granted.

This constitutes technical spreading solely for the purpose of determining the applicable tax rates and tax credit points. It does not permit the use of personal exemptions or losses carried forward from prior years, and the additional tax under Section 121B of the Ordinance is calculated by reference to the full income recognized in the year of realization. Any employment or business-income component of the award may not be spread under Section 8(c) of the Ordinance.

Different rules apply to consultants, controlling shareholders and other recipients who are not treated as employees for purposes of Section 102 of the Ordinance and whose income is taxable under Section 3(i) of the Ordinance. Such income may be spread under Section 3(i)(2) of the Ordinance, in equal annual portions, from the year of grant through the year of realization, over a maximum of six tax years ending in the realization year. This constitutes substantive spreading, allowing personal exemptions and loss offsets to be applied in the relevant years and the additional tax to be calculated at the rate applicable in each year.

Israel Tax Authority Professional Position Paper No. 08/2026 concerning the spreading of income from equity-based compensation, published July 30, 2026.



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

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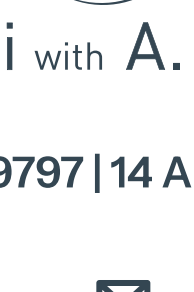
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