By **Alon Kaplan, Lyat Eyal** & **Daniel Paserman**

# Israel Taxation of Trusts

Help your clients accommodate their estate plans to these rules

Trusts historically have been recognized in Israel prior to the foundation of Israel as a state. During the British Mandate and after the founding of the state, trusts were used mainly for real property transactions. Following the founding of the State of Israel in 1948, waves of immigrants flowed there from different countries, bringing with them not only goods, but also a myriad of cultures and the use of trusts based on various legal systems abroad.

Legislation favoring immigration to Israel encouraged Jewish families and Israelis living abroad to move their residences to Israel. Such changes require adequate planning for estate and tax purposes both in Israel and in the country of origin.

Between 1948 and 1998, Israeli legislation had a regime of exchange control regulations for Israeli residents. New immigrants weren't subject to the same limitations on investments in foreign currency as Israeli residents. During those years, the use of foreign trusts was preferable for new immigrants. New immigrants from countries with unstable political regimes preferred the use of trust structures in jurisdictions such as Liechtenstein for relative confidentiality. They tended to settle trusts under the laws of the jurisdictions of origin for estate-planning purposes.

Modern Israeli legislation governs trusts, as well as continental trusts (such as Liechtenstein or Panama foundations or establishments) settled under the laws of foreign jurisdictions. This legislation includes the Trust Law 1979, the Income Tax Ordinance [New Version], 1961-5721 (the ITO), the Succession Law 1965, the Real Property Taxation Law 1963 and the Law of Agency 1965.

Today, the Israel Tax Authority (ITA) has a separate department responsible for trusts, reporting and tax payments by trustees.

## Recognition of Trusts in Tax Law

According to the ITO, a trust is defined for Israeli tax purposes as an arrangement by which a trustee holds assets for the benefit of a beneficiary, whether carried out in Israel or abroad, either defined by statutes applicable to it as a trusteeship or as defined in some other manner.

In this respect, the ITO defines a trustee as a person who's transferred assets or income to a trust or one who personally holds assets in trust. The definition of a trustee also pertains to a corporation specified in Annex A of the ITO, which includes:

1. A foundation according to the laws of the Netherlands, Liechtenstein, Panama, the Bahamas or the Dutch Antilles;
2. An establishment according to the laws of Liechtenstein;
3. A trust regulation according to the laws of Liechtenstein.

In practice, the ITA may accept corporate trustees and similar structures settled under other jurisdictions, but there's no certainty that they'll indeed do so. Recently, the ITA published a tax ruling that dealt with the taxation and repercussions of an establishment incorporated under the laws of Liechtenstein. The

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ruling explains that, according to the ITO, a Liechtenstein establishment is viewed and treated as if it were a trust, further strengthening the position that such establishments should be recognized as independent entities.

## The 2006 Reform

In 2006, Israel enacted a comprehensive tax reform, regulating the taxation of trusts in Israel (the 2006 Reform). This new legislation applied to both new trusts, yet to be established, as well as to those that were established prior to the 2006 Reform, with respect to income and gains produced or accrued after the 2006 Reform came into effect. In light of the 2006 Reform, the ITO was amended, and a new chapter regulating taxation of trusts was added.

The ITO defines a "settlor" of a trust as the person who directly or indirectly transfers assets into the trust (even if such a person isn't officially defined under the deed of trust as the settlor). The ITO also includes certain anti-avoidance provisions, according to which additional people are regarded as "deemed settlors" of the trust:

(1) A person who, directly or indirectly, was a substantial shareholder in an entity that transferred assets into a trust;

(2) A person who, directly or indirectly, held one or more categories of means of control in an entity that transferred assets into a trust in which such a person or such a person's relatives were beneficiaries;

(3) A trustee who transferred an asset or income to another trustee after the last settlor passed away or after the beneficiaries were replaced, all without a provision included in the trust documents, unless it was proven to the assessing officer's satisfaction that the beneficiary in no way influenced the transfer of the assets or the change of beneficiaries;

(4) A beneficiary who has the power to control or influence, directly or indirectly, the management of the trust, the assets of the trust, the determination of beneficiaries, the nomination or replacement of trustees, distributions and so forth;

(5) An asset transferred to the trustee in a relatives trust (that is, a trust in which all Israeli resident beneficiaries are "relatives" as defined in the ITO) that originated in an asset previously transferred from an Israeli resident who's a beneficiary of a trust or from a relative who's a beneficiary.

In principle, the classification of a trust for Israeli tax purposes is determined according to the residency of the settlors and the beneficiaries of the trust, under the ITO definitions. In this respect, it should be noted that neither the residency of the trustee nor the place of management and control of the trust are relevant for the purpose of determining the tax classification of the trust under Israeli tax law.

Following the 2014 Reform, whenever a trust consists of an Israeli beneficiary, it's subject to tax and reporting in Israel.

## The 2014 Reform

On July 30, 2013, the Israeli government approved the "Reform of Change in National Priorities (2013-2014 Legislative Amendments to Achieve Budgetary Goals) 5773-2013" (2014 Reform), most of which took effect on Jan. 1, 2014.

The 2014 Reform provided major amendments to the classification and taxation of trusts in Israel.

Up until the 2014 Reform, if the settlor was a foreign resident, assuming certain requirements were met, the trust was accordingly deemed a foreign resident for tax purposes (foreign resident settlor trust), despite the beneficiary being an Israeli resident. Following the 2014 Reform, whenever a trust consists of an Israeli beneficiary, it's subject to tax and reporting in Israel.

## Classification of Trusts

Today, following the 2014 Reform, the ITO defines five types of classifications of trusts: (1) Israeli resident trust (IRT); (2) foreign resident trust (FRT); (3) Israeli resident beneficiary trust (IRBT); (4) foreign resident beneficiary trust (FRBT); and (5) testamentary trust.

**IRT.** A trust may be regarded as an IRT if: (1) at the date of settlement, at least one settlor and one beneficiary were residents of Israel, and during the current tax year, at least one settlor or one beneficiary is a resident of Israel; (2) all the settlors have passed away, and in the current tax year, at least one beneficiary is an Israeli tax resident; or (3) the trust isn't considered an FRT, an FRBT or a relatives trust.

Notwithstanding the abovementioned, a testamentary trust shall not be considered an IRT but should be first classified as a testamentary trust according to the provisions as mentioned hereinafter.

An IRT is treated and considered as an Israeli resident for tax purposes. As such, it's subject to reporting in Israel and is taxable on its worldwide income.

Contributions by individuals aren't considered to be a sale under the ITO and aren't liable to taxation in Israel.

Distributions may be liable or exempt from tax accordingly, with the asset being viewed as if it were transferred directly from the settlor to the beneficiary.

**FRT.** A trust may be regarded as an FRT if: (1) during the current tax year, all settlors and all beneficiaries are foreign tax residents, or all the settlors are foreign tax residents and all of the beneficiaries are Israeli charity beneficiaries or foreign beneficiaries and there were no Israeli beneficiaries since the trust had been established; or (2) all settlors have passed away and all beneficiaries are foreign tax residents, or all settlors have passed away, all beneficiaries are Israeli charity beneficiaries or foreign tax residents and there were no Israeli beneficiaries since the trust had been established.

An FRT is viewed and treated as a foreign resident for tax purposes and thus, as a general rule, is subject to reporting and tax obligations in Israel only to the extent that it holds Israeli assets or has a source of income within Israel (subject to certain exemptions and relief provided to foreign tax residents under the ITO or any applicable tax treaty).

Contributions by individuals aren't considered to be a sale under the ITO and aren't liable to taxation in Israel.

Distributions may be liable or exempt from tax accordingly, with the asset being viewed as if it were transferred directly from the settlor to the beneficiary.

**IRBT.** In an IRBT, all settlors have been foreign tax residents since the date of its establishment and through the current tax year, and during the current tax year, at least one beneficiary is an Israeli tax resident (Israeli charity beneficiaries aren't regarded as beneficiaries for this purpose).

An IRBT can be classified into two types: (1) one that doesn't qualify as a relatives trust; or (2) a relatives trust—if all Israeli resident beneficiaries of the IRBT are relatives (as defined in the ITO) of the foreign settlors still alive.

A beneficiary is a relative if: (1) the settlor is his parent, grandparent, spouse, child or grandchild; or (2) the settlor is his sibling, spouse of a sibling, offspring, offspring of a spouse, spouse of an offspring, offspring of a sibling, uncle or aunt, provided that the ITA was convinced that the trust was settled bona fide and that the Israeli beneficiary didn't provide any consideration in exchange for his right in the trust.

An IRBT that doesn't qualify as a relatives trust is taxed as an IRT. As such, it's taxed as an Israeli resident and subject to tax and reporting in Israel on a worldwide basis, as though the income of the trust is the income of the Israeli beneficiary.

Contributions by individuals aren't considered to be a sale under the ITO and are thus not liable to taxation in Israel.

Distributions may be liable or exempt from tax accordingly, with the asset being viewed as if it were transferred directly from the settlor to the beneficiary.

An IRBT that qualifies as a relatives trust is taxed according to one of two alternatives, chosen by the trustee:

1. **Distribution basis.** A distribution to an Israeli resident beneficiary that originated from an asset or income produced outside of Israel and is thus subject to taxation at a rate of 30 percent. If an asset was distributed to the Israeli beneficiary, then the 30 percent tax rate is imposed on the fair market value of the asset on the date of the distribution. However, if the

trustee can prove that the distribution is from an asset that's been transferred to the trustee (that is, from the capital of the trust) and that a direct transfer of the asset from the settlor to the beneficiary is exempt from taxation (such as in case of a gift bestowed on an Israeli resident), then its distribution by the trustee to the beneficiary shall be exempt from taxation in Israel.

2. **Designation basis.** A situation in which the trustee may choose to designate the income of the trust to Israeli tax resident beneficiaries. Such income, which is taxed in the tax year it was produced or accrued as income of an Israeli tax resident, is subject to taxation at a rate of 25 percent. Once the tax is paid on the designated trust income, the distribution of this income to the Israeli beneficiary is exempt from taxation in Israel.

In either alternative, contributions may be liable or exempt from tax accordingly, with the asset regarded as though it were transferred directly from the settlor to the beneficiary.

On the passing of one of the foreign settlors in a relatives trust, the trust shall become an IRT from that day on and will thus be subject to taxation and reporting requirements in Israel, on a worldwide basis. Nonetheless, the ITO provides that if the foreign spouse of the foreign resident settlor is still alive and was married to the settlor at the time of at least one of the contributions of assets to the trust, then the foreign spouse is regarded as the "deemed settlor" of the trust, and thus the trust may continue to be classified as a relatives trust until the demise of the foreign spouse of the foreign settlor.

**FRBT.** This structure: (1) isn't considered an IRT or a testamentary trust; (2) is irrevocable under the ITO; (3) has beneficiaries who are all individual foreign residents, whose identities are known; and (4) has at least one settlor who's an Israeli tax resident (including


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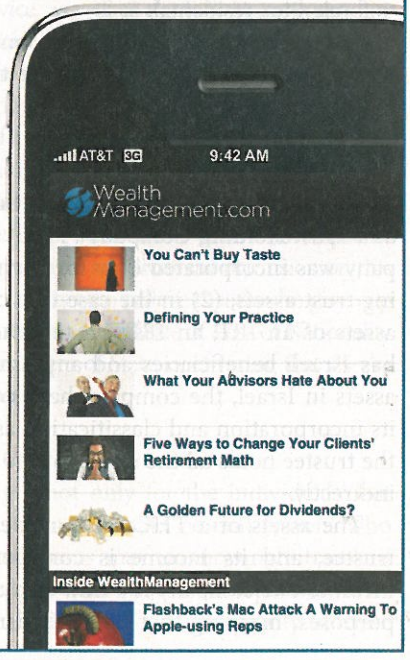


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a settlor who was an Israeli tax resident on the date he passed away).

An FRBT is considered and treated as a foreign resident for tax purposes. As such, it's liable to taxation in Israel only in respect of a source of income within Israel (subject to certain exemptions and relief provided to foreign tax residents under the ITO or any applicable tax treaty). If the assets and the income derived therefrom are derived from sources outside Israel, there's no taxation in Israel.

Contributions are liable to taxation, as in the case of an asset transferred directly from the settlor to the foreign resident beneficiary.

Distributions aren't liable to taxation in Israel.

**Testamentary trust.** A trust is considered a testamentary trust if it's settled under an individual's last will and testament, and all the settlors were Israeli residents at the time of their demise.

The testamentary trust is categorized for tax purposes as an IRT or an FRBT, depending on the residency of the beneficiaries.

If there's at least one Israeli beneficiary, the trust is considered an IRT and is subject to tax and reporting in Israel on a worldwide basis.

Otherwise, the trust is considered an FRBT and a foreign resident for tax purposes. As such, it's liable to tax in Israel only in respect of a source of income within Israel (subject to certain exemptions and relief provided to foreign tax residents).

Neither contributions nor distributions are considered a sale under the ITO and are thus not liable to taxation in Israel.

## Trust Holding Company

The requirements for the classification of a company as a Trust Holding Company (THC) are: (1) the company was incorporated only for the purpose of holding trust assets; (2) in the case of a company holding assets of an IRT, an IRBT, a testamentary trust that has Israeli beneficiaries and any other trust that has assets in Israel, the company has notified the ITA of its incorporation and classification as a THC; and (3) the trustee holds all the shares of the THC, directly or indirectly.

The assets of a THC are considered assets of the trustee, and its income is considered the trustee's income. The company is a flow-through entity for tax purposes, meaning that the THC isn't considered an Israeli resident for tax purposes and isn't liable to taxation and reporting in Israel. A THC isn't entitled to the benefits of the tax treaties to which Israel is a party.

## New and Returning Residents

According to the ITO, an individual who became an Israeli tax resident after 2007, whether for the first time or after spending considerable periods of time outside of Israel as a foreign tax resident, may be entitled to various material tax benefits. For example, new immigrants and veteran returning residents are entitled to an exemption from the payment of taxes on all forms of income, active or passive, including capital gains, derived from sources outside of Israel for a period of 10 years.

These benefits shall also apply to an IRT if: (1) the settlor became a new immigrant or a returning veteran resident or a returning resident; and (2) all the beneficiaries are new immigrants and/or returning veteran residents and/or foreign residents.

The same benefits shall also apply to a relatives trust if one beneficiary in the trust became a new immigrant, a returning veteran resident or a returning resident. In that case, the benefits shall apply according to the beneficiary's share.

## Non-tax Issues

The use of trusts in Israel over the past few years is becoming increasingly frequent in non-tax issues, such as succession planning, inter-generational transfers, asset protection or philanthropic purposes.

In principle, from an Israeli taxation perspective, as of today, there are no particular tax advantages or disadvantages in the settlement of a trust. This is due, principally, to the fact that trusts that have Israeli resident settlors and/or beneficiaries are generally subject to Israeli taxation and reporting obligations, irrespective of the jurisdiction where they're settled.

*—The authors acknowledge Inbar Barak-Bilu, Advocate (CPA from Gornitzky & Co. in Tel Aviv, Israel), who assisted in the research and writing of this article.*

## Endnotes

1. Income Tax Ordinance—Article 75c (Taxation Decision No. 6893/15). Taxes, 29/2 c-19.
2. Income Tax Ordinance Amendment (No. 147) Law 5765-2005.
3. *Ibid.*
4. Income Tax Ordinance—Article 75D.
5. Income Tax Ordinance—Article 75H1(b).