

The new Israeli Law for Taxation of Trusts

By: Alon Kaplan and Shai Dover

Introduction

The tax reform which was enacted in Israel on January 1, 2003 introduced the concept of personal taxation. One of the objects of the reform was to change the tax regime from territorial to global taxation. An Israeli resident is now taxed on his worldwide income. However, some Israeli residents used overseas trusts for investment and management of their financial assets. It became inevitable that the taxation of trusts be carefully examined since the legislation of the tax reform did not include this subject. After long deliberations the Knesset legislated a law for the taxation of Trusts.

Before examining the main points of the law, it may be beneficial to review some basic points about trusts in Israel.

The Use of Foreign Trusts in Israel

The concept of private trust under the Trust Law 1979 (the "Trust Law") is widely known and used by professionals in Israel. However, its main application is in the capacity of nominee agreements and trust relationships created by law.

Israeli professionals tend to use foreign trust structures for organizing private and business affairs where a common law type of trust is required. Sometimes the continental foundation entity is also used.

One can identify several reasons for the above usage:

The legal structures available under the Trust Law are mostly insufficient. The establishment of a trust which would "skip" generations, often available under foreign trust structures, is not available in Israel. Therefore, there is a need for probate proceedings in order to achieve the settlor's goal of creating a trust that will exist for a number of generations.

Israel recognizes the common law concept of trusts.

The Israeli law distinguishes between revocable and irrevocable trusts. Briefly, whether a trust will be classified as a revocable or irrevocable trust depends on the amount of control that the settlor preserves for himself for the management of the trust assets. In most cases, the settlor completely separates himself from the trust assets from the moment he transfers the assets to the trustee and provides him with the discretionary powers to manage the trust assets. This is an irrevocable trust. The taxation of revocable trusts are already regulated by existing tax laws. The new law aims to regulate the taxation of irrevocable trusts.

We can now examine the main features of the new law.

The main features of the law

On the 1st of January 2006, the Trusts Taxation Law will come into effect in Israel.

The Trusts Taxation law defines three types of trusts:

- A. A trust of residents of Israel.
- B. A foreign resident settlor trust.
- C. A foreign resident beneficiary trust.

In the following issues of the newsletter we will discuss in detail each of the trusts, but in this edition we will focus on a general review.

Foreign resident settlor trust

Definition

This type of trust makes Israel and the local trustees attractive to every foreign resident.

A foreign resident settlor trust is a trust that fulfills one of the following two conditions:

- 1) At the time of its establishment and during the tax year all its settlors are foreign residents (regardless of the beneficiaries' residency).

2) During the tax year all its settlors and all its beneficiaries are foreign residents.

The first condition deals with cases in which individuals would like to establish a trust for a resident of Israel, usually parents for their children or a donor for the needy (a charitable trust).

The second condition includes all the circumstances in which foreign residents with no connection to Israel, would like to use an Israeli trustee for the purpose of managing the trust. For example, an American resident who is not interested in using a trust in Gibraltar or the BVI. The use of an Israeli trustee for his benefit or the benefit of another person who is not an Israeli resident will establish this type of trust.

Taxation

Whether or not the trust is irrevocable, a foreign resident settlor trust will be considered as a foreign resident. The assets held by the trustee will be viewed as assets that are held by an individual foreign resident and the trust's income will be viewed as the income of an individual foreign resident. The meaning of the law is that if the trust profits are not derived from sources in Israel, they are not taxable in Israel and there are no reporting obligations in Israel. The legislator chose to emphasize this point in order to remove the fear that acquiring the assistance of a professional in Israel will render the trust taxable in Israel. To remove any doubt about it's intention, at the end of the Trusts Taxation Law, the legislator added the following paragraphs:

Section 75O(E) - a trustee of a foreign resident settlor trust, a trustee of a foreign resident beneficiary trust and a trustee of a trust by will in which there is no beneficiary who is a resident of Israel will not have to submit a report according to section 131¹ related to the income of the trust that was produced or derived outside Israel, even if the trustee is a resident of Israel and even if

¹ Section 131 is the section in the Israeli Tax Ordinance that requires reporting of income

he submitted a report according to section 131 about income that was produced or derived in Israel.

Section 75P(C)- A trustee who is a resident of Israel will not incur tax liability or be obligated to submit a report as a result of the trustee's (i.e. the trust) income, in addition to the requirements that are detailed in this chapter, that would not exist if all the trustees were foreign residents.

It is important to understand that not only is income from rental, interest, dividend, capital gains and business profits outside Israel not taxable and not only does it not involve reporting duties by the Israeli trustee, also interest income within Israel can, in certain cases, enjoy exemptions because it is seen as interest income of a foreign resident.

A foreign resident settlor trust for the benefit of a beneficiary who is a resident of Israel

Israel is a country of immigrants and has many residents whose parents are residents of foreign states. When a foreign resident settlor establishes a trust for a beneficiary who is an Israeli resident, the trust is not taxable on income that the settlor does not have to pay tax for, that is, income with no connection to Israel. The parent who would like to ensure the wellbeing of his child in Israel can establish a trust for him. The income of the trust outside Israel is not taxable, while if the child would have received the assets directly into his hands his income outside Israel would have been taxable.

It is important to note that a foreign settlor trust for a beneficiary who is a resident of Israel, that is, one that the child in our example will not have to pay tax on its income outside Israel even if he is an Israeli resident, can be established not only during the lifetime of the settlor. A trust established for the child by will of the settlor will also entitle him to the benefit stated above.

A trust of residents of Israel

Definition

The trust of residents of Israel requires two conditions:

- 1) At the time it is established, at least one settlor and one beneficiary are residents of Israel.
- 2) During the tax year (1st of January to the 31st of December), at least one settlor or one beneficiary are residents of Israel.

In addition, a trust of residents of Israel is the default if the trust does not match the definition of another type of trust. From the definition it is clear that if the settlor and the beneficiary are not residents of Israel, the trust can never be a trust of residents of Israel.

Taxation

A trust of residents of Israel is taxable according to the Israeli laws and according to the tax rates that apply for an individual. In Israel, tax rates are progressive for income from a business (that is, increase with the increase in the income) and are fixed for income from capital, such as 15% to 20% of the interest, 20% to 25% of the dividend, 20% to 25% of the gains from selling capital etc. These are also the tax rates that will apply for the income of the trust. Distributing the income to the beneficiary will take place after the tax deduction, that is, from the net value, and the beneficiary does not have any additional tax liability. The trustee pays the tax on the income that would apply to the individual and releases said individual from dealing with this. In the case of an irrevocable trust, the trustee has the right to distribute the income to the beneficiary within six months from the end of the tax year and in such a case, the income will be considered the beneficiary's income for all intents and purposes. This action has an advantage when the beneficiary has special tax benefits such as exemptions due to a serious disability or in the more common case of losses for tax purposes that can be offset against the income (this model adopts the model that is accepted in New Zealand for taxation of trusts).

A foreign resident beneficiary trust

Definition

A trust of a beneficiary who is a foreign resident is a trust that an Israeli resident establishes for a beneficiary who is a foreign resident. In such a trust, assets and the income derived therefrom are taken out of the Israeli tax network. The legislator devoted several sections and severe sanctions to ensure that the Israeli settlor was indeed not connected to his assets and the beneficiary is indeed a foreign resident. Such a trust requires all the following conditions:

- 1) It does not qualify under the definition of a trust of Israeli residents.
- 2) It is an irrevocable trust.
- 3) All its beneficiaries are foreign resident individuals, whose identity is known.
- 4) At least one settlor is an Israeli resident.

In addition, there are different reporting duties and declarations in which the settlor and the trustee have to make a commitment that no beneficiary in the trust is an Israeli resident, and in certain cases that it is also not possible to add such a beneficiary.

Taxation

A foreign resident beneficiary trust will be considered a foreign resident and will be taxed in the same manner in which an individual foreign resident is taxed. If the assets and income are outside Israel, there is no taxation in Israel. If the assets or the income are in Israel, the double tax treaty, that would have applied if the beneficiary had held the assets directly, will apply. Here too the use of an Israeli trustee has no meaning for taxation.

A beneficiary in a trust of this type who immigrates to Israel, turns the trust into a trust of Israeli residents and it becomes taxable, although the trust will enjoy the tax benefits maintained by law for new immigrants.

Underlying Company In Israel

One of the major changes of the trust taxation law is the ability to establish an underlying company inside or outside Israel. This kind of company is used to legally separate between the trustee's personal assets and the trust's assets.

An "underlying company" is a "group of persons" holding the trust's assets, for the trustee, directly or indirectly. This group can be a typical company, foundation, partnership etc. Every group of persons which possesses assets that are not its own, but belong to the trustee by virtue of his duty, answer the definition.

The Benefits

Before the new law was legislated, every Israeli trustee holding such a company would, through the "management and control" test, cause it to be regarded as an Israeli company and subject it to corporation tax and reporting requirements in Israel. The new law provides that this corporation is now regarded as a "flow through entity" and the "management and control" test is no longer relevant. This means that the Israeli tax authority ignores the company and treats the assets and the income as if they were directly held by the trustee.

As previously noted, a "foreign settlor trust" is not subject to tax and does not have to file reports on income derived from outside Israel, even if the trustee is an Israeli resident. An Israeli trustee, of a foreign settlor trust, can use an underlying company (even if located outside Israel) to hold the trust's assets. Neither the trustee nor the underlying company is subject to tax or reporting obligations on the income derived outside Israel. In cases where the underlying company derives income in Israel, for example, by leasing a building, it does not have to pay taxes or file any report. The income will be considered the trust's income and the trustee will have to file reports and pay the taxes (but only on income derived from Israeli sources).

The concept of an underlying company is simple and advantageous in constructing the best trust arrangement possible.

Encouraging the Use of Israeli Trustees and Companies

Until now, settlors and practitioners preferred appointing foreign trustees out of concern that having an Israeli trustee could create tax liabilities in Israel. Following the new law, the place of residence of the trustees will not affect taxation. It is the tax status of the beneficiary and the settlor that will determine Israeli tax liability.

This can be seen as an important development in the Israeli tax system. It also provides opportunities to both Israeli and overseas trust companies and trust and estate practitioners. The appointment of Israeli trustees is encouraged by the Income Tax Authority. Not only will it stimulate the use of domestic professional services, but it will also enable the Income Tax Authority to communicate directly with trustees. Foreign trustees seeking assistance and better communication with the tax authorities may co-operate with Israeli trustees in order to fulfill their duties in Israel.

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