

The Taxation of Trusts in Israel and Reporting Obligations
המאמר פורסם ב-יום ראשון 01 יוני 2008
THE TAXATION OF TRUSTS IN ISRAEL AND REPORTING OBLIGATIONS

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1. BACKGROUND AND INTRODUCTION

1.1 **2003 Tax Reform** : up until 31st December 2002, the Israeli Tax regime was predominantly territorial, certainly with respect to income (although Capital Gains carried an extra territorial liability in many cases). As of 1st January 2003, the method of personal taxation of Israelis changed from territorial to personal i.e. worldwide. Accordingly, as of 1st January 2003, income accruing howsoever and wheresoever, whether in or outside of the State of Israel, irrespective of the original source of the Income – the producing asset and the nature of the income produced and accruing in favour of an Israeli Tax Resident – whether it is physically received in Israel – will attract Israeli Income Tax. It should be noted that there is no gift tax or inheritance tax in Israel. The new tax regime of personal taxation was a result of Amendment 132 to Income Tax Ordinance – New Version, 5721-1961 ("Ordinance"). Notwithstanding this, The Rabinowitz Committee on Tax Reform recommended that since the Trust concept did not find expression in the above Tax Reform and due to the complexity of the issue of the Taxation of Trusts, it recommended that a separate Committee be formed in order to deal with this issue. Indeed on the 2nd September 2002, a Committee was appointed and on 24th July 2003 the said Committee filed its recommendations. As a result the Taxation of Trust Law was passed by the Israeli Knesset on July 25th 2005 and came into effect on 1st January 2006 under Amendment 147 to the Ordinance (the "Amendment").

1.2 **Israeli Trustees and Underlying Israeli company**: what the Amendment has introduced for the first time is the facility to appoint Israeli Trustees, irrespective of the proper law which governs a trust deed as well as the opportunity to use an underlying Israeli holding company without either of these features incurring any Israeli tax consequence.

1.3 The use of trusts in Israel is not the norm and it is still largely embryonic. It has primarily remained the domain of foreigners and of new immigrants to Israel who have brought the tradition of the institution of the trust with them from other jurisdictions, principally common law jurisdictions. Indeed, Israeli law is not well-suited to the establishment of trusts. If a trust is established under Israeli law, it will terminate on the death of the settlor, because the Israeli succession rules override the rules of trusts. Any intending settlor will probably be advised therefore to set up his trust under the laws of some other jurisdiction. It was perhaps the sporadic creation of a small number of hugely asset-rich foreign trusts that jogged the Israeli Fiscal into addressing very actively the tax treatment of trusts at the time of the 2003 tax reform. A handful of trusts created by very rich new immigrants to Israel, or by former Israeli residents returning to Israel, coupled with trusts created on a wholesale basis by the many Israeli high-tech boom bonus recipients, alerted the Tax Authority in Jerusalem to radically examine the hitherto somewhat unexplored area of the taxation of trusts. That examination was thorough, but the absence of what one may call a "trust tradition" was the main reason for the delay in formulating the reforms. **This is also the reason that the Amendment deals mostly with the taxation of off-shore trusts rather than Israeli trusts.**

1.4 **Reporting obligations** : the present situation is that the promulgation of the tax reporting requirements for trusts and trustees is being completed and has been deferred to **31 August 2008** – most of the reporting obligations will fall on foreign trustees and this will be dealt with below. One may see this delay as a window of opportunity, giving us some

breathing space to do a little planning and a little adjustment where appropriate and where possible.

1.5 **The key to the taxability of trusts in Israel is the tax residence of the settlor** where beneficiaries are Israeli residents, and, conversely, the tax residence of beneficiaries where the settlor is an Israeli resident. **The definition of "tax residence"** has been very specifically addressed in the 2003 reform: it is essentially the same as the traditional UK domicile test: where is the individual's centre of life? If it can be shown that the centre of his life is in Israel, notwithstanding the fact that he spends very little time physically residing in Israel, he will be tax resident. Where the test cannot easily be applied or satisfied, there is a minimum residence presumption test: where a person resides at least 183 days in Israel – a day meaning any part of a day in any given tax year (which is based on the Gregorian calendar), or in the alternative, has resided in the current tax year for at least 30 days, and the total of his residence in Israel during the current tax year and the immediate preceding two tax years is 425 days or more, he will be presumed tax resident in Israel. These are presumptions only, which are rebuttable by factual evidence as to where the person's centre of life (or the centre of his vital interests to borrow a tax treaty term) really is. Where does he work? Where does his family reside? Where does he own a home? Where does he belong to a synagogue? Where is his burial plot? Which clubs does he belong to? And where do his business interests focus principally? Gone, therefore, are the days when foreigners living in Israel on a tourist visa – and a tourist visa, classified B1, can be obtained for a 90-day period renewable by the Ministry of the Interior (though never to be extended beyond the consecutive period of twenty-seven months) – could regard themselves, and believe that they would be regarded by the Israeli Fiscal, as non-resident for tax, just because the stamp in their passport said, "Tourist Visa". This is definitely past.

1.6 **Tax Holidays** : new immigrants will enjoy the following tax holidays: 5 years tax holiday on income (e.g. interest, rental income, dividends, royalties) and 10 years on capital gains income – all with respect to assets owned prior to immigrating to Israel. Additionally a new Bill is being passed in the Knesset to extend the tax holiday on income also to 10 years – in this sense Israel can become a new tax haven of choice. It is therefore important that prior to immigrating to Israel proper advice is taken in order to ensure all financial affairs and structures are correctly placed in order to enjoy these tax holidays in full.

2. **THE TAXATION OF TRUSTS – A GENREAL OUTLINE**

The Amendment refers to a number of categories of Trusts. It is important to remember that the Amendment, in the main, aims to deal with, foreign trusts. Therefore, the taxation or non-taxation of a trust in Israel, as dealt with herein, has nothing to do with the jurisdiction in which a trust was created or where the trustee is situated.

The question of whether a Trust will be taxed in Israel depends on the status it acquires in accordance with the said categories:

2.1 **ISRAELI RESIDENT TRUST** (Section 75g to the amendment)

This is a Trust that when it was created at least one settlor and at least one beneficiary were Israeli Residents, and in the tax year at least one settlor and at least one beneficiary thereof are resident in Israel.

Tips and examples:

• Please note it does not make a difference if the trust is revocable or irrevocable, or discretionary by nature, if the assets are outside of Israel, if there are foreign Trustees, or if there is a foreign holding company (the latter is pierced through).

- *A trust that does not fit into any of the categories will be regarded as an Israeli Resident Trust.*
- *Even if the original Israeli settlor dies or leaves Israel, the trust will still remain an Israeli Resident Trust.*
- *Therefore be aware that if, for example, an Israeli resident, creates a Trust in favour of his non-Israeli grandson (a Trust that as described hereinbelow if drafted properly will not be subject to Tax in Israel) and that grandson immigrates to Israel – the Trust will be taxed in Israel and acquire the status of an Israeli Resident Trust.*
- *Additionally this will also apply if the said Israeli settlor has several grandchildren residing outside of Israel and only one grandchild immigrated to Israel, since it suffices that at least one settlor and one beneficiary are resident in Israel for the entire Trust Fund to be taxed.*
- *Here even if the beneficiaries of the Trust are mixed, i.e. Israeli Resident and non-Israeli Resident, the entire Trust Fund will be subject to tax in Israel. Moreover, this will still be the case even after the demise of the settlor. However we are awaiting for new legislation to pass with Regulations allowing for only the assets of the Trust Fund held for Israeli beneficiaries to be taxed but this will most probably have the price of a onetime capital gains tax on the initial settlement of assets.*
- *SOLUTION TO ALL OF THE ABOVE EXAMPLES - to create a separate Trust for each foreign beneficiary. This way if one beneficiary immigrates to Israel it will not affect the rest of the beneficiaries.*
- *Finally, a New Immigrant settlor will enjoy the tax holidays referred to in paragraph 1.6 hereinabove, since the trust will be pierced through- though if the beneficiaries remain non-Israeli then subject to the conditions described in Paragraph 2.3 hereinbelow, the trust will be exempt from tax in Israel by its status over and above any tax holidays.*

2.2 **FOREIGN RESIDENT SETTLOR TRUST** (Section 75i to the Amendment)

This is a Trust that all settlors were foreign when created and in the tax year all settlors are foreign residents or during the tax year all settlors and beneficiaries are foreign residents.

It is this type of trust that can be used as an **"offshore"** trust in Israel, since regardless of the residence of the beneficiaries, so long as the settlor is non-Israeli resident, the Trust is exempt from tax in Israel.

There is one crucial factor in this connection and that is that if there are Israeli beneficiaries, then such beneficiaries cannot manifest any control over the trust assets, directly or indirectly, since such "control" could result in the Israeli beneficiary to be deemed as the settlor of the Trust, which would result in the Trust being treated as an Israeli Resident Trust. There is no specific definition of "control" in the Amendment and so it is important to scrutinize the Trust Deed and ensure that there are no provisions of delegation of authorities to the beneficiaries. For example: - it is fundamental that an Israeli beneficiary cannot dismiss or appoint the Trustees, the Protector or beneficiaries, and that he has no control, either directly or indirectly, over the assets of the Trust (e.g. cannot make distributions). In this type of Trust, the assets held by the Trustee are deemed as being owned by the settlor personally and therefore not subject to tax in Israel.

As with the Israeli Resident Trust, there is no requirement here for the trust to be revocable or irrevocable. Obviously, though there is no mention of this in the amendment, it is important for the trust to be discretionary in the sense that no control is deemed to be given to any Israeli beneficiaries.

Tax Planning tip:

A non-Israeli resident who has family members in Israel, for which he wishes to provide for, can settle a trust in their favour and so long as the Israeli beneficiaries do not have control over the trust assets, the entire trust fund would be exempt from tax in Israel and the Israeli beneficiaries could enjoy tax free income in Israel. Moreover, if a foreign resident plans to leave in his Will assets for Israeli residents, he can instead leave such assets to a Trust settled by him in favor of an Israeli Beneficiary, thereby enabling the Israeli Beneficiary to enjoy tax free income from the Trust in perpetuity.

For example: *A non-Israeli resident, intends to leave in his Will certain assets to his Israeli granddaughter. If he creates a Trust in favor of his Israeli granddaughter, and makes that trust an heir under his Will, his granddaughter can enjoy tax free income from the Trust. Controversially, if she were to receive the assets under the Will directly in her name, the actual inheritance would not be subject to tax, however once the assets were in her name she would be subject to tax in Israel on the income accruing.*

This type of trust can be used by foreign settlors in favor on non-Israeli residents without having any Israeli tax implications. In this sense Israel could be deemed a new player in the international trust and asset protection arena.

And moreover, such a trust does not have to be governed the laws of the State of Israel, it can just enjoy the use of Israeli trustees or foreign trustees and/or Israeli or foreign holding company, which is pierced through and not subject to Israeli tax, as discussed more particularly hereinbelow.

2.3 FOREIGN RESIDENT BENEFICIARY TRUST (Section 75j to the Amendment)

This is a Trust settled by an Israeli resident in favour of Non-Israeli Beneficiaries. This Trust is not subject to tax in Israel as long as the following conditions are met:-

(i) The Trust is irrevocable*;

(ii) All beneficiaries are non-Israeli residents and their identity is known (therefore cannot have unborn beneficiaries);

(iii) For Trusts settled from 1st January 2006 there must be specific provision within the Trust Deed that no Israeli resident beneficiary can be appointed.

An "Irrevocable" Trust:

Please note that with respect to the requirement of irrevocability

in this trust category, this is a unique feature under the

Amendment in the sense that if for example, an Israeli resident,

flies to Jersey and settles a Trust in favour of his non-Israeli

children or grandchildren, the Jersey Trustee must be aware

that when drafting the Trust Deed, even though the Deed will be

subject to the Laws of Jersey, in order to enjoy the exemption of

tax in Israel, it must be irrevocable within the definition of

"irrevocable" under the Amendment.

* The definition of a revocable Trust under the Amendment:-

- (1) there is a possibility to cancel it or to transfer or return the asset or the income to the creator, his spouse, his estate or to a held body of persons, all either directly or indirectly;
- (2) one or more of the beneficiaries is the creator or his spouse, or the creator or his spouse can become beneficiaries;
- (3) one or more of the beneficiaries are the creator's children, who have not reached age eighteen in the tax year, or there is a possibility to transfer an asset or income directly or indirectly to his aforesaid child, on condition that the creator or his spouse is still alive;
- (4) one or more of the beneficiaries are bodies of persons, which are not public institutions as defined in Section 9(2) of the Ordinance, of which 10% or more of any means of control are held by the creator, by his spouse or by his child who has not yet reached age eighteen, if the creator or his spouse is still alive, all either directly or indirectly (in this definition "held body of persons");
- (5) the trustee or protector of the trusteeship is the creator or a body of persons;
- (6) the trustee or the protector of the trusteeship is a relative of the creator, unless it was proven to the Director's satisfaction that there was a special justification for the appointment of the relative as trustee, and that the appointment does not indicate any ability to direct the trustee's activity or to issue instructions on the matter of the trusteeship; for purposes of this definition, "relative" – as defined in paragraphs (1) to (3) of the definition of "relative" in section 88 (of the Ordinance);
- (7) the creator or his relative are able to direct the trustee's activity or to give him instructions on the way the trusteeship and its assets are managed, beneficiaries are changed, the trust assets and trust incomes are distributed to beneficiaries, or his approval is required for the trustee's acts, or he is able to order cancellation of the trusteeship or replacement of the trustee, otherwise than for lawful grounds, all either directly or indirectly;
- (8) the identity of one or more of the beneficiaries is not known, or the identity of a shareholder – directly or indirectly – in a beneficiary that is a body of persons is not known, unless it is proven to the Director's satisfaction that the beneficiary cannot be the creator, his spouse the creator's child who has not reached age eighteen or a held body of persons;
- (9) the beneficiaries of a trusteeship have been replaced or new ones were added, without instruction to that effect being included in the trusteeship documents;
- (10) no certified affidavit was delivered on a form and at the time prescribed by the Director, as said in the definition of "irreversible trusteeship".

Tax Planning tip:

A New Immigrant settlor who has a trust settled in favour of both Non-Israeli and Israeli residents should, if possible, prior to immigrating to Israel separate the assets of the trust for those non-Israeli residents in order to enjoy a full tax exemption on those assets so long as the trust meets the requirements of a Foreign Resident Beneficiary Trust. The assets held in a trust in favour of Israeli residents will be taxed since the trust will be deemed an Israeli Resident Trust once the settlor immigrates, but will enjoy the tax holidays described in Paragraph 1.6 hereinabove.

For example : *A non-Israeli resident has a Trust in favor of him and his wife during their lifetime and thereafter his children and remoter issue, who are all non-resident in Israel. The settlor and his wife immigrate to Israel- their trust is now deemed an Israeli Resident Trust (since at least one settlor and one beneficiary are Israeli residents during the tax year) and even though the Trust will enjoy a five year tax holiday- on income plus ten year tax holiday on capital gains, if certain conditions are fulfilled- such tax holiday given to new Israeli*

Immigrants, the original settlor finds himself in a situation where the entire Trust Fund is taxed in Israel regardless of the fact that most of the beneficiaries are non-Israeli residents. Moreover, even after the death of the settlor, the Trust will continue to be taxed in Israel.

Solution - Before immigration to Israel the settlor can create an Irrevocable Trust within the definition of the Amendment, in favor of his non-Israeli family members thereby insuring non-taxation on the Trust Fund.

2.4 **A TRUST PURSUANT TO A WILL** (Section 75I to the Amendment)

This is a Trust created under a Will and where all the settlors of the Trust are Testators who were residents in Israel at the time of their demise.

In this type of Trust, the assets of the Trust shall be deemed the beneficiary's assets therefore if there is at least one Israeli resident beneficiary under the Trusteeship created by a Will, then the Trust shall be deemed an Israeli Resident Trust and visa versa.

3. **UNDERLYING COMPANY**

Under the Amendment an Underlying Company is pierced through and is regarded as a 'pass through entity' and therefore the assets are treated as if held directly by the Trustee and so the company is ignored. Therefore a Trustee can utilize an Israeli Company or foreign Company to hold the Trusts' assets and neither the trustee or the Underlying Company will be subject to tax in Israel on income derived from non-Israeli sources and where the underlying company derives income from Israeli sources, such income is considered to be earned by non-Israeli resident. If an Israeli company is utilized as a holding company for a trust and an Israeli trustee manages the assets of the trust will not in itself lead to the conclusion that the control of the business of that company and its management are operated in Israel, which would have classified it as an Israeli resident for tax purposes.

** Useful tip for non-Israeli residents planning to immigrate to Israel – if one shifts personal assets into a company, such as an Israeli company, or any other jurisdiction, prior to immigrating to Israel, that company can, for example in the case of securities, sell and purchase new securities and the income distributed to the new immigrant by way of dividend will be exempt for 5 years from Income Tax and 10 years from Capital Gains Tax – for the sale of the shares in the company. Whereas, if the securities remain in to be held personally by the new immigrant he would lose the tax holiday as soon as the first security would be sold.*

4. **GENERAL TRUSTEES (WHETHER ISRAELI OR NOT) REPORTING OBLIGATIONS**

As mentioned in Paragraph 1.4 hereinabove, the promulgation of the tax reporting requirements for trusts and trustees is being completed and the reporting obligations have been deferred to **31 August 2008** –we are currently waiting for the reporting forms and Regulations to be published.

There are certain reporting obligations that trustees will have to follow- regardless of the jurisdiction of which a Trust is set up or the residence of the trustees- which as a general outline are as follows:-

(i) **ISRAELI RESIDENT TRUST**

Such a Trust is subject to tax in Israel as of 1st January 2006 and is reportable by the Trustee who considered to be the Assessee although the settlor or the beneficiaries, as the case may be, can opt to be the Assessee or be bound to be the Assessee by the Tax Authorities, depending on the occurrence of certain conditions.

(ii) **FOREIGN SETTLOR ISRAELI BENEFICIARY TRUST**

There are no reporting obligations here on the Trustee, unless the assets of the trust contain Israeli assets, however, if a distribution is made to an Israeli beneficiary such distribution has to be reported by the beneficiary.

(iii) **ISRAELI SETTLOR FOREIGN BENEFICIARY TRUST**

The Trustee has file as Declaration at the end of the first tax year to the effect that there is no Israeli resident beneficiary, that the trust is irrevocable (within the meaning of the Amendment), that there is no Israeli resident beneficiary whose entitlement under the Trusteeship is conditional on his ceasing to be an Israeli Resident, and that no said Beneficiary can be added. Additionally, an Israeli settlor has to report the actual creation of a Trust.

Please note that the creation of a trust by an Israeli Resident is a taxable event in itself though the settling money into a trust will not normally create a tax liability as opposed to real estate assets, for example, that will.

N.B. The reporting obligations have not yet been manifested in full – we are waiting for the Regulations and Directive to be published and for the reporting forms as well. This is a very articulate issue and so any trustee who may be under an obligation to report to the Israeli Tax Authorities should seek separate conclusive advice.

[**ARRANGEMENTS NOT COVERED BY THE AMENDMENT**

- * Mutual Funds
- * Provident Funds
- * A Trust established to ensure the satisfaction of a specific obligation: e.g. an escrow arrangement.
- * Estate Administrator – Bankruptcy Trustee, a Receiver or Liquidator.
- * Charitable endowment for a Public Institution.]

Originally published in Oxford Journals Trust & Trust & Trustees, June 2008