



# Israeli trust provisions

*George Rosenberg* and *Inbal Faibish* discuss the use of an Israeli resident trustee and underlying companies

Following the major tax reform that transformed the Israeli tax system from a territorial one to a personal worldwide one and that came into force on 1 January 2003, further tax reform legislation was enacted, coming into force on 1 January 2006. This new legislation amended the Income Tax Ordinance (the Ordinance), particularly in relation to the taxation of trusts. The Ordinance now contains detailed provisions for the taxation of trusts (the Trust Rules<sup>1</sup>). In this article we will scrutinise the relevant Trust Rules and the benefits that may arise from using an Israeli underlying company and/or Israeli trustee.

## Definitions

The Ordinance defines 'trust' as an arrangement, made in Israel or abroad, according to which a trustee holds the trustee's assets for the benefit of a beneficiary, whether the law that governs it defines it as a trust or otherwise. 'Trustee' is defined as a person in whom assets or income from assets are vested (settled), or who holds assets in trust<sup>2</sup>. 'Beneficiary' is a person entitled to benefit, directly or indirectly, from the trust assets or income<sup>3</sup>. 'Settlor' is any person who vests (settles) an asset upon a trustee, directly or indirectly<sup>4</sup>, either as creator of the trust or as a subsequent contributor.

A 'Company for Holding Trust Assets' (underlying company) is defined as an entity that holds the trust assets directly or indirectly for the trustee. Such an underlying company, whether incorporated in Israel or not, is transparent for tax purposes, so that in and of itself it has no liability to tax and has no tax reporting obligations in respect of the income generated by the trust assets that it holds<sup>5</sup>.

<sup>1</sup> Sections 75C-75R of the Ordinance (unless otherwise indicated, all references to sections are to sections of the Ordinance).

<sup>2</sup> Foundations under the laws of the Netherlands, Liechtenstein, Panama, The Bahamas and the Netherlands Antilles, and Establishments and Trust Enterprises (Trust Reg.) under the laws of Liechtenstein are all specifically included in the definition of trustee.

<sup>3</sup> The Trust Rules include an expanded definition of beneficiary: e.g. certain potential beneficiaries, unborn beneficiaries.

<sup>4</sup> The Trust Rules also include an expanded definition of settlor: e.g. certain shareholders of a company which settled assets on a trust; beneficiaries who control or influence the trust; residents who transfer assets abroad to a non-resident for purpose of settling a trust; settlor of another trust which settles the trust in question.

<sup>5</sup> Section 75P(b)

## Taxation of *inter vivos* trusts

The Ordinance divides the different trusts into four different types – Israeli Resident Trust (IRT); Foreign Settlor Trust (FST); Foreign Beneficiary Trust (FBT); and Trust by Will. Following are the definitions and the taxation of the three *inter vivos* trusts.

### IRT Definition

A trust, revocable or irrevocable, in which, at the time it was created, at least one settlor/contributor and at least one beneficiary were Israeli residents, and during the tax year, at least one settlor or one beneficiary is resident; or a trust that is neither a FST nor a FBT (see definitions below).

### Taxation

**Creation/contribution (transfer of assets to trust without consideration)** – is not deemed a sale under the provisions of the Ordinance and therefore not taxable. This would apply to contributions of cash and all assets that are not immoveable property.

**Accrued income** – the IRT is fully taxable on its worldwide current income whether distributed or not since the IRT is deemed resident in Israel.

**Distributions** – are taxable or non-taxable as would have been the case if transferred directly from settlor to beneficiary in accordance with the provisions in the Ordinance regarding capital gains tax; i.e. cash distributions are not taxable, but distributions of non-cash assets may be taxable if they would not have qualified as a bona fide gift, or if the assets consist of immoveable property.

A potential tax relief can be found in the draft income tax regulations (directions regarding amendment of trustee's income assessment and determination of capital gain following distribution to a non-resident beneficiary) (the draft regulations), circulated by the Tax Authority in March 2007. The draft regulations provide tax benefits to an IRT when distributions are made to a foreign beneficiary. If all conditions set in the regulations are met, a cash distribution may be deemed the income of the foreign beneficiary, and not of the trust, and as such, it is subject to rules of taxation of non-residents – i.e. not taxable in respect of foreign-sourced income. The regulations apply in principle only to an irrevocable trust. To date, however, the draft regulations still have not been tabled for a first reading in the Knesset (the Israeli Parliament).



## FST

### Definition

A trust, revocable or irrevocable, in which all the settlors are non-residents both at the time it was established and during the tax year; or a trust in which all the settlors and all the beneficiaries are non-resident during the tax year.

### Taxation

**Creation/contribution (transfer of assets to trust without consideration)** – same as in the case of IRT.

**Accrued income** – not subject to Israeli tax, whether distributed or not, except in the case of Israeli sourced income, FST being deemed a non-resident trust.

**Distributions** – same as in the case of IRT, keeping in mind that the settlor is non-resident and the liability or non-liability is governed accordingly.

## FBT

### Definition

An irrevocable trust<sup>6</sup> in which, subject to certain other conditions, all the beneficiaries during the tax year are identifiable non-residents and at least one settlor is an Israeli resident and Israeli resident beneficiaries are excluded in the trust deed.

### Taxation

**Creation/contribution (transfer of assets to trust without consideration)** – is subject to tax as would have been the case if the asset were transferred directly from the settlor/contributor to the beneficiary.

**Current income** – is deemed the income of the non-resident beneficiaries and, therefore, not subject to Israeli tax, whether distributed or not, except in the case of Israeli sourced income, FST being deemed a non-resident trust.

**Distributions** – not taxable except in the case of distributions of immovable property that may be taxable under the *Land-Tax Law*.

The above rules also apply to trusts created before 1 January 2006, save that tax is imposed on such trusts – if taxable under the above rules – only from that date onward.

Subject to specified conditions, trusts may change their characterisation from one tax year to another if a change occurs in the residence status of the settlor/contributor and/or beneficiaries.

The liability to tax on the accrued income of any trust is imposed on the trustee – resident or non-resident – who is the person assessed but whose accrued income is deemed the income of the settlor<sup>7</sup>.

<sup>6</sup> For Israeli tax purposes, a trust is deemed revocable, not only if it provides for revocability, in whole or in part (in favour of the settlor and/or settlor's spouse) but even if it is declared irrevocable, if any one of ten listed conditions exists – e.g.: one or more of the beneficiaries is the settlor or the settlor's spouse, or the settlor or the settlor's spouse may become a beneficiary; the settlor or their relative has the ability to direct the acts of the trustee or give instructions on the manner of administering the trust, its assets, change of beneficiaries or distribution of the assets or income to the beneficiaries, or the settlor's approval is required for the acts of the trustee, or the settlor has the ability to direct that the trust be dissolved or the trustee changed for any reason not in law, the whole directly or indirectly; the beneficiaries have been changed or new ones have been added without there being provisions permitting this in the trust documents.



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The determination whether or not there exists a liability to tax on the accrued income, however, depends on the residence status of the settlor and/or the beneficiaries, even though in general, it is not the settlor and/or beneficiaries – whether resident or non-resident – who are personally assessed to tax, but rather the trustee<sup>8</sup>.

## Tax neutrality and tax planning

The Trust Rules specify that: 'The fact that a trustee is an Israeli resident does not create any tax obligation or obligation to submit a return in respect of the trust income, in addition to the obligations specified [in the Trust Rules], and which would not exist if all the trustees were foreign residents.'<sup>9</sup>

Moreover, since an underlying company (see definition above) 'shall not be obligated to submit a return under section 131 [of the Ordinance] or to pay any tax in respect of trust income or in respect of trust assets held by it for the trustee'<sup>10</sup>, therefore, effectively, the status of the trustee and/or of the underlying company holding the trust assets – even if such a company is technically tax resident in Israel in accordance with the general definitions in the Ordinance<sup>11</sup> – is tax neutral as far as Israeli tax is concerned.

The above provides some interesting planning opportunities where an Israeli company is an underlying company of a non-resident FST or FBT. Since the Trust Rules do not classify the underlying company itself as resident or non-resident – only the trust is classified as such – it would appear, therefore, that an underlying company of a non-resident FST or FBT incorporated in Israel<sup>12</sup>, which is resident under the general definition in the Ordinance, may qualify for benefits under the various tax treaties concluded by Israel, subject to the definition of residence in the particular treaty. In the light of the definition of FST, the above tax planning may well be utilised by a trust settled by non-residents of Israel for the benefit of other non-residents and/or Israeli residents.

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<sup>7</sup> The income may be deemed that of the beneficiary in an irrevocable trust if a full distribution is made within six months of the end of the tax year in which the trust accrued the income, and the settlor, trustee and beneficiary opt accordingly.

<sup>8</sup> Exceptions: settlor or beneficiaries are liable to tax if they opt accordingly or if tax cannot be collected from trustee, but in the case of a beneficiary only up to the amount actually distributed to them.

<sup>9</sup> Section 75P(c)

<sup>10</sup> Section 75P(b)

<sup>11</sup> A company ('body of persons') is defined as having its tax residence in Israel if one of the following holds true: (i) It is incorporated in Israel; (ii) Its business and management are controlled from Israel. (Section 1 – Definitions)

<sup>12</sup> Israel has entered into over 40 tax treaties to date.