

Israeli Taxation of Trusts

The 2005 Reform

S. Friedman & Co. ▶ *The Tax Group*

August 2005

The New Israeli Tax Regime for Trusts: An Introduction

The taxation of trusts under Israeli law remained in a state of flux for many years, which hindered many legitimate transactions on the one hand, while encouraging aggressive “last minute” tax planning on the other hand.

As part of Amendment no. 147 to the Income Tax Ordinance, that became binding law in July 2005, a new chapter was added, governing the taxation of trusts. The new provisions are meant to form an exclusive regime for the taxation of trusts of all kinds (Israeli and foreign, revocable and irrevocable, *inter vivos*, testamentary, and those created by a will).

To help grantors, trustees and beneficiaries align their structures and activities with the new tax rules, we present below the main features of the new tax regime and their possible implications.

Trust Types

| Grantors \ Beneficiaries | Israeli | Mixed | Foreign |
|--------------------------|-----------------------------|-----------------------------|-----------------------|
| Israeli | Israeli Residents Trust | Israeli Residents Trust | Foreign Grantor Trust |
| Mixed | Israeli Residents Trust | Israeli Residents Trust | Foreign Grantor Trust |
| Foreign | Foreign Beneficiaries Trust | Foreign Beneficiaries Trust | Foreign Grantor Trust |

Israeli Residents Trust

A trust (whether revocable or irrevocable) in which at least one grantor and at least one beneficiary is an Israeli resident. This is also the default category and applies to any trust that cannot be positively categorized into one of the other categories.

Taxation of an Israeli Residents Trust is based on the grantor: the assets and income of the trust are treated as belonging to the grantor, and taxed accordingly. The transfer of assets to the trust is not a taxable event for Israeli tax purposes, and the distribution of assets and income from the trust to the beneficiaries is treated as if the same were transferred directly by the grantor to the beneficiaries.

Note that the trust maintains its status even upon a subsequent immigration of the grantor outside of Israel. In these circumstances the provisions of section 100A of the Income Tax Ordinance (the “Exit Tax”) would not apply either.

Foreign Grantor Trust

A trust (whether revocable or irrevocable) in which all grantors are foreign residents.

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Taxation of a Foreign Grantor Trust is based on the grantor: the assets and income of the trust are treated as belonging to the grantor, and taxed accordingly.

Foreign Beneficiaries Trust

An irrevocable trust in which at least one grantor is Israeli and all beneficiaries are known and foreign residents. The trust terms should expressly prohibit the addition of Israeli beneficiaries, and the trustee should file a deposition attesting that the above conditions (including the irrevocability of the trust as per the law's provisions – see below) are met.

Taxation of a Foreign Beneficiaries Trust is based on the beneficiaries: the assets and income of the trust are treated as belonging to the beneficiaries, and taxed accordingly. The transfer of assets to the trust is a taxable event for Israeli tax purposes if it were taxable upon a transfer by the grantor directly to the beneficiaries.

Common Definitions

“Grantor”

Any person transferring assets to the trust, as well as (a) a major shareholder in a company transferring assets to a trust; (b) any shareholder in a company transferring assets to a trust, if he (or his relative) is a beneficiary of such trust; (c) the beneficiary of a trust to which another trust has transferred assets upon the death of the original grantors, or a beneficiary in a trust in which the identity of the beneficiaries has changed without authority in the trust documents; (d) the beneficiary in a trust, if he has ability to control or influence the management of the trust, the replacement of trustee or the distribution of funds from the trust; (e) the Israeli beneficiary, in case where the asset transferred to the trust by a foreign grantor originated from said beneficiary (or her Israeli relative).

“Beneficiary”

A person entitled to benefit from the trust's assets or income, including entitlement which is subject to a condition; an unborn beneficiary; and the holder of a means of control (rights in equity, liquidation, management etc.) in a corporate beneficiary which is not a tax-exempt organization.

“Revocable Trust”

A trust in which (a) the trust is revocable and the assets can be returned to the grantor, its spouse or estate or

an affiliated entity; (b) the grantor (or its spouse) is a beneficiary in the trust, or can become one; (c) one of the beneficiaries is the grantor's child under 18 years of age, or there exists a possibility to transfer income and/or assets to the child from the trust; (d) one of the beneficiaries is a corporate entity (other than a tax-exempt institution) affiliated (10%+) with the grantor; (e) the trustee or protector is the grantor or a relative of his; (f) the grantor can control or influence the management of the trust, the replacement of trustee, the identity of the beneficiaries or the distribution of funds from the trust; (g) the identity of one or more beneficiaries is unknown; (h) the trust's beneficiaries have been changed without authority in the trust documents; or (i) no deposition was made as required for the trust to qualify as an Irrevocable Trust.

Additional Provisions of Interest

A company transferring assets to a trust for no consideration is considered to have distributed these assets to its individual (direct or indirect) shareholders as a dividend. Consequently, the company shall be liable to tax on any built-in gain, while the individual shareholders shall be subject to dividend tax on the fair market value of the asset.

Despite the fact that the new regime taxes trusts based on the residence of the grantors or beneficiaries, the trusts will be taxed as a separate tax unit, and cannot offset losses of the grantors or beneficiaries, as applicable, against their income, nor can the grantors/beneficiaries offset the trust's losses against their own income.

Special provisions govern the termination of a trust and the ability of grantors and/or beneficiaries to utilize any losses accumulated therein.

Reporting Requirements

Section 131 of the Ordinance has been amended to provide that the following persons are required to file an annual tax return:

■ A grantor who created a trust during the tax year in question or transferred assets or income to a trust is required to file a tax return and detail therein the identity of the trustee and protector of such trust, the identity and residence of the beneficiaries, and the assets transferred to the trust.

■ A **trustee** in a trust created by an Israeli resident or a trustee deriving income from, or holding assets in, Israel (whether or not such trustee is an Israeli resident) is required to file a tax return and detail therein the identity of the grantor, beneficiaries and any distributions made to them of assets or income.

■ A **beneficiary** receiving distributions from a trust, whether or not such distribution is subject to tax in Israel is required to file a tax return and detail therein the assets or income received.

Transitory Rules for Existing Trusts

The new provisions apply to existing trusts; however they pertain only to income derived after **January 1, 2006**. Israeli grantors are required to report, as part of their 2006 annual tax return, the details of any trust created by them in past.

Making Sense of It All: The Practical Implications of the New Regime

The effects of the new regime will be most strongly felt by Israeli residents who formed discretionary irrevocable trusts outside of Israel in the past. Prior to the introduction of the new regime, such trusts were commonly considered to be outside the Israeli tax net.

The new regime introduces both reporting requirements and current tax liabilities on these trusts. We recommend to the Israeli grantors in such trusts to review the viability of the structures under the new rules. In some cases, an outright gift of the assets to the ultimate beneficiaries may produce better overall tax results than a trust.

Foreign Grantor Trusts and Foreign Beneficiaries Trusts remain in principle outside the scope of Israeli taxation. Nevertheless, as noted above, certain features of the trust structure may cause an Israeli beneficiary to be considered a grantor of the trust, so that the trust may inadvertently fall within the Israeli Residents Trust category. We therefore recommend that the trust documents be reviewed, and amended if needed, to ensure that the trust in question complies with the requirements of the category to which it is intended to belong.

Lastly, the new regime imposes reporting and tax payment obligations on trustees – both Israeli and

foreign. While the legality and effectiveness of such extra-territorial provisions may be questionable, foreign trustees acting for Israeli grantors or beneficiaries are advised to seek concrete advice regarding their reporting and tax withholding obligations.

The tax group of S. Friedman & Co. will be happy to assist you and advise on the specific implications of the new tax regime for trusts to your specific circumstances. For further details, please contact Dr. Doron Herman (doronh@friedman.co.il) or Adv. Doron Schweppe (dorons@friedman.co.il).

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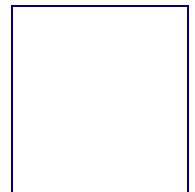
S. Friedman & Co.'s Tax Group provides its clients with creative solutions to savings in tax costs with respect to their business operations, especially in cases involving dominant international considerations. The Tax Group combines broad experience gathered through many years of work with a large number of clients, thorough knowledge of the Israeli tax system and the tax systems of the United States and European countries, and good working relations with the Israeli tax authorities and foreign correspondents. All of these enable the Group to render its clients tax-planning advice that is comprehensive, efficient and directly related to their business needs, including:

- Tax planning for foreign operations of Israeli companies, the establishment of foreign subsidiaries, regional support and marketing centers, the location of intellectual property, transfer pricing and lowering the effective tax rates on cash flows among group members;
- Tax planning for foreign investments of Israeli companies in business assets, real estate and securities;
- Tax planning for Israeli individuals investing in securities and real estate abroad;
- Tax planning for foreign companies investing in Israel, including M&A planning, the establishment of local subsidiaries and the implementation of transfer pricing strategies in intra-group agreements;
- Tax planning for Israeli companies, including the use of financial instruments to optimize their corporate tax results;
- Tax advise on Israeli mergers, spin-offs and reorganizations;
- Tax planning for real estate, the taxation of real estate appreciation and local and municipal taxation;
- Representation before the Israeli tax authorities, appeals for pre-rulings and tax litigation.

The Tax Group has advised many technology companies on their international tax matters and routinely advises other major Israeli companies with international operations in the shipping, construction and manufacturing industries on international tax issues related to their operations, ESOPs and M&A activities.

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