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Israeli Tax Authority Issues Circular on Taxation of Trusts, Including New Rules and Clarifications, but Many Questions Remain

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The Israeli Tax Authority (the “ITA”) has recently published a circular (the “Circular”) which sets forth in detail the ITA’s interpretation of Israeli tax law regarding the taxation of trusts, settlors and beneficiaries. Although the Circular does not carry the force of law, as an expression of the ITA’s position and interpretation of the law, the Circular is very important, especially given that the trust taxation law is relatively new, case law in this field is almost nonexistent and market practice is still developing. In this client alert, we have focused on the most significant changes and new positions expressed by the ITA, and we have also highlighted some of the issues raised by the Circular or that the Circular has failed to sufficiently resolve.

Background

While the institution of a “trust” has been legally recognized for hundreds of years, Israeli taxation of trusts was enacted only in 2006. On August 10, 2005, amendment 147 to the Income Tax Ordinance (New Version), 5721-1961 (the “ITO”) added a new chapter addressing for the first time in a structured manner the income taxation of trusts, beginning with the settlement of a trust, through the taxation of the income during the life of the trust, and to the treatment of distributions of trust income and assets to the beneficiaries. Amendment 147 was effective from January 1, 2006.

On June 11, 2008, Amendment 165 to the ITO supplemented Amendment 147 and added provisions regarding reporting requirements, notices, declarations, and other compliance issues regarding trusts.

On August 1, 2013, Amendment 197 was enacted. This amendment added and expanded certain reporting requirements, broadened the tax base for taxation of trusts, and effectively terminated certain tax strategies. In most instances, Amendment 197 is effective starting January 1, 2014, but its provisions are in most cases applicable also to previously formed trusts and some provisions were made applicable as of August 1, 2013. The most dramatic change in Amendment 197 relates to the changes in the status of a Foreign Settlor Trust. Previously, such a trust was exempt from Israeli income tax on income from sources outside Israel as long as the settlor remained a nonresident of Israel. In fact, the exemption extended beyond the settlor's death if he/she died a nonresident of Israel. Amendment 197 eliminated this exemption and changed the status of a Foreign Settlor Trust, replacing it by one of the following types of trusts: a Relatives Trust, an Israeli Resident Beneficiary Trust and a Foreign Resident Trust. In addition, Amendment 197 provides that, in certain situations, a trust with an Israeli beneficiary may become an Israeli Resident Trust upon the death of the settlor (and surviving spouse) and will be subject to Israeli tax accordingly.

On August 16, 2016, the Circular was published by the ITA. The Circular's purpose is to explain in detail and clarify the trust tax considerations, including discussion of common situations and special cases. This is the first circular published by the ITA in this area, with the exemption of a technical procedure (which was amended and augmented after amendment 197). Up to its publication, practice in this area was based almost solely on interpretation by practitioners.

The Circular is especially long (55 pages) and cannot be covered in full in a client alert. We have decided to focus this alert on the essential changes and new positions expressed by the ITA in the Circular. We also discuss certain issues that the Circular has failed to sufficiently resolve.

Discussion

1. Relatives Trust

A Relatives Trust is an Israeli Resident Beneficiary Trust (where all of the settlors are foreign residents and at least one beneficiary is an Israeli resident) in which all the Israeli beneficiaries are relatives (a statutorily defined term) of the foreign settlors. The trustee of a Relatives Trust is required to file a notification with the ITA that the trust is a Relatives Trust within 60 days from the date of its establishment or on which it first became a Relatives Trust. This notification should also include an election of the tax track (the "Distribution Track" or the "Allocated Income Track")

which will determine the Israeli tax rate that will be imposed on the trust's foreign source income and the timing of its taxation. The default track, if no choice is made, is the Distributions Track.

Under the Distributions Track, an Israeli resident beneficiary will be taxed at a rate of 30% on foreign source income if and when such income is distributed. On the other hand, under the Allocated Income Track, an Israeli resident beneficiary will be subject to tax at a rate of 25% on his/her allocable share of foreign source income in the year it is earned and not when it is distributed.

The Circular includes a few important clarifications and determinations regarding Relatives Trusts:

Late Notice. The Circular clarifies that a late notice to the ITA regarding a Relatives Trust does not necessarily preclude the trust from qualifying as a Relatives Trust. Notwithstanding, the Circular does not address the question of whether a trust can elect the Allocated Income Track in a late notice, and absent any explicit allowance in the Circular, it would appear that such election would not be available if made in a late notice. In our opinion, it would seem that such an election, even in the case of a late notice, should be allowed.

Foreign Tax Credit. The Circular clarifies that a credit for foreign taxes paid with respect to the trust's foreign source income may be available in either the Distribution Track or the Allocated Income Track. Furthermore, the Circular clarifies that foreign taxes may be creditable in Israel against the trustee's tax liability, even if such foreign taxes were not paid by the trustee (e.g., if paid by the settlor). The Circular does not, however, clarify how the credit should be calculated. In the Allocated Income Track the calculation is simple, since the allocated income is reported and taxed annually (in the year it is derived by the trust regardless of when distributed). On the other hand, in the Distributions Track there could be a situation in which there were no distributions for many years, yet, during such years foreign taxes were paid on the trust's foreign source income. Then, upon distribution, it will be necessary to allocate the foreign taxes previously paid (potentially many years earlier) to the income that is distributed to the Israeli beneficiary. We believe there should not be any limitation in amount or timing with respect to allowing such credit.

Taxation of Distributions also in the Allocated Income Track. Generally, once the tax is paid on the allocated trust income, the distribution of such income to the Israeli beneficiary is exempt from taxation in Israel. It was not entirely clear, however, what the tax consequences would be if a beneficiary were to receive a distribution in excess of the income that was allocated to him. The Circular provides that in such case the excess amount would be subject to a 30% tax, unless the trustee can establish that the distribution is a distribution of trust principal and not income. In the case of discretionary trusts (*i.e.*, where the time and amount of

distributions to the beneficiaries are at the sole discretion of the trustee), income may not be specifically allocable to beneficiaries on a current basis, as the trustee cannot determine the allocation of the income when the tax return is filed. In such case, the future distributions will be taxed at a rate of 30%. Unfortunately, the Circular does not provide any guidance to the opposite situation, where the income allocated to a beneficiary is taxed at 25% on a current basis, but when the allocated income is distributed, it is distributed to another beneficiary (for example, to a foreign resident). We believe that in such case a refund for the Israeli tax paid should be allowed, even if the distribution takes place years after the year in which the income was included and the tax thereon was paid.

Distribution of Income that was Derived Prior to January 1, 2014. It is important to emphasize that until January 1, 2014, foreign source income of a Relatives Trust was exempt from tax in Israel, for so long as the trust qualified as a “Foreign Settlor Trust”. The question arises, how should the distribution of such pre-2014 income be taxed? In that regard, the Circular includes some controversial statements. With respect to trusts in the Distributions Track, the Circular does not discuss this issue but does provide an ordering rule that income derived after January 1, 2014 shall be deemed to be distributed first. With respect to trusts in the Allocated Income Track, the Circular states that pre-2014 income shall be taxed at a rate of 30%, unless the trust has participated in the transitional arrangements published by the ITA in February 2014. This is a controversial statement that has no support in the statutory language. The transitional arrangements were voluntary arrangements that allowed certain trusts to voluntarily disclose and settle their status with the ITA. A trust that was fully compliant with all of the ITO’s requirements had no reason to participate in these arrangements. In our opinion, this statement by the ITA discriminates between taxpayers and constitutes invalid retroactive application of Amendment 197 to pre-2014 income, as this income, including its distribution, was tax exempt and the ITA has no authority to tax it retroactively.

Distributions from a Trust that Ceases to be Relatives Trust. Amendment 197 added a draconian provision that states that a trust with Israeli beneficiaries will cease to be a Relatives Trust upon the death of the settlor and the settlor’s spouse and the trust will then become an Israeli Resident Trust and thus fully taxable. The consequence is that a trust settled by a foreign settlor and which has numerous foreign beneficiaries could be subject to Israeli tax on *all* of its worldwide income from the date of the death of its settlor (and the settlor’s spouse), and not on just the portion allocable to the Israeli beneficiaries. This raises the question as to how distributions of income that was derived prior to the change in the tax status of the trust should be taxed. The Circular clarifies that the preferential regime that was applicable to such income will continue to apply with respect to the distribution of such income.

2. Foreign Resident Trust

A trust will be treated as a Foreign Resident Trust if all the settlors and all the beneficiaries are foreign residents, and there were no Israeli beneficiaries at any time since the trust was established. The Circular provides several important points of note:

Relaxation Rule for Pre-2003 Beneficiaries. The Circular provides a relaxation rule and clarifies that in cases in which the trust had an Israeli resident beneficiary, who died or ceased to be an Israeli resident prior to 2003, the trust will continue to be treated as a Foreign Resident Trust, assuming all other requirements are satisfied. It appears that the ITA chose 2003 since prior to such time, Israeli taxes were generally imposed only on a territorial basis. Nevertheless, the choice of 2003 is perplexing.

Prior to Amendment 197, a trust that had only foreign settlors was classified as a Foreign Settlor Trust (even if it had Israeli beneficiaries) and was not subject to Israeli tax on its foreign source income. Therefore, it would have been appropriate for this relaxation rule to provide that such trust can continue to be taxed as a Foreign Resident Trust if any Israeli resident beneficiaries ceased to be resident of Israel prior to December 31, 2013. It is important to note, however, that this relaxation rule proposed by the ITA is more lenient than the statutory requirement that denies the Foreign Resident Trust status if the trust had any Israeli beneficiary from the date of its settlement. In our opinion, in situations where it can be demonstrated that there was no intention to effect any inappropriate tax planning, it should be possible to request from the ITA a ruling that will allow the trust to continue to be treated as a Foreign Resident Trust even if the beneficiary ceased to be an Israeli resident after 2003.

Exclusion of Beneficiaries or Modifications of a Trust. The Circular emphasizes that if a trust has an Israeli beneficiary who ceases to be a beneficiary due to a modification of the trust documents, the trust will, nevertheless be treated as an Israeli Resident Trust, and not a Foreign Resident Trust. The Circular further clarifies that even if all of the assets of such trust are transferred to a newly formed trust of which there are no Israeli beneficiaries, and the absence of Israeli beneficiaries is the primary difference between the two trusts, the new trust will still be classified as an Israeli Resident Trust. We believe, however, that this interpretation is overly broad and is not supported by current law. It appears that the ITA is reacting to its experience with modifications to trusts that were made in order to ensure that the trust remained a Foreign Resident Trust in situations where the changes were not made for legitimate purposes.

Nevertheless, the ITA's assessing officers have sufficient authority within other applicable sections of the ITO to combat inappropriate tax planning that a broad interpretation of this provision by the Circular is not necessary. For example, the ITO states that persons can be treated as beneficiaries if they will become a beneficiary upon the satisfaction of certain conditions or at a certain date and even someone who is not a defined as a "beneficiary" but who, in fact, receives distributions from the trust through another beneficiary who serves as a conduit can also be

viewed as a beneficiary.

Lack of Discussion Regarding a Foreign Resident Trust that “Severs” Residency. The ITO includes provisions regarding an Israeli Resident Trust that ceases to be treated as resident of Israel and applies to its assets the Israeli “exit tax” as if the trust had sold all of its assets upon expatriation.

Naturally, such a trust could have Israeli beneficiaries. The Circular does not address this situation. In our opinion, it would have been appropriate for the Circular to clarify that a trust that expatriates and no longer has any Israeli settlors or beneficiaries should be treated as Foreign Resident Trust, even if the trust previously had Israeli beneficiaries.

3. Foreign Resident Beneficiary Trust

The main purpose of a Foreign Resident Beneficiary Trust is to allow an Israeli resident to settle a trust for the benefit of foreign beneficiaries under favorable terms. Accordingly, income from sources outside Israel will be exempt from tax in Israel. The ITO provides certain restrictions in order to avoid abuse of those tax benefits: the trust must be irrevocable; all of the beneficiaries of the trust must be foreign residents; and the trust documents must specifically state that an Israeli resident beneficiary cannot be added to the trust. In addition, there is an annual requirement that the trustee must certify that all these conditions are met and that the trust does not have any Israeli beneficiaries.

The Circular states that the reporting requirement is a material condition, and without it the trust cannot be classified as a Foreign Resident Beneficiary Trust.

The ITO does not address reporting requirements of a Foreign Resident Beneficiary Trust that is settled by a “benefitted individual,” *i.e.*, a person returning to Israel after an extended stay abroad as a foreign resident or a new resident (*i.e.*, an *oleh chadash*). For the sake of comparison, there is no reporting requirement for an Israeli Resident Trust that is settled by a benefitted individual and all of its beneficiaries are benefitted individuals or foreign residents, so long as the tax benefits period (for both settlor and beneficiaries) has not ended. Neither the ITO nor the Circular addresses the question of whether a Foreign Resident Beneficiary Trust that is settled by a benefitted individual would have a reporting requirement during the tax benefits period. For the sake of comparison, the Circular does provide an important clarification regarding a Trust Holding Company which is part of a trust that enjoys the tax benefits period. The Circular provides that the deadline for the notice to the ITA may be extended until 90 days from the end of the tax benefits period, as long as the Trust Holding Company satisfies all the conditions in order to be classified as a Trust Holding Company and not as a regular company. We believe the same logic should also apply to the reporting requirements of a Foreign Resident Beneficiary Trust during the tax exemption period.

Insofar as there is no published guidance by the ITA on this issue, and in light of the ITA's position that such reporting is a material condition, we recommend that a Foreign Resident Beneficiary Trust within the tax benefits period comply with the reporting requirement on a current basis or apply to the ITA for a tax ruling.

In a separate subject, the Circular clarifies that if the last Israeli resident settlor dies, and the trust consequently becomes a Foreign Resident Trust (since upon death it would have no Israeli settlor and no Israeli beneficiaries), the trustee may apply to the ITA to close the trust's file so that reporting will no longer be required.

4. Beneficiaries Deemed Settlers

In order to avoid abuse of a trust structure, the ITO provides that certain actions or powers, if taken or held by the beneficiaries, can cause the beneficiary to be deemed to be the settlor of the trust, which could result in a change of the classification of the trust. Once the tax exemption granted to a Foreign Settlor Trust was cancelled, the possibility for abuse was significantly narrowed but Amendment 197 did not reduce the situations where a beneficiary might be deemed to be a settlor. The Circular further expands this concept and provides certain examples that, in our opinion, unnecessarily expand the statutory provisions in this matter. Below we discuss a few of them.

Who is a Beneficiary. Generally, the ITO provides that a beneficiary is a person who is entitled to benefit from the assets held by a trustee or to enjoy the income from such assets, directly or indirectly. The ITO also adds that a person who is entitled to become a beneficiary but only when a condition is met, or on a date set in the trust documents, will also be considered a beneficiary; provided that a person whose entitlement is conditioned upon the death of the settlor or another beneficiary shall not be considered a beneficiary so long as such settlor or beneficiary is still alive. The Circular clarifies that "exclusion clauses" will be ignored. For example, a clause that excludes an Israeli resident from being a beneficiary of a trust for as long as such person is resident in Israel, will be deemed as a "condition" and therefore such excluded beneficiary will be viewed as a beneficiary of the trust. Our recommendation, in such cases is that any exclusions used in trust language should be full and not conditional exclusions.

The Protector. The Circular states that an appointment of a protector, after the death of the settlor, shall be viewed as a change of the trustee by the beneficiaries (leading them to be deemed settlers), unless it can be shown that the beneficiaries of the trust did not influence the decision to change the protector. This position has no statutory support and in fact is in stark contrast with reality. The protector normally serves in a supervisory role over the trustee and upon the death of the settlor, it is only normal and reasonable that the beneficiaries should have the right to

choose who the protector should be.

The Settlor. The ITO provides that whenever the beneficiary has the ability to influence the management of the trust or of its assets, to determine the beneficiaries not as a result of the settlor's determination, to appoint or replace trustees or to determine distributions of trust income or capital to the beneficiaries, such beneficiary will be a deemed settlor of the trust. The Circular provides certain examples for cases that may result in treating the beneficiaries of a trust as settlors, and two of the examples are especially problematic: (i) where the trust assets are used to secure a loan taken by one of the beneficiaries and the trust deed does not specifically provide for this situation; (ii) where a beneficiary borrows funds from a trust for a particular number of years, the loan is not made under market terms and the trust deed does not specifically provide for this. The ITA would view the beneficiary as a settlor in these cases. In our opinion, these examples demonstrate actions that provide a benefit to the beneficiary and could be viewed as a deemed distribution from the trust, but should not be considered to demonstrate control over the trust by the beneficiary. Such an approach would impose unreasonable limitations on a trustee's ability to manage the trust for the benefit of the beneficiaries and these examples have no support in the statutory language.

5. Transactions between the Settlor and the Trust

A grant of an asset to a trust is defined by the ITO as a transfer of an asset to a trustee for no consideration. Generally, such grant by an individual is not considered a sale. However, the Circular provides a few situations whereby a transfer of an asset to the trust will be considered a sale for tax purposes. For example, the Circular provides that if a trust has two settlors, and one settlor transfers shares of a company to the trust, and the other settlor transfers cash to the trust, those two transfers will be treated as a sale. Moreover, the Circular provides that the date of the taxable event will be the date on which the assets were transferred to the trust. We believe that this interpretation is overly broad and is not supported by the ITO, which contrarily provides that only the distribution of the assets by the trust to the beneficiaries will be treated as taxable events with respect to the transferred assets. Furthermore, such a provision essentially presumes the occurrence of future events; the ITA assumes that the settlor who transferred the asset will receive the cash and vice versa. In reality, though, there is a reasonable chance that the assets will be distributed to others. This is especially true when the trust is irrevocable and the trustee has full discretion with respect to the distributions of the assets.

6. Grant of Assets from a Company to a Trust

Generally, the ITO provides that a grant of assets from a company to a trust is treated as a sale of the assets by the company, and the assets granted are treated as a deemed dividend (in kind) to the shareholders of

the company. Nevertheless, the ITA apparently understands that there can be circumstances in which a company may need to establish a trust for solely commercial purposes. Therefore, the Circular enables a company to establish a trust and transfer property to such trust without the transfer being treated as a sale and dividend, provided the following conditions are satisfied: (i) the only settlor of the trust is the company; (ii) the settlor/company is the sole beneficiary of the trust; (iii) the trust settlement provides clearly and irrevocably that no other beneficiary may be added; (iv) the settlor/company and the trustee provide notice to the ITA that the trust's income will be attributed to the settlor/company; and (v) a tax ruling is obtained.

While such clarification is welcome, we do not believe it was necessary to impose so many conditions and it would be enough to require that the company be the only beneficiary and that no other beneficiaries could be added. The other conditions unnecessarily complicate the process.

7. Trust Holding Company

The Circular provides a welcome clarification regarding a Trust Holding Company, which is defined in the ITO as a company that was incorporated in Israel or out of Israel that holds the trusts' assets on behalf of the trustee directly or indirectly. Amendment 197 provided the following three additional requirements that must be satisfied in order for a company to qualify as a Trust Holding Company: (i) the trustee owns, directly or indirectly through another company, 100% of the Trust Holding Company's shares; (ii) the company was incorporated only for the purpose of holding the trust's assets; (iii) the company has notified the ITA of its incorporation and classification as a Trust Holding Company within 90 days since the date of incorporation.

The notification requirement, which is a material condition, is not reasonable if the Trust Holding Company is held by a trustee of a Foreign Resident Trust or other trusts that are exempt from reporting obligations, such as trusts in which the settlors and the beneficiaries are new immigrants or returning residents. In such cases, the Circular defers the notification deadline to 90 days after the termination of the exemption period granted to such new immigrant or returning resident, as long as the company had met the other requirements mentioned above during the exemption period.

8. Conclusion and Recommendations

While the Circular does not have the force of law, it does provide a clear indication of the ITA's positions on many issues. It was publicized at a critical point, close to the time when 2015 tax returns must be filed. We recommend that all trustees, settlors and beneficiaries review their

particular circumstances and seek advice from their tax advisors to determine the potential implications of Amendment 197 and the Circular on their specific situation. If necessary, they should consider what modifications or adjustments may be appropriate in order to ensure that the preservation of family wealth is not adversely impacted by unnecessary tax exposure.

Contact Persons:

<u>Eldar Ben-Ruby</u>	<u>Meir Akunis</u>	<u>Shaul Grossman</u>	<u>Keren Shitrit</u>
Partner, Practice Group Leader	Partner	Partner	Partner
03-6103615	03-6103186	03-6103199	03-6103890
<u>E-mail</u>	<u>E-mail</u>	<u>E-mail</u>	<u>E-mail</u>

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Meitar Liguornik Geva Leshem Tal, Law Offices. 16 Abba Hillel Rd. Ramat Gan, Israel, +972-3-6103100
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