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General review of the Revisions to the Israeli Trust Regime Taxation

Introduction

As of January 1st 2014, a significant revision with respect to the taxation regime of trusts in Israel came into effect ("**Revision**"). In this short article we focus on the main changes in the tax regime, which relate mainly to non-Israeli residents and new immigrants. In addition, we also mention shortly the new tax arrangements set out recently in a new circular by the Israeli tax authority.

A short Summary of relevant classifications prior to the Revision

The following is a short summary of the tax aspects of two classifications of trusts in the Israeli tax regime prior to the Revision:

- Israeli Resident Settlor Trust – IRST: In general, if the Settlor (the grantor) of the trust was a resident of Israel, and in addition at least one of the Beneficiaries of the trust was an Israeli resident, the trust would have been classified as an Israeli Resident Settlor Trust. Under such classification, all of the income of the trust would have been classified by default as the Settlor's income. As such, the trust's income would have been reported and taxable in Israel on an annual basis. In general, the trustee of an **IRST** have had a liability to file an annual tax return and report the trust income. These rules still apply also after the Revision.

- Foreign Resident Settlor Trust – FRST: In the event that the trust was formed by a non

resident of Israel, the trust would have been classified as a Foreign Resident Settlor Trust. In such event, the income of the FRST, and the distributions from the trust to the Beneficiaries (even Israeli Beneficiaries) would not have been subject to tax in Israel, provided that such income was not derived from Israeli sources, and the assets were located outside of Israel. Those rules were applied even after the death heaven forbid of the Settlor. Accordingly, the Trustee of a **FRST** did not have an obligation to file tax returns or other reports with the Israeli Tax Authority, unless the income was derived from Israeli sources, and/or the assets were located in Israel.

The New Trust Regime, following the Revision, in a Nutshell

The Revision basically cancels the FRST classification and creates three different new classifications instead:

- Foreign Resident Trust - FRT: The definition of FRT is of a trust in which during the tax year: (1) all its Settlers and Beneficiaries are foreign residents; or (2) a trust in which all Settlers are foreign residents and all Beneficiaries are Beneficiaries for public purposes and there were no Israeli resident Beneficiaries from its establishment day; or (3) a trust in which all of its Settlers have passed away and all the Beneficiaries during the tax year are Beneficiaries for public purposes or foreign residents, and there were no Israeli resident Beneficiaries from its establishment

day. As such, the FRT is considered as foreign resident for Israeli tax purposes and shall not be subject to Israeli taxation. **- Israeli resident Beneficiary Trust – IRBT:** The IRBT is a trust in which all Settlers, from the date of creation, are foreign residents, and during the tax year there is at least one Israeli resident Beneficiary. A public Beneficiary, such as hospitals, universities etc., will not be viewed as an Israeli resident Beneficiary. Please note that upon the death of the Settlers the IRBT shall become classified automatically as **Israeli Resident Settlor Trust – IRST**, with all the implications pertaining thereof.

There are two kinds of IRBT as follows:

Relative Trust - A Relative Trust is an IRBT in which all Settlers and Beneficiaries are bound in close family relations, as defined in the Israeli Tax Ordinance. For example: parents and their children, grandfather and his grandchildren etc. Please note that sibling relationships aren't considered basically as relative relations, without the approval of the tax official.

Classification as a Relative Trust means that the transfer of property from the Settlor to the trust, without receiving any remuneration, will not be considered as sale and rather will be considered as a direct transfer between the Settlor to the Beneficiary.

The income of the trust shall be considered as a foreign resident income and as such will be tax exempt in Israel, except for income sourced in Israel.

However, the distribution of an asset made by the trustee to the Israeli Beneficiary will be subject to either 25% or 30% tax rate in Israel.

25% tax rate shall apply upon the distribution, if the trustee notifies the tax official that the Relative Trust shall be taxed in Israel on an annual basis with respect to the share of the Israel Beneficiary in the trust's annual foreign income. In all the other cases, 30% tax rate shall be imposed upon the distribution, unless the trusty proves that he distributes the principle of the trust fund.

Non Relative Trust - Non Relative Trust is an IRBT trust which does not satisfies the conditions specified for the Relative Trust. Non Relative Trust is considered as Israeli Residents Trust, and therefore the income and the assets of the Trustee will be viewed as the income and assets of an Israeli resident and will be taxed in Israel.

Please note that, in order to be classified as a Relative Trust rather than as a Non Relative Trust, the trusty shall notify and provide the Israeli tax official with specific forms within 60 days from the date the trust become an Israeli resident Beneficiary Trust (IRBT). **The trustees of an IRBT, as of January 1, 2014, should notify the Israeli tax official up to June 30, 2014.**

Implications & Conclusions:

- Following the Revision, a foreign resident who considers making Aliya, or returning to Israel should review, inter alia, the tax aspects of the new trust regime in Israel. For example, Aliya of one of the Beneficiaries in a Foreign Resident Trust to Israel shall reclassify the trust automatically to an Israeli Resident Beneficiary Trust. Also and as mentioned above, the death of the foreign Settlor in such situation shall

reclassify the trust to an Israeli Resident Trust, which shall be taxed as Individual Israeli resident. Another point to be aware of is that in accordance with the Revision, in a case of an Aliya of the Settlor to Israel, the 10 years tax exemption period in Israel shall apply only if there is no Israeli resident as a Beneficiary of such trust. As such, Trustees, Settlers, and Beneficiaries, who were part of a Foreign Resident Trust (such a Living Trust in the US), should analyze the impact of the Revision on their specific situation.

- Another issue of concern, is with regards to foreign funds accumulated in a Foreign Resident Settlor Trust (FRST), prior to the Revision (January 1, 2014), and following the Revision the FRST becomes an Israeli Resident Beneficiary Trust (IRBT). In such case, the question remains whether such funds will receive a step up basis with regards to distributions made to an Israeli resident Beneficiary following the Revision. If a step up is not in place, than there might be some situations in which the foreign tax exempt income produced prior to the Revision, would now be taxable, either upon of distribution to the Israeli resident Beneficiary or even before.

- The Israeli Tax Authority has published on March 9th 2014, a circular of which title is: **Transitional Arrangements for Israeli Resident Beneficiary Trusts ("Circular")**. In general, the circular points out four different arrangements to achieve certainty regarding the tax consequences of trusts, which transformed from a Foreign Resident Settlor Trust into an Israeli Resident Beneficiary Trust following the Revision, in particular with respect to the step

up basis issue in Relative Trusts. The circular mainly focuses on the degree of influence of the Beneficiary on the trust, as following:

- 1) In cases when the tax official will be persuaded that no influence whatsoever was in place between the Settlor and the Beneficiary, a step up basis will be given to the trust assets as for December 31, 2013, without any additional tax payment.
- 2) In all the other cases the step up basis will be given subject to additional payment of taxation. The tax amount will be determined by the tax official in accordance with the scope of the influence of the Israeli Beneficiaries, as following: (a) 33% of the Trust income's from 2006 or 3% from the trust funds (b) 50% of the Trust income's from 2006 or 4% from the trust funds (c) 66% of the Trust income's from 2006 or 6% from the trust funds.

The circular further provides that in order to be entitled to apply for the arrangement; the application should be filed to the tax official until December 31, 2014.

- As mentioned above, generally the Foreign Resident Settlor Trust (FRST) did not have any reporting obligations to Israel if its income and assets were of Non-Israeli Source. Currently and after the Revision this situation has changed as both the Relative Trust and not Relative Trust have reporting obligations on income and distributions to Israeli resident Beneficiaries. **To conclude**, it is recommended to analyze one's situation in cases where a Foreign Resident Settlor Trust (FRST) was in place prior to the Revision. It is also recommended to perform an analysis prior to any immigration to Israel in

which the immigrant has relations to a trust. In relevant cases, the tax arrangements provided in the Circular should be taken into consideration. A proper analysis can avoid situations of double taxation and overpayment of tax.

This publication provides general information only and does not have a pretention to be a full and complete guide to the Israeli tax regime and/or to the Revision and/or the Circular. As such, it should not be used or taken as legal advice for specific situations, that depend on the evaluation of precise factual circumstances. For further information please contact us by e-mail: Meori@ampeli-tax.co.il, or by phone: 972-3-5420100. We will be happy to be of service to you with these matters.

Sincerely,
Meori Ampeli, ADV. (CPA)