



## FEATURE: INTERNATIONAL PRACTICE

By **Alon Kaplan**, **Lyat Eyal** & **Daniel Paserman**

# Israel Taxation of Trusts

Help your clients accommodate their estate plans to these rules

**T**rusts historically have been recognized in Israel prior to the foundation of Israel as a state. During the British Mandate and after the founding of the state, trusts were used mainly for real property transactions. Following the founding of the State of Israel in 1948, waves of immigrants flowed there from different countries, bringing with them not only goods, but also a myriad of cultures and the use of trusts based on various legal systems abroad.

Legislation favoring immigration to Israel encouraged Jewish families and Israelis living abroad to move their residences to Israel. Such changes require adequate planning for estate and tax purposes both in Israel and in the country of origin.

Between 1948 and 1998, Israeli legislation had a regime of exchange control regulations for Israeli residents. New immigrants weren't subject to the same limitations on investments in foreign currency as Israeli residents. During those years, the use of foreign trusts was preferable for new immigrants. New immigrants from countries with unstable political regimes preferred the use of trust structures in jurisdictions such as Liechtenstein for relative confidentiality. They tended to settle trusts under the laws of the jurisdictions of origin for estate-planning purposes.

Modern Israeli legislation governs trusts, as well as continental trusts (such as Liechtenstein or Panama

foundations or establishments) settled under the laws of foreign jurisdictions. This legislation includes the Trust Law 1979, the Income Tax Ordinance [New Version], 1961-5721 (the ITO), the Succession Law 1965, the Real Property Taxation Law 1963 and the Law of Agency 1965.

Today, the Israel Tax Authority (ITA) has a separate department responsible for trusts, reporting and tax payments by trustees.

### Recognition of Trusts in Tax Law

According to the ITO, a trust is defined for Israeli tax purposes as an arrangement by which a trustee holds assets for the benefit of a beneficiary, whether carried out in Israel or abroad, either defined by statutes applicable to it as a trusteeship or as defined in some other manner.

In this respect, the ITO defines a trustee as a person who's transferred assets or income to a trust or one who personally holds assets in trust. The definition of a trustee also pertains to a corporation specified in Annex A of the ITO, which includes:

1. A foundation according to the laws of the Netherlands, Liechtenstein, Panama, the Bahamas or the Dutch Antilles;
2. An establishment according to the laws of Liechtenstein;
3. A trust regulation according to the laws of Liechtenstein.

In practice, the ITA may accept corporate trustees and similar structures settled under other jurisdictions, but there's no certainty that they'll indeed do so. Recently, the ITA published a tax ruling that dealt with the taxation and repercussions of an establishment incorporated under the laws of Liechtenstein. The

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a settlor who was an Israeli tax resident on the date he passed away).

An FRBT is considered and treated as a foreign resident for tax purposes. As such, it's liable to taxation in Israel only in respect of a source of income within Israel (subject to certain exemptions and relief provided to foreign tax residents under the ITO or any applicable tax treaty). If the assets and the income derived therefrom are derived from sources outside Israel, there's no taxation in Israel.

Contributions are liable to taxation, as in the case of an asset transferred directly from the settlor to the foreign resident beneficiary.

Distributions aren't liable to taxation in Israel.

**Testamentary trust.** A trust is considered a testamentary trust if it's settled under an individual's last will and testament, and all the settlors were Israeli residents at the time of their demise.

The testamentary trust is categorized for tax purposes as an IRT or an FRBT, depending on the residency of the beneficiaries.

If there's at least one Israeli beneficiary, the trust is considered an IRT and is subject to tax and reporting in Israel on a worldwide basis.

Otherwise, the trust is considered an FRBT and a foreign resident for tax purposes. As such, it's liable to tax in Israel only in respect of a source of income within Israel (subject to certain exemptions and relief provided to foreign tax residents).

Neither contributions nor distributions are considered a sale under the ITO and are thus not liable to taxation in Israel.

### Trust Holding Company

The requirements for the classification of a company as a Trust Holding Company (THC) are: (1) the company was incorporated only for the purpose of holding trust assets; (2) in the case of a company holding assets of an IRT, an IRBT, a testamentary trust that has Israeli beneficiaries and any other trust that has assets in Israel, the company has notified the ITA of its incorporation and classification as a THC; and (3) the trustee holds all the shares of the THC, directly or indirectly.

The assets of a THC are considered assets of the trustee, and its income is considered the trustee's income. The company is a flow-through entity for tax purposes, meaning that the THC isn't considered an

Israeli resident for tax purposes and isn't liable to taxation and reporting in Israel. A THC isn't entitled to the benefits of the tax treaties to which Israel is a party.

### New and Returning Residents

According to the ITO, an individual who became an Israeli tax resident after 2007, whether for the first time or after spending considerable periods of time outside of Israel as a foreign tax resident, may be entitled to various material tax benefits. For example, new immigrants and veteran returning residents are entitled to an exemption from the payment of taxes on all forms of income, active or passive, including capital gains, derived from sources outside of Israel for a period of 10 years.

These benefits shall also apply to an IRT if: (1) the settlor became a new immigrant or a returning veteran resident or a returning resident; and (2) all the beneficiaries are new immigrants and/or returning veteran residents and/or foreign residents.

The same benefits shall also apply to a relatives trust if one beneficiary in the trust became a new immigrant, a returning veteran resident or a returning resident. In that case, the benefits shall apply according to the beneficiary's share.

### Non-tax Issues

The use of trusts in Israel over the past few years is becoming increasingly frequent in non-tax issues, such as succession planning, inter-generational transfers, asset protection or philanthropic purposes.

In principle, from an Israeli taxation perspective, as of today, there are no particular tax advantages or disadvantages in the settlement of a trust. This is due, principally, to the fact that trusts that have Israeli resident settlors and/or beneficiaries are generally subject to Israeli taxation and reporting obligations, irrespective of the jurisdiction where they're settled.

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### Endnotes

1. Income Tax Ordinance—Article 75c (Taxation Decision No. 6893/15). Taxes, 29/2 c-19.
2. Income Tax Ordinance Amendment (No. 147) Law 5765-2005.
3. *Ibid.*
4. Income Tax Ordinance—Article 75D.
5. Income Tax Ordinance—Article 75H(b).