

# **STEP JOURNAL**

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**Trust Quarterly Review**

## **Israel's trust revolution**

A brief history of the taxation of trusts in Israel

## Abstract

- The Israeli tax system and trust regime have undergone significant amendments over the past decade.
- In 2003, the tax system was revised from a system based on territorial taxation. The amendments did not include the introduction of a taxation regime for trusts.
- In September 2003, the Yisraeli Committee submitted the first-ever recommendation for a full trust taxation regime in Israel.
- In March 2005, the Kapota-Matza Committee adopted most of the Yisraeli Committee recommendations, with a few changes aimed at simplifying the regime.
- On 10 August 2006, the trust taxation legislation came into effect, retroactive from 1 January 2006.
- The most recent reforms took effect on 1 August 2013 and 1 January 2014, and expanded the tax net to encompass trusts settled by foreign residents in favour of Israeli residents.

The Israeli tax system was completely revised in 2003. On 12 June 2002, the recommendations of the Public Commission on Tax Reform, headed by Yair Rabinovich, were published. In July of that year, the Tax Reform Bill (Amendment No.132 to the Income Tax Ordinance) passed its second and third readings in the Knesset (the Israeli Parliament), and, on 1 January 2003, the tax reform came into effect. The institution of trusts was not addressed in the reform, although, during those years, this institution was an accepted and widely used tool for holding assets and investing abroad.

One of the principal aspects of the tax reform was the transition from the territorial system, which was customary in Israel until that time, to the personal (worldwide) taxation system for earned income produced by an Israeli resident (capital income had been taxed under the personal system even prior to the reform). In order to address future aggressive tax-planning systems, countermeasures were put in place that were intended to tax the income earned through foreign companies controlled by Israeli residents: passive income (from controlled foreign companies) or active income from carrying out an occupation (foreign operating companies).

The Rabinovich Commission decided that, because of the scope and complexity of the issue of trusts, there was insufficient time to consider the matter. Nonetheless, the Commission recommended that the trust arrangements customary in Israel and in foreign countries be examined, and, where necessary, provisions be enacted under primary legislation for the taxation of trusts.[1](#)

## The Yisraeli Committee on Taxation of Trusts

On 2 September 2002, the then Income Tax Commissioner appointed a committee, headed by Deputy Commissioner Frieda Yisraeli, which was tasked with examining trust law as implemented in Israel and other countries, including the practices customary in each, and with making recommendations in the

following areas:

- Determination of taxation arrangements for trusts (with emphasis on trusts created under the laws of foreign countries).
- Determination of reporting arrangements in respect of the various persons involved in trusts (settlor, trustee and beneficiary).

The Commissioner stated the recommendations could include proposals to amend primary and secondary legislation. She also instructed the committee to receive advice from experts in the area of trusts,<sup>2</sup> not members of the committee. The committee was composed of representatives of the Income Tax Commission, the State Revenue Authority and representatives of the private sector.

A number of experts (some from outside Israel) appeared before the committee, presenting their viewpoints and helping the committee understand foreign tax systems and how they deal with special issues.

The main principles guiding the committee in formulating its recommendations were: the need to achieve tax neutrality, enforcement ability, a desire to encourage the import of capital and immigrant absorption, and the removal of obstacles to the appointment of Israeli residents as trustees.<sup>3</sup>

The committee presented its recommendations on 24 July 2003, and they were accepted by the Commissioner. The Tax Authority began work on the necessary legislative changes, but the law was not amended at that time.

## **The Kapota-Matza Committee on the Multi-Year Tax Plan**

In March 2005, a joint committee of the State Revenue Authority and the Israel Tax Authority began to formulate a multi-year plan to continue the reforms in the tax system. Among the committee's recommendations was advancing legislation for the taxation of trusts. The principle recommendation was to tax trusts in line with the Yisraeli Committee's recommendations, but with modifications designed to simplify the arrangements. The main change was that the tax outcome should be based on the place of residence of the settlor of the trust, rather than the place of residence of the beneficiary. In addition, the committee recommended that the trust's assets and income be viewed as the assets and income of the settlor. At the same time, the trustee (whether an Israeli resident or an overseas resident) would be the individual (or body) liable for tax and subject to assessment for the trust's income. The trustee would be required to file annual returns to the Tax Authority and to pay the taxes accordingly.<sup>4</sup>

## **Legislation: Amendment No.147 to the Income Tax Ordinance**

On 10 August 2006, the Income Tax Ordinance was amended (Amendment No.147). Among the various clauses in this comprehensive tax reform were those relating to the taxation of trusts. The law set out four types of trusts for taxation:

- the Israeli resident's trust
- the foreign settlor trust
- the foreign beneficiary trust, and
- the testamentary trust.

For each type of trust, a tax framework was set up, as well as provisions for change in the categorisation of a trust. Particular attention was given to trusts whose settlor or beneficiary was a new immigrant or a returning resident.

In respect of taxable income, with emphasis on the Israeli resident's trust, it was decided that the trust's income would be subject to the highest individual tax rate; however, for types of income that attracted a concessionary tax rate when received by an individual (e.g. income from interest, capital gains and dividends), the reduced tax rates applying to the individual's income would also apply. No personal relief or exemptions would be given if these were subject to a maximum or minimum sum.<sup>5</sup>

Where the settlor of the trust was a foreign resident, the trustee would not be liable for tax on the income of the trust produced or derived abroad, or for income produced or

derived in Israel, for which a foreign resident is exempt from tax. Following the death of the settlor, there would be no change in the status of the trust: the income would be attributed to the settlor's estate, and would continue to be liable for tax in the name of the trustee, should there be any tax liability in Israel.<sup>5</sup>

It was further decided that the settlor would be guarantor for the trustee's tax debts. Transfer of assets by an individual to the trust would not be deemed a tax event, while the transfer of assets by a corporate entity, under certain circumstances, would be liable for tax, and would be viewed as a dividend distributed to shareholders.<sup>5</sup>

In order to encourage the appointment of Israeli residents as trustees, it was decided that the tax liability for the income of the trust would not be affected by the identity or residence status of the trustee, and that a trustee may hold the assets of the trust through a 'trust holding company', without this having an effect on the tax liability of the trust's income.<sup>5</sup>

## **Reporting on trust arrangements following the legislation**

Following the passage of the reform legislation, it became necessary to report on trusts formed prior to 1 January 2006. In addition, forms needed to be drafted for reporting on the activities of trusts. On a number of occasions the Tax Authority postponed the due dates for filing the annual returns and applications for 'old' trusts. Finally, on 23 June 2008, the Tax Authority issued a notice providing that the forms – including the notices, declarations and reports to be filed with the Tax Authority in respect of the activity of trusts and assets held by trusts – had been uploaded and made available on the Authority's website. Publication of the forms was made possible with the publication in the Official Gazette (Reshumot) of Amendment No.165 to the Income Tax Ordinance, which completed the

provisions of the trusts chapter in the Ordinance. In this amendment to the law, certain reporting obligations were cancelled, and replaced by requirements to simply file notices.[6](#)

On the same day, the Tax Authority distributed to local tax offices, and to chartered accountant and tax advisor organisations, an outline tax agreement, formulated by the Tax Authority, which would be a voluntary arrangement in respect of the income of trusts formed prior to 1 January 2006.

The proposed arrangement allowed the trustee of an irrevocable trust, established before that date, to pay the tax rate set out in the proposed arrangement – 4, 6 or 10 per cent of the value of the trust's assets as at 31 December 2005 (described in the arrangement as the 'trust's capital'), and thus settle the tax liability for any trust income produced to that date. In addition, the value of the trust's assets on 31 December 2005, as determined for the purpose of application of the arrangement, would serve as a new original price, so that, upon sale of those assets from tax year 2006 onwards, only the increase in value from 1 January 2006 onward would be taxed.[7](#)

Following further postponements, 31 December 2009 was set as the final date for filing annual returns for 2006–2008, and the final date for submitting an application to regularise trusts set up prior to 1 January 2006.[8](#)

## **Attribution regulations**

On 23 June 2008, two new regulations were published on the subject of trusts:

- Income Tax Regulations (Provisions for Amending Assessment of the Income of a Trustee and Determination of a Capital Gain to It Following a Distribution to a Foreign Resident Beneficiary), and
- Income Tax Regulations (Allocation of Income to an Individual Foreign Resident Beneficiary and Determination of a Capital Gain in a Dedicated Trust).

The essence of these two regulations was to allow attribution of the trustee's income in an Israeli-resident trust to foreign-resident beneficiaries, so that part of that income will be deemed as having been produced by the foreign-resident individual and not by an Israeli-resident individual. The regulations applied retroactively from 1 January 2006.[9](#)

## **Implementation Instruction 1/2010**

On 11 June 2008, the Income Tax Ordinance Amendment (No.165) Law, 5768-2008, was published. This law formalised, among other things, the obligations regarding reports, notices, declarations and applications in connection with trusts. One of the purposes of Amendment No.165 was to narrow the scope of the annual reports required under Amendment No.147, and to apply the requirement to submit an annual return, in principle, only to the trustee, while the reporting requirements that applied to Israeli-resident settlors or beneficiaries were changed to a requirement to file notices.

On 25 January 2010, the Tax Authority published a directive setting out the technical process involved in managing a trust. The directive provided that the duty of filing notices or submitting an annual return, applicable to a trustee, settlor, representative settlor, beneficiary or representative beneficiary, depending on the circumstances, related to each trust separately. For each trust for which a notice or return has been filed, the Tax Authority will keep a separate assessment file, and the trust will be registered in the Authority's database. The directive also stated that the trust files will be opened through Tel Aviv Tax Office 1 or Tel Aviv Tax Office 3, depending on the following criteria:

- For a trust, all of whose trustees are foreign residents, the file will be opened and handled by Tel Aviv Tax Office 1.
- For a trust in which at least one trustee is an Israeli resident, or which has a 'representative settlor' or 'representative beneficiary', the file will be opened and handled by Tel Aviv Tax Office 3.

The directive also gave additional instructions regarding the opening of a file for a trust, how its assessments should be handled, a list of the forms related to the various types of trusts, exemptions from filing annual returns and forms, and issues related to entry of trusts in the Authority's computers.

## **Precedential decisions**

Over the years since enactment of the Trust Law, the Tax Authority has adopted and published three precedential tax decisions in connection with trusts.

### Recognition of a Foreign Settlor Trust with a 'Crummey Power' Provision (2009)[10](#)

Under US laws, an individual may gift a certain annual sum exempt from gift tax in the US. The exemption is subject to the condition that the recipient has the right to have immediate use and benefit from the gift; otherwise, the gift will be deemed to include a 'future interest', and will not meet the conditions for the gift tax annual exemption. The precedential approval regularised the use of such gifts to the trust, by granting the trust's beneficiaries the right to withdraw their portion of each year's gift from the trust, within a 30-day window of opportunity, without this right being viewed as giving the beneficiaries influence over the trust, which would cause them to be deemed as settlors. Such a provision is called a 'Crummey Power'.

### Activity of a Foreign Trust in Israel (2012)[11](#)

The applicants in this instance were trusts that were set up under the laws of a number of foreign countries, and the source of all the funds transferred – directly or indirectly – into the trusts since their inception was foreign income of foreign residents who had never been Israeli residents. In line with the trust deeds of those trusts, and the policies of the trustee, these trusts operated solely for charitable purposes. The trustee in these trusts was also a foreign resident. The trusts were considering a transfer of their administrative functions to Israel. The precedential approval established the status of the trusts, and ruled that the transfer of the administrative activity to Israel, in and of itself, would not

revoke the classification of the trusts as foreign settlor trusts, which would have subjected the trusts to taxes in Israel.

Trust Underlying Company (2012)[12](#)

This precedential ruling confirmed that a certain company met the definition of a 'trust underlying company', and, as such, its income and losses would be considered as the income or losses of the trustee. In addition, it was ruled that the company could not obtain a certificate of domicile from the Tax Office.

## **Judicial rulings**

The field of taxation of trusts is a relatively new one and, therefore, lacks an extensive corpus of judicial rulings. Below are the principle judgments in this area.

Duty of disclosure of documents in a trust[13](#)

The taxpayer requested the Tax Office disclose all the information in its possession relevant to a tax dispute between them. In addition, the taxpayer requested the Tax Office reveal details of orders and/or tax assessment agreements drawn up in similar circumstances to the matters in dispute between them, 'including in connection with the taxation of foreign trusts and the attribution of the income of foreign trusts to Israeli-resident beneficiaries.'

The response of the Tax Office was that the taxpayer had not yet provided all the material required from him, and that the proper order of things would be for him to provide all the information that the Tax Assessor requires, and only thereafter would he receive the material relating to his application. One of the taxpayer's arguments was that he was prevented from submitting the material that had not yet been provided to the Tax Office, since the managers of the foreign trusts involved were forbidden to provide the Tax Office with the requested documents and data. The taxpayer's attorneys also argued in court that: 'They had approached the foreign foundations and their representatives, more than once, to beg them to transfer documents and materials to the Tax Assessor. In light of these approaches, (very) many documents had been given to the Tax Office some time ago, with clenched teeth on the part of the boards of the foreign foundations. It should be noted that, in these matters, representatives of the foreign foundations contacted me more than once, in correspondence, text messages, conversations and meetings, in a most angry and insistent tone, in which they complained about these repetitious requests, and the undersigned [the declarant] cannot but respect their refusal, in keeping with what is required of them under Liechtenstein law.'

The Court ruled that 'in spite of the obstacle that would ostensibly exist under Liechtenstein law and in the articles of the foreign trusts, the applicant provided the respondent with documents and data on the foreign trusts. To this we should add that the reasoning of the appeal filed by the applicant indicates that representatives of the trusts came to a meeting with the respondent, and even provided [the respondent] with partial documents and various explanations on the foreign trusts and their

dealings... Therefore, I cannot give weight to the claim by the applicant that he or the administrators of the foreign trusts are prevented from providing the respondent with the documents and data that were requested, and thus I do not see a need to rely on the opinion submitted by the applicant in regard to Liechtenstein law.'

In addition, the judge added: 'To the extent that the documents and/or data demanded by the respondent [the Tax Office] are not in the possession, knowledge or control of the applicant [the taxpayer], the respondent consented to be satisfied with a detailed affidavit in relation to each required document or piece of data, and this demand appears to me to be reasonable.' Ultimately, the court required the taxpayer to provide, within 60 days, the information requested by the Tax Office from the trusts or, alternatively, an affidavit on behalf of the taxpayer.

The duty of disclosure of documents in an underlying company held by the trust<sup>14</sup>

A British-resident settled a trust in Liechtenstein. The trust held shares in a Gibraltar company. The Gibraltar company formed a corporation in Denmark, and the latter purchased shares of an Israeli company classified as a real estate association. Without getting into the complex details of how all this is defined, we will only say that this is an association, the bulk of whose assets are real estate assets in Israel.

Some years later the Danish company sold the shares in the Israeli association at a profit, and asked to receive the exemption to which it was entitled by virtue of the tax treaty between Israel and Denmark. The Director of the Capital Gains Tax Division refused to grant the exemption, claiming that the foreign corporation was an artificial entity, established solely to evade tax in Israel, and was not the true seller: the seller company was actually a Gibraltar-resident entity, which was not entitled to benefit from the tax treaty. The Director asked to view the documents of the parent corporation in Gibraltar, as well as the trust deed and other documents.

The Appeals Committee, before which the matter was brought, rejected the Director's arguments, and ruled that the requested documents were not held by the Danish corporation, and so it could not be asked to produce them. Furthermore, the Committee ruled that the Director was not entitled to argue that the corporation was not Danish and that the transaction was artificial, and then ask for documents supporting his argument. The committee ruled that the Director had to first prove his claim, and not go on a 'fishing expedition' in the documents of the foreign corporation and its shareholders.

### **The Law for the Change of National Priorities<sup>15</sup>**

Up to 1 January 2014, trusts settled by a foreign resident (foreign settlor trusts), whether revocable or not, were subject to tax in Israel on income produced in Israel. Income produced abroad was not taxable at all. For this matter, it made no difference whether the beneficiary of the trust was an Israeli resident. On 1 August 2013, the Law for the Change of National Priorities came into effect. This law amended the trusts chapter in the Income Tax Ordinance and inserted Amendment No.197 into the



Ordinance. The commencement date for this substantive change was 1 January 2014. The main change in the trusts chapter related to the tax liability of trusts settled by a foreign settlor, and defined as 'foreign settlor trusts'. This type of trust was abolished, and instead trusts of this type were divided into two new categories. All of the trusts were taxable on the income produced in Israel, with consideration given in certain instances to the provisions of dual taxation treaties. In regard to income produced abroad, the tax liability will be as follows:

- A foreign resident trust – a trust that does not have any Israeli-resident beneficiaries will not be subject to tax.
- An Israeli-resident beneficiary trust which is a relative's trust – a trust in favour of the settlor's relatives will be subject to tax, with the trustee being entitled to choose between annual tax payments on income attributable to the Israeli-resident beneficiary or taxation of distributions to the Israeli-resident beneficiary.
- An Israeli-resident beneficiary trust which is not a relative's trust – a trust in favour of someone who is not related to the settlor will be taxed as an Israeli-resident's trust – that is, annually on all of its worldwide income.

### **Trust arrangements circular [16](#)**

On 9 March 2014, the Tax Authority published interim arrangements for the previously categorised foreign settlor trusts which were tax-exempt, but which, following the enactment of the law, had become liable to tax. According to the law, where the beneficiary has control or influence over the trustee or the trust's assets, they are deemed a settlor. In this case, if they are an Israeli resident, the trust should be classed as an Israeli-resident trust and not as a foreign settlor trust.

To prevent disputes with the Tax Assessor over tax from 2006–2013, following reporting on the trusts, the Tax Authority proposed an arrangement. Under this arrangement, the trust could pay, based on specified criteria, tax on one-third, one-half or two-thirds of its income for the years 2006–2013, and in return it would be given 'immunity' from an audit by the tax office. In other words, it would not be alleged that the beneficiary had control over the trust, and that the full amount of tax should be paid. Another option offered was to pay 3, 4 or 6 per cent of the trust's capital as at 31 December 2013, and to receive a step-up for the assets and immunity from claims of beneficiary control. Entry into this arrangement is voluntary.

## **Summary**

Over the past ten years, trusts have evolved from an unfamiliar, rather strange entity into a recognised, legitimate one whose tax liability is clear and regularised. Recently, the tax net has been expanded to encompass trusts settled by foreign residents in favour of Israeli residents, thus closing the circle and equating the taxation of a trust in favour of an Israeli resident with the situation in which the resident holds the asset directly. It is to be expected that, as time passes and trusts become a

more familiar structure, greater use will be made of them, and further amendments to the law will be enacted.

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- [1](#) *Rabinovich Commission report*
- [2](#) *Appointment letter of the Commissioner Adv Tal Yaron Eldar to the committee*
- [3](#) *Report of the Committee on the Taxation of Trusts*
- [4](#) *Report of the Committee on the Multi-Year Tax Plan*
- [5](#) [a](#) [b](#) [c](#) [d](#) *Ibid*
- [6](#) *Tax Authority press release*
- [7](#) *Trust arrangement (attached to the press release)*
- [8](#) *Tax Authority press release*
- [9](#) *Income Tax Regulations*
- [10](#) *Tax Ruling 1201/09 – Tax Ruling Area: International Taxation; Subject: Recognition of a Foreign Resident Settlor Trust with a ‘Crummey Power’ Provision – Tax Decision by Agreement*
- [11](#) *Tax Ruling 4987/12 – Tax Ruling Area: International Taxation; Subject: Activity of a Foreign Trust in Israel – Tax Decision by Agreement*
- [12](#) *Tax Ruling 6359/12 – Tax Ruling Area: International Taxation; Subject: Recognition of a Company as a Holding Company for the Assets of a Trust, as Defined by Section 75c of the Ordinance – Tax Decision by Agreement*
- [13](#) *District Court, Income Tax Appeals 55419-01-12, Binyamin Steinmetz v Gush Dan Tax Office (31 October 2013)*
- [14](#) *Appeals Committee – Tamares Israel Real Estate ApS – handed down on 1 October 2013*
- [15](#) *Law for the Change of National Priorities (Legislative Amendments for Achieving Budgetary Goals for the Years 2013 and 2014)*
- [16](#) *Transitional Arrangements for Israeli Resident Beneficiary Trusts, 9 March 2014*

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