

Taxation of Trusts in Israel

1. General

On August 10th, 2005, amendment no. 147 of the Income tax ordinance (new version), 1961 (hereinafter: "**ITO**") was published. The amendment added chapter 4 II to the ITO (from Article 75c and on) covering taxation of trusts. Chapter 4 II and other provisions imposing reporting requirements came into force on January 1st, 2006 (hereinafter: "**the effective date**"). Certain provisions have different effective dates.

Important notice: The Director General of the Israel Tax Authority has recently informed that the deadline for presenting the reports required by the chapter 4 II (and complementing provisions) is postponed to September 30th, 2007. Similarly, submission date for all notifications, declarations, depositions and requests required following the introduction of the trusts chapter is postponed, as well as the date for reporting income generated in trusts and for activities undertaken in a trust. In addition, the date for filing the annual tax return by those required to do so as a result of the trusts chapter and for this reason alone¹ will also be postponed.

2. Types of Trusts

Chapter 4 II of the ITO defines four types of trusts (for income tax purposes):

Israeli-residents trust – being one of the following alternatives:

- A. When settled, at least one settlor and at least one beneficiary were residents of Israel and during the tax year at least one settlor or at least one beneficiary was resident of Israel;
- B. A trust which is not a foreign-resident-settlor trust and not a foreign-resident-beneficiary trust ("the default option").

This type of trust can be either revocable or irrevocable.

This type cannot be a trust established by will.

As for alternative A., it should be noted that according to existing legislation, a settlor of such trust who, immediately before his death, was an Israeli resident will be considered Israeli resident for the purpose of classifying the trust after his death, even if all beneficiaries have become foreign residents.

¹ The Israel Tax Authority has also informed it was in the process of introducing amendments to the ITO and formulating regulations and forms there under, aiming to determine the obligation and requirements of reporting about trusts and other fundamental issues, and that the delay would allow the completion of the legislative process, as well as allow the public and the representatives to make advance arrangements necessary for submitting the said reports.

Foreign-resident-settlor trust – being one of the following:

- A. When settled and throughout the tax year, all its settlors were foreign residents;
- B. Throughout the tax year all its settlors and all its beneficiaries are foreign residents.

This type of trust can be revocable or irrevocable.

As for alternative A., it should be noted that a settlor of such a trust who, prior to his death, was a foreign resident will be considered a foreign resident for the purpose of classifying the trust after his death. A trust created by a will of a settlor (testator) who was a foreign resident prior to his death will also be regarded as a foreign resident trust.

The case for alternative B is, for example, when a trust was settled as an Israeli resident trust, however in the course of the tax year all settlors and all beneficiaries are no longer residents of Israel.

Foreign-resident-beneficiary trust – a trust in which, during the tax year, the following conditions are met:

1. the trust is irrevocable;
2. all its beneficiaries are foreign-resident individuals of known identity; an unborn beneficiary will be regarded as a beneficiary of known identity;
3. at least one of its settlors is a resident of Israel;

For a trust that was settled as such (i.e. conditions 1 – 3 were met at that time), the following must also be met (during tax year):

- a. the trust's documents stipulate that an Israeli resident may not become a beneficiary;
- b. in his annual tax return for the year the trust was settled, the settlor declared that no Israeli resident is a beneficiary in the trust, nor any Israeli resident whose becoming a beneficiary is conditioned upon him ceasing to be an Israeli resident, and that none of which may become beneficiaries.

In order to maintain the trust's status as a foreign-resident-beneficiary trust, the trustee must declare yearly that conditions a + b mentioned above are met. Had the trustee fail to declare so, the trust will be classified as an Israeli-residents trust and be taxed accordingly.

A trust originally settled as an Israeli-residents trust or as a trust established by a will may not be classified as a Foreign-resident-beneficiary trust.

A trust established by a will – a trust in which the following are met:

1. the trust is settled according to a will.
2. all of the trust's settlors are the testators who died while being Israeli residents.

3. Taxable events in the lifetime of a trust and liability to tax in Israel

- 3.1 In the case of an Israeli residents trust and a foreign resident settlor trust - transferring an asset to a trustee without consideration is not a taxable event. The distribution of an asset to a beneficiary will be considered as a direct transfer from the settlor to the beneficiary and will be taxable (or exempt) accordingly.
- 3.2 In the case of a foreign-resident-beneficiary trust, transferring an asset to a trustee is considered a sale and taxable accordingly.
- 3.3 In the case of an Israeli residents trust, the current income of the trustee (including capital gain) will be assessed as the income of an Israeli resident individual, e.g.: worldwide income in the trust will be taxable in Israel, subject to tax treaties.
- 3.4 In the case of a foreign-resident-settlor trust and a foreign-resident-beneficiary trust, the current income of the trustee (including capital gain) will be assessed as income of a foreign resident individual. Income originating in Israel will be taxable, subject to Israel's tax treaties. Income originating outside of Israel is not subject to tax in Israel.
- 3.5 In the case of an Israeli residents trust and a foreign resident settlor trust, distribution of funds to beneficiaries (including Israeli residents) is not subject to tax.
- 3.6 Settling a trust established by a will is not a taxable event. The trustee's income is taxable as follows: in case all the beneficiaries are foreign residents, the current income of the trustee (including capital gain) will be assessed as income of a foreign resident individual; in case there is one beneficiary who is an Israeli resident, the current income of the trustee (including capital gain) will be assessed as the income of an Israeli resident individual, e.g.: worldwide income in the trust will be taxable in Israel, subject to tax treaties. Distribution of assets or funds to beneficiaries (including Israeli residents) is not subject to tax.

Events during the lifetime of a trust, even those which are not taxable, are to be reported as detailed below.

4. General principles governing taxation of trustee's income

- 4.1 In all types of trusts, the income of the trustee shall be taxed in his own name and he will be assessable and taxable for the said income and for activities in the trustee's assets.
- 4.2 The trustee will probably be required to open an income tax file under his name (most probably, according to the place of abode of the Israeli resident beneficiary or majority of Israeli beneficiaries). The file will be used for reporting all income related to the said trust and for the tax assessment procedures.
- 4.3 The income of the trustee and his taxable income will be assessed according to the ITO. A trustee's income will be taxable in the year it was generated or accrued.
- 4.4 The trustee's residency and the fact that the trust was created under the laws of a foreign country will have no bearing on the taxability of the trustee's income and on the obligation to report as stated.
- 4.5 The trustee's income will be taxed at the marginal tax rate for individuals as stated in article 121 of the ITO (currently 48%). Income assigned a specific tax rate which applies to an individual will be taxable at the specific rate (for ex. capital gain yielded through the sale of traded securities of which the trustee holds less than 10% will be taxed at 20%).in addition, trustee's income will not be entitled to a tax exemption accorded to a limited amount of income, such as the exemption for income generated from residential letting up to about 4,200 NIS per month.
- 4.6 Trustee's losses and the tax imposed on trustee's income cannot be set-off nor credited against settlor's or beneficiary's income. Losses of the settlor or the beneficiary and the tax levied on their income cannot be set-off nor credited against the trustee's income, unless specifically stated otherwise.
- 4.7 As for calculating depreciation and capital gain relating to an asset whose transfer to the trustee was exempt from tax or not subject to tax, the trustee will "step into the settlor's shoes" and the principle of tax continuity will therefore apply (that means that the original cost of the asset and depreciation will be those applied to the settlor had he been the seller).

- 4.8 In case there are several trustees, they are all liable to pay the tax imposed on the trustee's income, together and separately.
- 4.9 In an Israeli-residents trust there is a possibility, provided the conditions required by the law are met, to submit a request to attribute the trustee's income, entirely or partly, to the settlor or to the beneficiary, as the case may be, and to tax it as if it were their own with all it implies.

5. Reporting obligation of the trustee

Annual tax return

- 5.1 A trustee of a trust created by an Israeli resident or a trustee who had income or an asset in Israel is required to submit an annual tax return. This return will specify the trustee's total income in the tax year and will include notification regarding distributions of income and assets during the tax year, itemizing names of beneficiaries and the sums distributed to them.
- 5.2 In the annual tax return the trustee is required to give a detailed account (in addition to trustee's income and the other details as requested by law) of the settlor, date of transfer of the asset to the trust, particulars of each beneficiary, dates of distribution and details of any asset distributed, details of transferred assets including their original cost, the balance of the original cost, purchase value, balance of purchase value and date of purchase.

Additional reports and notifications

- 5.3 There are specific reporting obligations when applying to attribute income of an Israel residents trust to a settlor or a beneficiary, as the case may be.
- 5.4 There are specific reporting obligations (including the duty to submit an annual tax return) that apply to the settlor or to a beneficiary. For ex., a beneficiary who received distribution during the tax year (even if the sum received is not taxable) must present an annual tax return.
- 5.5 Specific notifications and reporting obligations have been set for types of trusts settled prior to the effective date (1.1.06). In some cases these obligations may apply to a trustee.

6. Tax payment, collection and penalty

- 6.1 Provisions of any applicable law regarding tax payment, reporting, collection and penalty apply to the trustee for his income and assets, unless otherwise specified.
- 6.2 If there are several trustees in the trust, they are liable to tax imposed upon trustee's income together and separately.

6.3 In an Israeli residents trust, a trustee's final tax debt may be collected from each of the settlors, even if they are no longer Israeli residents. As for such trust created prior to the amendment (i.e. prior to 1.1.06) this provision applies only if the trust is revocable. As for a trust created after the publication of the amendment, this provision applies to any Israeli residents trust, whether revocable or irrevocable.

It should be noted, that a trust is considered revocable if, for example, there is a beneficiary who is also a settlor, if it is possible to annul the trust and return its assets to the settlor, if one of the beneficiaries is the child of the settlor and a minor, or if the settlor possesses the ability to instruct the trustee as to the management of the trust, its assets, its beneficiaries etc...

6.4 Final tax debt of a trustee's may be collected from any beneficiary to whom a distribution was made after the beginning of the tax year for which the debt exists, as long as the sum collected will not exceed the total final tax debt or the sum or value of assets received by such a beneficiary (through the distribution), whichever is lower. This provision will also apply after the trust has ended.

Trust-taxation-website