



The Reform to the Taxation of Trusts under Israeli Law November 2013

Dear Clients and Colleagues,

On July 30, 2013, the Knesset (the Parliament of the State of Israel) enacted a reform to the taxation of trusts in Israel (the "**Amendment**"). The Amendment will become effective on January 1, 2014, with the exception of certain reporting obligations that apply to beneficiaries on an immediate basis. We summarize below the main provisions of the Amendment and would counsel clients to review the implications of the Amendment on existing Israeli-related trust structures.

The Cancellation of the Foreign Settlor Trust and Its Substitution by the Foreign Residents Trust

Until the Amendment, trusts that were established by non-residents of Israel were generally treated as foreign residents for tax purposes and accordingly were tax-exempt in Israel with respect to assets and income sourced outside Israel. Following the Amendment, a Foreign Settlor Trust will continue to be treated as tax-exempt in Israel, but only to the extent where all the beneficiaries under such a Trust are non-residents of Israel, such trust will then be classified as a Foreign Residents Trust. In order to maintain the status of a Foreign Residents Trust, no Israeli resident may have been in the past, or may be in the future, a beneficiary of such Trust.

Trusts established by foreign residents, whose only Israeli beneficiaries are "Beneficiaries for Public Purposes" (*e.g.* the State of Israel, an Israeli municipal authority, Keren Kayemet LeYisrael, Keren HaYesod and other institutions established for public purposes and that are tax-exempt under Israeli law), will still be deemed to be Foreign Resident Trusts.

The Israeli Beneficiary Trust and the Relatives Trust

The Amendment establishes a new category of trust under Israeli law – the Israeli Beneficiary Trust. A trust will qualify as an Israeli Beneficiary Trust if it: (i) was established by a foreign resident who continued to be a foreign resident from the date of its establishment until the relevant tax year; and (ii) has at least one Israeli beneficiary. Accordingly, a trust that was classified as a Foreign Settlor Trust prior to the Amendment and that has at least one beneficiary who is a resident of Israel will change its status to an Israeli Beneficiary Trust. Generally, an Israeli Beneficiary Trust (that is not a Relatives Trust, as explained below) will be subject to tax in Israel on its worldwide income.

A Relatives Trust is an Israeli Beneficiary Trust that fulfills the following conditions: (i) the settlor is the beneficiary's parent, grandparent, spouse, child or grandchild. If the settlor and the beneficiaries are relatives of second degree (this should include, *inter alia*, siblings, siblings' issues, parents' siblings, spouse's issue), then in order for the trust to qualify as a Relatives Trust the assessing officer must confirm that the trust and any contribution thereto were made in good faith and that the beneficiary has not paid any consideration in order to be entitled to the trust's assets; and (ii) the settlor of the trust is still alive in the relevant tax year.

The tax regime that applies to a Relatives Trust is as follows: (a) a distribution that is sourced from income generated and produced outside of Israel and that is made to the Israeli beneficiary will be subject to tax in Israel at a tax rate of 30%, unless it is otherwise proven that the trustee distributed principal of the trust, in which case the distribution will be tax-exempt; (b) the trustee may elect (with irrevocable effect) that the trust's income generated or produced outside Israel will be subject to tax at a rate of 25% in the year in which such income was generated or produced, and any distributions made therefrom will be tax-exempt; and (c) income generated or produced in Israel will generally be subject to tax in Israel.

The trustee of a Relatives Trust is required to file a notification with the Israel Tax Authority 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. With respect to existing trusts, such a notification must be filed within 180 days commencing from August 1, 2013

According to the plain language of the Amendment it is not possible to allocate the assets and income in an Israeli Beneficiary Trust and Relatives Trust to beneficiaries that are non-residents of Israel, and accordingly the entire income of such a Trust will be subject to the aforementioned tax regime. However, we anticipate that regulations with regard to the allocation of income of an Israeli Beneficiary Trust between Israeli and non-Israeli beneficiary of such a Trust will be promulgated in the future.

Provisions Concerning New Immigrants

The Amendment provides that an Israeli Resident Trust whose settlors are new immigrants who are generally entitled to tax benefits provided to new immigrants under Israeli law (generally, a ten-year exemption on income and gain sourced outside of Israel) (a "**New Immigrant Trust**"), will be entitled to such benefits, only to the extent that all the beneficiaries under such a Trust are also new immigrants who are entitled to new immigrant benefits or are foreign residents.

The transition provisions of the Amendment provide that a trust that became a New Immigrant Trust before August 1, 2013 will continue to be entitled to such benefits as long as the settlor is alive and regardless of the beneficiaries' entitlement to new immigrant benefits. However, upon the settlor's demise, such trust will be entitled to new immigrant benefits only if all the beneficiaries are also entitled to such benefits or are foreign residents.

A trust that became a Relatives Trust as a result of the immigration of one of its

beneficiaries to Israel will also be entitled to new immigrant benefits with respect to the portion of the trust's income that is attributable the new immigrant beneficiary.

The Status of an Israeli Resident Trust after the Demise of the Settlor

The Amendment provides that an Israeli Resident Trust all of whose beneficiaries are foreign residents and whose last settlor has passed away will be subject to tax as a Testamentary Trust, i.e., the trust's income and assets will be attributed to the beneficiaries, and accordingly will be subject to tax as a non-resident of Israel.

On the other hand, in the event where the last settlor of an Israeli Resident Trust has passed away and the Trust has at least one Israeli beneficiary, then the Trust will maintain its status as an Israeli Resident Trust. Specific regulations allow the allocation of part of an Israeli Resident Trust's assets and income to foreign residents who are beneficiaries under such a Trust. The applicability of these regulations is subject to the fulfillment of certain conditions.

A Trust Holding Company

Until the Amendment, a Trust Holding Company was defined as a company that holds the trustee's assets for the trustee, either directly or indirectly. Generally, a Trust Holding Company is a look-through entity under Israeli law. The Amendment provides that a company will be regarded as a Trust Holding Company only if it meets all of the following conditions: (i) it was established for the sole purpose of holding the trust's assets; (ii) if such a company holds the assets of an Israeli Resident Trust or an Israeli Beneficiary Trust or a Testamentary Trust having an Israeli beneficiary, or assets of any trust that are deemed to be Israeli assets, the trust must notify the Israel Tax Authority regarding the establishment of such a company and its status as a Trust Holding Company within 90 days from its incorporation; and (iii) the entire shareholding of such Company is held by the trustee.

New Reporting Obligations Applicable to Beneficiaries

The Amendment provides that an Israeli beneficiary that has received a distribution from a Trust will be required to report such income to the Israel Tax Authority, regardless of whether the income is subject to tax in Israel. This provision does not apply to the distribution of non-Israeli assets to a beneficiary of a Foreign Residents Trust, a beneficiary in a Foreign Beneficiary Trust or a beneficiary in a Testamentary Trust all of whose beneficiaries are foreign residents.

According to the plain language of the Amendment, this provision applies to new immigrants, although they are generally exempt from tax reporting obligations during the ten-year period from their immigration to Israel. We anticipate that the Israel Tax Authority will publish clarifications in this regard.

The foregoing reporting obligations are in effect on an immediate basis and apply from and after August 1, 2013.

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If you have any questions about the matters addressed in this newsletter, please contact the following FBC author or your regular FBC contact.

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