Dear Clients, Colleagues and Friends,

This is an important update on the topic of taxation of trusts in Israel.

I. Background

a. On the 17th of August, 2016, the Israel Tax Authority (the "ITA") published a circular (the "Circular") addressing the taxation of trusts in Israel. The Circular is published following a significant amendment to the tax law in Israel pertaining to the taxation of trusts which came into effect on August 1, 2013 (the “Amendment”) and it also covers the original law which was enacted in 2006. The Amendment aimed to expand the tax base for taxing trusts in Israel, combat various loopholes that existed prior to the adoption of the Amendment, and add several reporting obligations that had not existed.

b. This Circular is the first significant ITA published guidance since the law for taxation of trusts in Israel became effective in 2006. Prior to publishing the Circular, the ITA published only two technical memorandums which mainly covered technical aspects regarding reporting obligations of trusts. This Circular is the first time in which the ITA publishes its legal positions and interpretations regarding the law for taxation of trusts in Israel.

c. The Circular is a final version of a draft circular that was released in October 2015 to a number of industry participants and professionals for comments and feedback. The draft circular contained various positions...
and interpretations of the tax law that the ITA had taken which, if accepted, would have unjustifiably expanded the scope of taxation of trusts in Israel and led to unintended results. Due to combined efforts of our firm in collaboration with the Tax Forum of the Israel Bar Association, the Circular has been revised in many aspects following comments that we provided to the ITA and which reduced the potential impact of the draft circular. Nevertheless, certain ITA positions, as reflected in the Circular, seem to have widened the scope of the taxation of trusts beyond the legislative intent, as more fully discussed below.

d. It should be noted however, as detailed below, that the Circular also provides relief and certain favorable positions in connection with the somewhat strict wording of the law.

e. The Circular is extensive in length (over 50 pages) and covers a considerably wide range of areas and topics relevant to the taxation of trusts in Israel. It is, thus, beyond the scope of this Client Update to address the various provisions and potential implications of the Circular to taxpayers. We summarize below only the main and the most important provisions contained in the Circular. Accordingly, we encourage each trust to examine the potential impact the Circular may have on it based on its specific circumstances.

II. Key Provisions of the Circular

a. The Trust's Protector. The ITA states in the Circular that it may view an appointment of a protector, after the death of the settlor, as a change of the trustee, to the extent the assessing officer determines that the beneficiaries of the trust were able to influence the decision to change the protector. Such a position of the ITA may have the effect of causing the beneficiaries to be considered as settlors of the trust.
b. **Distributions.** The Circular provides that subordinating trust assets for the benefit of a beneficiary, and certain loans or services from the trust to a beneficiary or anyone on the beneficiary’s behalf may be deemed a distribution from the trust, if such loan or services are provided below market value. **More significantly, the Circular takes the view that certain loans, even if granted at market value, may be deemed distributions, if such loans are not returned within 24 months.**

c. **Underlying Companies.** It is not uncommon for trustees to use Underlying Companies (that is, holding companies) to hold trust assets in order to maintain separation from the trustee’s personal assets or assets of other trusts. Such holding companies are generally treated as transparent entities for Israeli tax purposes, and thus transfers of assets between the trustee and the holding company are generally not treated as a tax event. The Circular clarifies that in order to be respected as a holding company, and as stipulated in the Amendment, the company (i) should be 100% held by the trustee or another holding company of the trust; (ii) should be established solely for the purpose of holding the trust assets; and (iii) a notification regarding the incorporation of the holding company and its status as such should be provided to the assessing officer within 90 days of its incorporation.

It should be noted that with respect to trusts that are exempt from reporting obligations (e.g., trusts in which the settlors and the beneficiaries are new immigrants or returning residents), the Circular extends the 90-day notification period such that it starts after the end of the exemption period granted to such new immigrant or returning resident. However, the trustee would be held, in such case, to a higher burden of proof with respect to proving that the holding company was in fact incorporated solely for the purpose of holding the trust assets and has been operating as such since its incorporation.
Finally, the Circular clarifies that an Underlying Company is not considered an Israeli resident and therefore cannot obtain a residency certificate from the ITA.

d. **Beneficiaries Deemed Settlors.** The Circular provides that in cases where the settlor of a trust is deceased and beneficiaries of the trust are added or removed, this may result in treating the beneficiaries of the trust as settlors of such trust, unless such actions are made pursuant to a provision in the original trust documents, or it is proven that the beneficiary had no influence over such change of beneficiaries. The Circular takes a somewhat extreme position pursuant to which any changes in the trust documents after the death of the last settlor would cause the beneficiaries to be treated as settlors. The Circular clarifies that the grant of broad authority to the trustee in the original trust documents to remove a beneficiary without cause or without providing clear criteria for such removal of a beneficiary will not satisfy the requirement that such actions be made pursuant to a provision in the original trust documents.

The Circular further notes the following as indicative of a beneficiary being treated as a settlor:

- the beneficiary has authority to name other beneficiaries, a trustee or to manage the trust assets;
- the beneficiary provides certain management or consulting services to the trust;
- the beneficiary is a member of the trust’s investment committee or other managing organ of the trust;
- the trust assets serve as a security for a loan that he trust provided to the beneficiary not pursuant to the trust documents;
- a below market value loan was granted to the beneficiary.

e. **Grants to a Trust.** A grant of an asset is defined under the tax law as a transfer of an asset to a trustee for no consideration. In cases where
such a transfer is made for consideration, the assessing officer may treat the transfer as a taxable sale. The Circular provides relief in this respect and determines that in circumstances where the settlor transfers assets for partial consideration, the assessing officer has authority to treat the transfer as two separate transactions, one that is a taxable sale and another as an exempt grant of an asset, the value of which is the difference between the asset’s market value and the partial consideration paid.

f. **Definition of the term Beneficiary.** A beneficiary is a person who benefits from the trust assets or the trust income, directly or indirectly (e.g., through another beneficiary, chain of trusts, or a company held by the trust). The Circular provides that a person will be considered as a beneficiary if such person received distributions from the trust or is (or was) registered as a beneficiary in the trust documents. The Circular aims to prevent situations where a beneficiary is removed from the trust in order to prevent it from being classified as an Israeli trust. Thus, the Circular reiterates the position that a person will be considered as a beneficiary even if such person benefits from the trust through another beneficiary, or receives assets (cash or cash equivalents) from a beneficiary after being removed as beneficiary from the trust, which assets are classified as "gifts" to such person.

g. **Foreign Tax Credits.** The Circular provides a very important clarification with respect to the possibility of obtaining a credit for foreign taxes. Pursuant to the Circular, foreign taxes paid in respect of the trust’s foreign source income, including state taxes in countries where such taxes are levied in addition to any federal taxes, are creditable in Israel against the trustee’s tax liability, even if such foreign taxes were not paid by the trustee. For example, if a non-Israeli resident settlor of an Israeli trust pays foreign taxes with respect to rental income of the trust, such foreign taxes would be creditable by the trustee against the trust’s Israeli tax liability. It should be noted that the Circular is silent with respect to "dual resident" trusts (i.e., trusts that are considered as
residents both in Israel and in other countries), despite comments and requests to clarify that the foreign tax credit would be granted to such trusts as well.

h. **Tax Exemptions for New Immigrants’ and Returning Residents' Trusts.** Under applicable tax law provisions, new immigrants of Israel and "senior returning residents" (Israeli citizens who have resided outside of Israel for at least 10 consecutive years) are eligible for a 10-year exemption period from the date of obtaining or resuming Israeli residency, with respect to their non-Israeli source income ("eligible individuals"). The Circular confirms that trusts with certain nexuses to eligible individuals will be eligible for the said exemption. **However, the Circular clarifies that following the Amendment, the method for calculating the 10-year exemption period for trusts has changed such that the exemption period will be the shorter between either that of a settlor or of the shortest among beneficiaries who are eligible individuals.**

With respect to a "regular returning resident" (an Israeli citizen who has resided outside of Israel for at least 6 consecutive years), the Circular states that such trust is generally not eligible for the tax breaks granted to a regular returning resident. Nevertheless, the Circular confirms that if a trust has become an Israeli trust due to the regular returning resident resuming Israeli residency, then the trust would be eligible for the tax breaks granted to the regular returning resident with respect to such assets that the regular returning resident purchased and granted to the trust prior to resuming Israeli residency.

The Circular takes an extreme position which suggests that the tax exemptions available to new immigrants and returning residents are not available when the trust is an "Israeli Beneficiary Trust" which is not a "Relatives Trust", as such terms are defined in the applicable tax law. It is unclear why the ITA takes such position, given that nothing in the Amendment is indicative of legislative intent not to grant the tax
exemptions in such cases. Requests to revise the Circular in this regard have been rejected. We note that this position is problematic and it is yet to be seen how the ITA will further interpret its position on this matter.

i. **Clarification Regarding Children of New Immigrants.** The Circular also provides an important clarification with respect to newborn children of new immigrant beneficiaries. The Circular clarifies that if all settlors and all beneficiaries of a trust are new immigrants eligible for the 10-year exemption period, a **newborn child of a beneficiary who also becomes a beneficiary of the trust, will not affect the classification of the trust as eligible for said exemption, despite the fact that the newborn child is not a new immigrant, such child’s birth.**

j. **An Israeli Resident Trust that becomes a Testamentary Trust.** The Amendment states that when the last Israeli settlor of a trust which was an Israeli resident trust dies, the trust becomes a testamentary trust to the extent that all the beneficiaries are foreign residents. This is a very important clarification as it enables the transfer of the trust's assets to the beneficiaries and the exit of the trust from the Israeli tax net without triggering a tax event.

Following comments that we provided to the draft circular, the Circular clarifies that with respect to trusts which were established prior to the Amendment, any such change in the trust’s status that results from the Amendment, will not trigger, in and of itself, a tax event. Nevertheless, the Circular notes that this provision will apply only to the extent that all the beneficiaries of the trust are non-Israeli residents. This provision is somewhat problematic as it relates to trusts that were established prior to August 1, 2013 given in many cases, such trusts may have included both Israeli and non-Israeli beneficiaries. It is unclear whether the ITA would be willing to apply bifurcated treatment such that the portion of the trust that relates to non-Israeli beneficiaries would be treated as if it
were a trust in which all of the beneficiaries are non-Israelis, and the portion of the trust that relates to Israeli resident will continue to be treated as if it were an Israeli trust.

k. **Grant of Assets to a Relatives Trust.** The Circular confirms that the grant of an asset with a built-in-gain to a Relatives Trust, which gain was generated outside of Israel, is treated as a sale of such asset from the settlor to the beneficiary of the trust for purposes of determining the basis of such asset and the date of its purchase. Put differently, because the transfer of the asset to the Relatives Trust is treated as a sale, the **basis of the asset is stepped-up to the fair market value of the asset on the date of such transfer, provided** that the transfer of the asset to the trust has been reported to the assessing officer on a designated form. According to the Circular, the assessing officer has broad authority to examine the value of the assets that were granted as of the day of grant and at a later date. In addition, the Circular imposes many conditions in order to obtain such a step-up.

l. **Clarifications Regarding Relatives Trusts which Chose the Distribution Route.** Under existing law, a Relatives Trust can choose the distribution route pursuant to which distributions will generally be subject to 30% tax. The trustee can provide proof that all or a portion of the distribution is from an asset that the settlor granted to the trustee (such portion being the principal portion and thus exempt from tax), in which case only the portion of the distribution reflecting a profit (such portion being the profit portion) would be subject to tax. The Circular provides three important clarifications on this end:

- In the distribution route, the Israeli resident beneficiary that received the distribution will be liable for the tax and will need to report the receipt of such distribution to the ITA; and
- The profit portion of the distribution will be classified based on its classification by the trustee and it will be possible to claim foreign tax credit against this income.
The ITA takes the position that distribution of profits which were accumulated before December 31, 2013 (the date on which the Amendment became effective), will be subject to tax in Israel unless it was settled in the special transition settlements which were offered by the ITA. This clarification also applies when the trust chooses to be taxed under the current income route.

m. **Foreign Trusts which Excluded Israeli Beneficiaries before the Amendment.** The Circular clarifies the ITA’s interpretation of the law that a Foreign Residents Trust will only be so classified absent any nexus to Israeli beneficiaries or settlors. In cases in which the trust had an Israeli resident beneficiary, who died or ceased to be resident in Israel prior to the 2003 tax year, the trust would continue to be treated as a Foreign Residents Trust. In other words, the ITA will not treat trusts which had in the past Israeli resident beneficiaries who died or ceased to be Israeli resident after the 2003 tax year as Foreign Resident Trusts. This position of the ITA is very problematic and we are not certain that it complies with the applicable law. This position may cause many trusts to fall within the Israeli tax system although the Israeli beneficiaries were excluded from these trusts. Accordingly, the relevant trusts who had Israeli beneficiaries in the past, should carefully examine their position.

n. **Foreign Beneficiary Trust.** The Circular clarifies the ITA’s position pursuant to which in order for a trust to maintain its status as a Foreign Beneficiary Trust, the trustee needs to submit an annual declaration certifying that all of the beneficiaries of the trust are non-Israeli residents, and that no beneficiary is an Israeli resident beneficiary whose entitlement is conditioned on such beneficiary ceasing to be treated as an Israeli resident. The Circular states that the reporting is a material condition for the classification of the trust as a Foreign Beneficiary Trust and therefore if such a reporting is not made, the trust may lose its eligibility to be classified as a Foreign Beneficiary Trust.
It should be noted, that in previous versions of the Circular, it was determined that failure to make the required reporting will automatically deny the status of the trust as a Foreign Beneficiary Trust. Following comments which we provided, the final version of the Circular determines that a failure to report may cause the trust to lose such a status. Thus, the Circular leaves certain discretion to the ITA to confirm the status despite the failure to report.

o. **Grant of Assets from a Company to a Trust.** The Circular reiterates a general rule with respect to the grant of assets from a company to a trust: the grant is treated as a sale of the assets by the company, and the assets granted are treated as a deemed dividend in the hands of the individual shareholders who hold, directly or indirectly, the interests and rights in the company.

While the Circular states that this is rule aims to prevent tax avoidance by artificially transferring assets from companies to its shareholder through the utilization of trusts, it *nevertheless confirms that in certain circumstances, the need to establish a trust is solely commercial and, thus, the ITA provided some relief which also enables companies to establish trusts without a tax event*. Pursuant to the position of the ITA as reflected in the Circular, the ITA would not deem the grant of assets as a sale, provided several conditions are met, including:

- the only settlor of the trust is a company (and not an entity the profits of which are attributable to its interest holders such as a partnership);
- the settlor (the company) is also the only beneficiary of the trust and the trust documents clearly state that no other beneficiary is allowed to be added;
- the assets granted to the trust are reported as assets on the company’s balance sheet (as opposed to off-balance sheet assets) and the financial activities of the trust are reflected in the company’s profit and loss statements;
the settlor and the trustee have irrevocably chosen to attribute the income of the trust solely to the settlor company and a notification of the same has been provided to the ITA within 30 days of the establishment of the trust.

III. What Next

a. As noted, the Circular is extensive in its length and scope and contains many complex provisions, only some of which we have briefly discussed above.

b. It is yet to be seen how the Circular will be implemented. We expect disputes with the ITA will surface in connection with several of the positions and interpretations contained in the Circular.

c. Finally, it should be noted that while the Circular generally reflects the position of the ITA on the matters contained therein, it is not enforceable as a law and Israeli courts are not bound by the positions of the ITA as reflected in the Circular.

As noted above, we encourage each trust to examine the potential impact the Circular may have on it based on its specific circumstances. We will keep you updated as to any developments in this area and are at your disposal to provide comprehensive advice based on your specific circumstances.

Tax Department
Herzog Fox Neeman

KEY CONTACTS

Meir Linzen | Managing Partner
Head of Tax Department
Tel: +972 3 692 2035
linzen@hfn.co.il

Guy Katz | Partner
Tax Department
Tel: +972 3 692 2035
katzg@hfn.co.il