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Israel changes its tax law to include the taxation of many foreign trusts

Debra T. Hirsch and Sara Y. Weinberg,
Fox Rothschild LLP, New Jersey

From being a tax friendly jurisdiction for foreign trusts to one that will seek to impose overly harsh reporting requirements and taxes on them, Israel has taken a completely contrary position in this instance.

Debra T. Hirsch and Sara Y. Weinberg are attorneys with Fox Rothschild LLP..

I. Introduction

For many years, Israel had a tax regime that was extremely advantageous for foreign trusts, defined for the purposes of this article as trusts settled by a foreign person with a foreign trustee unrelated to the beneficiaries. Not only did Israel refrain from taxing its residents on any distributions they received from trusts created by a foreign person, but beneficiaries were not even required to report such distributions. This all changed when the Israeli Knesset passed its recent tax reform law, *effective January 1, 2014*, subjecting many previously tax-exempt trusts to significant Israeli income tax liability. (Note: The new law was intended to tax trusts that do not pay tax in any jurisdiction. However, unfortunately, the law was written very broadly, and includes trusts paying taxes elsewhere, which can be problematic, as is discussed below with respect to double taxation.)

The reporting and tax obligations discussed below are imposed even if there are no trust assets in Israel, no trustee resident in Israel and the settlor is not an Israeli resident. With this new law, Israel went from one extreme to the other – from imposing no tax or reporting requirements on foreign trusts to imposing rigor-

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ous reporting requirements and significant taxes on foreign trusts with the beneficiary being the only connection to Israel. Since the law imposes a number of deadlines that occur in early 2014, time is of the essence to plan and comply, but further guidance is needed from the Israel Tax Authority before this can be done with certainty.

II. Explanation of the law

According to the new law, an Israeli Beneficiary Trust is a trust under which all settlors are foreign residents, and there is at least one Israeli resident beneficiary. All trusts that can be categorised as such will be taxed under the new law, but the timing and rate of the tax will depend on the exact relationship between the settlor of the trust and the beneficiaries. An Israeli Beneficiary Trust can be either:

- a Relatives Trust (sometimes referred to as a Family Trust), when the settlor is the parent, grandparent, spouse, child or grandchild of the beneficiary, or
- a Non-Relatives Trust, a designation which applies to all other Israeli Beneficiary Trusts.

If the settlor and the beneficiary are relatives of a second degree, they will be considered as "relatives" for these purposes only if the assessing officer is convinced that the trust was settled in good faith and the beneficiary has not paid consideration for his right in the trust assets.

The tax implications of a Non-Relatives Trust are straight-forward: such a trust is taxable as an Israeli Resident Trust and subject to income tax in Israel on all of its world-wide income. There are no choices or elections to be made here – simply a tax to be paid. The more complicated tax-planning issue arises in the context of the Relatives Trust.

Trustees of existing Relatives Trusts must notify the Israeli tax assessor of the existence of such trusts *by late January 2014* (or within 60 days of the creation of a new Relatives Trust). Then, the Trustee must choose between two possible taxation regimes. The default rule, if the Trustee takes no further action, is the Deferred Tax Regime, under which there is no yearly tax at the trust level but the Israeli resident beneficiary is taxed at a 30 percent rate upon trust distributions when received. Note that only income, not principal, is subject to taxation, but there is a presumption that income is distributed before principal. Instead, the Trustee of a Relatives Trust may make an irrevocable election to be taxed under the Alternative Regime, which imposes a 25 percent tax at the trust level on a yearly basis with respect to the portion of the income allocated to Israeli beneficiaries. Under the Alternative Regime, distributions to beneficiaries are not taxed. It appears that this election must be made *by February 2014*.

Regardless of which regime is chosen, at the death of the settlor, the trust would become an Israeli Resident Trust, subject to Israeli taxes on its worldwide income. However, the trustee has the option to maintain the status of the trust as a Relatives Trust for taxation purposes after the death of the settlor until the death of the settlor's spouse, if the surviving spouse was married to the settlor at the time that the settlor made any contribution to the trust in question.

Non-Israeli clients, who have established trusts for their children and grandchildren, some or all of whom live in Israel, need to be made aware of the new reporting requirements and the income tax liability that the trusts, or their children and grandchildren themselves, will now bear. It does not appear to make any difference whether the trust is treated as grantor or non-grantor, or is revocable or irrevocable. Many factors must be considered in choosing between the possible taxation regimes, and clients with applicable trusts need to consult with qualified Israeli and foreign tax counsel.

III. Open issues

One of the most important things to know about the application and implementation of the new law is that much is still unknown; therefore, tax planning recommendations remain unclear. Further guidelines and regulations are expected, but it is uncertain when these guidelines will be released. There have been indications that the Israeli tax authorities will release them by year-end, but others project that it could be many months later than that. Given the imminent reporting and election deadlines set forth in the law, this current state of unknown is particularly challenging.

The most basic open issue at this point is that the Israeli government has not yet released any form for trustees and beneficiaries to use to fulfill their reporting and election requirements. Practitioners in Israel are attempting to obtain an extension of these approaching deadlines so that the government has time to release a form and so that people can make informed decisions about this new law. Whether such efforts are successful remains to be seen.

Another open issue is to what extent a foreign trustee or an Israeli beneficiary will face penalties (civil or criminal) in Israel for failing to report the existence of or distributions from a newly-taxable trust. To what extent this will be enforced is unknown, especially since many people will fail to report simply because they are unaware of the change in the law and the new requirements.

A more complicated issue that has significant ramifications in terms of planning is the problem of double taxation – in other words, will trusts that fall under this new regime be forced to pay taxes in two countries without credit? If we consider the United States specifically for a moment, and consider the combination of the foreign tax credit granted by US law and the application of the Israel-US tax treaty, it would be reasonable to assume that where the trust is the relevant taxpayer in both jurisdictions, some credit for taxes paid in the other country would be offered. However, this conclusion assumes that the taxpayer is the same in both jurisdictions. If the trust is the taxpayer in one jurisdiction and the settlor is the taxpayer in the other, the conclusion with regards to tax credit is much less certain. Also, every treaty is different, and practitioners in other countries must analyse the relevant treaties in light of this new law.

Yet another open issue is the question of the basis of trust assets. The law as it currently stands does not offer any basis step-up upon the law's effective date. A trust with low-basis assets that is subject to this new tax regime and sells assets would have a very significant tax liability. It is anticipated that the expected guidelines and regulations will address this point.

IV. Planning suggestions

There are a lot of open questions, and unfortunately not many answers currently available that provide certainty. Nevertheless, below are some planning suggestions to help navigate this very uncertain period. Note at the outset that every trust and situation is different and will require separate analysis.

A. Division of trusts

The first planning tip is to divide trusts, where possible and where applicable, such that there are separate trusts for the Israeli beneficiaries and for the non-Israeli beneficiaries. As discussed above, the law will impose a 25 percent tax at the trust level (assuming the Alternative Regime election is made), with respect to the portion of the income allocated to Israeli beneficiaries. How exactly this income will be allocated is not clear. It has been widely suggested that it would be advantageous from a tax perspective to separate the trusts such that no portion attributable to a non-Israeli is taxable by Israel.

B. Distribution of trust assets

In an even more extreme move, a number of practitioners are terminating trusts with both Israeli and non-Israeli beneficiaries, and distributing as much as possible to non-Israeli beneficiaries. This may be advisable (or even present a planning opportunity) where compatible with the family dynamics or where the original purposes of the trust for the Israeli beneficiaries has changed. However, this also requires careful consideration, because there can be significant disadvantages. First, the trust was certainly created for some purpose – whether asset protection, the need to professionally manage assets for children or grandchildren not yet ready for such management, or otherwise – and this purpose will be defeated by distribution of trust assets. Furthermore, a trust can have the benefit of preventing assets from being subject to estate tax on the death of the settlor and/or the beneficiary and may provide generation-skipping transfer tax advantages, both of which could be undermined by a termination of the trust.

C. Current gain realisation

In terms of the basic issue, another planning move to consider is to force the realisation of gain now, before the law takes effect, while the income from existing trusts is still exempt, and the re-investment of proceeds in similar assets. This would effectively increase the basis of trust assets and ensure that any sales after January 1, 2014 would incur less income tax.

D. Change of timing or payor of tax to avoid double tax

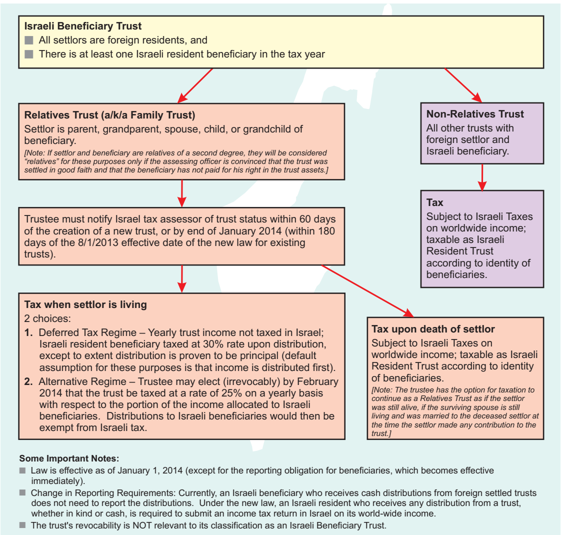
Finally, the issue of double taxation has sparked much speculation. The first consideration is whether the Deferred Regime or Alternative Regime would offer a better chance at obtaining a credit for taxes paid elsewhere. It has been suggested that electing to pay 25 percent per year at the trust level, rather than 30 percent at the beneficiary level upon distributions, would be more advantageous from a taxation perspective. The prevailing thought seems to be that Israel is more likely to offer a credit for taxes paid in the US if they are being paid at the same time as the taxes owed in Israel. Therefore, if tax is owed by the trust on a yearly basis in both countries, a credit might be more likely.

However, the issue of an available credit is more complicated when the relevant taxpayer in each jurisdiction is not the same. This would be the case for grantor trusts that opt for the 25 percent Alternative Regime. In the US, taxes would be paid by the grantor, while the trust would possess the tax liability in Israel. To deal with this issue, some practitioners are considering the possible advantages of terminating grantor trust status for such trusts, so that the relevant taxpayer is the trust in both countries. However, those considering such a move must also beware of several points. First, the resolution of double taxation is unclear and it is not certain that a credit will be available even in this scenario. Second, there are very significant advantages to grantor trust status. When the grantor pays US tax, it is equivalent to a tax-free gift to the beneficiaries. This is a significant advantage that should not be relinquished without careful analysis.

V. Conclusion

The new Israeli income tax law has created far more questions than answers. It is at once far-reaching and frustratingly unclear. It is hoped that further regulations and guidelines over the coming months will address the many open issues, and that extensions for reporting and electing will be granted until such clarifications can be made. It is possible that there may be some grandfathering of existing trusts, but this is unclear at this time. This topic will be closely-monitored and updates provided as available. In the meantime, the suggestions and planning tips laid out in this article are intended to raise awareness of the issues and give some preliminary guidance to help obtain as favourable a tax result as possible within the confines of the new law, as currently understood.

Taxation of trusts under new Israeli law



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Debra T. Hirsch is a partner and Sara Y. Weinberg is an associate *in the Taxation and Wealth Planning Department of Fox Rothschild LLP. They can be reached at dhirsch@foxrothschild.com or sweinberg@foxrothschild.com.*