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Dear Clients,

Re: Recent major Changes in Trusts' Taxation

The Law for the Change of National Priorities (Legislation Amendments for Achieving Budgetary Targets for the Years 2013-2014) ("the New Law") has changed the tax treatment of Israeli-resident beneficiaries of trusts established by foreign settlors.

Below please find a summary of the major trusts-related tax changes:

1. New status of an "Israeli-Resident Beneficiary Trust" and a "Relatives Trust"

a. An Israeli-Resident Beneficiary Trust ("IRBT")

An IRBT is a trust, either revocable or irrevocable, whose settlors since its establishment are all foreign residents and during the relevant tax year such trust has at least one Israeli-resident beneficiary. It is very important to note, that the Pre-New Law definition of a "Non-Resident Settlor" that included a deceased person who was non-resident on the day of his or her death, has been changed. Under the New Law, the scope of the definition of an Israeli Residents' Trust now covers a trust whose settlors have all passed away and that has at least one Israeli-resident beneficiary within the tax year.

b. A Relatives Trust ("RT")

An RT is an IRTB, whose settlors and Israeli-resident beneficiaries are all inter-related as follows:

1. The settlor is a parent or a grand-parent or a spouse, or a child or a grandchild of the beneficiary.

2. There exist ties between the settlor and the beneficiary other than those set forth in the foregoing Sub-Section (1), under Section 88 Of the Income Tax Ordinance, and the Assessing Officer is convinced that both the establishment of the trust and contribution of assets thereto are in good faith and for no consideration.

Section 88 of the Income Tax Ordinance extends the "relative" definition's scope to a brother, a sister, a spouse's descendant and a spouse of each relative. The definition also includes a descendant of a brother or a sister and a brother or a sister of a parent.

c. Tax treatment of an IRBT

An IRBT which is not a RT shall be treated as an Israeli-Resident Trust ("IRT") and its income and assets will be regarded as derived and owned respectively by an Israeli resident.

d. Tax treatment of a RT

- i. The trustee should report an RT's status to the Assessing Officer no later than 60 days after the trust's establishment or becoming an RT, and no later than 180 days after August 1ST, 2013, in respect of a trust that existed before this date.
- ii. Any distribution made from a RT to an Israeli resident, out of income derived outside Israel, will be subject to tax at a 30% rate.
If the trustee can establish that a distribution, in full or part, is of an asset vested to the trustee that if transferred directly from the settlor to the beneficiary would be exempt from tax (i.e. – a gifted asset or distribution from corpus), then such distribution would be exempt from tax.
Taxable distributions will be deemed as being prior to exempt distribution.
- iii. Where a distribution is made to other beneficiaries as well, the Israeli-resident beneficiary's share in the exempt part shall be pro-rata to his or her share in the overall distributions.
- iv. Notwithstanding the 30% upon- distribution tax arrangement, the trustee may elect an alternative tax route, by submitting a notice to the Assessing Officer within 60 days after the later of the establishment day of the trust or of the day it became a RT, and if the RT existed before August 1st, 2013, the due date is the 2014 tax return filing due date. Under the alternative tax route, a 25% tax will apply to the trust's non-Israeli-source income distributable to the Israeli-resident beneficiary, and such income will be deemed as an Israeli Resident's income, taxable in the year in which it was derived.
Subject to tax payment under such timely election, no tax will apply upon

actual distribution. Such election is irrevocable so long as the trust qualifies as a RT. An Israeli-source income derived by a RT will be subject to Income Tax at the rates applicable to individuals.

- v. A contribution of an asset to a RT will be regarded for capital gains tax assessment purposes as a direct transfer from the settlor to the beneficiary.
- vi. If a trust becomes a RT due to one beneficiary becoming an Israeli resident as either a New Resident or as a Returning Resident under Sections 14(a) or (c) of the Income Tax Ordinance, the tax benefits applicable to the new or returning resident will apply in respect of his or her share in the trust's income or distribution, as the case may be.
The foregoing tax benefits shall also apply to a RT established by a foreign resident for the benefit of new or returning Israeli residents only.
- vii. Subject to the below exception, in case one of the settlors of a RT passes away, the RT automatically becomes an Israeli-Resident Trust as of the day of death, and its income and assets will be deemed as derived and owned respectively, by an Israeli resident.
The tax benefits applicable to a beneficiary who is a New or Returning Resident will be preserved in respect of his or her share in the trust's income or distribution.
However, if the settlor's spouse, who was already his or her spouse at least on one contribution day, survives the settlor, then the trust shall still qualify as a RT.
- viii. If a trust ceases to qualify as a RT under the tax-upon-distribution route, and becomes an IRBT which is not a RT or another type of trust, then distribution from income derived before disqualification and while the beneficiary is an Israeli resident, will still be taxed under the tax-upon-distribution arrangement, mutatis-mutandis, and any distribution will be deemed as a distribution made before disqualification date, unless proven otherwise.

2. The "Foreign Resident Trust"

- a. The Foreign Resident Trust ("FRT") has replaced the no longer existing Foreign Settlor Trust.
It is defined as a trust, that in the relevant tax year, its settlors and beneficiaries are all non-residents, or its settlors are all non-residents and its beneficiaries are either Beneficiaries for Public Purposes or non-residents, and it has not had any Israeli-resident beneficiaries since its establishment.
A "Beneficiary for Public Purposes" is defined as the State of Israel, a municipality,

"Keren Kayemet LeIsrael", "Keren Hayesod", The United Jewish Fund for Israel, or a "Public Institute" under Section 9(2) of the Income Tax Ordinance, or similar corporations exempted from tax under Israeli Law, or a public entity qualified by the Head of the Tax Authority, and approved by the Finance Committee of the Knesset.

- b. Like the no longer existing "Foreign Settlor Trust", a FRT will be deemed as a foreign resident and will not be taxed on its non-Israeli-source income.
- c. In addition, the trustee of a NRT will be exempt from filing a tax return in respect of non-Israeli-source-income.

3. Changes in respect of a Trust Assets Holding Company -

The definition of a "Trust's Assets holding Company", (here-in-after: "TAHC"), has changed. It is now mandatory that the TAHC be established for the sole purpose of holding the trust's assets.

If the respective trust is an "Israeli Resident Trust" or a "Testamentary Trust", or one of its beneficiaries is resident in Israel or it holds assets in Israel – the TAHC's incorporation and status should be reported to the Assessing Officer within 90 days after incorporation.

For trusts set up before August 1st, 2013, the due reporting date is the due date for filing the 2014 tax return.

In addition, it is required that the TAHC be held 100% either directly or indirectly by the trustee.