

A NEW STAR IS BORN - THE ISRAELI UNDERLYING COMPANY

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A. Introduction

Israel's taxation system has been significantly revised and has undergone a major reform over the past few years. Commencing with the new taxation laws of 2003 pursuant to which an Israeli resident is taxed on worldwide income and continuing with the Taxation of Trusts Law which became effective on January 1, 2006. The Taxation of Trusts Law has great relevance for Israeli residents with respect to the taxing of trusts and may be advantageous to foreign residents from a tax perspective. If the Taxation of Trusts Law is utilized correctly by foreign individuals, Israel may become a major international business and financial center for non-residents.

B. The Foreign Resident Settlor Trust and the Taxation Thereof

There are a number of categories of trusts under the Taxation of Trusts Law. This article will emphasize the category relevant to foreign residents which is the foreign resident settlor trust. This trust is designed either for non-resident family members who wish to provide for their family in Israel or for foreign residents who wish to appoint an Israeli trustee, rather than trustees in various offshore jurisdictions, to manage family assets and wealth.

The conditions required for a trust to be classified as a foreign settlor trust are: (i) the settlor must be a non-resident of Israel at the time of formation of the trust and during the tax year; or (ii) the settlor and the beneficiaries must be non residents of Israel during the tax year.

A foreign resident settlor trust is viewed as a foreign resident personally, with the country in which the settlor resides as its place of residence, regardless of whether the trust is classified as revocable or irrevocable. The assets held by the trustee are viewed as though said assets were held by a foreign resident personally. As a result, the income of the trust is regarded as the income of a foreign resident. Trust profits that are not derived from sources in Israel are not taxable in Israel. Further, there are no reporting obligations in Israel.

This tax and reporting exemption relates to income derived from sources such as rental, interest, dividend, capital gains and business profits outside Israel. The foreign resident settlor trust, in certain cases, may also be exempt from tax on certain income derived from Israel from interest or capital gains as such income may be viewed as income of a foreign resident.

C. Israel as an International Business Center

Foreign investors have a number of options before them for holding funds in Israel:

1. Individually.
2. By a local trustee on behalf of an individual.
3. By an entity established abroad.
4. By an underlying company of a trust.

1. Individually/Local Trustee

For various reasons many individuals do not wish to open bank accounts in Israel in their own names. The option of a local trustee on behalf of an individual is also not usually one that individuals prefer as the client's name forms part of the name of the bank account (i.e., _____, as trustee for _____(name of

client)). Therefore, many clients decide to resort to the option of a corporate entity incorporated abroad to hold the bank account in Israel.

2. An Entity Established Abroad

The definition of the Tax Ordinance for an Israeli company (which is subject to taxes in Israel) consists of two options: (i) the company was originally incorporated in Israel; or (ii) the company's "management and control" is conducted in Israel. The term "management and control" is difficult to define and companies which appoint Israeli directors and professionals are, in many cases, at risk of being declared Israeli companies by the Israeli Tax Authority. As a result, Israeli trustees have been unable to operate foreign trusts from Israel, not to mention Israeli companies. A company that held assets for the benefit of a foreign resident could not have been managed and controlled from Israel as it was liable for Israeli taxes.

3. The Underlying Company

A new concept, introduced by the new Taxation of Trusts Law is that of an underlying company in Israel. The Taxation of Trusts Law provides for the establishment of an underlying company of a trust within Israel or abroad for the purpose of the legal separation between the trustee's personal assets and the trust's assets.

An underlying company is a separate legal entity ('group of persons') holding a trust's assets for the trustee, directly or indirectly. This entity can be a company, foundation, partnership, etc. Every entity which possesses assets that are not its own, but belong to the trustee by virtue of his duty as trustee, fulfills the definition of an underlying company.

As mentioned above, before the new law was legislated, every Israeli trustee holding such a company would, through the 'management and control' test, cause the company to be regarded as an Israeli company and subject it to corporate taxes and reporting requirements in Israel. The new Taxation of Trusts Law provides that this underlying company is now regarded as a 'flow through entity' and the 'management and control' test is no longer relevant. The Israeli tax authority is to 'ignore' and 'look through' the company and treat the assets and the income derived therefrom as if they were held directly by the trustee.

As the trustee of a foreign settlor trust is not subject to tax or reporting requirements, said trustee may utilize an underlying company, whether in Israel or abroad, to hold the trust's assets. Neither the trustee nor the underlying company is subject to tax or reporting obligations on the income derived from sources outside Israel. Where the underlying company derives income from sources within Israel, such income is considered earned by a foreign resident. Since income from foreign currency deposits in Israeli banks is exempt from taxes if held by a foreign resident, the underlying company (even if established and managed in Israel) may receive the same exemption. The exemption may also be granted if the income is derived from sources such as capital gains from the sale of securities on the stock exchange or capital gains from several capital instruments all of which are exempt from taxes if owned by a foreign resident. Moreover, other sources of income may be exempt from taxes if owned by a foreign resident by virtue of tax treaties.

D. Conclusion

The concept of an underlying company is simple and advantageous in constructing the most efficient trust arrangement possible. Until now, settlors and practitioners preferred appointing foreign trustees out of concern that having an Israeli trustee could create tax liabilities in Israel. Following the new law, the place of residence of the trustees will not affect the taxation of the

trust. It is the tax status of the beneficiary and the settlor that will determine Israeli tax liability.

This is an important development in the Israeli tax system. It provides opportunities to both Israeli and overseas trust companies and trust and estate practitioners. The appointment of Israeli trustees is encouraged by the Tax Authority. Not only will it advance the use of domestic professional services, but it will also enable the Tax Authority to communicate directly with trustees. Foreign trustees seeking assistance and better communication with the tax authorities may co-operate with Israeli trustees in order to fulfill their duties in Israel.