

Taxation of Trusts in Israel: Filing Tax Reports and Reporting Duties

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I. Introduction

Much has been published over the past few years in connection with the tax reforms passed by the Israeli Knesset (Parliament). In particular, tax reforms relating to the taxation of trusts, which came into effect on January 1, 2006 have raised much interest with US practitioners as they affect US Trustees as well as many residents and non-residents of Israel. The main purpose of the Trust Taxation Law (the "Law") is to provide legislation with respect to the use of trusts by Israeli residents which has not been governed by law prior to 2006.

As the Law imposes obligations based on the role in connection with a trust (i.e., a trustee, settlor, beneficiary), professionals in Israel and abroad have been waiting for the publication by the Israeli Tax Authority of Regulations clarifying the Law. In the process of drafting the Regulations, a number of issues have arisen with respect to certain sections of the Law which result in great difficulty in drafting said Regulations. In December 2007, a bill was proposed amending the Law (the "Proposed Bill"). This article is a summary of said Proposed Bill in an attempt to clarify various uncertainties relating to obligations under the Law.

II. The History of the Israeli Trust Law

The trust law concept has been recognized under the Israeli legal system and government regulations for many years. The enactment of the Charitable Trusts Ordinance (1924) established the rules for public trusts. The laws for private trusts were enacted by the Trust Law of 1979.

III. The Taxation of Trusts Law

The tax system in Israel was revised in 2002. Under the new Income Tax Regulations 2002 as well as the Income Tax Ordinance No. 132, Israeli residents are subject to tax in Israel on their worldwide income. The new tax rules became effective on January 1st 2003. The tax reform of 2003 did not cover the taxation of trusts. In 2005, the comprehensive Law followed the revisions to the taxation system in Israel in order to regulate personal taxation via the use of trusts.

The new law introduced certain innovative positive provisions for the use of trusts in Israel –

1. Managing a trust in Israel is not, in itself, sufficient reason to tax the trust
2. An Israeli company may be used as an underlying company

Taxation of Trusts in Israel and Reporting Duties under the Law

The Law defines different types of trusts:

* A foreign settlor trust is a trust settled by a non-resident of Israel. This trust makes Israel attractive to foreign residents. Whether or not the trust is revocable, a foreign settlor trust is considered a foreign resident. The assets held by the trustee are viewed as assets held by an individual foreign resident and the trust's income is viewed as the income of an individual foreign resident. If the trust profits are not derived from sources in Israel, they are not taxable in Israel.

* An Israeli residents' trust is a trust settled by an Israeli resident and in which at least one of the beneficiaries is a resident of Israel. This trust is taxable on its worldwide income according to the laws of Israel and according to the tax rates applicable to individuals.

* A foreign beneficiary trust is a trust settled by an Israeli resident for the benefit of non-resident beneficiaries. In such a trust, the assets and income derived therefrom are taken out of the Israeli tax network.

* A testamentary trust is a trust settled by a will executed by an Israeli resident. Said trust may be treated, for tax purposes, as an Israeli residents' trust or a foreign beneficiary trust.

* Another broad classification is a distinction between a revocable trust and an irrevocable trust. The former was already regulated by the tax laws prior to 2003, since it attributes the income of the trust to the settlor whereas the latter is now governed by the Law. Most of the provisions of the Law relate to irrevocable trusts **but**, under certain circumstances, also cover revocable trusts.

IV. Reporting Obligations Based on One's 'Role' in a Trust

A. Trustee

A trustee of an Israeli residents' trust or a testamentary trust for the benefit of an Israeli resident beneficiary is required to report the trust's worldwide revenue. For other types of trusts, only revenue derived from sources in Israel is to be reported. The residence of the trustee is immaterial for tax purposes, and there is nothing in the Proposed Bill to suggest that this may change. The Proposed Bill proposes subjecting trustees to additional reporting duties, as follows:

1. A change of trust classification notice (i.e., a change from an Israeli residents' trust to a trust of foreign residents, and vice versa).
2. An obligation to report the settlement of a testamentary trust pursuant to a will executed by a resident of Israel.
3. A trust liquidation notice relating to any of the following: an Israeli residents' trust, a testamentary trust deemed an Israeli residents' trust, or any other trust type the assets of which were located in Israel on the liquidation date. The notice is to include details of the assets distributed from the trust.

B. Settlor

The Law imposes a reporting obligation on a person who, during the relevant fiscal year, settled a trust or transferred assets or income to a pre-existing trust. Said reporting obligation is imposed on any settlor regardless of said settlor's country of residence. This is likely due to a drafting oversight and has been slightly clarified by the Proposed Bill:

1. The Proposed Bill amends the reporting obligation and limits it to Israeli resident settlers.
2. While the Proposed Bill removes the reporting obligation from any settlor worldwide, it imposes an obligation to report the existence of a trust on settlers who were foreign residents when they settled a trust (i.e., classified as a foreign settlor trust under the Law) yet immigrated to Israel.

3. Once the settlor is an Israeli resident, said reporting is to be made in the year following the settlor's becoming so resident. Said report is to include the identity of the trustee, as well as specify the trust assets. At this time, the Proposed Bill does not require that such a report include the identity of the beneficiaries although it is likely that such disclosure may be required to be made by the trustee. In the event that a settlor of a foreign settlor trust immigrates to Israel where the relevant trust was settled at least ten years prior to his immigration, the reporting is to include only the details of the trustee and not the trust assets.
4. The Proposed Bill also revises the contents of the report to include only the settling of an asset or income to a pre-existing trust as well as the settling of new trusts, rather than an obligation to file a complete annual tax report. Said reporting is to include identifying details of the trust such as the trustee, beneficiary and existing assets.

C. Beneficiary

A beneficiary is required to submit a complete annual tax report if said beneficiary receives a distribution from a trust even if said distribution is not taxable in Israel. A special regulation exempts the beneficiary from said obligation if said distribution does not exceed the amount of NIS 100,000 (approximately \$26,000 at the beginning of 2008). As in the case of the settlor, said obligation was likely unintentionally imposed on any beneficiary, even if not an Israeli resident.

Therefore, the Proposed Bill's proposals are as set forth below:

1. Limiting this obligation to Israeli resident beneficiaries.
2. Replacing the obligation to file a complete annual tax report with a duty of filing a notice relating to distributions made.

V. Additional Amendments to the Reporting Obligations

A. Expanding the Exemption from Submitting an Annual Report for Foreign Trusts

The Proposed Bill proposes authorizing the Minister of Finance to exempt trustees from reporting on tax-exempt income derived from Israeli sources, an exemption from filing annual reports (regardless of whether any such trustee is a resident of Israel), provided such exemptions are approved by the Finance Committee. In the event that the Proposed Bill is enacted, said authority may be advantageous to trustees of trusts other than Israeli residents' trusts who may hold trust assets in Israel where the income of such assets is tax exempt. It is interesting to note that income from certain investments of non-Israeli residents is exempt from tax in Israel. The exemptions will now be extended to foreign settlor trusts.

B. Amendments to the Transitional Provisions

The time periods for the filing of various reports relating to trusts settled prior to 2006 is established by the Law but may be quite difficult to adhere to. The Proposed Bill attempts to revise said time periods in order to ease the burden imposed for such complicated matters and extend the filing deadlines. The preferred time frame is one set by the director of the Tax Authority.

VI. The Tax Authority Announcement

In addition to the Proposed Bill, the Tax Authority announced that all reporting requirements that stem exclusively from the Law are deferred to May 31st, 2008.

VII. Conclusion

Certain elements of the Law, as it applies to foreign trustees are "unorthodox" in as much as they put a heavy burden on a trustee operating outside of Israel. The declared purpose of the Law is to regulate all matters relating to the taxation of trusts. This is in an attempt to prevent Israeli residents from using trusts as a method of tax evasion. Once the process is established and followed, we believe the 'machine' will run smoothly and the matters will be learned by those involved. In the meantime, it is a work in progress and will take some time to implement. Trust practitioners are advised to be acquainted with the various detailed announcements of the Israel Tax Authorities and additional regulations are expected to be published during this year.

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