The tax reform which became law in Israel on January 1, 2003 introduced the concept of personal taxation. One of the objects of this reform was to change the tax regime from territorial to global taxation. An Israeli resident is now taxable on his worldwide income. However, some Israeli residents used overseas trusts for investment and management of their financial assets. It became inevitable that taxation of trusts be examined carefully since the legislation of the tax reform did not deal with this subject. Due to the complexity of the subject, the Income Tax Commissioner appointed a special committee: “The Committee for the Taxation of Trusts” (hereinafter the “Committee”) whose task was to recommend how trusts should be taxed in Israel. Members of the Committee included public servants and senior practitioners from the private sector. The Committee was headed by Ms. Frida Israeli, CPA, a senior officer of the Tax Commissioner.

After long deliberations, the Committee published a report on July 24, 2003 presenting its recommendations.

Before examining the main points of the Committee’s recommendations, it may be beneficial to review some basic points about trusts.

I. Trusts and their Uses

The creation of a trust may have numerous uses and advantages. It may be a flexible and private arrangement for holding and managing assets. Many people create trusts to preserve family wealth and ensure the orderly flow of assets from one generation to the other.

Israel recognises the common law concept of trusts and has enacted the Trust Law 1979. The Israeli law distinguishes between revocable and irrevocable trusts. Briefly, whether a trust will be classified as a revocable or irrevocable trust depends on the amount of control that the settlor preserves for himself for the management of the trust assets. In most cases, the settlor completely separates himself from the trust assets from the moment he transfers the assets to the trustee and provides him with discretionary powers to manage the trust assets. This is an irrevocable trust. The taxation of revocable trusts are already regulated by existing tax laws. The Committee’s recommendations relate to the taxation of irrevocable trusts.

We can now examine the Committee’s recommendations.

II. Principles of the Recommendations

The Committee has adopted the following key principles:

- A trust is not a separate entity for tax purposes and the taxpayers are the beneficiaries. The Committee recommends imposing the same tax rates on assets held by trusts for the benefit of Israeli beneficiaries as would have been imposed had the assets been held by the beneficiaries personally.
- The recommendations only apply to irrevocable trusts.
- The trustees will be served with an assessment of tax to be paid from the trust fund on behalf of the beneficiaries.
- Revenues of trusts will be taxed on a current basis, i.e., even if not distributed to the beneficiaries.
- The place of residence of the trustee has no importance in terms of tax liability.

The Committee dealt with four categories of trusts and these are outlined below.
A. “Trusts of Israeli Residents”

In this category, the settlor and the beneficiaries are Israeli residents.

- **Transfer of property to the trust**: This will be exempt from tax if the settlor can prove that an outright transfer of the property directly to the beneficiary would have been exempt from tax (e.g., as a gift, exempt from tax in Israel).
- **Taxation**: Trust revenues will be taxed on a current basis and a tax assessment will be sent to the trustee for settlement. The applicable tax rates will reflect the normal income tax rates in Israel applicable to individuals (10 percent, 15 percent, 25 percent and 35 percent according to each case).
- **Distribution to beneficiaries**: This will not be regarded as a taxable event since the revenues of the trust have been taxed on a current basis.

B. “Foreign Beneficiary Trusts”

In this category, the settlor is an Israeli resident but the beneficiaries are foreign residents.

- **Transfer of property to the trust**: A transfer will also be exempt from tax if the settlor can prove that an outright transfer of the property directly to the beneficiary would have been exempt from tax (e.g., a gift).
- **Taxation**: Trust Revenues accrued outside Israel will not be taxed but all revenues accrued in Israel will be taxed according to the tax status of the foreign beneficiary.
- **Distribution to beneficiaries**: This will not be regarded as a taxable event since the revenues of the trust have been taxed on a current basis.
- **Enforcement**: The settlor and the trustees will be obliged to declare that the trust does not comprise any Israeli beneficiaries.

C. “Foreign Settlor Trusts”

In this category, the settlor has been a “foreign resident” for more than 15 consecutive years and the beneficiary is an Israeli resident.

- **Transfer of property to the trust**: The Committee recognises the wish of the Israeli government to encourage transfers of foreign assets to Israeli beneficiaries and therefore recommends that various tax allowances must be provided to achieve this goal. The transfer of the settlor’s property to the trust will also be exempt from tax if he can prove that an outright transfer of the property directly to the beneficiary would have been exempt from tax (e.g., a gift).
- **Taxation**: Only trust revenues accrued in Israel will be taxed in this situation. Foreign trust income will be exempt from tax.
- **Distribution to beneficiaries**: This will also not be regarded as a taxable event.
- **Enforcement**: The beneficiary must prove that the settlor has been a foreign resident for more than 15 consecutive years and must also report all distributions made to him throughout the trust’s life.

D. “Limited Foreign Settlor Trusts”

This is a situation where the settlor has been a foreign resident for fewer than 15 consecutive years or is a foreign company and the beneficiaries are Israeli residents.

- **Transfer of property to the trust**: Again, the transfer of the settlor’s property to the trust will be exempt from tax if he can prove that an outright transfer of the property directly to the beneficiary would have been exempt from tax.
- **Taxation**: Only trust income accrued in Israel will be taxed. Both the trustee and the beneficiary may choose the tax liability as for “Trusts of Israeli Residents” and the beneficiary may at the time of a distribution prove to the Tax Commissioner what the exact amount of tax would have been had the beneficiary received it directly. The beneficiary may then pay such amount of tax together with interest and linkage increments.
- **Distribution to beneficiaries**: The beneficiaries will be liable to 15 percent tax on all distributions made to them from the trust without distinguishing between capital and income. The Committee recommends this stipulation as it is convinced that under this scenario it will be difficult to obtain information from the trustees as to the “financial history” of the trust assets.

The Committee’s recommendations also address the following special topics:

- **Multiple settlors or beneficiaries**: The Committee made special provisions for trusts comprising multiple settlors and multiple beneficiaries with different places of residence.
- **Changes in the county of residence**: Detailed recommendations have been made relating to the migration of settlors and beneficiaries to or from Israel.
Corporate entities as settlors or beneficiaries: The Committee made special provisions in order to combat tax avoidance by the use of companies as settlors or beneficiaries.

Charitable Trusts: The Committee recommends to exempt income of charitable trusts from tax upon the fulfilment of certain conditions.

Trusts holding real estate: Numerous recommendations have been made regarding trusts holding Israeli real estate.

III. Encouraging the Use of Israeli Trustees and Companies

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 Committee’s recommendations, the place of residence of the trustees will not affect taxation. It is the tax status of the beneficiary and the settlor that will determine Israeli tax liability.

This can be seen as an important development in the Israeli tax system. It also provides opportunities to both Israeli and overseas trust companies and trust and estate practitioners. The appointment of Israeli trustees is encouraged by the Income Tax Commission. Not only will it stimulate the use of domestic professional services, but it will also enable the Income Tax Commission 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 fulfil their duties in Israel.

Furthermore, the Committee recommends that Israeli companies may serve as underlying companies of trusts which could hold the assets without incurring tax liabilities. This may also be regarded as a positive provision to aid trustees.

IV. Conclusion

The Committee’s recommendations provide a distinction between the various categories of trusts and recommends taxing them according to the status of the beneficiaries and the settlors.

It remains to be seen to what extent the “Knesset” (Israeli Parliament) will adopt the Committee’s recommendations. If the recommendations are enacted by the end of 2003 as planned, the resulting measures could take effect retroactively to January 1, 2003.

1 Alon Kaplan was appointed as a member of the Committee from the private sector together with Meir Linzen, Advocate, and Alex Hilman, CPA.

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