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Israel

Update on Israeli Taxation of U.S. Trusts with Israeli Beneficiaries

Until 2014, Israel generally exempted from its income tax any trust that had been created by a foreign person, even if there were Israeli resident beneficiaries, and similarly did not seek to tax such Israeli resident beneficiaries on any distributions. But under new tax laws that became effective on January 1, 2014, many of these previously tax-exempt trusts and/or their Israeli resident beneficiaries have become subject to significant Israeli income tax liabilities and reporting obligations.

The law imposes reporting, as well as tax filing requirements. Therefore, it is essential for all trustees and trust beneficiaries subject to its provisions to be aware of and comply with the new law.

Relatives vs. Non-Relatives Trusts

According to the 2014 law, an Israeli Beneficiary Trust is a trust in which all settlors are foreign residents and there is at least one Israeli resident beneficiary. An Israeli Beneficiary Trust can be either:

(i) *a Relatives Trust*, which refers to a trust under which the settlor is still alive, and is closely related to the beneficiary as detailed in the law; *or*

(ii) *a Non-Relatives Trust*.

The new law subjects the portion of a Non-Relatives Trust allocable to Israeli beneficiaries to income tax in Israel on all of its worldwide income, at the regular rates; generally 25% on passive income and marginal tax rates on regular income (from 15%-52%). The law does not clarify how to determine the taxable portion allocable to Israeli beneficiaries.

A Relatives Trust is treated differently. So long as the Trustee of a Relatives Trust notifies the Israeli tax assessor of the trust's existence within 60 days of creation (or, for existing trusts, notified by December 31, 2015), the Trustee may make an irrevocable election between the following two tax regimes:

(a) *Annual Tax Regime*: An annual 25% tax is imposed at the trust level on the portion of the income allocated to Israeli beneficiaries. Subsequent distributions are not taxed. In most cases that the authors have encountered, the annual tax regime makes economic sense, particularly for trusts that are expected to make distributions within the next 15-20 years.

(b) *Deferred Tax Regime*: There is no yearly tax at the trust level, but the Israeli resident beneficiary is subject to a 30% tax upon distribution of trust income. There is a presumption that distributions are first from income before principal.

Note, though, that a Relatives Trust ceases to be designated as such upon the settlor's death. However, the Trustee has the option of maintaining the Relatives Trust status—and thus preserving the option of the Deferred Tax Regime – until the death of a surviving spouse, provided that such spouse was married to the settlor at the time that the settlor made any contribution to the trust. Once the foreign grantor dies, the entire trust becomes taxable in Israel. We understand that the ITA is considering new bylaws to except the share of foreign beneficiaries, but those rules are not yet written.

Credit for U.S. Income Taxes

The ITA has just issued a circular in August 2016 confirming that any U.S. tax paid on trust income will be applied as a tax credit against Israeli tax, regardless of whether the U.S. tax was paid by the settlor, the trust, or the beneficiary. The availability of this tax credit is particularly important for U.S. grantor trusts, where the grantor pays the trust's U.S. income tax. Matching U.S. tax payments to trust income for purposes of the Israeli credit will be easier under the Annual Regime than under the Deferred Regime because both countries will be imposing their tax on a current basis in the same year.

The authors note that for most tax paying trusts the result of applying the US tax credit will be very little or no additional taxes to pay in Israel.

New Beneficiary Reporting Requirement

A recent amendment to the 2014 law requires Israeli beneficiaries starting from the age of 25 years to file annual tax returns if the assets of the trust are valued at 500,000 new shekels or more, (if they are aware of the fact that they are beneficiaries), even in years where no distributions were made. It is unclear what happens if, due to exchange rates or market fluctuations, a beneficiary's share is worth under 500,000 new shekels in a year following a year the beneficiary has already reported.

Conclusion

U.S. clients who have established trusts for Israeli-resident descendants need to be aware of these new reporting requirements and tax liabilities. Every trust and family situation is different and will require separate analysis by qualified U.S. and Israeli tax counsel to determine appropriate compliance. The ITA is encouraging settlement on all unclear areas, so it may be useful to seek a negotiated settlement with the ITA.

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