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**ISRAEL &  
OFFSHORE TRUSTS**

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## 1. Introduction

Israel's Income Tax Ordinance has, since 2006, included specific rules regarding the taxation of trusts. The rules for taxation, such as they are, are actually very simple, perhaps even simplistic, but in trying to assess their impact, the devil is in the details.

The general rule of thumb is that the creation or existence of a trust should, as far as possible, be tax-neutral. The title of this article is really a little misleading, as it is an expressed goal that the *situs* of the trust or the trustees not be relevant.

Trusts are split into four categories, Israeli Resident Trusts, Foreign Settlor Trusts, Foreign Beneficiary Trusts and Will Trusts.

## 2. Definitions

2.1 A "Trust" is defined as "an arrangement whereby a Trustee holds the Trust assets for the benefit of a Beneficiary...whether it is defined as such in the law applicable to it, or whether it is defined otherwise". Clearly, this includes within the ambit of the law other structures that are treated differently in other jurisdictions.

2.2 Further, a "Trust Asset Holding Company" is defined as "a corporation that holds trust assets on behalf of the Trustee, directly or indirectly"; and the definition of "Trust" both includes such a corporation and expressly says that a "Settlement" (see below) to such a corporation amounts to a settlement to the trustee. This is an attempt to define an underlying company, and possibly also more remote subsidiaries, although whether the wording actually achieves that is not at all clear.

2.3 "Settlement" is defined as a "transfer of an asset to a Trustee in Trust, without consideration. "Consideration" is defined, as a general rule, as fair market value, such that a sale to a trust, or (subject to the above analysis) an underlying company on other than market terms will be considered an act of Settlement.

2.4 A "Settlor" is anyone who has made a Settlement, and includes any shareholder of a corporation that has made a settlement. Further, where any Beneficiary has certain elements of supervision or control over the actions of the Trustees, then that Beneficiary is also deemed to be a Settlor. In addition, where one trust settles another trust, then any settler of the first trust is deemed to be a settler of the second trust. These deemed-settlor rules are amongst the most effective anti-avoidance measures included in the legislation.

2.5 A "Beneficiary" is anyone entitled to enjoy Trust assets or income, and includes one who is conditionally entitled (which, presumably, is a fancy but not entirely useful, way of including discretionary beneficiaries), and an as yet unborn beneficiary.

2.6 A "Foreign Resident" Settlor will continue to be treated as such even after his death.

2.7 An "Irrevocable Trust" is a trust that is not revocable.

2.8 A "Revocable Trust" is very unpleasant, but important to understand. Any similarity between the definition and the usual interpretation is entirely coincidental, but this is on purpose. The distinction between revocable and irrevocable trusts is really, here, a technical tax term, and is used primarily regarding trusts with Israeli resident settlors, and particularly where the

beneficiaries are all non-resident. Revocable Trusts are trusts that are, on their terms, revocable, or where an asset or income can go, directly or indirectly, to the settlor, his spouse, his estate or a corporation of which he holds 10% or more. So too, any trust of which the settlor is a beneficiary, is a Revocable Trust. Also caught is a trust where a minor child (but not, interestingly enough, remoter issue) of the Settlor is a beneficiary, a trust where the Settlor or a relative (which is very widely defined elsewhere, but subject to certain exceptions) is also either a Trustee or Protector and a trust where the Identity of the Beneficiaries is unclear. Further, anti-avoidance clauses have the effect of treating trusts that have not been properly declared to the tax authorities, and any Trust where the Settlor can direct the Trustee's actions, as Revocable.

### **3. General Rules**

Certain general rules apply to trusts, although some of these are subject to certain elections depending on the type of trust.

- 3.1 The income and gains of the trust are taxed on an accrual basis.
- 3.2 The Trustee is the assessable party and the tax payer (although there are provisions for collection from settlers, and beneficiaries - to the level of any benefits received), even where he is foreign resident, and even where the trust is governed by the laws of a foreign jurisdiction. For those trusts with reporting requirements, the Trustees are liable to ensure proper reporting in Israel.
- 3.3 Where the trust has foreign resident Settlers or is a Foreign Beneficiary Trust or Will Trust, there is no requirement for the trustee to file trust returns, even if he is a resident of Israel, unless there is Israeli sourced (and thus usually taxable) income. Even then, the return is limited to such income.
- 3.4 Where a transfer of an appreciated asset is made to a trust by way of settlement, and where that transfer is not subject to Capital Gains Tax, there is no step-up in value.
- 3.5 Upon termination of a trust, there is no step-up in value when the asset is transferred to a beneficiary.

### **4. Israeli Resident Trusts**

These trusts are defined as trusts where at the time of settlement and during each tax year at least one Settlor and at least one Beneficiary are residents of Israel (although a subsequent provision makes the trust retain this status notwithstanding the fact that the Settlor has ceased to be a resident of Israel).

- 4.1 The income will be treated for tax purposes as the income of the Settlor.
- 4.2 If the trust becomes an Israeli Resident Trust by virtue of the immigration of a Settlor, then the trust income will be accorded the same tax exemptions as apply to immigrants personally.
- 4.3 A distribution of assets will be tax free if an exemption would have applied to a direct gift from the Settlor to the Beneficiary, (but there will be no step-up in value).

- 4.4 Where the trust is Irrevocable, the income may, subject to certain elections and guarantees, be treated as the income of the Beneficiary, although the trustee retains reporting obligations.
- 4.5 Where the Trust is Revocable, then subject to certain elections and guarantees, the income may be treated as the income of the Settlor, and he shall be responsible (in his lifetime) for reporting and paying the tax.
- 4.6 In all cases, the tax rates will be those applicable to individuals, and, where the specific individual has been identified (Settlor or Beneficiary, as above) as the taxpayer then the rates applicable to their individual circumstances (rather than maximum rates) will apply.
- 4.7 Where the Settlor expatriates or dies and there are no longer any Israeli resident beneficiaries there is considered to have been a sale, and a deemed sale of all assets such that Capital Gains Tax (“Exit Tax”) will become payable.

## **5. Non-Resident Beneficiary Trusts**

These are trusts with at least one Israeli Settlor, including the case where the Settlor *became* resident, but where *all* the beneficiaries are foreign resident individuals, and where the trusts deed provides that residents of Israel may not be added as beneficiaries. The specific rules only apply to Irrevocable Trusts, although there is some leeway in the deeming provisions described above.

- 5.1 A transfer of assets to the Trustee will be a taxable disposal for Capital Gains Tax Purposes.
- 5.2 The assets and income are considered to be the assets and income of the beneficiary.
- 5.3 Where a beneficiary immigrates to Israel, the Trust will become an Israeli Resident Trust, but the underlying income and gains of any distributions made to that beneficiary will be subject to the same tax exemptions as apply to immigrants personally.

## **6. Foreign Resident Settlor Trusts**

These are Trusts either where all Settlers were, at the time of settlement, *and remain* (or were at the time of their death) foreign residents, or where Israeli resident Settlers have expatriated and all the beneficiaries are foreign residents.

- 6.1 Whether the trust is revocable or irrevocable, the income and gains will be treated, for Israeli tax purposes, as those of the Settlor, such that only Israeli-sourced income will be liable to tax. Distributions to beneficiaries, whether of capital, gains or income, will not be subject to tax in Israel.

## **7. Will Trusts**

These are trusts created by will.

- 7.1 Where the testator was a resident of Israel at his death, the assets and the income and gains are treated as belonging to the beneficiaries, and taxed as such, so that this is essentially a bare trust.

7.2 Regarding foreign resident testators, it seems that such trusts will be treated as Foreign Resident Settlor Trusts, though this is a construction of interpretation, and it is hoped that this point will be clarified in due course.

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