Taxation of trusts in Israel – update

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Until 2006, there were very few specific provisions in the Israel Income Tax Ordinance [New Version] – 1961 ('the Ordinance') regarding the taxation of trusts, despite the fact that trusts, essentially in their common law form, have been recognised formally in Israel as of the legislation of the Trust Law 1979, and even before that thanks to the common law legal system which Israel generally adopted when it became independent in 1948 upon the cessation of the British Mandate.

As of 1 January 2006, the Ordinance contains detailed provisions for the taxation of trusts ('the Trust Rules').[1] These were amended importantly (Amendment 197 – 'the Amendment') on 5 August 2013, the Amendment coming into force on 1 January 2014 in respect of the tax liability of the trust, including trusts that already existed on that date.

Below is a summary of the Trust Rules as they are today, including the Amendment:

Key Definitions

'Trust'

An arrangement, made in Israel or abroad, according to which a trustee holds the trustee's assets for the benefit of a beneficiary, whether the law which governs it defines it as a trust or otherwise.

'Company for Holding Trust Assets' ('underlying company')

A company incorporated solely for the purpose of holding the trust assets for the trustee, who must own all the shares, directly or indirectly. A notice regarding the incorporation and status of the company must be filed with the assessing officer within 90 days of incorporation in all cases where the company will hold assets situated in Israel, or the assets of an Israeli resident trust, an Israeli resident beneficiary trust, or a trust by will with a resident beneficiary (see below for definitions of these trusts). Such an underlying company, whether incorporated in Israel or not, is transparent for tax purposes, so that in and of itself it has no liability to tax and has no tax reporting obligations in respect of the income generated by the trust assets which it holds.

'Settlor' (ie, creator, and includes any contributor to the trust)

Any person who vests (settles) an asset upon a trustee, directly or indirectly, including, among others:

- A person who was, directly or indirectly, a substantial shareholder (holds ten per cent or more of the means of control, which include right to profits) in a corporate entity at the time the corporate entity transferred the asset to the trustee; if such person, or his relative, is a beneficiary of the trust, then the holding of any one of the means of control suffices.
- Any beneficiary who, among others, is able to control or influence, directly or indirectly: the manner in which the trust is managed; the trust assets; the designation of beneficiaries other than by the settlor; the appointment or removal of trustees; or the distribution to beneficiaries.
- The settlor of another trust, which settled the trust in question.

'Beneficiary'

A person entitled to benefit, directly or indirectly, from the trust assets or income, including:

- a person entitled to benefit upon fulfilment of a condition or when a date prescribed in the trust documents is reached, save if such condition is the death of the settlor or another beneficiary;
- an unborn beneficiary;
- an indirect beneficiary through a chain of trusts;
- a person who holds, directly or indirectly, one or more of any type of means of control in a corporate entity beneficiary, which is not a public institution.

'Public purpose beneficiary'

Any one of the following:

1. The State of Israel, a local authority, the Jewish National Fund, The United Jewish Appeal for Israel, National Lottery, Provident Fund (under certain conditions) and a public institution. ('Public Institution' is defined as a body of at least seven persons the majority of whom are not related, or a trust the trustees of which are not related, either of which exists and operates solely for the purpose of achieving a public purpose, and files annual reports as required. 'Relative' is defined as spouse, sibling, parent, grandparent, descendant and spouse's descendant, and the spouse of any one of these.[2] 'Public purpose' is defined as: a purpose concerned with religion, culture, education, encouragement of settlements, science, health, nursing care, or sport, and any other purpose approved by the Minister of Finance as a 'Public purpose'.[3])
2. An association of persons similar to any one of the above which is tax exempt in accordance with Israeli law.
3. A public body approved by the Director of the Israel Tax Authority (ITA) and confirmed by the Finance Committee of the Knesset (the Israeli Parliament).

Liability to tax

The liability to tax on the accrued income of the trust is imposed on the trustee – resident or non-resident – who is the person assessed but whose accrued income is deemed the income of the settlor.[4] As can be seen from the following classifications of the trusts, however, the determination whether or not there exists a liability to tax on the accrued income depends on the residence status of the settlor and/or the beneficiaries, even though in general, it is not the settlor and/or beneficiaries – whether resident or non-resident – who are personally assessed to tax, but rather the trustee.[5]

Classification of trusts and taxation

Israel resident trust (IRT)

Definition:

- An *inter vivos* trust, revocable or irrevocable, in which, at the time it was created, at least one settlor and at least one beneficiary were Israeli residents, and during the tax year, at least one settlor or one beneficiary is resident; (Primary Definition); or
- An *inter vivos* trust which is neither a foreign residents trust, nor a foreign resident beneficiary trust, nor a relatives trust (see definitions of these trusts below) (Default Definition).

Taxation of IRT:

- Creation/vesting (transfer of assets to trust without consideration) – if the creation/vesting is by an individual, it is not taxable; if by an entity, see above in the definition of 'vesting'.
- Accrued income – since the IRT is deemed resident in Israel, it is fully taxable on its worldwide current income, whether distributed or not, at the highest marginal rate applicable to taxation of individuals, and subject to special rates as specified in the Ordinance.
- Distributions – are taxable or non-taxable as would have been the case if transferred directly from settlor to beneficiary in accordance with the provisions in the Ordinance regarding capital gains tax; that is to say, cash distributions are generally not taxable, but distributions of non-cash assets may be taxable if they would not have qualified as a bona fide gift, or if the assets consist of immoveable property situated in Israel, or the distribution of the asset is to a non-resident beneficiary.

Relatives Trust (RT)[6]

Definition:

- An *inter vivos* trust, revocable or irrevocable, in which: (1) from the date of its establishment until the relevant tax year all its settlors were, and are, non-residents, and (2) during the relevant tax year there is at least one resident beneficiary (an 'Israeli Resident Beneficiary Trust'), and in which all the settlors and all the resident beneficiaries are relatives. 'Relatives' means essentially relatives in the first or second degree.

Taxation of RT:

Israeli-sourced income is fully taxed similarly to income of an IRT, but there are two options regarding the taxation of foreign-source income:

- Default option – taxation of income distributions to a resident beneficiary at the rate of 30 per cent. No other tax is imposed.
- Trustee election – taxation of accrued income, which is allocated for distribution

to resident beneficiaries, at the rate of 25 per cent. Such election must be made by the trustee by written notice to the ITA within 60 days upon the establishment of the RT.[7]

Foreign Residents Trust (FRT)

Definition:
An *inter vivos* trust, revocable or irrevocable, in which during the tax year:

- All settlors and all beneficiaries, and/or public purpose beneficiaries are non-residents and since its creation it had no resident beneficiaries; or
- All the settlors have died and all its beneficiaries, and/or public purpose beneficiaries are non-residents and since its creation it had no resident beneficiaries.[8]

Taxation of FRT:

- FRT is deemed non-resident and therefore it is taxed only on its Israeli sourced-income or assets and not on its foreign-source income.

Foreign Resident Beneficiary Trust ('FRBT')

Definition:

- An *inter vivos* irrevocable[9] trust with at least one resident settlor, alive or deceased, in which none of the conditions required in the Primary Definition of IRT had existed, all the beneficiaries during the tax year are identifiable non-residents, and resident beneficiaries, conditional or otherwise, are specifically excluded in the trust deed.

Taxation of FRBT:

- Creation/vesting (transfer of assets to trust without consideration) – is subject to tax as would have been the case if the asset were transferred directly from the settlor to the beneficiary. Note that under the provisions of the Ordinance regarding the taxation of capital gains, a gift – that is to say, divesting of an asset without consideration – from an Israeli resident to a non-resident is subject to capital gains tax.
- Current income – as FRBT is deemed a non-resident trust, its accrued income is deemed the income of the foreign resident beneficiary, and is subject to tax in Israel as would be the accrued income of any other non-resident individual; that is to say, it is subject to tax only on its Israeli-source income.
- Distributions – not taxable except in the case of distributions of immovable property that may be taxable under the taxation of land law.

Testamentary trust (trust by will; TT)

Definition:

- Trust created under a will in which all settlors are testators who were residents on the date of death.

Taxation of TT:

- Creation/vesting (transfer of assets to trust by way of will) – not taxable.
- Current income – the trustee's income and assets are deemed to be that of the beneficiary; that is to say, if there is at least one resident beneficiary the trust will be deemed IRT, and taxed accordingly. If there are no Israeli beneficiaries, the trust will be deemed a non-resident trust and taxed in the same manner as an FRBT.
- Distributions – if there is a resident beneficiary, taxable as in the case of an IRT. If there is no resident beneficiary, taxable or non-taxable as in the case of a FRBT.

Change of classification of a trust

A trust may change its classification, and hence its tax liability status, from one tax year to another pursuant to any relocation of the settlor and/or beneficiaries. In certain cases such change may be a taxable event.

Reporting duties

The Ordinance provides for the filing of certain notices or tax returns within specified time limits in connections with trusts. Some of these are the following:

- Settlor (or contributor) - who establishes a trust in any tax year or contributed an asset to a trust must file a notice accordingly.
- Trustee – of IRT and RT (where the trustee has elected the taxation of the accrued income of the RT) must file annual tax returns. The trustee of an FRT or FRBT which has Israeli-sourced income or assets situated in Israel (even if no tax is payable in connection with such assets) must also file a tax return.
- Beneficiary – an Israeli resident beneficiary, who receives a distribution, even if not taxable, must file a notice, and if taxable, a tax return.

Tax exemptions for new residents and returning residents

Individuals who are new residents or veteran returning residents (returning residents who have been non-residents for at least ten years) are entitled to full exemptions from taxation and reporting in respect of all types of foreign-source income for a period of ten years from the time of becoming a new resident or veteran returning resident, as the case may be. If such an individual is the settlor and/or the beneficiary of a trust, then generally the trust will also be entitled to the same exemptions.

Transitional arrangements for taxation of trusts affected by the amendment

On 9 March 2014, the Israel Tax Authority published transitional arrangements ('the Arrangements') regarding the taxation of relative trusts.

The purpose of the Arrangements is to provide parameters for the taxation of relative trusts in respect of income earned between 1 January 2006 and 31 December 2013 ('the Relevant Period') where there is doubt as to the tax-exempt status of the trust prior to the coming in force of the Amendment – the trust would have been classified then as a non-resident trust, tax exempt on its foreign-source income – because of one kind of influence or another, de facto or *de iure*, exerted by the resident beneficiaries. In certain cases, the Arrangements also will enable a step-up on the value of the trust assets as of 1 January 2014.

Below is a brief summary of the main points of the Arrangements:

1. Eligibility - only relative trusts (or trusts which would qualify as such if the settlor had been still alive) are eligible for the Arrangements.
2. Tax options – the default option is the taxation of part of the income, between one third and two thirds, during the relevant period at the normal tax rates (generally 20 to 25 per cent). Under certain circumstances, upon application, the capital, instead of the income, may be taxed at rates ranging between three and six per cent of the capital. 'Capital' refers to the value of the assets on 31 December 2013 plus all the distributions made during the relevant period.
3. Factors determining the income parameters – The following are examples of factors which will increase the part of the income to be taxed: the settlor is no longer alive; the beneficiary had certain powers or authority in respect of the beneficiaries, the trustee or the administration of the trust; the beneficiary transferred assets to the trust for incomplete consideration; the beneficiary received a loan below market conditions and not in accordance with the provisions of the trust deed.
4. 'Clean' trusts – The Arrangements provide that only where the assessing officer is convinced beyond all doubt of lack of influence, that is to say mainly in cases where the non-resident settlor was alive throughout the whole relevant period and the resident beneficiaries were either minors or constituted ten per cent or less of all the beneficiaries – then the trust will not be subject to tax and the assets will enjoy a step-up valuation for the purpose of future taxation.

In general, the Arrangements allow the assessing officer very broad discretion in deciding how prejudicial the influence of the resident beneficiaries is upon the tax liability of the trust. The examples stated are by way of guidelines only.

The Arrangements are not law, nor even directions/interpretative rules, and are strictly voluntary. Trusts not choosing to be included in the Arrangements will be subject to the provisions of the Ordinance governing taxation of trusts in the ordinary course of the law.

Trusts that choose to be included in the Arrangements must file the application, including all relevant documentation, by 31 December 2014.

Notes

1. Chapter 4(2) of the Ordinance.
2. Section 76(d) of the Ordinance.
3. Sections 97(a)(4) and 9(2) of the Ordinance.
4. The income may be deemed that of the beneficiary in an irrevocable Israeli resident trust (see definition below) if a full distribution is made within six months of the end of the tax year in which the trust accrued the income, and the settlor, trustee and beneficiary opt accordingly (Section 75G).
5. Subject to certain conditions, where there is a non-resident trustee and either a resident settlor in an Israeli resident trust, or a resident beneficiary in a testamentary trust (see definition below), the respective settlor or beneficiary may be liable to tax instead of the trustee if the trustee and the settlor, or beneficiary, as the case may be, opt accordingly.

6 Relatives Trust is a new classification created by the Amendment and effectively replaces the former tax beneficial Foreign Resident Settlor Trust whereby a trust settled by any Non-resident in favour of any resident was deemed a Non-Resident Trust fully exempt from tax on all foreign source income, and if the settlor died as a non-resident, the non-resident status of the trust remained forever.

7 If the Relatives Trust was created, or converted from another type trust existing before 1 January 2014, then the notice must be filed by 30 June 2014.

8 Section 75(I) of the Ordinance.

9 In order for the trust to be irrevocable, it is not sufficient to declare it as such. The Ordinance sets ten conditions for a trust to be deemed irrevocable.

Tax news from Brazil

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On 14 May 2014, Provisional Measure No. 627/2013 was converted into Law No. 12973 (Law No. 12973/2014) after long debates carried out among companies, tax experts and the tax authorities, and the purpose of this article is to summarise the most relevant changes provided by such Law with respect to the Brazilian tax laws.

Among other things, such as the extension of the possibility for companies to enroll into the existing tax special instalment plan[1], Law No. 12973/2014 revoked the Transitory Tax Regime ('Regime Tributário de Transição – RTT'), which was created to neutralise the effects of the convergence of the BR GAAP (Brazilian Generally Accepted Accounting Principles) with the international accounting rules (IFRS)[2] in the calculation of the taxable income for purposes of determining the amounts of corporate income tax and social contribution on profits due from Brazilian companies. According to this new law, the Transitory Tax Regime will be extinguished in January 2015 and companies may elect to terminate the regime as of January 2014.

Law No. 12973/2014 has also modified the treatment of goodwill on merger and acquisition transactions, determining that the deduction[3] of the premium (which will be proved in a specific technical appraisal report[4]) would be taken based on the depreciation and/or amortisation of the assets acquired and liabilities assumed at fair value and/or amortised within a minimum five-year period (as to the amount allocated to goodwill). It has also set forth that the tax amortisation triggered by a given merger would be determined based on the existing accounting balance at the acquisition event date, and that reorganisations carried out until 31 December 2017 involving companies in which participation was acquired before 31 December 2014 are thus grandfathered.

This new law has also introduced a new concept of gross income for tax purposes,[5] it has modified the tax aspects regarding dividends[6] and interest payments on net equity,[7] and particularly the taxation of profits arising abroad from subsidiaries and affiliates of Brazilian multinational companies, which imposes the taxation on a worldwide basis.

Thus, as per Law No. 12973/2014 the corporate income tax and social contribution on profits shall be paid in proportion to the profits distributed abroad in the years subsequent to the end of the relevant assessment period until the eighth year provided that the minimum payout of 12.5 per cent is met in the first year.

Law No. 12973/2014 has also allowed Brazilian companies to consolidate the profits of their subsidiaries and affiliates abroad until 2022. As a result, Brazilian companies are allowed to offset losses of a given subsidiary/affiliate with the profits earned by another. Please also note that according to such law it is not possible to consolidate profits related to subsidiaries/affiliates which are domiciled (or controlled directly or indirectly by companies located) in tax havens or in countries or territories that impose a privileged tax regime (as per Brazilian laws), and/or in countries that have not entered into an agreement to exchange information with Brazil.

When determining the taxation of profits of controlled and affiliate companies, Law No. 12973/2014 has also allowed[8] a few deductions, as follows: (1) part of profits arising from the shareholding of other legal entities (controlled or affiliates) domiciled in Brazil; (2) amounts related to the values spontaneously added as a result of the applicable transfer pricing rules; and (3) the corporate income tax paid abroad by the controlled or affiliate companies.