

Steve Leimberg's International Tax Planning Email Newsletter - Archive Message #39

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From: Steve Leimberg's International Tax Planning Newsletter

Subject: [Mary O'Reilly, Yair Benjamini & Shiran Polishuk: Israeli Income Taxes Lurking in Your US Estate Plan](#)

“Whenever engaging in trust planning with clients who wish to benefit Israeli residents, extreme care should be taken to make sure the trust plan does not unnecessarily trigger Israeli income taxes or reporting. In these situations, the best practice is to consult with Israeli tax counsel to ensure the trust is structured to minimize any Israeli income tax exposure.”

Mary O'Reilly, Yair Benjamini and Shiran Polishuk provide members with commentary that examines the issues that should be considered when doing trust planning on behalf of US citizens or residents who have children, grandchildren or other beneficiaries who live in Israel. Members who wish to learn more about this topic should consider watching this [LISI Webinar: Estate Planning for U.S. Persons Who Have Assets or Descendants in Israel: What You Don't Know Can Indeed Be Costly](#).

Mary O'Reilly is Co-Chair of the firm's nationally recognized Trusts & Estates Practice Group and a Partner in the Business & Real Estate Taxation, Private Wealth & Taxation, Trust & Estate Litigation and Tax Exempt Organizations Practice Groups at **Meltzer, Lippe, Goldstein & Breitstone, LLP**. As an estate planning attorney to high net-worth individuals and families, Mary not only provides advice regarding tax planning, business succession and asset protection, but also serves as a trusted advisor to some of the country's wealthiest individuals and business owners, who seek her advice and counsel on all aspects of their family, finances and business interests. A frequent lecturer and writer in her field, she speaks at prominent legal conferences across the country and has written for leading industry publications such as Trusts & Estates Magazine, ABA Probate & Property Magazine and Steve Leimberg's Estate Planning Newsletter. Mary has been recognized as a leading estate planning attorney by various business publications including Chambers and Partners, Crain's New York and Long Island Business News. Mary received her LL.M. (Masters of Law) in Taxation from New York University School of Law and earned her J.D., cum laude, from St. John's University School of

Law in 2003, where she attended law school on a full academic scholarship.

Yair Benjamini is a Partner at **Benjamini & Co.** Yair has worked in the field of Israeli taxation for the last 20 years and over time has acquired broad legal knowledge and extensive experience in all areas of Israeli taxation, as well as in a wide range of complex international taxation issues.

Shiran Polishuk is an Associate at **Benjamini & Co.** Shiran is an attorney who specializes in Israeli and international taxation.

Here is their commentary:

EXECUTIVE SUMMARY:

Many United States citizens or residents have children, grandchildren or other beneficiaries who live in Israel. When estate planning for these clients, care must be taken to ensure Israeli income tax is not unnecessarily triggered under Israel's wide reaching trust taxation law that took effect in 2014. Although the law was enacted by Israel to curb a perceived abuse of Israelis using trusts to shelter income, its broad reach can cause an Israeli income tax for trusts created by US residents where the only connection to Israel is the residency of one beneficiary. This includes trusts that are "grantor trusts" for US income tax purposes. Unfortunately, the US/Israeli Tax Treaty does not always serve to mitigate against this double taxation. As such, care must be taken whenever a client creates a trust with an Israeli resident (an "Israeli") as a potential beneficiary.

COMMENT:

Identifying Trusts Subject to Israeli Income Tax

The Israeli income tax liability of a trust is based on the tax residency of the Settlor (as defined below) and the Beneficiary or Beneficiaries (as defined below) and the relationship between them. As such, the threshold issue in determining whether a trust will be subject to Israeli income tax is identifying the Settlor and the Beneficiaries. These rules are set forth in

Chapter Four 2 of the Israel Income Tax Ordinance [New Version], 5721-1961 (the “Ordinance”).

Who is a Beneficiary?

A Beneficiary is defined as a person that is “entitled to enjoy the assets or income of the trust, either directly or indirectly.”^[i] A Beneficiary includes a person whose entitlement is contingent upon a condition, unless the condition is the demise of the Settlor or another Beneficiary and such Settlor or other Beneficiary is still alive. In other words, contingent beneficiaries are considered “Beneficiaries,” except if the contingency is the death of the Settlor or other Beneficiary who are still living. In that case, the contingent beneficiary will not be regarded as a “Beneficiary” for purposes of the Israeli tax.^[ii]

Who is a Settlor?

A Settlor is defined as “a person that contributed, directly or indirectly, an asset to a trust.”^[iii] A contribution is a gift or bequest of an asset for no consideration. This is in line with the concept of a “settlor” for US purposes. However, under the Israeli law, a Settlor also includes “a Beneficiary who is able to control or influence— directly or indirectly—the manner in which the trust is managed, the trust assets, the designation of beneficiaries, the appointment or replacement of trustees, or the distribution of the trust assets or the trust income to beneficiaries.”^[iv] Thus, a Beneficiary of a trust may also be deemed a Settlor if he has control or influence over the trust. This would include both a Beneficiary who is a trustee of a trust and a Beneficiary who is not a trustee but who can exert control over the trust in other capacities.^[v]

Unfortunately, because the Israeli tax law is relatively new, there is little guidance in the case law on what level of control a Beneficiary has that will cause him to be a Settlor. Certainly, a Beneficiary acting as an investment advisor or a distribution advisor of a trust would rise to the level of a Settlor. However, less clear is whether a Beneficiary who is an officer or director of a company owned by the trust would rise to the level of a Settlor. As such care should be taken to analyze the role any Beneficiary has in a trust to determine if he or she is also a Settlor.

Once it is determined that a trust has at least one Settlor or Beneficiary who is an Israeli resident, then next step in determining whether the trust will be subject to Israeli income tax is identifying the type of trust. There are five types of trusts for Israeli tax purposes, namely:

- Foreign Resident Trust^[vi];
- Foreign Resident Beneficiary Trust^[vii];
- Relative's Trust ^[viii];
- Israeli Resident Beneficiary Trust^[ix]; and
- Israeli Resident Trust^[x].

Foreign Resident Trust

Not surprisingly, a trust where all Settlers and Beneficiaries are non-Israeli residents in the current tax year is considered a Foreign Resident Trust so long as the trust has never had an Israeli Beneficiary.^[xi] However, as explained above, a beneficiary whose interest in the trust is contingent upon the death of a Settlor or a Beneficiary is not considered a Beneficiary for purposes of the Israeli tax law.

Examples of Foreign Resident Trusts would include the following trusts:

- Trust created by a US resident where an Israeli grandchild is the remainderman of trust after his US parent's death. Since the Israeli grandchild's interest in the trust is contingent upon his parent's death, it is Foreign Resident Trust during the parent's life.
- Marital QTIP trust created by a US resident for the benefit of US spouse with trusts for Israeli children as the remainderman. Again, since the Israeli children's interest in the trust is contingent upon the death of the surviving spouse, the trust is a Foreign Resident Trust during the life of the surviving spouse.
- Revocable trust created by and for the benefit of the US resident that passes to his Israeli children after his death, the trust is a Foreign Resident Trust during the Settlor's life.

A Foreign Resident Trust is treated like any other foreign resident under the Israeli income tax law—meaning it will only be subject to tax in Israel on its Israel source income. Additionally, Foreign Residents Trust are only

required to open a tax file with the ITA and file annual tax returns if the trust holds assets situated in Israel or generates Israeli source income.

Foreign Resident Beneficiary Trust

A Foreign Resident Beneficiary Trust is an irrevocable trust where at least one Settlor is Israeli but none of the Beneficiaries are Israelis, and the trust agreement explicitly excludes Israeli residents from becoming a Beneficiary. Thus, although a beneficiary whose interest is contingent on the death of another Beneficiary is not considered a Beneficiary for general purposes of the Israeli tax law, an Israeli having a contingent interest in a trust it will disqualify the trust from being a Foreign Resident Beneficiary Trust since at some point in the future an Israeli will be a Beneficiary. For example, an irrevocable trust created by an Israeli for the benefit of their US descendants only would be considered a Foreign Resident Beneficiary Trust. This trust will remain a Foreign Resident Beneficiary Trust even after the demise of the Israeli Settlor. If the Settlor becomes a non-Israeli resident, and the trust has never had an Israeli Beneficiary then the trust will convert from a Foreign Resident Beneficiary Trust to a Foreign Resident Trust (described above).

Like a Foreign Resident Trust, a Foreign Resident Beneficiary Trust is considered a foreign resident and will be taxed in the same manner in which an individual foreign resident will be taxed—only on its Israeli income. Thus, if the trust assets and income are non-Israeli sourced, there are no income tax implications in Israel. However, the trustee of a Foreign Resident Beneficiary Trust is also required to submit an annual report to the ITA and notify it of any distribution made in the tax year, including the names of the beneficiaries and the amounts distributed to them. Failing to timely submit the annual report to the ITA results in a fine of 500 New Israeli Shekels (“NIS”) in respect of each whole month of delay in submitting the return.^[xii] In addition, financial sanctions and interest may apply.

Relative’s Trust

A Relative’s Trust is a trust where (i) one or more Beneficiaries are Israeli, (ii) the trust has never had an Israeli Settlor, (ii) all the Beneficiaries are “Closely Related” to all of the Settlers, and either the Settlor or his spouse^[xiii] is still alive. For these purposes, a Beneficiary is “Closely

Related” to a Settlor if the Beneficiary is a child, grandchild, a spouse, a parent or grandparent of a Settlor. If there is a family relation but it is more distant relationship, namely, the Beneficiary is either: (i) a sibling of the Settlor, (ii) a descendant (other than a child or grandchild) of the Settlor, (iii) a descendant of the Settlor’s spouse, (iv) a spouse of any of the above, or (v) a descendant of the Settlor’s sibling or a sibling of the Settlor’s parent (each of (i)-(v) a “Distant Relative”), the trust may qualify as a Relative’s Trust but it is not automatic. To qualify, the ITA must be convinced that the establishment of the trust and the contributions to the trust were done in good faith and that the Beneficiary paid no consideration for his or her right in the trust’s assets.[\[xiv\]](#)

An example of a Relative’s Trust is a sprinkle trust created by a US resident with his US spouse as the trustee for the benefit of his US daughter and her descendants and his Israeli son and his descendants, during the life of the settlor and his spouse. Likewise, if such trust was exclusively to benefit Israeli descendants, it would also be a Relative’s Trust. Note, however that once the Settlor and his spouse are both deceased, the trust would cease to be a Relative’s Trust and would become an Israeli Resident Trust (as explained below). Also, if during the Settlor’s life, the son who is an Israeli Beneficiary was named as a trustee or exerted control over the trust, the son would be considered a Settlor and cause make the trust to be an Israeli Resident Trust at that time. Additionally, if the US daughter was named as a trustee or exerted control over the trust, the daughter would be considered a Settlor. In such case, the trust would only qualify as a Relative’s Trust if the ITA approved to treat the daughter who is a Distant Relative to her brother and his descendants, who are Beneficiaries, as a Relative’s Trust.

There are two options for the taxation of a Relative’s Trust—the Distribution Track or the Current Income Track.

Distribution Track

The “Distribution Track” is the default option for the taxation of a Relative’s Trust and does not require any filing or affirmative election by the trustee.[\[xv\]](#) Under the Distribution Track, only distributions to Israeli Beneficiaries are taxed, and they are taxed at a 30% tax rate. The 30% tax rate applies only to the distribution of trust income and not of principal; however, any distribution is considered to have been made first from the

income and then from principal. While the ITA allows a Relative's Trust to claim foreign tax credits, certain timing issues may arise within the Distribution Track that do not always allow for the credit to be used. Note that decanting a trust from one trust to another trust should not be considered a distribution for these purposes.[\[xvi\]](#)

Although the trustee under the Distribution Track does not have to file with the ITA, the Israeli Beneficiary must file an annual tax return if he receives a distribution or if the Israeli Beneficiary does not receive any distribution but (a) such Beneficiary is an Israeli resident at least 25 years of age, (b) such Beneficiary is aware of his/her status as a Beneficiary, and (c) the value of the trust assets at the end of the tax year is at least 500,000 NIS.

Current Income Track

The other option for the taxation of a Relative's Trust is the "Current Income Track." Under the Current Income Track, non-Israeli sourced income is allocated among all trust Beneficiaries and the portion of the income attributed to the Israeli Beneficiaries in the tax year in which the income accrued, is taxed at a 25% tax rate, regardless of whether the income is distributed. If a trust is a completely discretionary trust with both Israeli and non-Israeli Beneficiaries and all or some of the income is retained in the trust and not in a given year, the portion of the retained income attributable to the Israeli Beneficiaries would be likely based on the percentage of the Beneficiaries who are Israeli.[\[xvii\]](#) Thus, for example if there were 10 permissible Beneficiaries of a trust—5 US residents and 5 Israeli residents, 50% of the income would be taxed in Israel at a 25% rate. This would likely be the case, even if in past years all distributions went to the US Beneficiaries. Under Current Income Track, the trust will generally receive a foreign tax credit for US taxes paid by the trust.

Although the Current Income Track offers a lower tax rate on distributions, one disadvantage of this track is when a grantor trust is funded by sale or loan as that transaction, which is ignored for US income tax purposes, would be recognized for Israeli income tax purposes and subject to the 25% tax rate. This would also be the case if a grantor exercised his reserved right in a grantor trust to substitute assets of equivalent value with the trust.

In order to elect the Current Income Track, the trustee of a Relative's Trust must notify the ITA of the trust's status as a Relative's Trust and make the Current Income Track election within 60 days from the creation of trust or from the day it becomes a Relative's Trust. Failure to file within the 60 days will preclude the trust from electing the Current Income Track unless special approval is granted by the ITA.

Additionally, any Israeli Beneficiary is required to file annual tax returns if the Beneficiary receives a distribution from the trust or if Beneficiary does not receive a distribution but (a) such Beneficiary is an Israeli resident at least 25 years of age, (b) such Beneficiary is aware of his/her status as a Beneficiary, and (c) the value of the trust assets at the end of the tax year is at least 500,000 NIS.

Israeli Resident Beneficiary Trust

An Israeli Resident Beneficiary Trust is a trust where at least one Beneficiary is an Israeli and the trust has never had an Israeli Settlor and there is no family relationship between the Beneficiaries and the Settlor. Although this type of trust is technically different than an Israeli Resident Trust (described below), the reporting requirements and the taxation of these trusts are the same as the Israeli Resident Trust and are described below.

Israeli Resident Trust

Israeli Resident Trust is a trust where at the time of its creation, at least one Settlor and one Beneficiary are Israeli residents, and in the current tax year at least one Settlor and one Beneficiary are Israeli residents^[xviii]. In addition, any trust that does not qualify as one of the other trusts outlined in this article will default to being classified as Israeli Resident Trust. In other words, this is the default regime for a trust that does not meet the definitions of the other trust types. The most prevalent example of an Israeli Resident Trust is when the Settlor and Settlor's spouse die in a Relative's Trust. At such time, a Relative's Trust will generally become an Israeli Resident Trust.

In general, an Israeli Resident Trust is taxed on its worldwide income in the same way as an Israeli resident individual is taxed. As a result, all the income of an Israel Resident Trust will become subject to tax in Israel on a

current basis, including income which is designated to be distributed to non-Israeli Beneficiaries and including income of a grantor trust. The trustee will be responsible for reporting and paying tax on this income and for notifying the ITA of any distribution made in the tax year, including the names of the Beneficiaries and the amounts distributed to them. Furthermore, the Israeli Beneficiaries will be subject to reporting on any distributions as described above.

Because an Israeli Resident Trust is regarded to be Israeli tax resident, this impacts the trust's ability to receive tax credits for US taxes. For example, capital gains taxes paid in the US would not be recognized as a foreign tax credit to be used against Israeli capital gains tax. For dividend or interest income from US sources, taxes paid in the US would be credited by Israeli but only at 25% for dividends and 17.5% for interest. Any additional taxes on dividends might not be recognized as a foreign tax credit against Israeli taxes on dividends. Additionally, a classification as an Israeli Resident Trust could affect other deductions and depreciation.

If an Israeli Resident Trust is also deemed to be a resident of the US for US purposes, there is a risk of double taxation of the trust income, and unfortunately the tax treaty between Israel and the US does not solve a situation of double residency of a trust. Hence, the only recourse with respect to potential double tax on the trust's income, can be a mutual agreement procedure between the countries initiated by the taxpayer or either tax authority to prevent double taxation.

Structuring Trusts to Minimize Israeli Taxation

One key to planning when your client wishes to create trusts for the benefit of Israeli residents is to make sure during the client's life that the trust qualifies as a Relative's Trust. For trusts with Israeli Beneficiaries, during the lives of the Settlor and his spouse, so long as an Israeli Beneficiary of the trust exerts control, they will be deemed a Settlor and the trust will not qualify as a Relative's Trust. Additionally, if a non-Israeli Beneficiary exerts control, he will be deemed a Settlor and may be a Distant Relative rather than closely related to some of the Beneficiaries, which could also jeopardize the trust's status as a Relative's Trust. Thus, if the trust is classified as Relative's Trust and it has both Israeli resident beneficiaries and non-Israeli beneficiaries, care should be taken to make sure that none

of the Beneficiaries are trustees or otherwise in a position to exert control of the trust.

Another key to planning is to separate trusts as much as possible so that separate trusts are created for Israeli residents and for non-Israeli residents. Trusts for non-Israeli residents should not be subject to tax or reporting in Israel even if an Israeli resident is a trustee. Also, trusts exclusively for Israeli resident Beneficiaries will be fully subject to Israeli taxes by the Israeli Beneficiaries minimizing any disconnect between the US and Israel to avoid double taxation.

Care should also be taken for clients who create revocable trusts for themselves. Often, children are included as potential current beneficiaries of these trusts but this should be avoided for clients who have children who are Israeli residents. Instead should the client wish to make gifts to their children, distributions should be made from the trust to the client and then from the client to the children directly, avoiding the trust having any tax reporting in Israel.

In conclusion, whenever engaging in trust planning with clients who wish to benefit Israeli residents, extreme care should be taken to make sure the trust plan does not unnecessarily trigger Israeli income taxes or reporting. In these situations, the best practice is to consult with Israeli tax counsel to ensure the trust is structured to minimize any Israeli income tax exposure.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary O'Reilly
Yair Benjamini
Shiran Polishuk

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CITATIONS:

^[i] Section 75E of the Ordinance.

^[ii] Note that an unborn person can be considered a Beneficiary and the Israeli Tax Authority (“ITA”, which is Israel’s equivalent of the IRS) can argue that the residency of the unborn person is the same as his/her parent’s residency. Thus, if a trust is for the benefit of grandchildren only and all grandchildren are living in the US but one child is living in Israel, because that child could have a child in the future, the ITA can argue the trust has an Israeli beneficiary.

^[iii] Section 75D of the Ordinance

^[iv] Section 75D(a)(4) of the Ordinance.

^[v] In Income Tax Circular 5/2016 (“Circular 5/2016”), which is titled “Trust Taxation”, the ITA also addressed this issue and presented examples of a Beneficiary’s influence which might lead to classify him as a Settlor of the trust:

- The beneficiary has powers in relation to the determination of the beneficiaries, the trustee or the management of the trust assets.

- The beneficiary is a member of the trust's investment committee or its other governing body.
- The beneficiary has provided to the trust and/or companies held by the trust, directly or indirectly, services such as management or consulting services.
- The beneficiary has a managerial position in one of the companies or ventures held by the trust.
- The trust assets constitute security for a loan taken out by the beneficiary in a trust not in accordance with the trust deed.
- A loan granted to a beneficiary for a period of X years that is not on market terms and is not in accordance with trust deed.

[vi] Governed by Section 75I of the Ordinance.

[vii] Governed by Section 75J of the Ordinance.

[viii] Governed by Section 75H1 of the Ordinance.

[ix] NEED CITE FOR THIS FN

[x] Governed by Section 75H1 and Section 75G of the Ordinance.

[xi] Note an Israeli non-profit is not considered a beneficiary for this purpose.

[xii] This assumes no tax liability was due.

[xiii] The Spouse must have been married to the Settlor when the Settlor made at least one contribution to the trust.

[xiv] It is not clear under the current authority if this assessment by the ITA's needs to be done at the outset, upon the establishment of the trust, upon its classification as a Relative's Trust, at the time of a distribution to the Distant Relative or when the trust is required to file an annual.

[xv] Technically, a trustee is required to notify the ITA within 60 days of the creation of a Relative's Trust. Although failing to make such notification may result in a penalty of up to 500 NIS per month, if no distributions have been made from the trust, it is likely this penalty will not be assessed.

[\[xvi\]](#) In addition, section 75D(b) of the Ordinance which is titled “Settlor of the Trust” provides, “If a trustee contributed an asset or income to another trustee, then the settlor who contributed the asset or income to the trustee shall be deemed the person who contributed it to the other trustee, and the trustee shall not be deemed a settlor.”

In Circular 5/2016, the ITA clarified the meaning of this section as follows:

“Section 75D (b) of the Ordinance provides that if a trustee contributes an asset or income to another trustee (*i.e.*: to another trust, whether new or existing), the settlor of the original trust shall be treated as a settlor of the new trust as well, and the new trustee shall be stepped into the original trustee's shoes. In this case, the original trustee will not be viewed as the settlor of the new trust and the classification of the trust will not change due to this action alone. It will be clarified that this section does not derogate from section 75D(a)(3) of the Ordinance.”

Therefore, we can conclude that a transfer of an asset or of income from a trustee of one trust to a trustee of another trust will not be considered as a “distribution” under the Israeli law.

[\[xvii\]](#) Although there is no clear guidance on the allocation of income among the Beneficiaries, this is the common recommendation for tax reporting for this scenario.

[\[xviii\]](#) In the event where the last settlor of an Israeli Resident Trust has passed away and the Trust has at least one Israeli beneficiary, then the Trust will maintain its status as an Israeli Resident Trust.