ISRAELI LAW CONFRONTS INTERNATIONAL TAX TREATIES AND PRINCIPLES VIA NEW TREATMENT OF MIXED-BENEFICIARY TRUSTS

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HISTORY AND OVERVIEW OF ISRAELI TAXING MODELS IN RESPECT OF NON-ISRAELI TRUSTS[1]

Pre-2006 Situation – the Corporate Model

Israel has come a long way in its efforts to tax foreign-established trusts, which historically were assumed to have been used to shelter Israeli-source funds of high net worth Israeli residents and their families. Prior to the adoption of any relevant comprehensive Israeli tax legislation in 2006, the practice consisted mostly of viewing trusts and beneficiaries similarly to corporations and shareholders.

Thus, under customary Israeli international tax rules, if the "management and control" of the non-Israeli trust was effected outside of Israel, the trust was considered to be nonresident because the trust's assets were situated outside of Israel and the trustees had full discretion over their control. No formal powers were exercised directly or indirectly by Israeli beneficiaries. Hence, the trust was simply not subject to Israeli taxation. Moreover, discretionary distributions were viewed as tax-free gifts. In this way, wealthy Israelis could cause foreign trusts to be funded by Israeli-source wealth and invested outside Israel without subjecting the resulting income to Israeli tax.

Israel has neither an estate/inheritance tax[2] nor a gift tax, which means that *bona fide* gifts and inheritances are free of tax for both the donor or the decedent and the recipient. Thus, a foreign trust ostensibly became the perfect Israeli tax planning tool. Assets could be donated by an Israeli settlor to a foreign irrevocable discretionary trust for the benefit of family members. Legally, the assets were no longer owned by the Israeli donor but rather by a foreign body managed and

1 Trust taxation in Israel is still a relatively new phenomenon, particularly in respect of the recent amendments to the legislation, which have entered into force only this year (2014). Consequently, this article reflects our views and opinions of the proper interpretation of Israeli legislation, practice, and case law as of October 15, 2014. We emphasize that most of the issues and topics discussed herein have not yet been exhaustively reviewed by the Israeli courts, tax authorities, or practitioners.

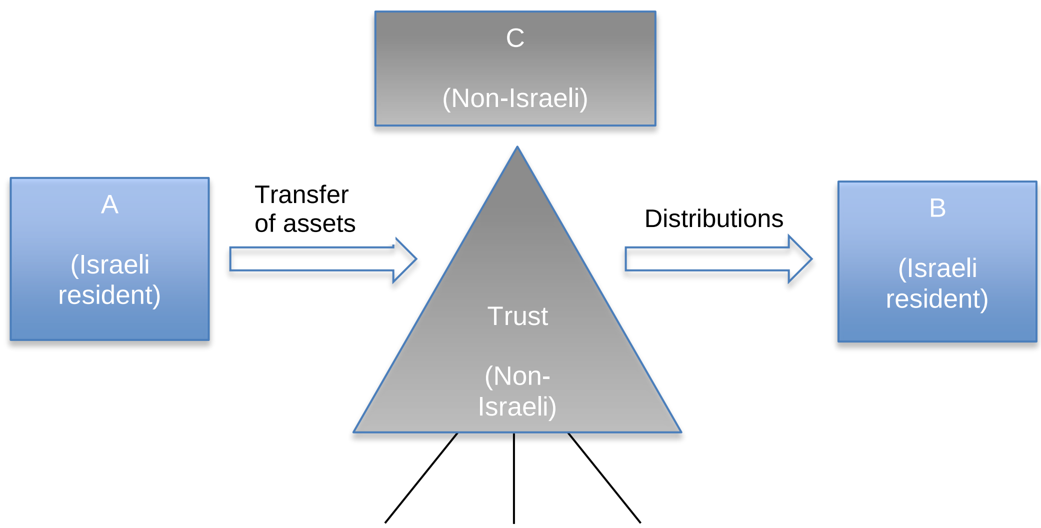
2 A rudimentary inheritance tax was repealed in 1980.

controlled by a foreign trustee. Therefore, the trust's non-Israeli assets and income were outside the scope of Israeli taxation. Distributions by these trusts to Israeli resident beneficiaries that were *bona fide* discretionary gifts were exempt in the hands of an Israeli recipient.

This perfect tax haven or shelter could, theoretically, be assailed only where the Israeli settlor or beneficiaries invaded the sanctity of the discretionary trust and exercised some form of management and control over the trust and its assets. In such cases, the Israeli Tax Authorities ("I.T.A.") could either (i) attempt to view the trust arrangement as a sham to be disregarded under appropriate doctrines or (ii) view the trust and any subsidiaries as Israeli tax residents by virtue of management and control emanating from Israel.

"The main thrust of the 2006 Legislation was to view the economic settlor – and not the trustee – as the person from whom the tax residence of the trust could be determined for Israeli tax purposes."

To summarize, the original trust taxation rules in Israel, based on the corporate model, emphasized the location of the effective place of management and control of the trust as the key to determining Israeli residence and taxation. In the customary Anglo-Saxon irrevocable discretionary trust scenario, the trustee is legally and formally possessed of ownership and control of the trust assets, and, if this structure was honored in practice, the scenario was effective. The following diagram may help to illustrate the situation:



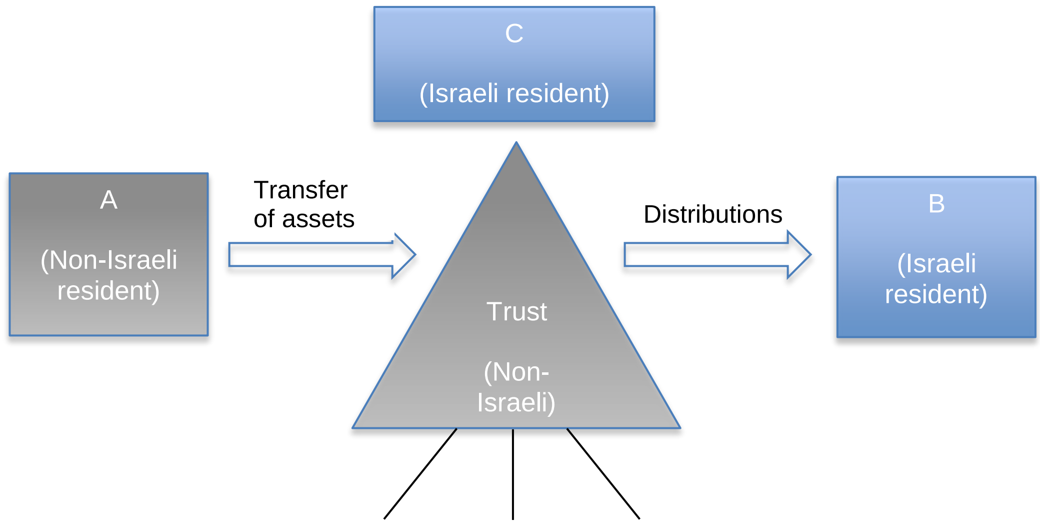
In the above diagram, the identity, status, operation, and actions of the trustee ("C") were the linchpin of non-Israeli residency and non-taxation. Neither the settlor's ("A's") transfer of funds to the trust nor the subsequent distributions of trust income or assets to the beneficiary ("B") were taxable.

<u>2006 Legislation – the Settlor Model</u>

In order to close this loophole, a new chapter was added to Israel's Income Tax Ordinance ("I.T.O.") which was devoted to the taxation of non-Israeli-established trusts. The legislation was effective as of January 1, 2006 (the "2006 Legislation"). The main thrust of the 2006 Legislation was to view the economic settlor – and not the trustee – as the person from whom the tax residence of the trust could be determined for Israeli tax purposes. An Israeli resident could be considered an economic settlor of a trust where he or she directly or indirectly transferred, controlled, or influenced the transfer or management of assets to or in the trust.

Where any of these acts occurred, the trust became a full Israeli tax resident.[3] The trust became taxable in Israel on a current basis in respect of its worldwide income, as is the case for any other Israeli tax resident.[4]

On the other hand, where the sole economic settlor or all of the economic settlors were nonresidents of Israel, the trust would be treated as a nonresident for Israeli tax purposes. Consequently, if the trust had no Israeli-source income, it was free of all Israeli tax and reporting obligations. Note that the identity and status of the trust's potential beneficiaries were irrelevant – the focus moved from the trustee to the economic settlor. The diagram below illustrates the change:



In the above diagram, the Trust is treated as a nonresident, since it takes the status of the economic settlor, A, rather than that of the discretionary trustee – who may now even be an Israeli tax resident. However, where the economic settlor is an Israeli tax resident, the entire Trust is an Israeli tax resident, even if the trust has several other economic settlors that are nonresidents with regard to Israel. Once the trust is treated as an Israeli resident, A's transfer of assets to the Trust is disregarded. Fundamentally, the Trust continues to be an extension of A, an Israeli resident.

Where A is Israeli, the trust is taxable on world-wide income. Either A or C is subject to tax reporting and payment obligations. Distributions to B by the Israeli resident trust remain nontaxable gifts (assuming a *bona fide* relationship between the Settlor/donor and recipient).

At the outset, the I.T.A. viewed the tax treatment of Israeli beneficiaries as fair and consistent with the overall Israeli tax treatment of gifts. On one hand, a non-Israeli trust that is set up economically by a non-Israeli person using non-Israeli assets

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[3] This determination applied even in instances where the Israeli resident was only one of many such settlors.

[4] In terms of the actual formal imposition of tax and accompanying reporting requirements, this was, in most cases, directed to either the settlor, or to the trustee.

and making distributions to Israeli beneficiaries should be subject to the same tax treatment as gifts made by a kindly non-Israeli uncle to his Israeli nephews and nieces. On the other hand, an Israeli resident settlor should not be able to escape Israeli tax on current income in respect of assets or activities simply by contributing the assets to a Jersey or BVI irrevocable discretionary trust. It was hoped that the broad definition given to the term "economic settlor" would be able to afford proper substance-over-form tax treatment, where the wealth of an Israeli resident found its way into a foreign trust, especially foreign trusts that were established for the benefit of Israeli beneficiaries.[5]

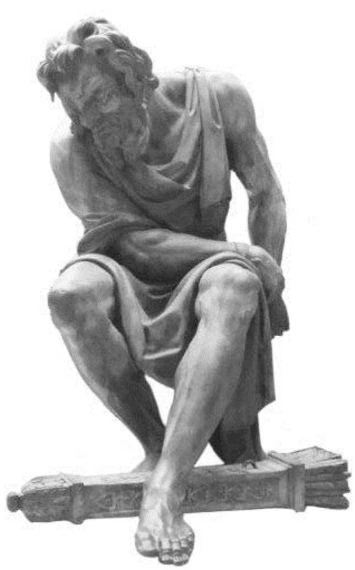
As mentioned above, the status and identity of the beneficiaries were basically overlooked or viewed as irrelevant within the context of the 2006 Legislation. Thus, a foreign trust settled by a non-Israeli person remained a non-Israeli resident forever, regardless of the residency status of the beneficiaries or the death of the non-Israeli settlor. Theoretically, the trustees could continue investing, accruing, receiving and distributing income to Israeli beneficiaries on a tax-free basis in Israel for as long as the relevant rule against perpetuities allowed.

I.T.A. Disillusionment with the 2006 Legislation and the Settlor Model

In the fiscal discussions leading up to 2014, it became clear that a radical change of perspective regarding the 2006 Legislation occurred within the I.T.A. The tax residence of the settlement itself and the settlor of the trust were viewed to be of less importance as a matter of policy. This shift in perspective was triggered by an overriding concern of the I.T.A. that the 2006 Legislation was being used to perpetrate massive tax fraud against the Israeli Treasury.

Tax Policy Considerations

The policy question was directed at the static status of the trust that remained unchanged even after the death of the settlor. If after the conclusion of the lifetime of the non-Israeli settlor, the Israeli beneficiaries are virtually assured of receiving the trust assets at some point in the future, the I.T.A. adopted a view that Israeli-resident beneficiaries are afforded the benefit of an endless tax shelter. Israeli beneficiaries would have a current income exemption at the trust level and unlimited deferral if the trust accumulated its income and gains. Under the new view, upon the demise of the original non-Israeli settlors, the Israeli resident beneficiaries are treated as the new persons-of-record for purposes of determining the Israeli tax status and residency of the trust.



Tax Evasion Considerations

The I.T.A. became convinced that wealthy Israelis were surreptitiously funding foreign settled trusts, treated in perpetuity as nonresident, while Israeli beneficiaries benefitted from unlimited deferral. Moreover, perceived widespread use of this tax evasion opportunity was viewed to be too difficult for the I.T.A. to effectively control through tax examinations. The I.T.A. concluded that the existence of even one

[5] Special provisions were made for trusts exclusively directed to benefit foreign beneficiaries and for "testamentary trusts." A full discussion of these provisions is outside the scope of this article.

Israeli beneficiary – however marginal – in a foreign trust is a *prima facie* reason to view the entire trust as an Israeli tax resident, with full taxpaying and reporting responsibilities. This gave birth to I.T.O. Amendment No. 197 earlier this year (the "2014 Legislation") which introduced the beneficiary model for purposes of determining residence.

2014 Legislation – the Beneficiary Model

The 2014 Legislation passed the Israeli Knesset on August 2, 2013, and most of its provisions became applicable as of January 1, 2014. The basic motif of the 2014 Legislation is as follows:

1. The legislation applies to all trusts, even those set up prior to its enactment.

2. Trusts that extended beyond the lifetime of a nonresident settlor would be treated as Israeli tax resident trusts subject to full Israeli tax on worldwide income if one or more of the beneficiaries are tax resident in Israel.

3. In order to be a foreign resident trust ("F.R.T.") during the lifetime of a non-Israeli settlor, all settlors and all beneficiaries from inception must be non-Israeli persons. If one Israeli resident beneficiary exists, the trust becomes either a conventional Israeli resident trust, or an Israeli Beneficiary Trust ("I.B.T.") as discussed below.

4. The 2014 Legislation introduces the newly-created mezzanine category of trust, the I.B.T., with a subcategory referred to as the Relatives Trust ("R.T."). An I.B.T. is a trust in which all settlors are non-Israeli but at least one beneficiary is an Israeli resident. An R.T. is an I.B.T. where there is an "adequate" first-degree family connection between all non-Israeli settlors and *all* of the Israeli resident beneficiaries. A connection is adequate, *inter alia*, if the relationship is that of:

    a. Parent-child;

    b. Grandparent-grandchild;

    c. Siblings and spouses of the foregoing persons, if approved as *bona fide* by the Assessing Officer;

    d. Nephew-Uncle, if approved as *bona fide* by the Assessing Officer.[6]

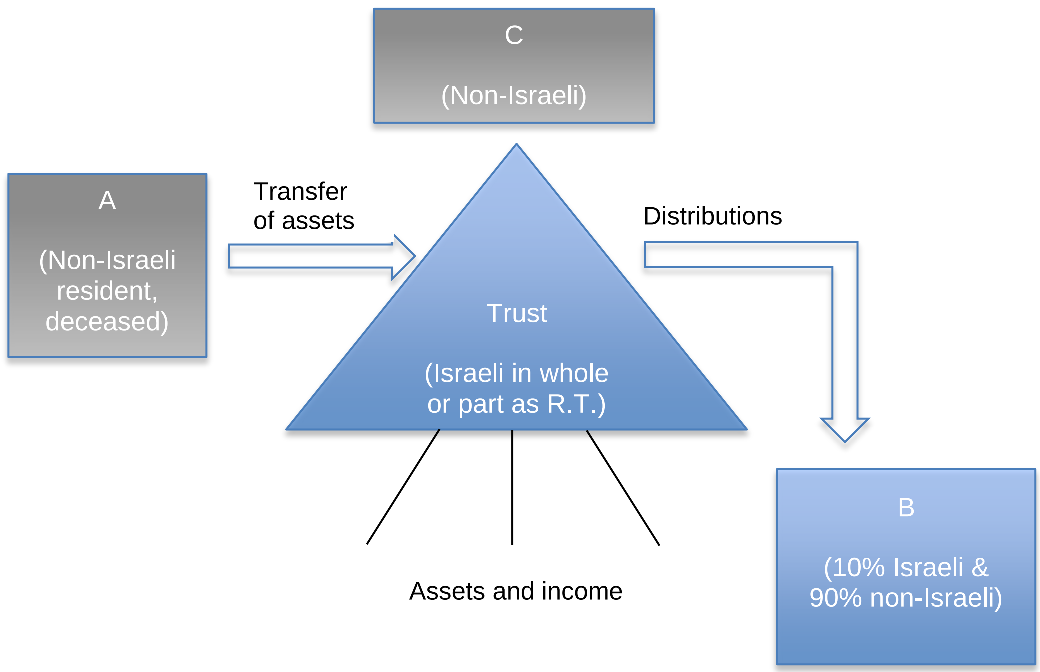
5. There are two alternatives set out in the 2014 Legislation regarding R.T. taxation.

[6] Both "sibling" and "nephew-uncle" connections were drafted in the 2014 Legislation with language preventing these connections from being considered if the Assessing Officer determines that the arrangement was purchased with consideration, created for inappropriate purposes, and/or is deemed artificial. The fact that this provision is applicable to first-degree siblings may be evidence of the extreme anti-avoidance concern of the I.T.A.

a. The default option provides that, in the absence of a distribution to an Israeli resident, the R.T. is not a taxpayer in Israel in respect of its assets and activities, to the extent these are not carried on, situated, or sourced in Israel. When a distribution is made by the R.T. to an Israeli resident, this distribution is taxable in Israel at a flat tax rate of 30%, except to the extent it is attributable to the Israeli resident beneficiary's portion of the original capital contribution.[7]

As an alternative, the trustee may elect current income taxation, in which case Israeli tax is imposed at the trust level on the Israeli beneficiary's theoretical portion of undistributed trust income. The rate of tax under this option is 25%. A subsequent distribution of previously taxed income to the Israeli beneficiary can be made on a tax-free basis to the Israeli resident.

6. The new regime of beneficiary-based taxation can be illustrated as follows:



In the example, a trust is settled by nonresidents with non-Israeli assets. The trustee is a nonresident trustee. The trust is liable to Israeli tax on worldwide income as an Israeli tax resident if there is at least one Israeli beneficiary and either

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7 The Israeli resident beneficiary's portion of the original capital contribution consists of assets contributed to the trust that would have been exempt from tax transferred or gifted directly from the settlor to the beneficiary by virtue of the classification of the transfer as a *bona fide* gift. Note that the law "orders" the distributions so that available noncapital value is always treated as distributed prior that attributable to capital contributions.

(i) the settlor[8] is deceased or (ii) the degree of family connection between the settlor and the Israeli beneficiary is less than an approved first-degree connection, even if the foreign settlor is still living. In such case, the 90% non-Israeli beneficiaries in our example become bear 90% of the economic burden arising from the imposition of full Israeli tax on all income of the trust.

In the one narrow case where (i) the settlor is alive and (ii) the family relationship between the foreign settlor or all foreign settlors and all Israeli beneficiaries is "first-degree" the Trust may still face Israeli taxation imposed at the rate of 25% on each Israeli beneficiary's theoretical portion of its income. Alternatively, the Israeli beneficiary may pay 30% Israeli tax on distributions actually received. In this case – and only in this case – are the nonresident beneficiaries not subject to Israeli taxation (although the tax reporting costs to the trust may be onerous as well).

CRITIQUE OF ISRAEL'S TRUST TAXATION SYSTEM AFTER THE 2014 LEGISLATION

Putting aside the I.T.A.'s concerns regarding tax avoidance and abuse issues, it is fairly easy to criticize the result of the 2014 Legislation as it applies to existing foreign settled trusts with marginal Israeli beneficiaries or any mixed-beneficiary group.

Lack of Grandfathering

These existing foreign trusts were foreign residents with no reporting or taxpaying obligations in Israel until December 31, 2013. In one fell swoop they became full Israeli tax residents subject to full taxation and reporting. This appears blatantly unfair.

Such trusts, set up or modified to fit the criteria of the 2006 Legislation, were given no advanced warning that having mixed beneficiaries would disqualify purely foreign entities and turn them into 100% Israeli taxpayers. It seems clear that had the Settlors known this, they would never have agreed to include Israeli-resident beneficiaries along with foreign residents in the same discretionary trust; unfortunately, it may be ineffective or impossible to amend or change the class of beneficiaries at this time, especially after the demise of the settlors.

Faulty Logic – Lack of Sufficient Nexus for Full Residency Taxation

It seems doubtful that currently accepted international tax logic could support the proposition that a trust should be treated as an Israeli resident, where the *only connection* to Israel is the residency of, say, *one out of ten* beneficiaries and *all* of the settlors, trust assets, trust income, and trustees are non-Israelis. In our view, this connection, which exposes the trust and its non-Israeli beneficiaries are exposed to full rates of Israeli taxation on worldwide income, is tenuous at best, in many cases accidental, and certainly trivial.

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8 An exception is made where the settlor's spouse remains alive, for as long as he/she are still living.

The international tax world operates within a certain logical framework, whereby tax liability should only be claimed where sufficient nexus exists. By comparison, larger and more substantive connections to Israel are not subjected to comparable adverse tax treatment. For example, investments by foreign persons in Israeli businesses which pay dividends or interest are subject only to limited Israeli withholding taxes, and certainly do not cause the investors to become Israeli residents. Yet, under the 2014 Legislation, foreign persons who never invested in Israeli assets may wake up one fine morning and discover that a significant portion of their non-Israeli wealth, held in a non-Israeli trust, is now essentially treated as subject to full Israeli taxation, as if the assets were held by an Israeli resident!

TAX TREATY RAMIFICATIONS

The faulty logic we referred to in the previous section appears to surface immediately when the new Israeli rules confront tax treaty provisions.

Assume that a U.S. family sets up a U.S. discretionary trust to benefit various relatives. Further, the U.S. trust is categorized as a complex trust that can accumulate income. Assume all the income of the trust is U.S. domestic source income. Finally, assume that all substantial trust decisions are controlled by U.S. persons and that a court in the U.S. has primary jurisdiction in reviewing trust administration. The trust reports to the I.R.S. under its own tax identification number and pays U.S. tax on its undistributed income, all of which is earned on its exclusively U.S. assets. Then suppose that one fine morning, following the demise of the two original U.S. resident settlors, one of the ten beneficiaries takes up residence in Israel.[9] Until that event, Israeli taxation of the Trust was unthinkable. Now, with the commencement of residency of one impulsive beneficiary, the entire trust may become an Israeli tax resident in respect of its worldwide income and assets.

When Israel's residency claim confronts the provisions of the U.S.-Israel Income Tax Treaty ("U.S.I.T.T."), it appears that the new 2014 Legislation must give way. Article 3(1)(b) of the U.S.I.T.T. defines a U.S. resident as including a "trust, only to the extent that the income derived by such…[a] trust is subject to U.S. tax as the income of a resident, either in the hands of the respective entity or of its partners or beneficiaries." Article 3(1)(a) contains the mirror image definition for an Israeli resident. However, Article 3(3) of the U.S.I.T.T., which deals with conflicts of residency for persons other than individuals, provides that if both Israel and the U.S. respectively determine the trust to be a resident, the competent authorities of the two countries will endeavor to settle the question by mutual agreement.[10]

"When Israel's residency claim confronts the provisions of the U.S.-Israel Income Tax Treaty ('U.S.I.T.T.'), it appears that the new 2014 Legislation must give way."

In our example, the trust is treated as a U.S. taxpayer in the U.S. because it meets the control and court tests required to a U.S. domestic trust. In addition, its assets

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9 The word "return" is inserted in this scenario for purposes of maintaining the purity of the example, in order to negate the extraneous effect of Israel's immigrant tax holiday provisions, which are irrelevant to our discussions here.

10 Note that in its original text, the U.S.I.T.T. simply excluded dual-resident companies from the treaty provisions, but clearly this is not a perfect or even preferred response to such conflicts.

are U.S.-situs, and its income is U.S.-source. At the same time, Israel claims that the entire trust is an Israeli tax resident because one out of ten beneficiaries moved to Israel.

In our view, there is no doubt what the result will be in the course of a mutual agreement procedure – the trust will be a U.S. resident. In principle, the I.T.A. should be comfortable with the result as the tax avoidance motivating the 2014 Legislation is missing. No offshore jurisdiction is involved and the trust or beneficiaries receiving distributions are fully taxed in the U.S.

Article 6(1) of the U.S.I.T.T. provides that the Trust, as a resident of the U.S., is exempt from any Israeli tax on its income, unless sourced in Israel. Thus, Article 6(1) precludes taxation imposed by Israel on the Trust's non-Israeli-source income. Of course, Israeli law provides that tax treaty provisions shall be applied notwithstanding local Israeli law and legislation.[11] Thus, in this example, the treaty effectively overrides the new Israeli legislative attempt to tax foreign trusts based on marginal or mixed Israeli beneficiary representation.

"In the offshore world where tax treaties are not customary, the trust may find that there is no escaping Israeli tax where one beneficiary is an Israeli resident."

Although it may appear anomalous, it is possible to argue that the U.S.I.T.T. leaves Israel the right to tax distributions made to Israeli residents by an R.T. This result may be rejected under the theory that 30% Israeli taxation on a distribution is clearly directed at the beneficiary's portion of the Trust's global, non-Israeli income. As such, in substance, Israeli taxation should also be precluded due to the treaty determination of the Trust's U.S. residency. Moreover, the beneficiary is viewed, from the U.S. point of view, as receiving distributions of previously-taxed U.S. income; thus, at minimum, it is arguable that Israel would have to afford the Israeli beneficiary a full U.S. tax credit in respect of U.S. taxes levied on the Trust income now being distributed, which may not leave much, if anything for Israel to assess.

Although the above is only one example based on the U.S.I.T.T., other cases may carry similar results under different facts and diverse tax treaties. As always, the specific factual background and relevant treaty would have to be examined and analyzed.

TAX PLANNING IN THE ABSENCE OF TREATIES

The previous example illustrates how the new Israeli legislation regarding foreign-settled mixed-beneficiary trusts may constitute legislative overreach when compared to customary international tax treaty principles. In such cases, it is reasonable to expect the legislation to give way before treaty provisions. Where, however, trusts operate in the offshore world where tax treaties are not customary, the trust may find that there is no escaping Israeli tax where one beneficiary is an Israeli resident. In these circumstances, certain planning alternatives may be worthy of consideration. However, the 2014 Legislation is too recent for tested plans to exist. A brief overview of several alternatives being discussed among tax lawyers are discussed below.

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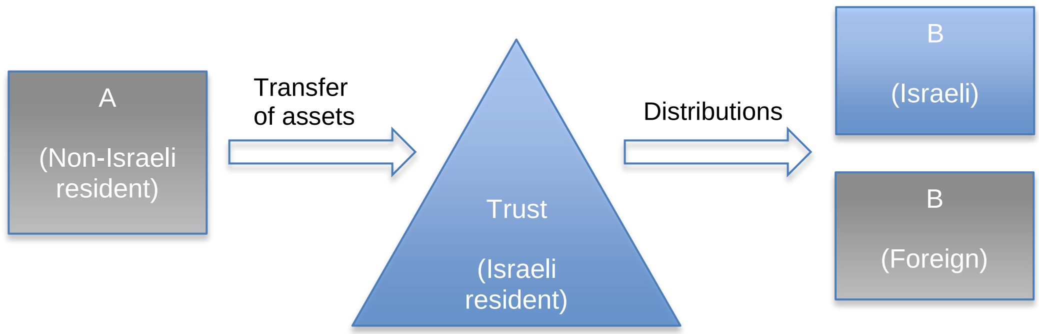
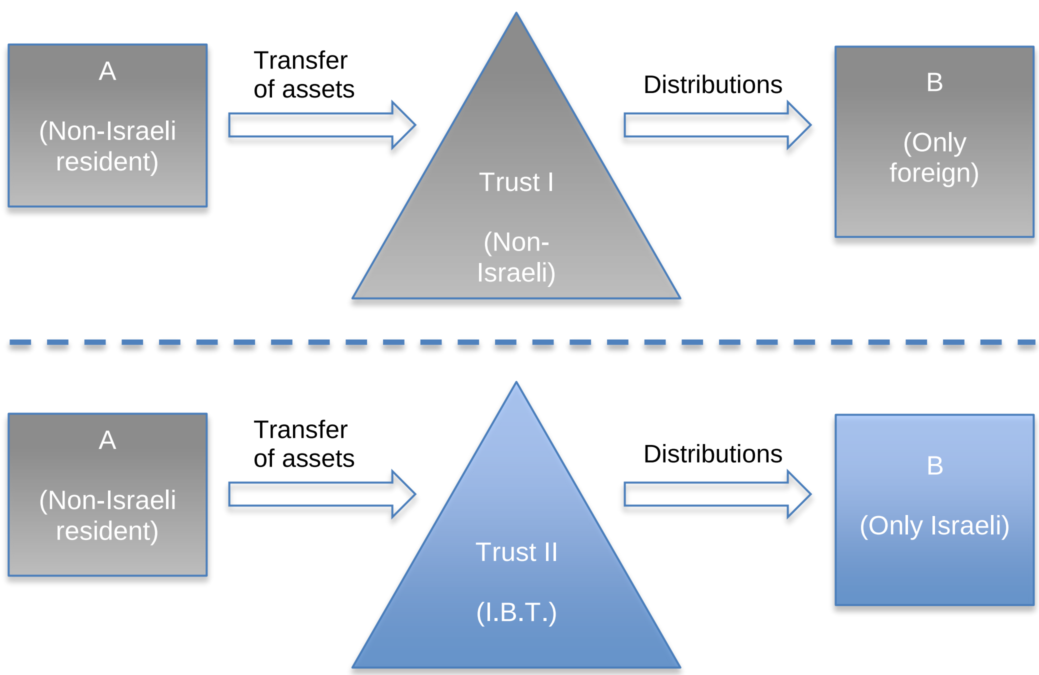
[11] I.T.O. §196.

1. *__Bifurcation of Trusts__* – It is often possible to avoid mixed classes of beneficiaries within existing trust deed provisions, without revoking the Trust.

<u>Original Position</u>



<u>Post-Bifurcation Position</u>[12]

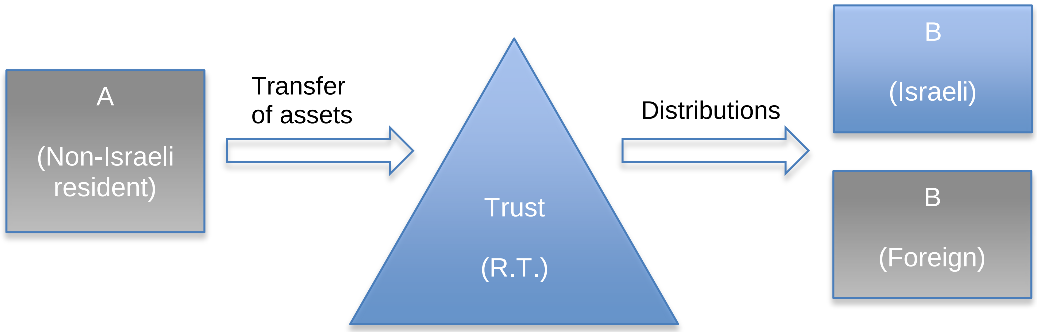


The intended effect of the bifurcation is to ring fence Israeli tax to assets and income that are intended to benefit Israeli resident beneficiaries.

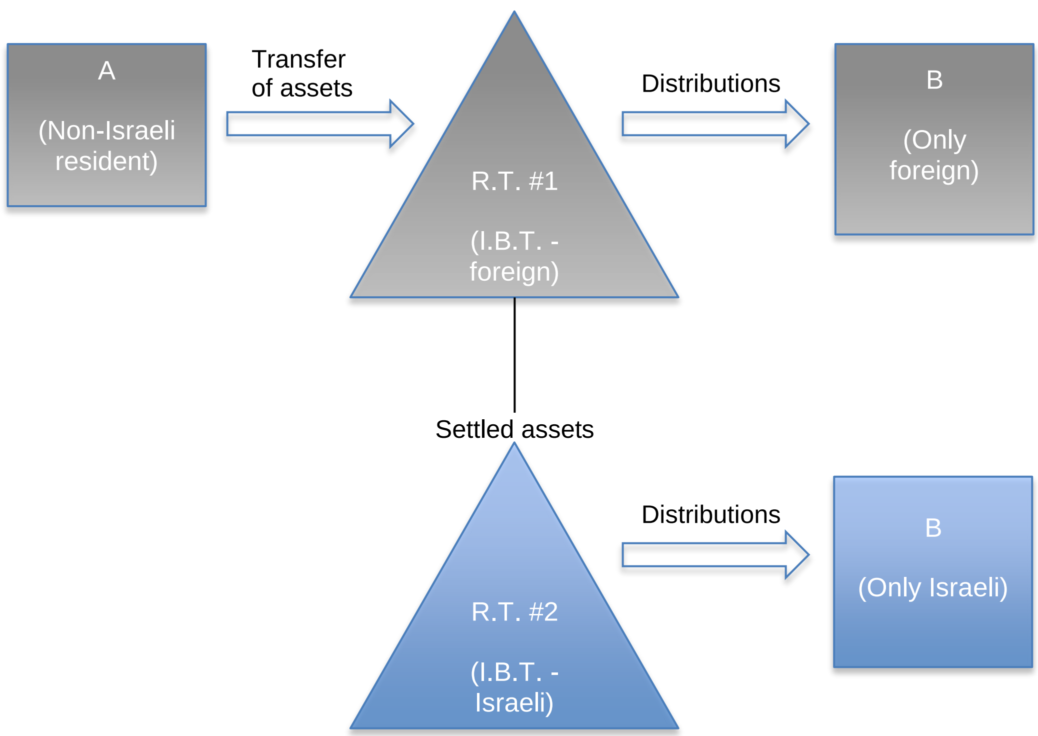
[12] Trust II may also be a "R.T.," which is a subcategory of an I.B.T. See earlier discussion in 2014 Legislation – the Beneficiary Model.

2. *Creation of Separate Sub-Trusts* – Assets intended for individual Israeli beneficiaries of an R.T. are placed in a subsidiary trust, while such beneficiaries are excluded from the parent-trust, thus avoiding onerous Israeli tax consequences for foreign beneficiaries of the parent trust.

Original Position



Post Sub-Trust Position



In this manner, the I.T.A. will have cause to deal only with R.T. #2 in regard to reporting and taxpaying obligations. Only R.T. #2 has Israeli beneficiaries that may receive taxable distributions.

3. *Discretionary Ordered Distributions in an R.T.* – With proper timing and payments to beneficiaries, ordered distributions may prevent the spill-over from what should be foreign non-taxable income to local Israeli-taxable income. Details are intricate.

“The zig-zag of reference points that control tax residence from a focus on the trustee to a focus on the settlor to a focus on Israeli beneficiaries – has created an unsettling and unsatisfactory regime.”

CONCLUSION

Legislative overreach in the tax area simply doesn’t work. In Israel, it usually creates a disorganized situation which encourages the I.T.A. to grant private extra-legal concessions in order to avoid the collection of tax in unjustified situations. However, this undermines the rule of law and creates confusion by virtue of the simultaneous existence of two tracks.

The history of Israel’s search for an answer to trust taxation – the zig-zag of reference points that control tax residence from a focus on the trustee to a focus on the settlor to a focus on Israeli beneficiaries – has created an unsettling and unsatisfactory regime, which we believe will not hold up against customary, international double-tax avoidance arrangements and principles.

On the other hand, legislation that is thought-through to reach a fair result for Israeli resident beneficiaries, nonresident beneficiaries and the Treasury is both easier for the taxpayer to accept and easier for the regulator and administrator to maintain. Our feeling is that Israel’s trust taxation rules are still in the process of formation. The 2014 Legislation is a midway point in the process and not the endpoint. Until legislation reaches a state of international tax equilibrium, taxpayers would be wise to proceed with caution – and with good advice.