

Israeli Taxation of Delaware Trusts

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Israeli Tax Residency



Israeli Residency – Definition

The Center of Life Test

- An Israeli Resident Individual is defined in the Income Tax Ordinance [New Version] 1961 as:
 - “One whose “Center of Life” is in Israel”
- An Individual’s Center of Life is determined by taking into account all his family, economic and social connections, including:
 - His permanent residence;
 - The dwelling of himself and his family;
 - His regular place of business and employment;
 - His active and substantive place of economic interest;
 - His place of involvement in organizations, associations or other institutions.

Israeli Residency – Definition

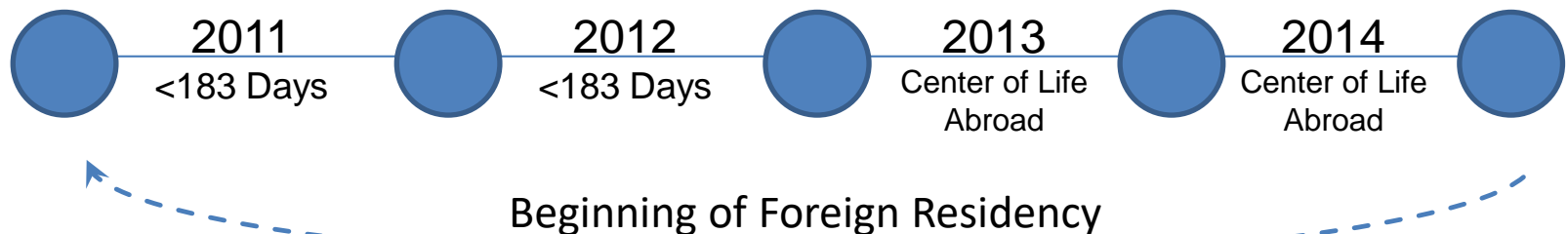
The Days Presumption

- The Ordinance also contains a residency presumption based on the number of days an individual spends in Israel.
- The Presumption contains two alternatives:
 - *An Individual spends 183 days or more in Israel during the tax year.*
 - *An Individual spends 30 days or more in Israel during the tax year AND 425 or more days in total in Israel during the tax year and the previous two tax years.*
- **Note: As a presumption, the Days Test can be refuted if the Individual shows that his center of life is not in Israel.**
- **Note: Partial days, such as travel days, are considered as full days for the purpose of the Days Presumption.**

Foreign Residency – Definition

Two alternative definitions:

1. An Individual who is not an Israeli Resident, namely an Individual whose Center of Life is not in Israel.
2. *The Four Years Test* - An Individual who meets the following two tests is considered a foreign resident from the time he leaves Israel in the first year:
 - The Days Component: spends less than 183 days in Israel during two consecutive tax years.
 - The Substance Component: in the following two years, the individual's Center of Life is Outside Israel.



Tie Breaker Rules in the US-Israel Tax Treaty

- The US-Israel Tax Treaty provides “tie breaker” rules for a Taxpayer who is a resident of both the US and Israel.
- The “tie-breaker” rules determine the residency of such individual for the purposes of the treaty:
 - (a) He shall be deemed to be a resident of that Contracting State in which he maintains his **permanent home**. If he has a permanent home in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of that Contracting State with which his **personal and economic relations are closest** (center of vital interests). In the case of a person who is an "oleh" (as defined in section 9(16) of the Israeli Income Tax Ordinance), his center of vital interests shall be deemed to be in Israel.
 - (b) If the Contracting State in which he has his center of vital interests cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has **a habitual abode**;
 - (c) If he has a habitual abode in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of the Contracting State of which he is a **citizen**; and
 - (d) If he is a citizen of both Contracting States or of neither Contracting State, the competent authorities of the Contracting States shall settle the question by **mutual agreement**.

Israeli Taxation of Delaware Trusts



Basics of Taxation of Trusts in Israel

- The default rule: **the trustee is the taxpayer and the person who is subject to the reporting obligations.**
- The trust's income/losses cannot be off-set against the beneficiary's/settlors income/losses.
- However, in certain circumstances an election can be made to allocate the trust's income or to transfer the reporting obligation to the settlor or to the beneficiary.
- A trust is generally subject to the tax rates that are applicable to individuals. However, as opposed to individuals:
 - Trusts are not entitled to tax brackets (highest bracket rate will apply);
 - Trusts are not entitled to credit points (personal credits) and exemptions that are limited by cap.

Possible Israeli Classifications of Delaware Trusts

- Under Israeli law, as of 2006, a trust may be classified under one of the following classifications:
 - Foreign Settlor Trust;
 - Foreign Beneficiary Trust;
 - Israeli Residents Trust;
 - Israeli beneficiary Trust;
 - Testamentary Trust.
- A Delaware trust in which an Israeli resident is the settlor may be classified as an Israeli Residents Trust or a Foreign Beneficiary Trust .

Israeli Residents Trust – General

- Definition: one of the following trusts:
 - A trust in which, at the date of creation, at least one beneficiary and one settlor were Israeli residents, and, during the relevant tax year, at least one settlor or one beneficiary are Israeli residents;
 - A trust in which all the settlors are deceased and at least one beneficiary is an Israeli resident;
 - Any trust that does not qualify as any other type of trust.

Israeli Residents Trust – General (*Cont'd*)

- Taxation of the trust: subject to tax as an Israeli resident on its world-wide income.
- Contribution will generally not trigger a tax event.
- Distribution will be regarded as a transfer from the settlor to the beneficiary and generally shall not trigger a tax event.

- The Situation Discussed



Israeli Residents Trust – Election of Taxable Settlor

- An election can be made to allocate the trust's income and to pass the reporting obligation to an Israeli resident settlor.
- The election is only available for a trust that meets the two following criteria:
 - It is a revocable trust;
 - There is one settlor (the settlor and his spouse are considered as one settlor for the purpose of the election);
- The election is irrevocable as long as the settlor is alive and considered as an Israeli resident.

Israeli Residents Trust – Possible Tax Trap – Tax Credit

- The US-Israel Tax Treaty does not provide “tie breaker” rules for a trust that is considered a resident of both the US and Israel but rather states that:
*“Where... a person other than an individual is a resident of both Contracting States, the competent authorities of the **Contracting States shall endeavor to settle the question by mutual agreement and determine the mode of application of the Convention to such person**”*
- Under a circular published by the ITA (3/2016), as well as a recently published tax ruling (3792/16), tax credit may be available even where the tax is paid in each of the countries by a different taxpayer (e.g., the trustee in one country and the settlor or the beneficiary in the other).

However, no clear rule which country has the first bite on the income!

Israeli Residents Trust – Issues to Consider

- Exit tax: the trust will not be subject to exit tax in case an the Israeli settlor ceases from being Israeli tax resident as long as the trust is still classified as an Israeli Resident Trust. However, a tax event may be triggered if the classification changes.

Foreign Beneficiary Trust – General

- Definition: a trust that meets the following criteria:
 - An irrevocable trust;
 - Was settled by an Israeli resident settlor;
 - All of the beneficiaries are identified foreign resident individuals;
 - Adding Israeli beneficiaries is forbidden under the trust's documents.



Foreign Beneficiary Trust – General (Cont'd)

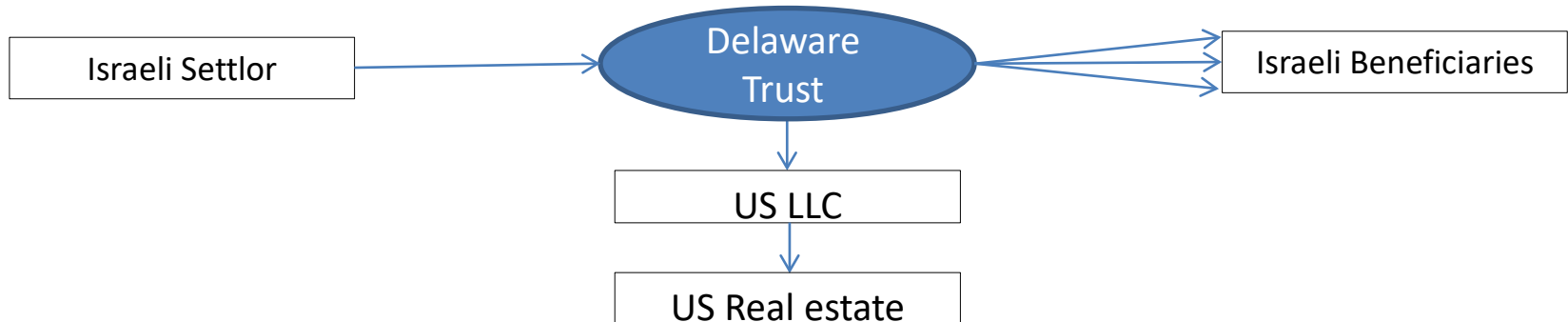
- Taxation: subject to tax as a foreign resident, i.e. only on Israeli sourced income.
- Contribution of assets will trigger a capital tax event.
- Distribution from the trust will not trigger a tax event in Israel.

Advantages in Establishing Delaware Trusts



Possible Reasons for Establishing Trusts

- Holding of US real estate.



- Tax advantages:
 - No estate tax in Israel or the US.
 - Reduced capital gain tax rates in the US upon the sale of the real estate.
 - Israeli tax rates:
 - Rent income: 50% or 15% of the gross income (no credits or offsets).
 - Capital gains: 25% (+ 3% surplus tax if applicable).
 - Tax credit in Israel for the tax paid in the US.

Dynasty Trust created by an Israeli deceased settlor



- An Israeli settlor (who is not a US person) creates a testamentary trust for the benefit of his U.S. children.
- Tax advantages:
 - No estate tax in Israel.
 - The trust is not subject to tax in Israel
 - Provides a step-up in the U.S. to the contributed assets.
 - Generation Skipping in the U.S.

Disclaimer

The sole purpose of this presentation is to provide general and non-binding information and it cannot be relied upon for any purpose or matter.

This presentation does not replace specific advice regarding the issues discussed and it does not refer to the relevant and unique circumstances of each case. Accordingly, readers are encourage to obtain specific advice regarding their situation.

The lecturer is qualified as an Israeli and not as a U.S. tax advisor and therefore any reference to U.S. tax laws should be verified with U.S. tax advisors.



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