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U.S. Trusts with Israeli Beneficiaries Now Taxable—What You Need To Know About the New Law and the Decisions that Must Be Made Now

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[1] The authors wish to thank Gidon Broide, Partner, at Broide & Co., an Israeli accounting firm, for his valuable insights and comments.

Until 2014, Israel generally exempted from its income tax any trust that had been created by one or more foreign persons, even though one or more beneficiaries were Israeli residents. Further, Israel did not generally seek to tax an Israeli resident beneficiary on receipt of a distribution from such a trust, and in certain cases did not require the beneficiary to even report such distributions to the Israel Tax Authority (ITA). However, under a new tax law that became effective on January 1, 2014, many of these previously tax-exempt trusts and/or their Israeli resident beneficiaries have become subject to significant Israeli income tax liabilities and reporting obligations. This new reach of Israeli tax law presents planning and compliance issues for many trustees and trust beneficiaries having the requisite ties to Israel.[2]

Action Plan Needed

In conjunction with the new law, the ITA is offering to negotiate and settle the tax liabilities of trusts as a form of transitional relief. These negotiations are aimed not only at compliance with the new law but also at resolving what the ITA believes are past liabilities of certain existing trusts. The ITA asserts that many trusts previously believed by taxpayers to be exempt from Israeli tax under the pre-2014 law actually should have been taxable on account of various factors, including, for example, influence and/or control that the Israeli beneficiaries may have had over the trustee.

To promote negotiations, the ITA is offering two inducements to trustees and beneficiaries: (1) attaining certainty and closure on the possibility of past tax liabilities; and (2) awarding the trust in certain circumstances, and at the discretion of the ITA, a step-up in the cost basis of trust assets to their fair market value at the time the trust became subject to Israeli taxation. Such a step-up is valuable because it can reduce future taxable gains when trust assets are sold. Requesting a tax settlement with the ITA is voluntary; however, without a settlement, a trust will become subject to the new law and will have no possibility of enjoying a step-up in cost basis. It is notable that the reporting and tax obligations of the new law can be imposed at the trust level even though the trust itself has no obvious connection to Israel. It remains an open question whether foreign trustees will have a defense against the new law based on its apparent scope. Regardless, though, we believe that the prudent path is to prepare for additional taxation—especially since punitive penalties may be levied on distributions if foreign trustees do not comply with the new regulations.

Since the law now imposes a deadline of June 30, 2015, to notify the ITA of the existence of a "Relatives Trust" (eligible for reduced tax rate; see below), it is essential for all trustees and trusts subject to its provisions to develop an appropriate plan of action in the coming months. Unfortunately, however, the ITA is issuing needed guidance on the law slowly, sometimes informally, and in pieces, which means that advisors must cope with considerable uncertainty in trying to give timely advice. Indeed, taxpayers may wish to put their trust income-tax returns on extension in case the ITA issues additional clarification.

[2] The enforcement mechanism for the new tax law is uncertain, but U.S. trust settlors are well-advised to regard the tax as an obligation.

Relatives vs. Non-Relatives Trusts

According to the new law, an Israeli Beneficiary Trust is a trust under which all settlors are foreign residents and there is at least one Israeli resident beneficiary.[3] All such trusts will be subject to tax under the new law, but the timing and rate of the tax will depend on the relationship between the settlor of the trust and the beneficiaries. An Israeli Beneficiary Trust can be either:

(i) *a Relatives Trust*, which refers to a trust under which the settlor (or settlor's spouse[4]) is still alive, and is related to the beneficiary as detailed in the law (e.g., a parent, grandparent, spouse, child or grandchild of the beneficiary, or a "second-degree" relative in certain circumstances); ***or***

(ii) *a Non-Relatives Trust*, a designation that applies to all other Israeli Beneficiary Trusts.

A Non-Relatives Trust is subject under the new law to income tax in Israel on all of its worldwide income, at the regular rates of 25%–52% (the 25% rate applies to passive income from financial investments including capital gains). Only the portion allocable to the Israeli beneficiaries will be taxable, but the ITA has not yet indicated exactly how the allocation may be made, other than to note that it may be negotiated (*see below*). It appears that any well-supported, reasonable allocation method will be accepted. For example, if four children are beneficiaries and only one is an Israeli resident, 25% of the income can reasonably be allocated and taxed. Another reasonable method could be based on the history of distribution patterns to the Israeli resident beneficiaries.

Choice Between Two Tax Regimes

A Relatives Trust is also subject to tax under the new law, but enjoys an option not available to a Non-Relatives Trust: So long as the Trustee of an existing Relatives Trust notifies the Israeli tax assessor of its existence by June 30, 2015 (or, in the case of a newly created Relatives Trust, within 60 days of creation), the Trustee has a choice between the two tax regimes below. The election of either Regime is irrevocable; if a decision is not made by midyear 2015, the trust will be deemed to be subject to the Deferred Tax Regime. The Regimes operate as follows:

(a) *Annual Tax Regime*: An annual 25% tax is imposed at the trust level on the portion of the income allocated to Israeli beneficiaries. Subsequent distributions to beneficiaries are not taxed.

(b) *Deferred Tax Regime*: There is no yearly tax at the trust level, but the Israeli resident beneficiary is taxed at a 30% rate upon trust distributions when received. Only income, not principal, is subject to taxation, but there is a presumption that income is distributed before principal. In some cases, though, it may be difficult in practice to distinguish between the principal and income portions of distributions, potentially leading to complications.[5] ("Principal" is considered generally to mean the original contribution to the trust by the settlor.)

Note, though, that the death of a settlor causes a Relatives Trust to lose that status. As a result, the Deferred Tax Regime is no longer available, and the trust itself becomes subject to Israeli taxes on the portion of its worldwide income allocated to Israeli beneficiaries. However, if the settlor is survived by a spouse, the Trustee has the option of maintaining a trust as a Relatives Trust until the death of the spouse, provided that he or she was married to the settlor at the time that the settlor made any contribution to the trust. There is also a tax exception for trusts created by, or for the benefit of, new immigrants to Israel: They are not taxed for the first 10 years on foreign-source income. This income is also not generally reportable during the 10-year period.

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[3] A "beneficiary" is generally defined in Israeli tax law as a person who may directly or indirectly enjoy the trust assets or income as long as he or she is alive, including a person who will be entitled to such enjoyment on the fulfillment of a condition, except a person whose rights depend on the passing away of the settlor or another beneficiary.

[4] A spouse at either the time of the creation of the trust or at the time of a contribution to the trust.

[5] It is possible, under the ITA rules, that if the Deferred Regime is chosen and taxable income accumulates, no tax may be due if the settlor dies prior to any distributions being paid out. This is an open issue, and we encourage settlors and practitioners to monitor the situation Still, at least for trusts that will pay out distributions in a short to intermediate time frame, the Annual Regime may be the preferred route. (See the Bernstein case study that follows.)

U.S. clients who have established trusts for their descendants, some or all of whom live in Israel, need to be aware of the new reporting requirements and the income tax liability that the trusts, or their descendants, will now bear. Many factors must be considered in choosing between the possible taxation regimes, and clients with applicable trusts need to consult with qualified U.S. and Israeli tax counsel. Some aspects of the application and implementation of the new law are still unknown; therefore, tax-planning recommendations remain difficult. However, as ITA guidance is issued, it will become easier to recommend a course of action in specific situations.

The case study below by Bernstein Global Wealth Management provides some guidelines for making decisions, based on what is now known and on Bernstein's projections of the impact of tax decisions on the amount of trust assets remaining for the beneficiaries after taxes. Further commentary and regulations are expected from the ITA, but it is uncertain when the Authority will release such information.

Existing trusts with low-cost-basis assets that are subject to Israeli tax for the first time under the new law have an additional issue to consider: Sale of the low-cost-basis assets today may produce a significant tax liability under the new law. Had such assets been sold by December 31, 2013, there would have been no taxable gain in Israel. The law as written does not offer any step-up in the cost basis of trust assets upon the law's effective date. However, a settlement arrangement with the ITA, discussed next, may achieve a step-up in cost basis to the market value as of December 31, 2013, under certain circumstances.[6]

Negotiated Arrangements with the ITA

As indicated above, the ITA is encouraging trustees to negotiate settlements as to reporting and tax requirements on specific trusts, both as to possible past tax liability and future taxation. Trustees can choose from two types of settlement routes:

(1) *Income Route*: This is most relevant for trusts that may not be fully compliant with tax law prior to 2014. The trust chooses to pay a portion (1/3–2/3) of the regular tax liability, depending on the extent to which Israeli beneficiaries influenced the trust, at the passive income rate (generally 25%) on 2006–2013 trust income. The Income Route does not provide for a step-up in cost basis of trust assets, unless the trustee agrees to pay tax as if all trust assets were deemed sold as of December 31, 2013.

(2) *Asset Route*: The trust chooses to pay a tax based on trust asset value as of December 31, 2013, at a rate of 3%–6% (again, depending on the degree of beneficiary influence). This route is available only where the yield on the trust's assets is not high (as determined by the ITA). The assets comprise the actual market value of the trust assets on December 31, 2013, plus any distributions to Israeli resident beneficiaries during 2006–2013.

Under either route, a foreign tax credit may be granted (*see below for discussion of credit for U.S. income taxes paid*), although the tax liability for prior years must be paid with interest (but no penalties).

One route may be applied to some assets, and the other to other assets; terms may be negotiated with the ITA. To qualify for a settlement, the Israeli beneficiary must not have transferred any asset to the trust, the settlor cannot be a beneficiary, and the trust assets cannot be derived from taxable income in Israel on which taxes were not paid.

The ITA officer may consider, in his or her discretion, various factors in reducing the tax liability, including the existence of any non-Israeli beneficiaries; any foreign tax liability paid by the trust, the settlor, or any beneficiary on behalf of the trust; and any applicability of a Double Taxation Treaty if the trust is housed in a country that has such a treaty with Israel (and is subject to tax in that country).

[6] The ITA's decisions on step-ups are likely to depend in part on expected tax revenues.

Credit for U.S. Income Taxes

Recently, the ITA has indicated verbally (but not yet in writing) that any U.S. tax paid on trust income will be applied as a tax credit against Israeli tax, regardless of whether the U.S. tax was paid by the settlor, the trust, or the beneficiary. Thus, in some cases—where the U.S. tax equals or exceeds the amount of the Israeli tax that would otherwise be payable—there will effectively be no additional Israeli tax. The availability of this tax credit, which is applied to the various types of income individually (ordinary/interest, dividend, capital gains), is particularly important for so-called "grantor trusts" under U.S. law, where the grantor pays the trust's U.S. income tax. Establishing a grantor trust is beneficial for U.S. tax purposes because it results in the equivalent of a tax-free gift to the beneficiaries and a reduction in the grantor's taxable estate. There are other considerations that may arise in connection with U.S. grantor trusts and the new Israeli tax; the issues are still being examined by the ITA.

Planning for the New Law

Every trust and family situation is different and will require separate analysis to determine appropriate compliance with the tax liability and reporting obligations of the new law, and the potential usefulness of seeking a negotiated settlement with the ITA. Some factors in such an analysis are the terms of the trust, the income of the trust over the relevant time horizon, the cost basis of the trust, the amount of foreign taxes paid, and the past and anticipated distributions to beneficiaries.

In the case of a Relatives Trust, analysis will be required to choose between the Annual Tax Regime (25% yearly tax paid at the trust level on income allocated to Israeli beneficiaries) and the Deferred Tax Regime (30% tax paid on income distributions to Israeli beneficiaries). If U.S. taxes are also being paid on trust income, the operation of the credit for foreign taxes may be a significant consideration. As mentioned above, the ITA should allow a credit on all U.S. taxes paid by the trust, the grantor, or a beneficiary as long as these taxes were paid on the same income. In general, we expect that matching U.S. tax payments to trust income for purposes of the Israeli credit will be easier under the Annual Regime than under the Deferred Regime—because both countries will be imposing their tax on a current basis *in the same year*, whereas Israel's tax may be delayed, possibly for many years, under the Deferred Regime. In other words, we see more clarity for taxpayers under the Annual Regime.

In the meantime, the Bernstein case study below is intended to promote awareness of several key issues raised by the new Israeli tax law and give some guidance on obtaining as favorable a tax result as possible within the confines of the new law, as currently understood.

Bernstein Case Study: Set Up a U.S. Trust for an Israeli Beneficiary?

To accompany the discussion above by Fox Rothschild, Bernstein Global Wealth Management prepared a case study that highlights some of the issues now faced by U.S. settlors of grantor trusts for relatives who are Israeli beneficiaries. The case study assumes that Israeli taxes will be due on the portion of the trust applicable to the Israeli beneficiary, offset by U.S. taxes paid. Even given a relatively simple scenario, several key decisions can have an outsized influence on the benefit that the trust confers.

Note that all Bernstein projections rely on a systematic planning tool. It overlays investor goals with a sophisticated Monte Carlo simulation engine that generates 10,000 possible market outcomes. The system factors in prevailing market conditions, which can heavily influence results, and projected outcomes range from spectacular to dismal. This case study shows only median outcomes, though Bernstein tests for projections far above and below the median.

Background

Andrew and Jennifer Lewis, U.S. citizens, both 55 years old, are the parents of one adult daughter, Melissa, who is a long-standing Israeli resident. The Lewises have a very high net worth of $50 million, and their wish is to transfer a considerable sum to Melissa, assuring her lifestyle and also reducing their taxable estate. At the current federal estate tax rate of 40% and an exemption of $10.68 million for the couple, their assets today would be subject to an estate tax of almost $16 million. While the Lewises realize that they almost surely will not be able to avoid estate taxation altogether, they want to lessen their tax burden.

With these goals in mind, the Lewises decide to set up a $10 million grantor trust for Melissa's benefit, with distributions to begin in the near term.[7] But they have questions to answer first, which Bernstein can help them with:

- What allocation of assets should they choose—and which allocations should they avoid?
- What impact would the trust have on the growth of wealth and on estate taxes?
- Should they elect to pay the 25% annual Israeli tax on the trust income (which in this case would be wholly allocated to Melissa) or the 30% deferred rate on trust distributions when received?

The Tax Regime Election: Counterintuitive?

Let's approach these issues from the bottom up. As to the tax-rate election, the Lewises' first impulse was to take advantage of the deferral, in accord with the conventional wisdom to defer taxation as long as possible. But Bernstein's preliminary view on the question, based on the currently known facts about the new Israeli law, favored the 25% regime (as indicated above), for several reasons.

For one, the Israeli credit for U.S. income taxes paid would have a more salutary effect in a 25%-tax environment. Since Israel imposes a flat 25% on all investment taxes, the closer a trust comes to generating U.S. income and proceeds taxable at 25%, the more *marginal* the effect of the Israeli taxes (*Display 1*). At the limit—a 100%-stock allocation,

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[7] Baseline assumptions: Top U.S. marginal income tax rates = 43.4% (39.6% + 3.8%) for ordinary income, 23.8% (20.0% + 3.8%) for qualified dividends and long-term capital gains. Funds to pay grantor trust taxes would have otherwise been subject to a 40% federal estate tax upon the death of the grantor. No state income or estate taxes have been modeled.

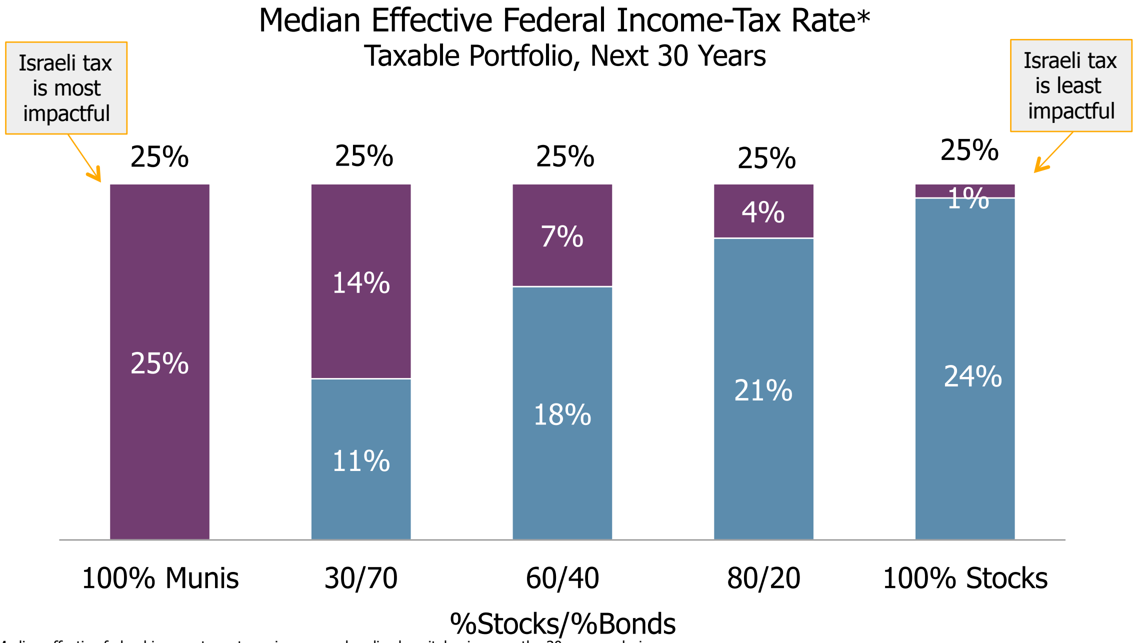
which would be subject to a 23.8% tax on qualified dividends and long-term capital gains—the impact of the new Israeli taxes would be only about a 1% increment in the tax rate. Not that Bernstein would necessarily advocate an all-stock trust, but the 25% regime would allow the Lewises to significantly reduce the additional cost of the Israeli tax liability on the trust.

Another benefit of the 25% regime relating to tax credits is that it will give the Lewises greater confidence that they will receive a credit for U.S. income taxes paid. As suggested earlier, taking the 30%-deferred route may entail complications that may affect the recognition of the credit. In Bernstein's view, why take any chance? This preference for the 25% regime assumes that the 30% rate will eventually have to be paid.[8]

Second, the tax rate on the annual schedule is simply lower (25% vs. 30%), making it harder for the deferred regime to be as beneficial. Deferral may *ultimately* preserve more wealth, but as *Display 2* illustrates, we would expect the crossover point to be decades in the future, even for a moderate allocation of 60% global stocks and 40% municipal bonds.

It is possible that ITA guidance, if issued, may contain considerations that will make the deferred regime more or less attractive than it currently seems to be, and so Bernstein may revisit this question. But in the meantime, the 25% annual tax regime seems more appropriate.

The Impact of Israeli Trust Taxes Varies by Asset Allocation



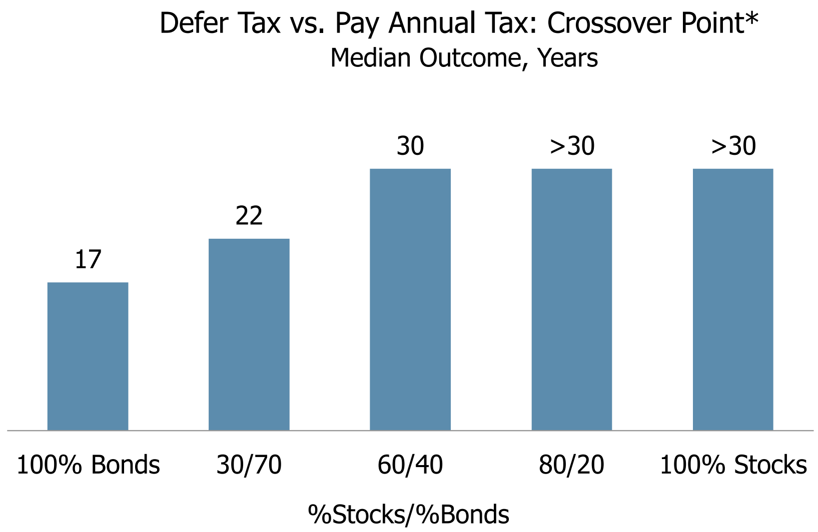
*Median effective federal income tax rate on income and realized capital gains over the 30-year analysis
Stocks are modeled as 63% U.S. diversified, 7% U.S. small/mid-cap, 22.5% developed international, and 7.5% emerging markets. Munis are modeled as intermediate-term diversified municipal bonds.
Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 30 years. Data do not represent past performance and are not a promise of actual future results or a range of future results. See Note on Bernstein Wealth Forecasting System at the end of this article for further details.
Source: AllianceBernstein

Bernstein.com

Display 1

[8] If there is a meaningful chance that certain transactions will avoid taxation altogether under the Deferred Regime (because of an ITA determination or the early death of both Lewis parents), that would become the preferred route. But given the fact pattern here, Bernstein would opt for the 25% annual taxation.

Defer or Pay Annual Tax: Crossover by Asset Allocation

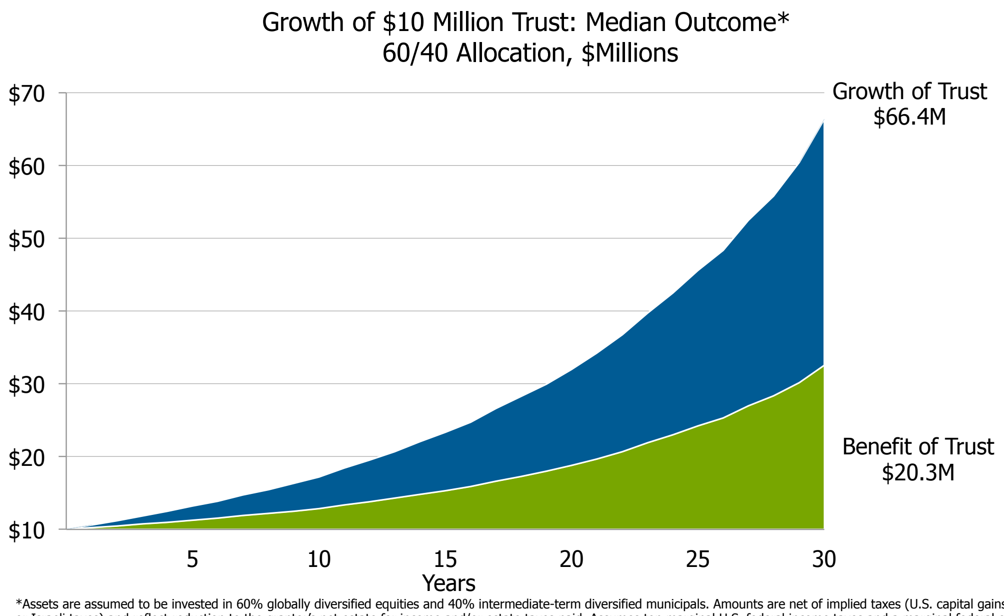


*Crossover point represents years required for deferring Israeli taxes to generate more wealth than paying taxes annually. Amounts are net of implied taxes (U.S. capital gains and/or Israeli taxes) and reflect reduction to grantor's net estate for income taxes paid. Assumes top marginal U.S. federal income taxes and a marginal federal estate-tax rate of 40%. Assumes trust receives Israeli tax credit for U.S. income taxes paid. Assumes that all income will be subject to a 25% annual or a 30% deferred tax (net of tax credits). Bonds are modeled as intermediate-term diversified municipals. Stocks are modeled as globally diversified equities.
Based on Bernstein's estimates of the range of returns for the applicable capital markets for the next 30 years. Data do not represent past performance and are not a promise of actual results or a range of future results. See Note on Bernstein Wealth Forecasting System at the end of this article for further details.
Source: AllianceBernstein

Bernstein.com

Display 2

Impact of Grantor Trust: No Israeli Tax



*Assets are assumed to be invested in 60% globally diversified equities and 40% intermediate-term diversified municipals. Amounts are net of implied taxes (U.S. capital gains and/or Israeli taxes) and reflect reduction to the grantor's net estate for income and/or estate taxes paid. Assumes top marginal U.S. federal income taxes and a marginal federal estate-tax rate of 40%.
Based on Bernstein's estimates of the range of returns for the applicable capital markets for the next 30 years. Data do not represent past performance and are not a promise of actual results or a range of future results. See Note on Bernstein Wealth Forecasting System at the end of this article for further details.
Source: AllianceBernstein

Bernstein.com

Display 3

How Much Benefit from the Trust?

As to what the Lewises can expect their trust to provide in the way of incremental wealth versus keeping all their assets on their balance sheet, we will assume a $10 million initial contribution and a moderate allocation of 60% global stocks and 40% municipal bonds over a 30-year time horizon. Assuming no Israeli taxes (the situation until this year), the impact of the strategy would be calculated as follows:

Wealth moved off the settlor's balance sheet x settlor's marginal estate-tax rate minus impact of forgoing capital-gains step-up.

Bernstein would anticipate the trust growing to $66 million over 30 years in typical markets—$56 million of off-balance-sheet growth—with a $20 million benefit for Melissa. (*Display 3)*

As evident from *Display 4*, if this were the tax regime, establishing a trust could make sound economic sense across all asset allocations (note this is also the benefit of setting up a grantor trust for U.S. grantors with U.S. beneficiaries).

But Israel *does* now levy taxes, and the benefit of the trust is calculated as:

Wealth moved off the settlor's balance sheet x settlor's marginal estate-tax rate minus impact of forgoing capital-gains step-up ***and any Israeli taxes paid****.*

When the Israeli tax is factored in (*Display 5*), the benefit of the trust is reduced, especially for fixed-income-heavy portfolios—but increases steadily with higher equity commitments, as the effect of the new Israeli 25% tax is diminished. In other words, for many U.S. donors to Israeli beneficiaries, a grantor trust is still a vehicle worth considering. (These calculations assume the wealth would otherwise be subject to U.S. estate tax. If this were not the case, settlors would wind up with only a cost from the trust and no benefit; for them, setting up a trust would not make sense.)

Asset Allocation Is More Important than Ever

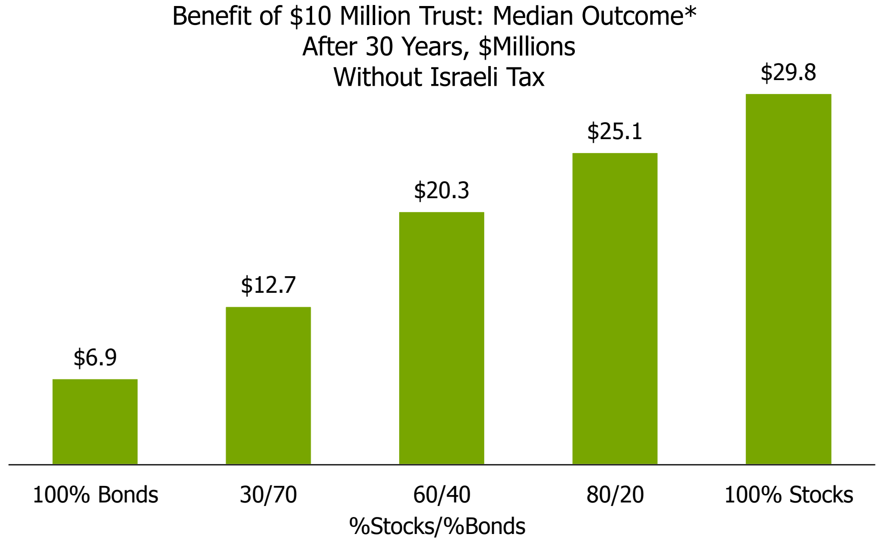
From Display 5, it may be tempting to conclude that the more stocks in a grantor trust for an Israeli resident, the better. And in fact that's true on a strictly economic basis; indeed, Bernstein would ordinarily counsel settlors with Israeli beneficiaries to set up a stock-tilted portfolio, especially since the trust terms in such cases tend to be long (albeit not necessarily advise all-stocks because of investor unease with short-term stock volatility).

The other side of the same coin is that bond-heavy grantor trusts should be avoided, and particularly so if the bonds in question are municipals. Why pay a 25% tax on muni income in the trust when it would be subject to a 0% rate in the U.S.? So one possibility for the Lewises would be to set up a $6 million grantor trust, allocated 100% to equities, and keep $4 million in municipal bonds, earmarked for Melissa, on their balance sheet. But even so, the Lewises were uncomfortable with an all-stock trust, since Melissa would likely be relying on relatively steady annual distributions—hard to come by from an all-stock portfolio.

The Lewises' decision was to allocate the trust 60/40, understanding that their results won't be as good as they would have been before the new Israeli tax was levied—but better nonetheless than without a trust in place.

Investment managers like Bernstein can help sort out the issues raised in this case study and the broader-based paper, and work in coordination with your other professional advisors. And as we mentioned before we introduced this case study, quick action is required on some key decisions. In general, setting up a grantor trust for an Israeli beneficiary is a complex task, and should be approached by a professional team: We encourage you to consult legal, accounting, investment, and tax experts, as appropriate.

Advantage of Grantor Trust: No Israeli Tax

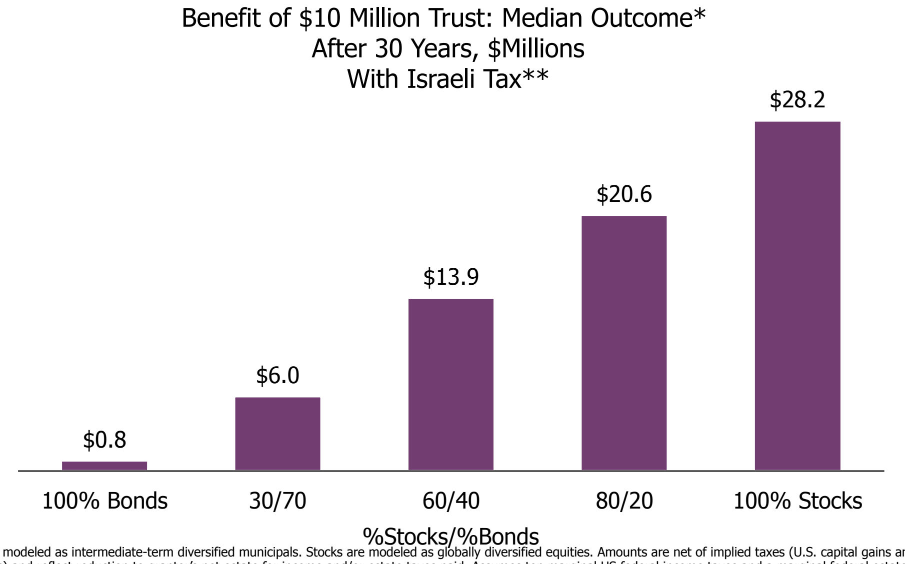


*Bonds are modeled as intermediate-term diversified municipals. Stocks are modeled as globally diversified equities. Amounts are net of implied taxes (U.S. capital gains and/or Israeli taxes) and reflect reduction to grantor's net estate for income and/or estate taxes paid. Assumes top marginal U.S. federal income taxes and a marginal federal estate-tax rate of 40%.
Based on Bernstein's estimates of the range of returns for the applicable capital markets for the next 30 years. Data do not represent past performance and are not a promise of actual results or a range of future results. See Note on Bernstein Wealth Forecasting System at the end of this article for further details.
Source: AllianceBernstein

Bernstein.com

Display 4

Grantor Trusts in the New Tax Environment: Still Advantageous



*Bonds are modeled as intermediate-term diversified municipals. Stocks are modeled as globally diversified equities. Amounts are net of implied taxes (U.S. capital gains and/or Israeli taxes) and reflect reduction to grantor's net estate for income and/or estate taxes paid. Assumes top marginal US federal income taxes and a marginal federal estate-tax rate of 40%. Assumes trust receives Israeli tax credit for U.S. income taxes paid.
**Assumes trust pays 25% tax on realized income and capital gains each year.
Based on Bernstein's estimates of the range of returns for the applicable capital markets for the next 30 years. Data do not represent past performance and are not a promise of actual results or a range of future results. See Note on Bernstein Wealth Forecasting System at the end of this article for further details.
Source: AllianceBernstein

Bernstein.com

Display 5

Note on Bernstein Wealth-Forecasting System

The Bernstein wealth-forecasting model simulates plausible paths of return for each asset class, producing a probability distribution of outcomes; however, it goes beyond randomization by projecting 10,000 forward-looking market scenarios, integrated with an individual's or a couple's unique circumstances. The forecasts are based on the building blocks of asset returns, such as inflation, yield spreads, stock earnings, and price multiples. These incorporate the linkages that exist among the returns of the various asset classes, take into account prevailing market conditions at the beginning of the analysis, and factor in a reasonable degree of randomness and unpredictability. In evaluating scenarios, we often focus on the 10th, 50th, and 90th percentiles of confidence as a proxy for excellent, median, and very poor markets, respectively.

Bernstein is not a legal, tax, or estate advisor. Investors should consult these professionals, as appropriate, before making any decisions.

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