Trusts and foundations under Israeli Law: so different, yet the same for tax purposes

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Abstract

This article treats the Israeli Hekdesh coupled with an Israeli underlying company as a foundation. It summarizes the taxation of foundations and trusts in Israel, as well as the main provisions of the relevant legislation as revised in 2013 which is now final and effective. The article then continues to discuss the appointment of protectors under Israeli law. Finally, the article provides for an interpretation of the arbitration law as it relates to foundations and trusts.

The Israeli Hekdesh is a legal structure with great similarities to a foundation as it is known in many countries. Under the Trust Law 1979 (the ‘Trust Law’), the Hekdesh, the Israeli trust/foundation, is categorized as a trust. It is thus not a separate legal entity as is a foundation. Under the Tax Ordinance, the Taxation of Trusts legislation puts trusts and foreign foundations into the same category for tax purposes. This article, in its third edition, will not discuss the basic issues but rather, will cover a number of interesting topics relating to Israeli trusts as well as a few recent developments. For the purpose of this article, we treat the Israeli Hekdesh coupled with an Israeli underlying company as a foundation as this arrangement is used to hold assets under a trust in Israel.

The settlement of a trust under Israeli law

Under the Trust Law, generally, a trust may be created by contract, by deed (Hekdesh) or by testament. Other options to create a trust under the Trust Law are less relevant for the purposes of this article and are thus not mentioned.

A trust created by contract is established by a written agreement between the settlor and the trustee. It is the view of professionals that such a trust contract is not valid for the transfer of the assets to the settlor’s heir, when the settlor passes away and the contract has not been executed in accordance with the Succession Law in the form of a testament. An inter vivos trust created by contract, thus requires a court probate procedure.

A trust created by deed, Hekdesh, is signed by the settlor before a notary and, therefore, does not raise the same concerns as the trust created by contract since the signature before a notary satisfies the
Succession Law requirement as a valid testament upon the settlor’s demise.

A testamentary trust is settled by an individual’s last will and testament and becomes valid upon the issuance of a probate order by the Inheritance Registrar.¹

**Protectors**

The Trust Law does not define a ‘trust protector’ whereas the Taxation of Trusts legislation defines a protector as a person with powers to appoint or remove trustees, to provide instructions to trustees and to confirm certain actions taken by trustees.

As a general rule, in practice, protectors are appointed to ensure that trustees carry out their duties in accordance with the trust deed, the law, and the settlor’s wishes. This is the case in common law trust jurisdictions as well as continental law foundation jurisdictions. Protectors are usually granted veto powers over the trustee’s decisions rather than decision-making powers. The role of the protector in Israel may be defined by the settlor in the trust contract or Hekdesh deed or in separate documents forming part of the trust documentation. The scope of the protector’s powers is, therefore, determined by the settlor. The scope of the protector’s fiduciary duties is, however, not defined under Israeli law and professionals tend to rely, where applicable, on the experiences gained in foreign jurisdictions and on the legal opinion of national professionals. The Law of Agency 1965 serves as good authority for backing the interpretation that the protector does have a fiduciary duty if his role may be considered as that of an agent (acting for the settlor or for the trust) with a fiduciary duty.

In cases where a protector is not appointed in the original Hekdesh deed, it may be difficult to appoint a protector at a later stage, as the Hekdesh Deed may be amended by its settlor only if it permits such amendments to be made, if all beneficiaries approve the amendment or upon court approval. Although these difficulties are apparent, it may be possible to have a protector appointed by trustee resolution once the trust is established, if the trust deed contains a provision for the appointment of a protector.

To date, few trust matters have been brought before the courts in Israel and, as mentioned above, many issues remain based on the opinions of professionals interpreting the laws or are based on practice in foreign jurisdictions. There is draft legislation of a Civil Code that resolves some issues but the day of its enactment is not foreseen in the near future and, therefore, will not be discussed in this article.

**Foundations/Trusts and arbitration**

The issue of an arbitration clause in a trust contract or a Hekdesh deed is a new approach to be considered when trying to resolve disputes.

The Trust Law provides that the District Court is the relevant forum for actions in connection with trusts but it does not make reference to dispute resolution options between the parties to a trust structure.
The legislation governing arbitration issues in general is the Arbitration Law of 1968. In a trust, the question may arise whether individuals who were not parties to certain agreements may be obligated to participate in arbitration and accept an arbitrator’s judgment imposed on them under the arbitration procedure. The issue in a trust is that the beneficiaries are not parties to the Hekdesh deed.

It seems unlikely that beneficiaries of a trust created by a Hekdesh deed would be bound by an arbitration clause included in the Hekdesh deed. Such a clause may possibly apply to disputes between the settlor and the trustee and/or protector if one is appointed in one of these documents.

Where a trust is created by contract, the parties to the contract, ie the trustee and settlor are bound by an arbitration clause if it is included in the contract as a means to resolve disputes between them.

In a testamentary trust, it is possible that a testator may demand, in a last will, that heirs who wish to benefit from the trust are required to confirm their agreement to an arbitration clause.

### Taxation of foundations/trusts

The Taxation of Trusts legislation, effective as of 1 January 2006, amended by the Arrangements Law effective mainly as of 1 January 2014 distinguishes between five trust categories:

- the Israeli residents trust;
- the foreign resident trust;
- the Israeli resident beneficiary trust (‘family trust’);
- the foreign beneficiary trust; and
- the testamentary trust.

The specific features of these types of trusts are outlined below:

#### The Israeli residents trust

The Israeli residents trust is a trust settled by a resident of Israel for the benefit of Israeli resident beneficiaries. This trust is subject to reporting obligations and tax payments on its worldwide income at the rates applicable to individuals with a view to the various types of income of the trust. This trust is also the default category for trusts that do not fit within the definition of other trust types.

#### The foreign resident trust

The foreign resident trust is settled by a non-resident for the benefit of non-resident beneficiaries. This trust is subject to reporting and tax obligations in Israel only to the extent that it holds Israeli assets or receives Israeli source income.

#### The Israeli resident beneficiary trust

The Israeli resident beneficiary trust (‘Family Trust’) is a trust: (i) established by a non-resident of Israel; and (ii) at least one of the beneficiaries of the trust is a resident of Israel.

Two additional criteria must be met for the trust to be classified as a Family Trust. First, the settlor and the beneficiaries must be immediate family members (ie the settlor is a spouse, parent, grandparent, child, or grandchild of the beneficiary (‘Family Trusts’). A broader family relationship (ie siblings, nieces, nephews, aunts, uncles) will only permit classification as an Israeli resident beneficiary trust upon the submission of evidence to the assessment officer of the Tax Authority that such a trust was settled in good faith and that the beneficiary did not give consideration for such settlement in his favour. Secondly, that the settlor is still alive.

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2. See Tax Authority Rulings discussed below.
If any one of these additional criteria is not met, the trust will not be categorized as an Israeli resident beneficiary trust. Rather, it is to be classified and taxed as an Israeli residents trust.

The Israeli resident beneficiary trust/Family Trust is subject to tax as follows:

i. Distributions to beneficiaries will be taxed at the rate of 30 per cent of the distribution amount unless the trustee provides evidence of the income and capital portions of the distribution. Where the distribution is comprised solely of capital and not of income, it is not taxable.

ii. The trustee may opt, under certain circumstances, to subject trust income allocated to an Israeli resident beneficiary to tax at the rate of 25 per cent in the tax year in which the income is accrued. This option requires the preparation of balance sheets, annual reporting, and annual tax payments on realized gains. If all of these requirements are met, the distributions to the beneficiary are not taxable. This route, once chosen by the trustee, is irreversible.

The foreign beneficiary trust

A foreign beneficiary trust is a trust established by an Israeli resident for the benefit of a foreign resident beneficiary. The trust is entitled to the tax exemptions listed below but is subject to reporting obligations upon its settlement and annually as confirmation of the beneficiaries’ residence abroad.

Such a trust must meet all of the following conditions:

i. It does not fall within the definition of an Israeli residents trust.

ii. It is irrevocable.

iii. All of the beneficiaries are identified and are foreign residents.

iv. At least one settlor is an Israeli resident.

A foreign beneficiary trust is regarded as a foreign resident individual and is taxed in the same manner in which an individual foreign resident is taxed in Israel. If the assets and the income derived therefrom are derived from sources outside of Israel, there is no taxation in Israel. If the assets or the income derived therefrom are derived from sources within Israel, they are subject to Israeli taxation. The appointment of an Israeli trustee has no relevance for taxation purposes.

The testamentary trust

This trust is settled by a last will and testament of an Israeli resident. It is treated for tax purposes as an Israeli resident’s trust, if it has at least one Israeli resident beneficiary or as a foreign beneficiary trust, if there are no Israeli resident beneficiaries, as the case may be.

Recent rulings on Family Trusts

Two Rulings were issue recently by the Tax Authority in connection with Family Trusts and the relationships required between family members to satisfy the Israeli resident beneficiary requirement of a Family Trust.

One of the Rulings3 provided that the brother of the settlor’s spouse is not considered a relative of the settlor for the purpose of Family Trusts, as defined above.

Another Ruling4 provided that step nephews and nieces of the settlor (the step children of the settlor’s sister) are not relatives for the purpose of Family Trusts.

Both recent Rulings result in the categorizations of these trusts as Israeli residents’ trusts and are taxed accordingly.

Conclusion

Israel, as a relatively young country of 66 years in age, has not yet developed sufficient legal precedents on the issue of foundations and trusts. Certain initiatives

3. 4938/14.
4. 6826/14.
for new legislation concerning trust matters are pending in a bill known as the ‘Civil Code’ and its final wording may enhance the laws relating to trust matters. The use of private foundations and trusts is not as prevalent as in other countries but is ‘up and coming’. An increasing number of high net worth individuals coupled with the view that significant inheritance amounts should be limited, are creating the grounds for estate planning options using trusts. This is likely to increase the creation of trusts over the next generations and as a result, court disputes and precedents involving trust matters.

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