FEATURE:
INTERNATIONAL PRACTICE

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And You Thought U.S. Taxation of Trusts Was Complicated

What if a trust beneficiary moves to Israel?

Like the United States, Israel has now moved aggressively to tax local resident beneficiaries on foreign trust income. Until 2014, Israel generally exempted from local income tax any trust established by a foreign settlor, even if there were Israeli resident beneficiaries who received trust distributions. In late 2013, Israel altered its taxation of trusts, migrating from a settlor-oriented model to a beneficiary-oriented model.

Because Israel doesn't have an estate/inheritance tax or a gift tax, legitimate gifts and inheritances are free of tax for both the donor (decedent) and the recipient. Obviously, a U.S. citizen moving to Israel faces different tax rules unless he renounces U.S. citizenship.

Pre-2006

Prior to 2006, an Israeli resident settlor could donate assets to an irrevocable discretionary offshore (to Israel) foreign trust for the benefit of family members. So long as the Israeli resident settlor respected the need for a foreign trustee to have complete management and control over the trust assets and didn't meddle, there wasn't much the Israeli Tax Authorities (ITA) could do. The identity, location, operation and actions of the foreign trustee were key to ensuring non-Israeli residency and taxation.

Legislation in 2006

To prevent this financial drain on the Israeli Treasury, trust legislation was adopted in 2006 to shift the focus of residency from the trustee to that of the settlor. Under the 2006 legislation, the economic settlor, not the trustee, would be the individual from whom the tax residence of the trust could be determined for Israeli tax purposes. An Israeli resident would be considered the economic settlor of a trust (including a foreign trust) if such individual transferred, controlled or influenced the transfer or management of assets to or in the trust. If any of these acts occurred, such trust would be considered a full Israeli resident and would be taxed on its worldwide income like any other Israeli resident.

When a U.S. citizen not a resident of Israel established an irrevocable fully discretionary trust in the United States and a U.S.-based beneficiary moved to Israel, unless such trust had Israeli-source income, there was no Israeli tax or reporting obligation. The status and identity of the beneficiaries were ignored as irrelevant in Israel under the 2006 legislation. Even if a beneficiary subsequently became an Israeli resident, the trustee of such a U.S. trust could continue to make distributions to the Israeli resident beneficiary on a tax-free basis for life and thereafter to such beneficiary's Israeli resident family members, long after the U.S. settlor had died.

According to Israeli commentators,[1] the ITA was alarmed that the trust itself was exempt from Israeli tax and the Israeli resident beneficiaries had unlimited deferral of the trust income and gains if the trustee never made distributions to the beneficiaries. The ITA was deeply concerned that wealthy Israelis were using the 2006 legislation to avoid paying tax in Israel. The ITA didn't believe that it could stifle this loss of revenue through conventional audits. Eventually, the ITA came

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to the position that the existence of even one Israeli resident beneficiary (regardless however contingent) in a foreign trust was a prima facie reason to view the entire trust as an Israeli tax resident with full taxpaying and reporting obligations.[2]

Legislation in 2014

The Knesset (Israeli legislature) was sympathetic to the ITA and, in 2013, adopted sweeping changes that ushered in the so-called "beneficiary-based" model of taxation of trusts in Israel. The new legislation applied to all trusts, even those established and funded before 2014. Under the 2014 legislation, if a trust continues after the death of a non-resident settlor and one or more of the trust beneficiaries are residents of Israel, such trust will be categorized as an Israeli-resident trust subject to Israeli tax on its worldwide income. Prior to the death of the non-Israeli trust settlor and the settlor's spouse, to be categorized as a foreign resident trust (FRT), the settlor and spouse and all beneficiaries must be non-residents of Israel. If a trust beneficiary moves to Israel while the settlor or spouse are alive, such trust then becomes either a conventional Israeli resident trust or an Israeli beneficiary trust (IBT).

The 2014 legislation introduced the concept of an IBT, which is a trust as to which the settlor isn't a resident of Israel but at least one beneficiary is an Israeli resident. An IBT can be a relatives trust (RT), which refers to a trust while the settlor is alive for which there's an adequate first-degree family connection between the non-Israeli settlor and all of the Israeli-resident beneficiaries (for example parents or children, grandparents or grandchildren). There are two different methods of taxation of an RT. The default method provides that absent trust distributions to an Israeli resident beneficiary, the RT isn't a taxpayer in Israel to the extent its trust activities aren't connected to Israel. When a distribution is made to the Israeli resident beneficiary, it's taxed in Israel at a flat 30 percent rate. Another method provides that the trustee may elect current income tax on the trust at 25 percent of the Israeli resident's portion of undistributed trust income. A subsequent distribution of previously taxed income to the Israeli resident beneficiary can be made tax-free.

At least one Israeli commentator has questioned whether prevailing international tax logic supports the current Israeli tax law treatment of an IBT as an Israeli resident, when the only connection to Israel is that residency of only one of say 10 beneficiaries is Israeli and the settlor, trustee, trust assets and trust income are non-Israeli. Such tenuous connection nevertheless exposes the non-Israeli beneficiaries to full Israeli tax rates on worldwide income.[3]

New Immigrants

Israel adopted a residency-based worldwide income tax reporting and payment system in 2003. However, since 2008, "new immigrants" and "senior returning residents" (Israelis who've lived outside of Israel for at least 10 years) are entitled to a 10-year tax exemption on their non-Israeli sourced income and capital gains. This tax exemption applies not only to investment income but also to salary, business income and pensions from non-Israeli sources. There's also a concurrent 10-year exemption from filing Israeli tax returns if the only income is from foreign assets. Once the 10-year tax holiday ends, the Israeli resident will be liable to report and pay tax on his foreign income like any other longstanding Israeli resident.

> For those U.S. parents who've already used up their enhanced $11.4 million gift and GST tax exemptions and are facing very large annual premiums to purchase PPLI, a private split-dollar loan program is a highly tax efficient yet safe solution.

If a new immigrant is also a beneficiary of an RT, such beneficiary is entitled to the benefits of the 10-year tax exemption on his allocable portion of the RT. If an RT is reclassified as an Israeli resident trust (IRT) on the death of the survivor of the settlor and spouse, the

portion of the trust's income allocable to the new immigrant beneficiary will be entitled to the same tax exemption for the same period of time as that which applies to the underlying beneficiary.

Assume that a wealthy U.S. patriarch establishes an irrevocable dynasty trust to benefit all his descendants. The trustee can accumulate trust income. All trust income is derived from U.S. sources. All substantial decisions of the trust are controlled by U.S. persons, and a U.S. court has primary jurisdiction to review trust administration. The trust obtains a separate federal tax ID number and reports and pays tax on its undistributed income from U.S. sources. The settlor subsequently passes away, which prevents the trust from continuing to be treated as a grantor trust for federal income tax purposes. One of the settlor's unmarried children without dependents decides to permanently move to Israel while retaining his U.S. citizenship and takes advantage of the Israeli new immigrant tax holiday rules for the first 10 years.

A key reason for using a U.S. domestic ILIT organized in one of the 50 states and ownership of the policy through an FC is that IRC Section 684 treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred.

What happens after the first 10 years when Israel's residency claim over the trust is analyzed under the United States–Israeli Tax Treaty (the Treaty)? In the event there are conflicts of residency for persons other than individuals, Article 3(1)(a) of the Treaty provides that competent authorities of the two countries will try to settle the question by mutual agreement. In the example in the preceding paragraph, the trust is treated as a U.S. taxpayer because it meets the control and court tests required to be a U.S. domestic trust. Moreover, the trust assets are all U.S. situs, and its income is entirely from U.S. sources. Israel's ITA would presumably claim that the entire trust is an Israeli resident because one of its many beneficiaries has moved to Israel and is no longer eligible for the 10-year new immigrant tax holiday.

Presumably, the Israeli ITA would acknowledge that such a trust will be a U.S. resident. No offshore jurisdiction is involved, and the trust beneficiaries receiving distributions are fully taxed in the United States. Such a result doesn't run afoul of the concern for the 2014 legislation over a tax avoidance motivation.

Article 6(1) of the Treaty provides that such a trust, as a U.S. resident, is exempt from any Israeli tax on its income, as none is sourced in Israel. Article 6(1) of the Treaty should preclude Israeli taxation on the trust's non-Israeli source income. Israeli law also provides that tax treaty provisions shall be applied notwithstanding local Israeli law and legislation.[4] Presumably, the Treaty overrides the 2014 legislation attempt to tax foreign trusts based solely on the residency of one of many trust beneficiaries.

Alternative Strategy

Since 2014, use of a foreign trust with at least one Israeli resident beneficiary provides at most a 10-year exemption on foreign income and reporting.

Suppose a wealthy U.S. citizen parent wishes to benefit a child (or grandchild) moving to Israel, but the child (or grandchild) isn't prepared to renounce U.S. citizenship. Such child (grandchild) will be subject to U.S. income tax on worldwide income. Further, any inter vivos trust established by the U.S. parent to benefit the Israeli resident beneficiary and conventionally funded with U.S. portfolio securities will offer at best a 10-year tax exemption for the child in Israel on trust income. Moreover, Israeli individual tax rates are generally higher than U.S. individual tax rates, with the result that a U.S. citizen residing in Israel generally should be able to obtain a full credit for taxes paid to Israeli tax authorities.

Most investments in mutual funds registered outside the United States pose a potentially complicated tax

issue for U.S. taxpayers. While U.S. registered mutual funds report gains and losses annually to the Internal Revenue Service and to taxpayers, foreign mutual funds don't. The IRS treats most foreign mutual funds as passive foreign investment companies (PFICs). PFIC investments, when sold at a profit, have to report to the IRS the income subject to interest charges for each year that the underlying mutual fund investment was held. In essence, the IRS can recoup the taxes that would have been paid in the year earned had the PFIC reported its activity annually. Adding to the U.S. tax burden, prior year PFIC income is ordinary income and therefore not eligible for capital gains rates. Also, because PFIC losses are limited, investing in a PFIC can become an expensive proposition for a taxpayer who has a U.S. filing requirement such as a U.S. citizen who resides indefinitely in Israel. There are alternative financial investments that can legitimately avoid the PFIC rules for U.S. taxpayers living abroad.

Offshore private placement life insurance (PPLI). As an alternative, the U.S. parent could consider the benefit of establishing a U.S. irrevocable life insurance trust (ILIT) for the exclusive benefit of the child residing in Israel. The U.S. parent would be the insured. (The child isn't envisioned as the insured, thereby removing this strategy from intergenerational life insurance, which recently suffered a major blow with the Tax Court decision in *Cahill*[5] and subsequent settlement by the taxpayer). As discussed below, such trust should be a grantor trust. The trustee could purchase for the ILIT an offshore (to both the United States and Israel) PPLI policy. As the Israeli resident beneficiary will continue to be a U.S. citizen, the policy should be U.S. and Israeli compliant.

The policy might be funded over a minimum of four years to ensure that it's a non-modified endowment contract (non-MEC) for U.S. tax purposes. As a non-MEC under U.S. tax rules, the trustee could withdraw up to basis (premiums paid) or borrow against the cash value on a tax-free basis. At the death of the insured parent, there's no income tax on the difference between the cash surrender value and the death benefit, and the entire death benefit will be exempt from income tax. If owned by an ILIT, the policy death benefit won't be subject to U.S. estate or generation-skipping transfer (GST) tax.

U.S. tax considerations. As a non-U.S. policy of a foreign carrier that's issued outside the United States, there's no state premium tax, which is often about 2 percent of the premium. Generally, because the foreign carrier won't make the Internal Revenue Code Section 953(d) election to be taxed as a U.S. domestic corporation, the U.S. federal deferred acquisition (DAC) tax can be avoided, but a 1 percent U.S. federal excise tax on premiums is payable for policies issued by a foreign carrier on the life of a U.S. citizen. The combination of no state premium tax, no DAC tax and lower premium load charges contributes to improved after-tax investment yields compared to taxable U.S. investments or U.S. domestic policies purchased in the United States. Like most foreign investments made by U.S. persons, if no IRC Section 953(d) election is made and the foreign policy has a surrender value, the U.S. owner of the policy will need to report annually the end-of-year cash value on Foreign Account Tax Compliance Act Form 8938 and must satisfy Report of Foreign Bank and Financial Accounts reporting on FinCEN Form 114.

For Israeli tax purposes, it's critical that the offshore PPLI policy be structured as an FCV policy.

In addition to the U.S. income tax benefits of offshore PPLI, the parent will insist on a flexible but efficient ownership structure that delivers wealth to Israeli resident beneficiaries in a transfer tax efficient manner. A previously funded U.S. dynasty trust established in a U.S. state with a modern trust law would be the logical first choice to purchase the offshore PPLI policy. There are no U.S. gift or GST tax consequences to fund the trust, and the policy can grow income tax-deferred during the U.S. parent's lifetime, and on the death of the insured, the dynasty trust receives the death benefit income tax and estate tax free.

Most wealthy U.S. parents don't have previously funded dynasty trusts let alone with sufficient assets to benefit just one child of the parent. This means that given the size of the annual premiums (often in excess of $2 million), traditional ILIT planning is needed. This new ILIT can take the form of either a GST tax-exempt,

multi-generational dynasty trust or a non-exempt trust that benefits the children. At first blush, this relies on either annual exclusion gifts for gift tax purposes and allocation of GST tax exemption, or increasingly, greater reliance between now and 2025 on making taxable gifts under the U.S. parents' enlarged $11.4 million gift and GST tax exemptions. It's critical that completed gifts be made for U.S. gift and GST tax purposes. For those U.S. parents who've already used up their enhanced $11.4 million gift and GST tax exemptions per parent (or combined $22.8 million in exemptions per married couple) and are facing very large annual premiums to purchase PPLI, a private split-dollar loan program is a highly efficient yet safe solution.

For U.S. persons with a beneficiary who's a U.S. citizen who becomes a long-term resident of Israel, the FCV solution is appealing.

The U.S. parent-settlor of the ILIT will lend the premium amounts to the trustee in return for the trustee's written promissory note of the trust. Interest on the loan could be accrued or paid currently. Both the U.S. parent and ILIT trustee would file a written representation with the IRS with respect to each premium advance (loan) to the ILIT confirming that there's a reasonable expectation of full repayment of such loan, precluding the IRS from recharacterizing such advance as a gift. On the death of the U.S. parent-settlor, the trustee would repay the parent-settlor's estate the accrued loan obligation and retain the excess in the trust for the benefit of the Israeli resident child (grandchild). Presumably, the growth in the policy cash value and death benefit should far exceed the growth of the loan interest accrual repayment obligation.

Most international carriers require that the policy owner have a non-U.S. situs (due to U.S. state regulatory or U.S. Security and Exchange Commission concerns). If an ILIT invests in an offshore PPLI policy, it will be required to take ownership through a wholly owned foreign corporation (FC) established in a tax-neutral common law jurisdiction (for example, Cayman Islands). It might be possible to have the ILIT itself established in the neutral common law jurisdiction outside the United States but classified as a U.S. trust for tax purposes. Alternatively, the ILIT can be organized in a U.S. state and own the FC, as this will ensure that it's at all times a domestic trust for U.S. tax purposes. The ILIT can file a check-the-box election to disregard the FC for U.S. tax purposes, which will streamline U.S. tax filings.

A key reason for using a U.S. domestic ILIT organized in one of the 50 states and ownership of the policy through an FC is that IRC Section 684 treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred. These rules don't apply to the extent that the U.S. parent is treated as the owner of the foreign trust under the grantor trust tax rules. However, on the death of the U.S. parent who's treated as the owner of a foreign trust, gains would be recognized under Section 684 because the foreign trust assets may not receive a step-up in basis at the death of the U.S. parent. To avoid uncertainty regarding Section 684 exposure, counsel should ensure that the ILIT is a U.S. domestic trust, controlled and supervised exclusively in the United States.

Israeli tax considerations. Taxation of a PPLI policy by the Israeli ITA can be divided into two phases.

During the life of the insured, the income earned in the investment portfolio inside the foreign policy separate accounts isn't subject to Israeli tax unless the separate accounts include specific Israeli assets that generate Israeli source income.

To the extent death benefit proceeds from the pure risk component (insurance) are paid on the death of the insured to the Israeli resident beneficiary, they're exempt from Israeli tax. Payments paid out of a PPLI policy during the lifetime of the insured from the savings component are taxed in the same manner as interest income (that is, at 15 percent to 25 percent).

For Israeli tax purposes, it's critical that the offshore PPLI policy be structured as a frozen cash value (FCV) policy.[6] A U.S. policyholder, such as a domestic ILIT, can invest in non-U.S. investment funds without the PFIC rules being applied to the policyholder.[7] Similarly, as the insurance company isn't a U.S. entity or person, it can invest in non-SEC registered securities not otherwise directly available to U.S. persons.

U.S. tax considerations. For U.S. tax purposes, an FCV policy isn't designed to meet the U.S. tax law definition of a life insurance policy under IRC Section 7702(a). Specifically, the FCVs don't meet either: (1) the cash value accumulation test in Section 7702(b), or (2) the guideline premium test of Sections 7702(c) and (d). Section 7702 merely requires that a contract be considered "life insurance" under the insurance laws that apply to the contract, which may be the insurance laws of a particular state or of a foreign jurisdiction (to the United States).

The key feature of an FCV for U.S. (and Israeli) tax purposes is that the policy is intentionally designed to freeze any increase in the net surrender value that's not attributable to premium payments, thereby avoiding current income on the policy. That is, there's no access to amounts above the premiums paid during the lifetime of the insured. An FCV policy will have income each year only on the amount of the actual mortality charges imposed on the policy for the year.

Like other PPLI policies, an FCV policy is a variable policy that must satisfy the separate segregated account rules requiring compliance with the diversification rules of IRC Section 817.

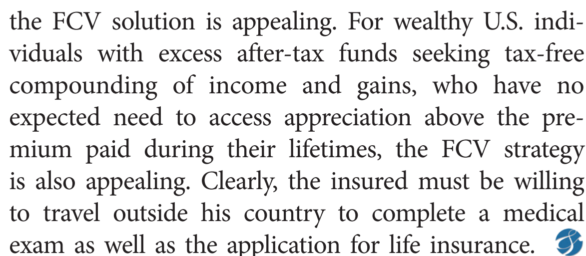
Similarly, the investor control rules must be satisfied. Like any PPLI policy, neither the policyholder nor the insured can personally select investments for the policy. It's permissible for the policyholder to suggest an investment manager and periodically make a general allocation of the separate account assets among broad investment guidelines (for example, fixed income, equity or alternatives).

Onshore vs. Offshore Products?

The bottom line is that the tax considerations don't typically drive the choice between U.S. onshore and offshore insurance products. The more significant differences are regulatory issues (SEC regulation), non-tax costs (agent commissions are lower offshore, premium taxes are lower offshore as no state premium taxes are due, insurance company charges are lower as carrier isn't regulated by a U.S. state) and marketing (offshore non-U.S. registered products can't be marketed or sold in the United States).

Appealing Solution

For U.S. individuals with a beneficiary who's a U.S. citizen who becomes a long-term resident of Israel, the FCV solution is appealing. For wealthy U.S. individuals with excess after-tax funds seeking tax-free compounding of income and gains, who have no expected need to access appreciation above the premium paid during their lifetimes, the FCV strategy is also appealing. Clearly, the insured must be willing to travel outside his country to complete a medical exam as well as the application for life insurance.



Endnotes

1. Joshua Rosenstein and Revital Avirim, "Israeli Law Confronts International Tax Treaties and Principles Via New Treatment of Mixed-Beneficiary Trusts," *Insights*, Vol. 1, Issue 9 of *Ruchelaw*, at p. 5.
2. *Ibid.*
3. *Ibid.*, at p. 8.
4. Israeli Tax Ordinance Section 196.
5. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018).
6. For a discussion of the U.S. tax treatment of frozen cash value private placement life insurance, *see, e.g.*, Gerald Nowotney, "Frozen Cash Value Life Insurance," *Trusts & Estates* (July 2012), and Mike Cohn and Edward J. Finley II, "An Advisor's Guide to Frozen Cash Value Life Insurance," *Trusts & Estates* (January 2014).
7. *See* Melvin A. Warshaw and Lawrence Lipoff, "How to Navigate the Choppy Seas for Foreigners With U.S.-Based Heirs: Part I," *Trusts & Estates* (June 2018), endnote 5.

SPOT LIGHT

Ship Ahoy

On board the Thomas Stephens on its journey from Melbourne to London by Edward Roper sold for $6,406 at Bonhams Travel and Exploration auction on Feb. 6, 2019 in London. An avid traveler, making numerous voyages by sea, Roper was seemingly inspired by his frequent journeys as landscapes of his destinations featured prominently in his works.