

Tax, Trusts & Wealth Management

Trusts and Real Estate in Israel - Has the Dispute Come to an End?



On June 30, 2022, the Supreme Court's judgment in the Galis Case was published. The judgment reached a decision on one of the most significant questions that have remained open since the legislation of the "Trusts Chapter" of the Israeli Income Tax Ordinance in 2006 – whether the contribution of Israeli real-estate by a settlor to trust is subject to real estate taxes in Israel (betterment tax for the settlor and purchase tax for the trustee)?

In the present case, a Canadian-resident couple contributed Israeli residential apartments to an Israeli trust (or, to be more precise, to an Israeli trust holding company). The beneficiary of the trust was the Israeli-resident granddaughter of the settlor; however, at the settlors' request, she was not aware that she was a beneficiary of the trust, and, pursuant to the trust deed, she could have been removed from the trust or other beneficiaries could have been added together with her. The trust was a classic irrevocable trust pursuant to common law, when the trustee and the protector (both of whom Israeli residents) were given extremely broad powers, and the settlors' wishes were set forth, *inter alia*, in a non-binding letter of wishes.

The couple and the trustee claimed that the contribution of the Israeli real estate to the trust was not subject to real estate taxes in Israel; whereas the Israel Tax Authority rejected this position. In the Appeal Committee's judgment of September 2019, the taxpayers' position was accepted, and it was ruled that the contribution in this case was not subject to real estate taxes in Israel. The decision was unanimous; however, the panel had differences of opinions in the reasons it provided for the decision. The Israel Tax Authority appealed to the Supreme Court, and the Supreme Court allowed the State's appeal.

In the judgment, the Supreme Court analyzed the relationship between the Trust Chapter of the Income Tax Ordinance, which formalizes the tax treatment that applies to trusts throughout the trusts' stages of life, commencing from the establishment of the trust, through the production of income from the trust assets, and ending with the distribution of the trust assets and the dissolution of the trust; and the Real Estate Taxation Law, which governs the taxation of real estate situated in Israel. The Court reached the conclusion that Part E of the Income Tax Ordinance formalizes the taxation of capital gains that are subject to tax under the Ordinance; however, it does not apply to the sale of real estate that is situated in Israel, the taxation of which is formalized in a separate law – the Real Estate Taxation Law, and in the regulations enacted thereunder.

According to the Supreme Court's approach, this is not a gap or lacuna, but, rather, this is an informed and clear choice by the legislator to leave unchanged the historical division between the taxation of the appreciation arising from the sale of Israeli real estate under the Real Estate Taxation Law, and the taxation of capital gains under the Income Tax Ordinance (including the taxation of appreciation arising from the sale of real estate outside of Israel). Therefore, the contribution of Israeli real estate to a trust will be subject to the provisions of the Real Estate Taxation Law only, and, therefore, the provision of the Trust Chapter of the Ordinance which determines that a contribution, without consideration, to an Israeli-resident trust is not a taxable event – does not apply to the contribution of Israeli real estate. This does not nullify the application of the Trust Chapter to the ordinary income from the real estate generated by the Trust (for example, rental income from the real estate).

Once the Court had decided that the contribution of Israeli real estate, without consideration, to a trust, must be examined through the prism of the Real Estate Taxation Law (and not the Income Tax Ordinance), it was required to examine the contribution in the present case from the perspective of the Real Estate Taxation Law. Given that the matter concerns an irrevocable trust, the court ruled that this case involves a "sale" pursuant to the Real Estate Taxation Law, and that this sale is not exempt from betterment tax for the transferors (the settlors) or from purchase tax for the purchaser (the trust).

At the same time, the Court notes that if there had been a specific, final, and informed beneficiary of the Trust, on the date of the contribution of the real estate to the trustee, and if the trust had reported as required by law, there would have been no impediment to applying the provisions of Section 69 of the Real Estate Taxation Law, whereby a tax event occurs at the time of the contribution to the trustee (in accordance with the identity of the settlor and the beneficiary), but no additional tax occurs at the time of the distribution (the transfer) to the beneficiary. However, in the present case, the granddaughter was not the final beneficiary, and she had not even been aware that she was a beneficiary of the trust from the outset, and, therefore, the provisions of this section do not apply.

The Court further emphasized that this unique arrangement in the Real Estate Taxation Law may apply not only with respect to an agency relationship but also with respect to a trusteeship relationship, as occurred in the present case. Nevertheless, the court does not expressly address the tax implications at the time of the distribution of the real estate to the beneficiaries in cases in which the provisions of the aforesaid Section 69 have not been satisfied, nor does it address the potential for double taxation, which could be entailed therein.

Furthermore, the Court states in an *obiter dictum* that if the contribution had been to a revocable trust, if the settlor had kept the control for themselves (including through the protector), or if the beneficiary had been the settlor himself only, then it is likely that this would not even have been viewed as a “sale,” which creates a taxable event.

The Court’s decision, therefore, clarifies that a contribution to a trust of Israeli real estate will be subject to the provisions of the Real Estate Taxation Law (and not the Income Tax Ordinance); however, there still remain open questions in this regard. At any rate, the Court actually does leave an opening for making use of trusts with respect to real estate in Israel in the context of succession planning and an intergenerational transfer – naturally, in the appropriate circumstances, and in accordance with the procedural provisions as set forth in the law.

Please feel free to contact us with any questions that you have on this matter.



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