TAXATION OF REAL ESTATE INVESTMENT IN ISRAEL

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INTRODUCTION

The Israeli tax system taxes Israeli residents globally. Nonresidents are taxed in Israel only to the extent they derive Israeli source income. The sale or disposition of a real estate asset located in Israel as well as any income produced by such real estate will be considered Israeli source income. Furthermore, under most double tax treaties, the country in which the real estate is located has the right to take the "first tax bite" of any income produced by the real estate.

Taxation of real estate investments is complex and depends on various factors, including the status of the owner of the property (individual or corporation), the nature of the asset (residential property, commercial property, land) and the purpose of investment (producing rental income or entrepreneurial profit). Investing in shares of a company whose main assets are real estate assets may also be considered real estate investment for tax purposes.

While the purchase and sale of a real property in most cases will be taxed in accordance with the Land Appreciation Tax Law (Appreciation and Purchase) 5723 – 1963 (the "Land Appreciation Tax Law"), rental and other income arising in connection with the exploitation of the land will be taxed in accordance with the Income Tax Ordinance [New Version] 5721 – 1961 (the "Ordinance"). Entrepreneurial profit earned in relation to real estate will also be subject to income tax.

In this paper we summarize the main factors one should take into consideration when contemplating real estate-related investments in Israel.

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PURCHASE TAX APPLICABLE TO THE PURCHASE OF REAL ESTATE ASSETS

In principle, when buying property in Israel, the buyer will have to pay purchase tax. There are no exemptions from that tax but there are different rates, for different types of assets.

Generally, the purchase of any "real estate right" (other than rights in residential property) is subject to Land Purchase Tax at the rate of 6%. The term "real estate right" is defined broadly to include ownership rights, lease rights for a period exceeding 25 years, and certain use rights for a period exceeding 25 years.

The purchase of rights in a "Real Estate Company" is also subject to 6% purchase tax. In a "Real Estate Company," the tax will be calculated on the basis of the proportionate shareholding percentage of the buyer, multiplied by the fair market value of all underlying real estate assets free and clear of any of debt. The definition of the term "Real Estate Company" includes any association, all of whose assets directly or indirectly, are real estate rights. Cash and cash equivalents are not considered as assets for that purpose and movable assets will be considered as an asset only to the extent they give rise to a significant and integral share of the income produced. A company or a R.E.I.T. whose shares are registered for trade on a stock exchange is excluded from the definition of "Real Estate Company."

The purchase tax rates applicable to residential property are updated from time to time and currently are as follows:

- **Single Residence Benefit** – If the purchaser resides in Israel and does not own a residence in Israel, or if the purchaser already owns one but is looking to upgrade and sell a current residence, the tax is imposed at the following rates (updated for 2020):

Value of the Asset (in NIS)	Rate
1,744,505	0%
1,744,506 - 2,069,205	3.5%
2,069,206 - 5,338,290	5%
5,338,291 - 17,794,305	8%
Above 17,794,305	10%

- **New Immigrants –** In general, the above rates apply only to a person who is an Israeli resident at the time of purchase with an exclusion for "new immigrants" who arrive no later than two years after the apartment was purchased. Alternatively, new immigrants are entitled to the following preferred rates for a total period of eight years starting one year before the new immigrant's arrival in Israel and ending seven years following the date of becoming a new immigrant. This is a one-time benefit. The following rates are updated for 2020.

Value of the Asset (in NIS)	Rate
Up to 1,838,615	0.5%
Over 1,838,615	5.0%

- **All Other Cases –** For nonresidents and other purchasers who own more than one residence in Israel, the following rates will apply (updated for 2020).

Value of the Asset (in NIS)	Rate
Up to 5,340,425	8%
Over 5,340,425	10%

VALUE ADDED TAX APPLICABLE TO THE PURCHASE OF A REAL ESTATE PROPERTY

Value Added Tax ("V.A.T.") is an indirect tax levied on the consumption of goods and services in Israel. The purchase of a real estate asset is generally subject to V.A.T. unless the seller is a private individual selling residential property.

The standard V.A.T. rate is currently 17%. V.A.T. is usually paid by the purchaser or service recipient against an invoice provided by the seller or service provider. Such "output tax" may in certain circumstances be recoverable against the "input tax" payable by the payer. V.A.T. is usually not recoverable if paid on a residential property.

HOW IS RENTAL INCOME TAXED?

Generally, rental income is classified as regular income for tax purposes. If the owner of the property is a company it will be liable for tax at the regular corporate rates (currently 23%).[1] When the rental income is distributed to shareholders, additional tax at the rate of 25%-30% will apply. If the owner of the property is an individual, the applicable rates would be in accordance with the individual's personal tax bracket. The highest rate is 50% at the present time.

"The Ordinance offers three different tracks for the taxation of rental income on a residential property produced by an individual."

Without derogating from the above, the Ordinance offers three different tracks for the taxation of rental income on a residential property produced by an individual: (i) the regular taxation track; (ii) the exemption track; or (iii) the 10% track on gross rental income. An additional fourth track may be available under the Law for the Encouragement of Capital Investments, 1959 (the "Encouragement Law") which provides tax incentives for rental income from at least six residential apartments located in one building.

- **The Regular Taxation Track** – Under this alternative the individual is taxed on the net rental income from the property. Deductible expenses such as depreciation, interest on a loan taken to finance the purchase of the land, and ongoing operating expenses will be deductible. The tax rate applicable to the *net* rental income will be the individual's regular income tax bracket.
- **The 10% Track** – Under this alternative the individual is taxed only at a 10% tax rate on the *gross* rental income from his real estate property. No expenses will be deductible. Upon the sale of the property the cost basis of the property will be reduced by the "theoretical" depreciation charges over the period such property was rented.
- **The Exemption Track** – Under this alternative the individual will not pay any tax, or will pay only certain limited taxes, on the rental income from his real estate property, when all the following conditions are met:
    - The residence, by its nature, is intended for residential use.
    - The residence is not registered as a business asset and is not required to be registered as such.

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[1] Certain real estate companies may be taxed as look through entities. In those cases, the income of the company will be attributed to its shareholders.

- The residence is rented to an individual (in certain circumstances it may also be possible to rent the property to an organization).
- The property is used by the tenant strictly for residential purposes.

If the rental income from all the owner's rental properties does not exceed NIS 5,100 per month (for 2020) ("Ceiling"), the entire rental income is exempt. If the rental income is between NIS 5,100 and NIS 10,200 per month (for 2020), only a portion of the rental income will be exempt from tax. The exempt amount is reduced by one shekel for each shekel of monthly rent in excess of NIS 5,100.

- **The Encouragement Law Track** – The Encouragement Law's main objective is to encourage investments in Israel. Under the Encouragement Law, an owner of at least six residential apartments, located in the same building, will be entitled to reduced tax rates on rental income and on gains from disposing of the apartments subject to the following cumulative conditions:
  - The taxpayer is the owner of at least six residential apartments, located in the same building.
  - At least 50% of the apartments were available for rent to third parties for a period of at least five years.
  - The rental income received from each apartment does not exceed NIS 8,000 per month (for 2020).

  If these conditions are met a reduced tax rate of 11% will apply to corporations, or 20% to individuals.[2]

DISPOSITION OF REAL ESTATE ASSETS

Land Appreciation Tax is a unique capital gains tax imposed on the disposition of real property located in Israel.

The capital gain calculation begins with the sales price and allows deductions for the original purchase price and certain deductible expenses from the sale price of the property. Where the Israeli tax authority (the "I.T.A.") considers the sale price to be significantly lower than fair market value, the I.T.A. can intervene and calculate the gain based on the fair market value.

The capital gain is divided into two elements. Part of the gain which is inflationary by nature is taxable at a rate of 10% in respect of the inflationary gain earned up to December 31, 1993, and at a zero rate thereafter. The balance of the gain is taxable at the rates detailed below. Foreign residents have the option of having the real gain calculated by reference to changes in the exchange rate of NIS *vis a vis* the applicable foreign currency.

Corporations are taxed at a flat corporate tax rate (currently 23%).

[2] A broader and more in-depth analysis of the Encouragement Law will be reviewed in a different publication.

The rates applicable to the sale of real estate assets by individuals depend on the date of purchase of the asset and the nature of the property.

Land Appreciation Tax will not be imposed on land disposition income classified as business income. Such income will be classified as regular income and taxed in accordance with the Ordinance.

Residential Properties

- **Single Residence Benefit** – Israeli residents owning only one residence will be entitled to receive an exemption from Land Appreciation Tax up to a value of NIS 4.5 million for the property, subject to certain conditions. If the value of the residential property is more than this amount, the value exceeding NIS 4.5 million will be taxed at standard rates (see below). Several less material exemptions may also be available. Practically, the single residence benefit is not available to a foreign resident who cannot prove that no personal residence is owned in another country.

- **Multiple Residence Owner** – An individual who is not entitled to receive the single residence benefit will be taxed on the sale of residential property at the following linear tax rates:

Gains Accumulated	Rate
Until January 2014	0%
From January 2013	25%

Thus, the seller is not taxed on the full amount of capital gains accrued, but only on the relative portion of the gain determined on a linear basis from January 1, 2014, until the date of the sale.

For example, if a property was purchased on January 1, 1995, and sold on December 31, 2014, with a profit of NIS 1 million, the tax authority would calculate the full gain (NIS 1 million), divide it by the number of years which elapsed between the date of the purchase and the date of the sale (20 years), calculate the relative gain for each year (NIS 50,000) and multiply that by the amount of time between January 1, 2014, and the date of the sale (one year). Thus, in our example, on a gain of NIS 1 million, only NIS 50,000 would be taxed at the capital gains tax rate (25%).

Please note, however, that additional building rights will be taxed at the same rates as nonresidential property.

Nonresidential Properties

- Gain on nonresidential properties which were purchased prior to March 1961 will be taxed at a flat rate of 25%.

- Gain on other properties will be taxed at the following linear tax rate. The number of days in each listed holding period will be divided by the total number of days in the total holding period, and multiplied by the applicable tax rate. All fractional rates will be rounded up to arrive at the applicable tax rate.

Holding Periods	Tax Rate
April 1961 to November 7, 2001	The highest applicable marginal tax brackets (highest is 50%).
November 7, 2001 to December 31, 2011	20%
January 1, 2012 onwards	25%

For example, if a property was purchased on January 1, 1995, and sold on December 31, 2014, for a profit of NIS 1 million, the tax authority would calculate and tax the full gain (NIS 1 million). The tax rate will be calculated as follows: [6/20 × 50%] + [11/20 × 20%] + [3/20 × 25%] = 30%. Such rate will be multiplied by the gain, resulting in NIS 300,000 tax.[3]

Land Betterment Levy

The disposition of a real estate asset may also require payment of a betterment levy. A betterment levy applies when a change in the zoning plans applicable to the property increases the existing building rights. The betterment levy is calculated on the basis of the appreciation of the value of the asset, to the extent the value of the property has been appreciated, compared to the value of the property prior to the change in the zoning plan. The appreciation will be multiplied by a 50% tax rate, to determine the betterment levy that is due. The betterment levy is due upon the earlier of the sale of the property or the issuance of a building permit.

The betterment levy is a deductible expense for purposes of the Land Appreciation Tax.

Value Added Tax

The sale of a real estate asset is subject to V.A.T. at the standard rate, currently 17%, if the seller is an "authorized dealer." If the seller is a private individual, V.A.T. may apply if the asset being sold is a commercial property or a plot of land. If the seller is a private individual and the purchaser is an authorized dealer, the tax liability is transferred to the authorized dealer, who self-invoices accordingly.

DISPOSITION OF SHARES IN A REAL ESTATE COMPANY

Shares in an Israeli company are considered to be an Israeli asset, and therefore the sale of shares of an Israeli company is a taxable event. A non-Israeli resident who derives capital gains from the sale of shares in a Real Estate Company will be liable for tax under the Land Appreciation Tax Law. As noted above, most double tax treaties allocate the principal right to impose tax on income generated by real estate to the country in which the real estate is located. Therefore the sale of shares in a Real Estate Company will be taxed in Israel.

[3] To simplify, this calculation assumes 2001 is treated in full as taxable at 20%, and not divided on a days-over-days basis.

In addition, even if the shares of the company being sold do not represent shares in a Real Estate Company, but most of the assets held by the company are, directly or indirectly, real estate rights or rights in a Real Estate Company in Israel, the sale may be liable to tax in Israel, to the extent no double tax treaty is available or if the relevant double tax treaty treats such shares as a real estate asset. In such cases the Ordinance will apply ordinary capital gains treatment to the sale of the shares.

The real estate tax is calculated based on the same principles as capital gains tax. The Land Appreciation Tax Law and the Ordinance distinguish between "real capital gain" and "inflationary surplus." Inflationary surplus generated after December 1994 will be exempt from tax. The real capital gain will generally be subject to tax at the corporate tax rate, currently 23%, if the seller is a corporation, and at the following rates if the seller is an individual.

Holding Periods	Tax Rate
April 1961 to November 7, 2001	The highest applicable marginal tax brackets (highest is 50%).[4]
November 7, 2001 to December 31, 2011	20% or 25% for Significat Shareholder[5]
January 1, 2012 onwards	25% or 30% for Significant Shareholder

Land Betterment Levy

No betterment levy applies to the disposition of shares in a Real Estate Company.

Value Added Tax

The sale of shares in a Real Estate Company is subject to V.A.T. at the standard rate (currently 17%) if the seller is an authorized dealer. If the seller is a private Individual, V.A.T. may apply if the shares are sold by an individual to an authorized dealer. In such cases, the tax liability is transferred to the authorized dealer, who self-invoices accordingly.

CONCLUSION

The way real estate investment income and gains are taxed in Israel depends on a blend of factors, including the status of the owner of the property (individual or corporation), the nature of the asset (residential property, commercial property, land), the date of purchase, the purpose of investment (producing rental income or entrepreneurial profit) and the tax rates that have applied over time. Navigating the rules is not for the misinformed.

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4 Shares which were purchased prior to March 1964 will be taxed at a flat rate of 25%.

5 A shareholder who holds, directly or indirectly, alone or together with a relative, at least 10% of one of the means of control in the company (*i.e.*, shareholdings, the right to appoint a board member, voting rights or the right to receive company assets upon dissolution of the company).