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Taxation of real estate investments in Israel

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Introduction

The Israeli tax system taxes Israeli residents globally. Non-residents are taxed in Israel only to the extent that 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. Further, under most double tax treaties, the country in which the real estate is located has the right of 'first bite' of any income produced by the real estate.

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

While the purchase and sale of a real estate property in most cases will be taxed in accordance with the Land Appreciation Tax Law (Appreciation and Purchase) 5723/1963, 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. Entrepreneurial profit earned in relation to real estate will also be subject to income tax.

This article summarises the main factors to be considered when contemplating real estate-related investments in Israel.

Purchase tax applicable to 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 this tax but there are different rates for different types of asset.

In general, the purchase of any real estate right (other than rights in residential property) is subject to 6% in land purchase tax. 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 buyer's proportionate shareholding percentage multiplied by the fair market value of all underlying real estate assets free and clear of any debt (regardless of whether the debt is related to or secured by such assets). The definition of the term 'real estate company' includes any association whose assets, directly and indirectly, are real estate rights. Cash and cash equivalents are not considered assets for this purpose and movable assets will be considered assets only to the extent that they give rise to a significant and integral share of the income produced. A company or a real estate investment trust whose shares are registered for trade on a stock exchange is excluded from the definition of a 'real estate company'.

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

- Single residence benefit – if a purchaser resides in Israel and does not own a residence there, or owns a residence, but is looking to upgrade and sell their current property, they are

entitled to lower tax rates (updated for 2020).

Value of asset	Rate
NIS1,744,505	0%
NIS1,744,506 to NIS2,069,205	3.5%
NIS2,069,206 to NS5,338,290	5%
NS5,338,291 to NIS17,794,305	8%
Over NIS17,794,305	10%

- New immigrants – in general, the above preferred rates apply only to a person who is an Israeli resident at the time of purchase, with an exception for 'new immigrants' who arrived no later than two years after a residence had been purchased. Alternatively, new immigrants are entitled to the following preferred rates for eight years starting one year before their arrival in Israel and ending seven years following the date of them becoming a new immigrant. This is a one-time benefit. The following rates have been updated for 2020.

Value of asset	Rate
Up to NIS1,838,615	0.5%
Over NIS1,838,615	5%

- All other cases – if the purchaser owns more than one residence in Israel, the following rates will apply (updated for 2020).

Value of asset	Rate
Up to NIS5,340,425	8%
Over NIS5,340,425	10%

Value added tax applicable to purchase of real estate property

Value added tax (VAT) 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 VAT unless the seller is a private individual selling their residential property.

The standard VAT rate is currently 17%. VAT 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. VAT is usually not recoverable if paid on a residential property.

How is rental income taxed?

In general, 'rental income' is classified as regular income for tax purposes. If the property owner is a company, it will be liable for tax at the regular corporate rate (currently 23%).(1) In case the rental income is distributed to the shareholders, additional tax at the rate of 25% to 30% will apply to the distribution of dividends. If the property owner is an individual, the applicable rate would be in accordance with their tax bracket (the highest currently being 50%).

Without derogating from the above, the Income Tax Ordinance offers three different tracks for the taxation of rental income on a residential property produced by an individual:

- the regular taxation track;
- the exemption track; or
- 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.

Regular taxation track

Under this alternative, individuals are taxed on their net rental income from 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 net rental income will be the individual's regular income tax bracket.

10% track

Under this alternative an individual is taxed at only a 10% tax rate on their gross rental income from their real estate property. No expenses will be deductible. Further, on the sale of the property, its cost basis will be reduced by theoretical depreciation charges for the period that such property was rented.

The exemption track
Under this alternative an individual will pay no tax or only certain limited taxes on the rental income from their real estate property, subject to the following cumulative conditions:

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

If the rental income from all of the owner's rental properties does not exceed NIS5,100 per month for 2020 (the ceiling), the entire rental income is exempt. If the rental income is between NIS5,100 and NIS10,200 per month for 2020, only a portion of the rental income will be exempt from tax. Such portion will be calculated as follows: the exciding amount over the ceiling (ie, the rental income received – NIS5,100 (exciding amount)) will be taken away from the ceiling. Only the residual will be exempt from tax. For example, if the rental income is NIS7,000 the exempt amount will be (NIS5,100 (NIS7000 to NIS5,100)) NIS3,200.

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 at least a five-year period; and
- the rental income received from each apartment does not exceed NIS8,000 per month for 2020.

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

Disposition of real estate assets

Land appreciation tax is a unique kind of capital gains tax imposed on the disposition of real property located in Israel. Land appreciation tax will not be imposed on income derived from real estate which is classified as business income (rather than capital gains), and such income will be classified as regular income and taxed in accordance with the Income Tax Ordinance.

The capital gain is calculated by deducting the purchase price and certain deductible expenses from the sale price of the property. In certain cases, where the Israel Tax Authority considers the sale price to be significantly lower than fair market value, it has the authority to 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 31 December 1993 and at a zero rate thereafter. The real 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 new Israeli shekel regarding the applicable foreign currency.

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

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.

Residential properties

Single residence benefit
Israeli residents owning only one residence will be entitled to receive an exemption from land appreciation tax up to NIS4.5 million for the property, subject to certain conditions. If the value of the residential property is more than this amount, the value exceeding NIS4.5 million will be taxed at standard rates (see below). Other (less material) exemptions may also be available. Practically, the single residence benefit is not available to a foreign resident who could have difficulty proving that they do not own another residential property in their country of residence.

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.

Gain accumulated	Rate
Until January 2014	0%
From January 2014 onwards	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 1 January 2014 until the date of the sale.

For example, if a property was purchased on 1 January 1995 and sold on 31 December 2014 with a profit of NIS1 million, the tax authority would calculate the full gain (NIS1 million), divide it by the number of years which elapsed between the date of purchase and the date of the sale (20 years), calculate the relative gain for each year (NIS50,000) and multiply that by the amount of time between 1 January 2014 and the date of the sale (one year). Thus, in the above example, on a gain of NIS1 million, only NIS50,000 would be taxed at the capital gains tax rate (25%).

However, additional building rights will be taxed at the same rates as non-residential property.

Non-residential properties

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

Gains on other properties will be taxed at the following linear tax rate. Each holding period will be divided by the total holding period, multiplied by the applicable tax rate. All fractional rates will be rounded up to arrive at the applicable tax rate.

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

> For example, if a property was purchased on 1 January 1995 and sold on 31 December 2014 for a profit of NIS1 million, the tax authority would calculate and tax the full gain (NIS1 million). The tax rate will be calculated as follows: [6/20]*50%+[11/20]*20%+[3/20]*25=30% and such rate will be multiplied by the gain resulting in NIS300,000 tax.(2)

- 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 asset's value to the extent that the value of the property has been appreciated, compared with 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 on 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.
- VAT – the sale of a real estate asset is subject to VAT at the standard rate (currently 17%), if the seller is an authorised dealer. If the seller is a private individual, VAT 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 authorised dealer, the tax liability is transferred to the authorised dealer, who self-invoices accordingly.

Disposition of shares in 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, under most double tax treaties the right of first bite from income generated by real estate belongs to the country in which the real estate is located and therefore the sale of shares in a

real estate company will most likely be taxed in Israel.

Further, 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 whose shares are being sold 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 that 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 Income Tax 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 Income Tax Ordinance distinguish between real capital gains 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.

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

Holding period	Tax rate
April 1964 to 7 November 2001	The highest applicable marginal tax bracket (the highest is 50%)
7 November 2001 to 31 December 2011	20%, or 25% for significant shareholders(3)
1 January 2012 onwards	25%

No betterment levy applies to the disposition of shares in a real estate company.

The sale of shares in a real estate company is subject to VAT at the standard rate (currently 17%) if the seller is an authorised dealer. If the seller is a private individual, VAT may apply if the shares are sold by an individual to an authorised dealer. In such cases, the tax liability is transferred to the authorised dealer, who self-invoices accordingly.

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Endnotes

(1) Certain real estate companies may be taxed as look-through entities. In such cases, the company's income will be attributed to its shareholders.

(2) To simplify, this calculation assumes that 2001 is treated in full as taxable at 20% and not divided on a day-over-day basis.

(3) 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 (ie, shareholdings, the right to appoint a board member, voting rights or the right to receive company assets on the dissolution of the company).

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