Taxing Real Estate Abroad: a Guide for the Perplexed

Chapter 1

Is there an obligation to report? Should an attorney be consulted in Israel or abroad? The following is a guide to overseas real estate investments – a professional article.

Attorney Ido Shaham, Attorney Michal Levy 01.11.2017

At the end of the summer, like most Israelis, my family and I went on vacation. This time we chose to travel with the kids to Poland, the "green country."

On the flight I sat separate from my wife and kids, in the same row but on the other side of the aisle. Sitting next to me was a young man named Dan (the name has been changed to preserve anonymity) who, within a few minutes from the moment he sat down, and even before the plane took off, began pulling out from his bag maps of different cities around the world and marking them with numbers. Since I am naturally a curious person, I asked Dan the reason for marking numbers on the maps. Soon, an interesting conversation developed between us. Dan explained he was interested in buying a residential building for investment and so he is looking at the feasibility of investing in various places around the world. His eyes lit up when he heard I am an attorney who specializes in real estate taxation and appraisals and immediately he began asking me many questions. Most of these questions had to do with locating real estate for investment and the tax considerations when investing in real estate.

I explained to Dan with yields in Israel being low, bank interest rates close to zero, and Israeli authorities creating legislation that can adversely affect real estate investors, the prospect for Israelis of investing in real estate overseas has become an attractive alternative. This is especially true when you consider it is possible to invest in real estate investment abroad with a relatively small amount of capital (even with an amount of $ 50,000), while achieving a higher yield than is generally possible in Israel.

Of course, there are numerous considerations investors need to take into account for purchasing real estate investments. So anyone seriously thinking about investing in overseas real estate should consult with an international tax expert, who can take into account all the relevant information and provide an accurate representation of the taxes to be paid for a real estate investment deal. In addition to ensuring tax compliance, consulting an attorney also helps investors get a true sense of the kind of profit a deal could bring. In this regard, it should be emphasized, most Israeli real estate investment companies that offer opportunities overseas, and even those that provide assistance identifying potential investment properties, do not provide appropriate answers to critical tax law questions. This is something every investor should be aware of.

When purchasing overseas real estate investments should one be assisted by an attorney on the ground where the property is located, or should an Israeli attorney be sufficient for such investment?

Each country has its own domestic laws, it's therefore advisable to use the services of a local attorney who has familiarity with the local language and has knowledge and expertise in the relevant foreign law. In this regard, it should be noted that in Israel there are attorneys familiar with foreign laws and who provide legal services in this regard; a list of such lawyers, divided into the countries of their expertise, can be found on the Israeli Bar Association website.

To return to our story, I explained to Dan that proper tax planning is a critical and essential stage in investing in real estate overseas, just as is the case in Israel.

Reporting obligations and paying taxes on overseas real estate investment income

Israeli residents are required to report and pay taxes in Israel on income generated both in Israel and abroad (something known as "personal taxation"), including income derived from assets abroad. It should be noted that there's an obligation to file an annual tax return if an individual Israeli investor (as opposed to a company) held foreign assets at any time in the tax year with a total value of 1,850,000 NIS or more on any day in the relevant year. (This is true for the 2016 tax year.)

Before setting out on the journey of an overseas real estate purchase, it 's important to carefully consider tax implications in Israel and abroad. First and foremost, in order to avoid double taxation check whether a tax treaty exists between Israel and the country where the asset will be purchased. In cases where a tax treaty does exist, the provisions of the treaty prevail over Israeli domestic tax law (Section 196 of the Income Tax Ordinance.) This principle, by which provisions of a tax treaty prevail over domestic law, is customary in countries around the world. It is worth noting that according to the terms of most tax treaties, the right to impose tax is granted to the country where the real estate investment is located.

In addition, it’s necessary to determine whether a purchase tax is imposed in the country where the asset is to be purchased (for example, the purchase tax rate in Montenegro is 3%); whether capital gains tax is imposed on the profit realized from the sale of the asset (in addition to capital gains tax to be paid in Israel); and whether investors are required to pay tax on rental income when renting an asset. In Germany, for example, rental income is subject to differential tax rates based on the amount of the rental income, in cases where income up to a certain amount is not taxable in Germany. Therefore, it is also advisable to consider whether a tax exemption is granted on rental income in the country where the asset will be purchased, and, if that's the case, it’s advisable to consider what the maximum tax exemption rate is (i.e. the maximum amount of exempt rental income). Investors looking at opportunities in the United States should also take into consideration that in addition to federal tax on monthly rental income there may also be state taxes on the income.

In regard to taxation of rental income, Israeli residents who generate rental income on foreign assets and are required to pay taxes in Israel on such income (as stated above, the basis of taxation is personal), can choose one of the following two tracks:

- Regular Taxation Track – According to this track, rental income will be added to the taxable income of the Israeli investor, such as income from salary, and his total taxable income will be taxed at the marginal tax rate (e.g., according to the tax brackets set out in Section 121(a) of the Income Tax Ordinance). By choosing this track, all expenses incurred for maintaining the property (such as municipal taxes, renovations, repairs, depreciation, etc.) can be deducted and a foreign tax credit can be claimed for the foreign taxes paid.

- Reduced Taxation Track – According to this track, rental income is subject to tax at a rate of 15%. By choosing this track, no deduction of expenses are allowed, except depreciation deduction, and no offsets, deductions or tax exemptions on rental income or on taxes applicable to it are permitted. In addition, foreign tax credit cannot be claimed for the foreign taxes paid.

As always, it’s best to consult with an international tax expert, who can advise on the tax track most appropriate for investor, given their individual circumstances.

We return again to our story. Dan shared with me that he intends to purchase a number of apartments, which would be rented through websites like Airbnb or Booking.com. I explained that since income from short-term rentals may be considered business income by the Israel Tax Authority, Dan could end up being denied the possibility of choosing the reduced taxation track for this purpose, meaning the rental income would be taxed solely according to the regular taxation track (i.e. according to the marginal tax rate).

In addition, consideration should be given to the number of properties from which an Israeli investor generates rental income. It is worth mentioning the remarks of Mr. Moshe Asher, Director General Israel, who addressed this issue at the 2017 Annual Conference in Accounting, saying his position is that "renting up to five apartments is a passive activity, renting up to 10 might be a business activity and renting over 10 apartments is a business activity". These remarks were made in regard to apartment for rent in Israel, especially in regard to the reduced taxation track of 10%. However, it should be emphasized that opinions are divided on this matter and recently the Supreme Court ruled that rental income of 20 apartments constitutes business income.
As mentioned above, there are many questions to ask and inquire about before embarking on the adventure of buying overseas real estate, which has a decisive impact on the feasibility of the deal. So consult with experts in the field of international taxation, not necessarily companies that offer overseas real estate investment opportunities.

The next article will deal with capital gains taxes derived from the sale of property purchased abroad and related issues.

Attorney Ido Shaham is a real estate tax attorney and land assessor who serves as a Chairman of the Taxation Committee at the Assessors' Bureau.
Attorney Michal Levy specializes in the field of international taxation.