Real Estate Investment Trust (REIT) in Israel: A Forthcoming Reform

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A. Introduction

The State of Israel, presently, does not have particular regulation for real estate investment trusts. By default, such assets are subject to ordinary tax laws. Recently, the chair of the Israel Securities Authority, Israel's answer to the United States Securities and Exchange Commission, and the head of the Israeli Tax Authority established a joint committee with the purpose of considering the combination of investment trusts whose expertise is in fruitful real estate in the stock exchange, a.k.a Real Estate Investment Trust (REIT). Thus, a REIT's bill has been prepared and is pending at the the Israeli parliament (Knesset). Earlier legislative examples exist in Canada, Italy, Belgium, France and the Netherlands.

Around the world, a REIT is normally a company that buys, develops, manages and sells real estate assets. REITs are owned by thousands of foreign and domestic individuals, large institutional investors including pension funds, endowment funds, insurance companies, bank trust departments and mutual funds.

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In light of REIT success in the United States and the spread of REITs across the globe, there is growing interest in Europe for a pan-European REIT structure. Although a number of member countries have REIT-type vehicles in place, they represent a small segment in the European property market. France passed legislation that created a REIT equivalent, known as the "sociétés d'investissements immobiliers cotees" (SIIC). REIT-like structures also exist in Luxembourg, Spain, Turkey, and Greece. Industry reports predict that the United Kingdom could permit the introduction of REITs during 2005. REIT movements also exist in the European Union, Germany, and the Nordic countries. A number of governments in East Asia have enacted REIT legislation in the past five years. In late 2000, Japan enacted an investment trust law that established a REIT vehicle. South Korea established REIT regulations in 2001 and Singapore listed its first "S-REIT" in 2002.

REIT movements are also at different stages of development in Canada and Latin America. REITs have existed in Canada for over a decade and are a well-established market. The recent passage of REIT legislation in Mexico provides a clear signal that the REIT movement is coming out of its infancy in Latin America.

REITs generally allow participants to invest in a professionally-managed portfolio of real estate properties and their business activities are usually restricted to generation of property rental income. The major benefit they offer is within taxation. Thus, typically, they qualify as pass-through entities, companies who are able distribute the majority of income cash flows to investors without taxation at the corporate level (providing that certain conditions are met). As REITs shares are primarily traded on major exchanges, they also offer the advantage of ease of liquidation of assets into cash, in comparison to traditional private real estate ownership which are hard to liquidate.

The promotion of REITs in Israel has been as part of the Israeli fiscal policy of expanding the supply of investment channels similarly to the U.S. and European experiences. To date, the United States has the biggest REIT market. It has more than 193 publicly traded REITs operating within the country and their assets total over $500 billion. Approximately two-thirds of this trade on the national stock exchanges. On a local scale, Israel, upon its average

$110 billion GNP per capita, is now expected to yield approximately $2 billion based on up to 10 Israeli REITs within the next few years.

B. The benefits of REITs

As total return investments REITs typically are said to provide high dividends plus the potential for moderate, long-term capital appreciation. Because most REITs have a small-to-medium equity market capitalization, their returns should be comparable to other small to mid-size companies. There is, on the other hand, relatively low correlation between REIT and publicly traded real estate stock returns and the returns of other market sectors. As overall attractive additions to investment portfolios, REITs offer numerous advantages that make them worthy of consideration as investment programs at large.

1) Tax advantage

The chief advantage of REITs is due to its tax rate. An individual who invests in real estate through a company is required to pay a higher tax than an individual that invests directly in a real estate asset. In Israel an investor through a company would need to pay double taxation upon selling the property – once at the company's level and once 25% on dividends. An individual who invests directly in such property would be taxed once, when profits are shared, and at a higher than the 15% tax rate an investor in a REIT would be.

The Israeli REIT bill further recommends that tax benefits would be fourfold and include: 1) tax on individual investors on the principal investment, 2) tax on the level of companies that establish the principal investment, 3) tax on the level of the real estate investment and 4) tax on the level of trust and pension funds.

Sole investors in the principal investment will pay 15% only in the event that stocks are sold in the stock exchange similarly to other financial investments, a 15% tax rate upon the distribution of profit – as opposed to a 25% tax rate on dividends in regular companies. In addition, individuals would be able to offset losses resulting in real estate stock sales against profits that would be distributed to them during the same year and against other profits that result in stock exchange transactions.

On the level of REIT funding companies, the Israeli bill recommends that profits distribution would be tax deductible, whereas the profits from selling real estate would be taxed at a rate of 15%. In addition, stock selling would be taxed at a rate of 25% only instead of the default 34% tax rate.

On the level of the asset itself, the Israeli bill recommends that income from real estate and real estate-related income would be taxed at a rate of 34%, the profits from selling real estate would be taxed at a rate of 12% only, which together with the 15% tax rate on investors would result in an overall 25% tax rate. The Israeli bill, furthermore, recommended that forbidden income from real estate would be taxed at a rate of 60% as opposed to the 100% American tax rate. In addition, REITs could exchange real estate tax deduction and losses could be offset from their profits.

Individuals would enjoy a tax rate of 15% during the distribution of profits, as opposed to the present day 25% tax rate on dividends in ordinary companies in Israel.

Lastly, similar to American REITs, the Israeli bill recommends that REITs would distribute at least 90% of their current profits and further would be able to distribute the amortization component. In addition, a REIT would be required to distribute 100% of its real estate profits (subject to deducing the amortization component).

2) Prevention of insolvency and bankruptcy

The real estate market is expected to benefit from the inauguration of REITs. Especially in difficult days, REITs would encourage investors to bear part of the burden of banks and other financial institutions in preserving fruitful real estate companies.

Furthermore, financial dispersion of portfolio investments would further be advanced by the introduction of REITs, as in every fund in which there would be several real estate assets, so will the particular risk be dispersed.

Last but not least, REITs would increase credit availability in the real estate market for the benefit of real estate companies who wish to invest in other than residential properties. Even concerning the latter, there sometimes are difficulties in attaining credit from major banks. Thus, real estate experts predict that one of the more promising solutions to this credit deficit would be in the offering of REITs stocks at the market.

3) Support in pension and trust funds

The establishment of REITs is expected to enhance investments in pension and other trust funds that would be tax deductible at the time when stocks and sold. In addition, REITs will be tax refunded per their share in the tax that was paid by its managing trust, as opposed to investments that are made in other companies.

4) Minimize transaction costs

Like other trusts, REITs are designed to be managed by trust managements that aggregately would reduce transaction costs for the individual investor.

C. The Israeli model: The challenge for small investors

There is no 'standard' legal structure for a multi-country real estate fund. In creating national REITs, such as within Israel, decision makers will scrutinize investor needs, local regulatory constraints, and conflicting member-state tax laws. With the advancement with the Israeli REIT legislative process some concerns still arise concerning the ability of REITs to benefit small or at least medium investors and entrepreneurs, as the present investment threshold is still relatively high.

Table: Comparing U.S. Internal Revenue Code REIT with the Israeli REIT bill

N	U.S. Internal Revenue Code provisions	Present Israeli bill provisions
1.	Structured as Corporation, business trust, or similar association	Structured as an Corporation Ltd. That has been incorporated in Israel
2.	Managed by a board of directors or trustees	Same
3.	Shares need to be fully transferable	Unspecified
4.	Minimum of 100 shareholders	Unspecified
5.	Pays dividends of at least 90 percent of REIT's taxable income	Same
6.	No more than 50 percent of the shares can be held by five or fewer individuals during the last half of each taxable year	Same
7.	At least 75 percent of total investment assets must be in real estate	At least 95 percent of total investment assets must be in real estate from which 75 percent must be located in Israel
8.	Derive at least 75 percent of gross income from rents or mortgage interest	Derive at least 95 percent of gross income from rents or mortgage interest or other real-estate related income
9.	Tax rate on forbidden revenue for REITs is 100%.	Tax rate on forbidden revenue for REITs is 60%.

Like other REIT equivalents, U.S. REITs must satisfy certain requirements in order to enjoy "pass through" tax treatment. A REIT must be organized in the form of a corporation or business trust, and must be managed by a board of directors or one or more trustees. In Israel, unlike the American model, REITs may be formed as closely-held corporations and should not have 100 or more shareholders. Instead, a small number of shareholders would do, subject to general Israeli securities regulation of public companies.

In an attempt to adapt REITS to the Israeli market, there has been a special attempt to generate interest with medium and small investors. Especially true for Israel, due to the high minimum investment requirements for participation in bank and insurance company pooled real estate vehicles in Israel, REITs like other public real estate partnerships were seen as the primary means by which small and medium sized plans invest in real estate. In the future, the plan is for REITs to expand also to the private apartment market and thus reduce the present Israeli incentive to purchase apartments instead of renting them.

In a means to further encourage small and medium investors, the Israeli bill drafters will probably shorten the two year investment pre-requirement into a one year pre-requirement.

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