

The Glue That Binds US Income, Estate Taxes and Passive Israeli Investors

The US continues to see ever-increasing foreign investment in US companies and real estate funds that promise returns of 10-12% or more. But how does the US government view an Israeli (non-US citizen) who has invested in US assets? And how does owning real property differ from owning shares in a US company?



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Two primary issues concern Israeli investors regarding US investment: income and assets. Without proper tax advice, including an appropriate plan and structure for the investment and prudent filing of taxes, a passive Israeli (non-US citizen) investor could be taxed on gains and even incur interest or penalties.

While income and assets often come hand in hand, let's address each of these separately.

What determines an individual's tax status?

1) A resident alien is generally a non-US citizen who either holds a green card or has substantial presence in the US ("presence" has its own guidelines - not addressed here).

2) A non-resident alien is generally a non-US citizen who does not meet either of the

conditions above.

3) Dual citizens may be eligible for special treaty rules. (This article does not address this classification; to hear more about dual citizenship kindly contact us.)

How is my taxable income determined?

First determine how your US income is classified. Interest and dividends, capital gains (e.g. stock appreciation) and income from real property (rent from an apartment) are all treated differently.

An Israeli (non-resident alien) owner of stock in a US company is generally not liable for capital gains taxes (although he may owe capital gains tax in Israel). However, the US-Israel tax treaty demands from the

same investor a rate of 25% on interest and dividends. The IRS requires that taxes be withheld by the US entity that is responsible for paying the interest or dividends to an Israeli investor.

In this instance, an Israeli investor is not obligated to actively pay any tax, and, as long as they receive the appropriate Form (1042-S) from their investment vehicle (the entity paying their income in the US), are not obligated to file. If your investment fits this description, discuss it with your tax professional to ensure that your investment vehicle is properly withholding taxes at appropriate rates (30% in 2016). These withheld taxes could serve as a credit against Israeli taxes on similar income sources.

If an Israeli (non-resident alien) owns a share of a partnership that holds US real property (e.g. apartment building or shopping center), that investor is obligated not only to file Form 1040-NR, but also to make quarterly estimated tax payments based on estimated taxable income from the property. Unlike passive income paid out in the form of interest and dividends, ownership in income-generating property is viewed for tax purposes as an active trade or business and is subject to ordinary income tax at effective rates. Failure to file or remit taxes due could result in interest and penalties above existing taxes.

What happens when I want to sell a property?

Under IRC 1446, sale of a property requires the investment vehicle to withhold taxes at a rate of 39.6% on any proceeds considered ordinary income and 20% on those consid-



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ered capital gains (for individuals). A foreign investor in such a property is obligated to file a US income tax return, which requires advance submission of an application for a Taxpayer Identification Number (TIN).

What should be taken into consideration with respect to estate taxes?

Income-producing, US real property comes with its own set of intricacies. Specifically, how is income from these assets treated and what liability does the value of these assets create for an investor's estate after death? That said, a bigger and perhaps lesser known concern for the average foreign investor, is what happens to the assets themselves after death. If an Israeli investor holds more

than \$60,000 in US assets at the time of their death, the entire amount in excess of \$60,000 is subject to estate taxes at approximately 40% of the asset value!

For example, if an Israeli investor owns \$500,000 in US real estate at the time of their death, the investor's Israeli heirs (assuming no US presence or citizenship) would only receive approximately \$324,000 of the liquidated value. If that same investor died with \$2,000,000 in US assets, only approximately \$1,224,000 would be distributable from the estate.

How does an investor, trying to capitalize on the real estate market in the US, avoid giving nearly half of their portfolio away to the US government? Fortunately, there are

ways to protect investors. Strategies include corporate structuring of the investing party or creating additional entities that effectively block an investor from personally owning direct interest in the property. Depending on the value of the assets, certain trusts may also be used in estate planning to serve as protection from tax liability. These strategies are not one-size-fits-all and require both an understanding of an individuals' personal situation as well as a thorough understanding of the US tax code and the US-Israel tax treaty.

Information in this article should not be misconstrued as tax advice.