Czech Republic & Israel

Taxation, Treaty & Business Potential

Czech Embassy

June 2023 - TLV

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Agenda

- Business in Israel
- Encouragement Law
- Tax Treaty
- Tax Rates
- Companies - Management & Control

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Why Israel is a **Great Place** to do Business

Why Israel is a Great Place to do Business

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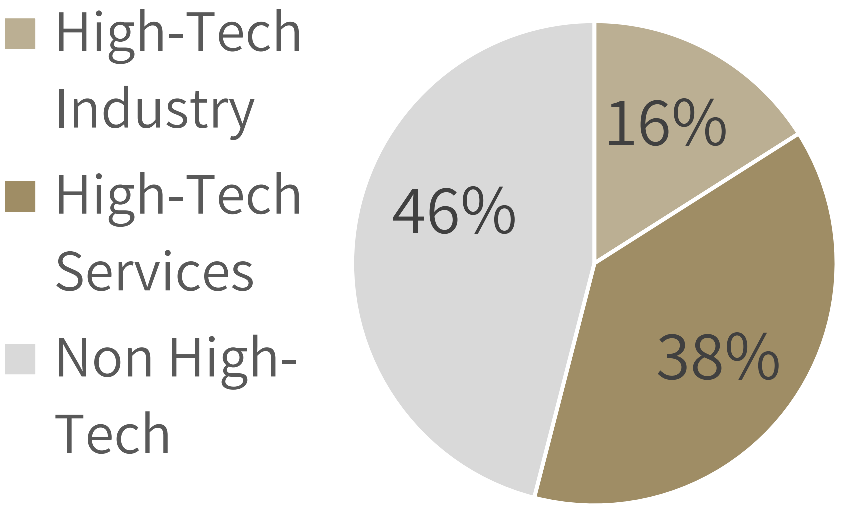
Israel is a Start-Up nation

The taxation legislation encourages Israeli high-tech companies to enter the R&D market, knowing they will have minimal loss

The results were not long in coming:

in 2021, high-tech became the main source of Israel's exports for the first time.

Export Distribution, 2021



Source: Israel’s Innovation Authority

Israel's Economy in 2020

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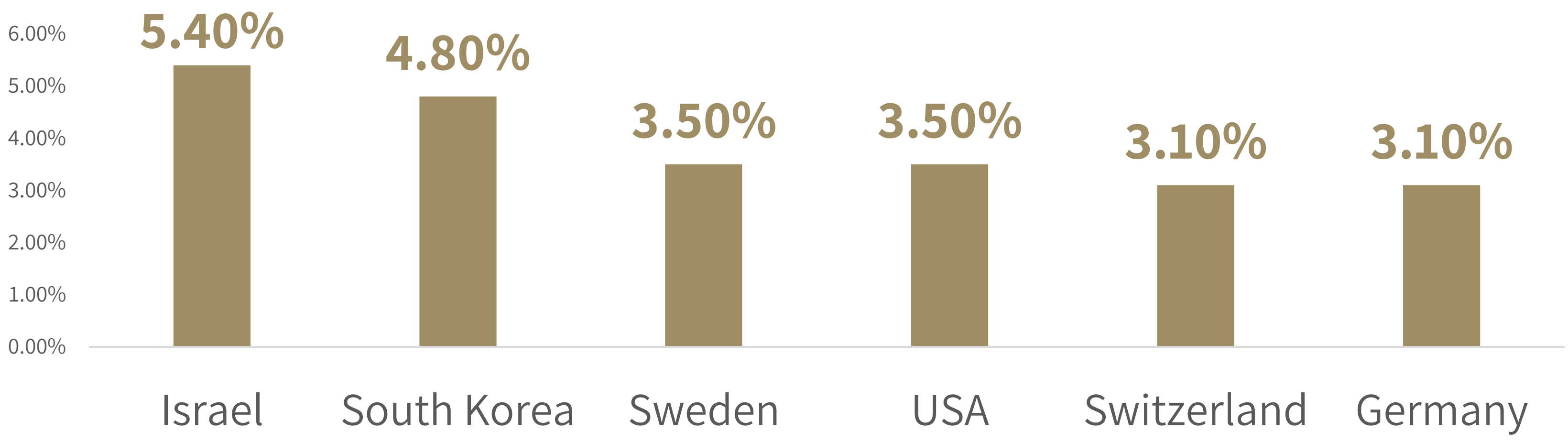
Israel was the leading country in R&D investments as a percentage of the GDP in 2020:

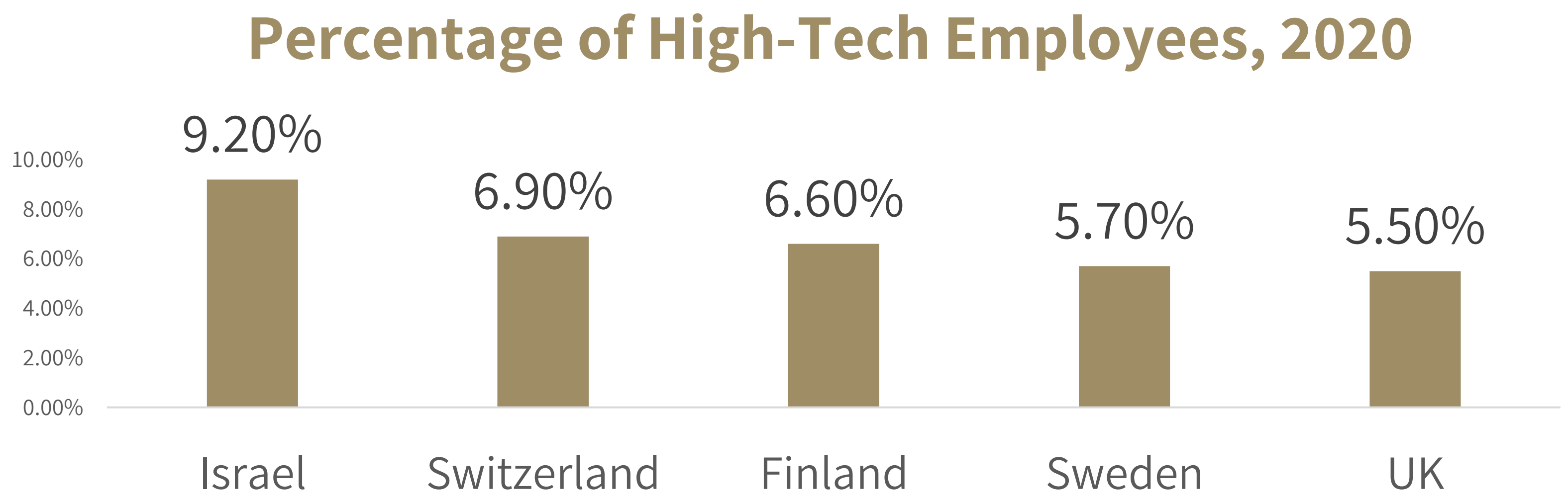


Source: Israel's Innovation Authority

The Covid-19 pandemic caused many industries to reduce or stop their activities – High-Tech industry remained stable as the other industries (such as tourism) faced uncertainty and instability.

Israel's Economy in 2020

- During the pandemic, The High-Tech and R&D industries helped to prevent the GDP from having an even larger decrease - the increase in the unemployment rate was higher than the rate of the GDP decrease;
- The Percentage of High-Tech employees (calculated as a part of Israel's labor) was the highest in the world in 2020:



- **Nowadays, it's crossed the 10%.**

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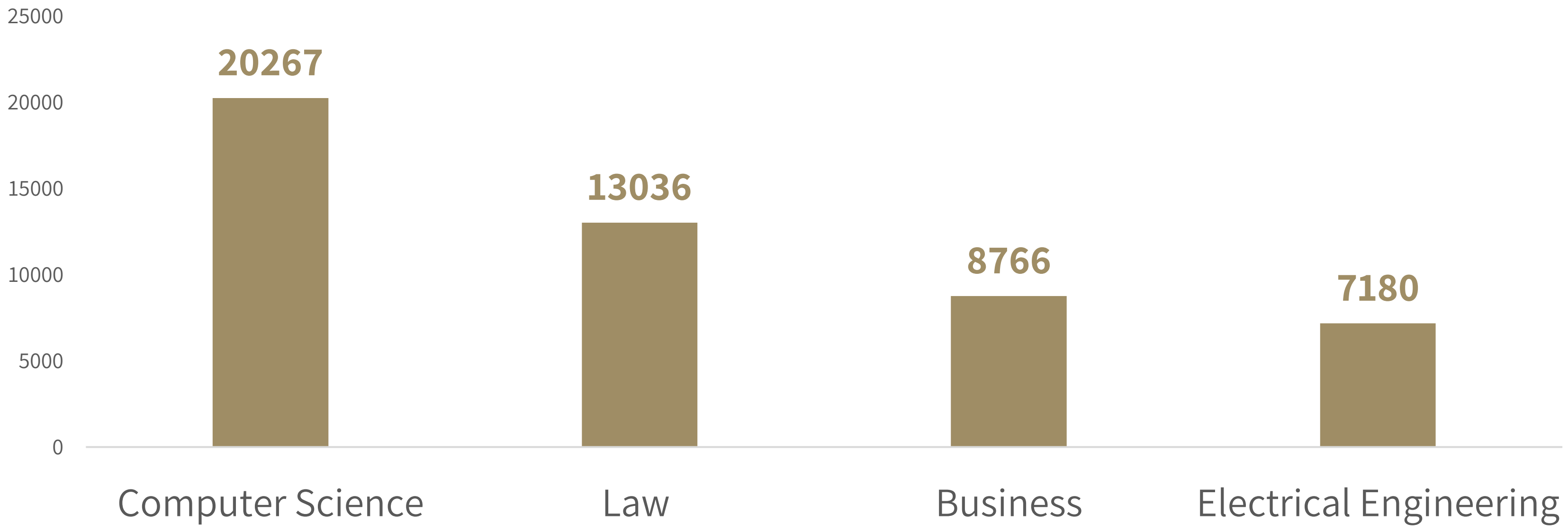
Israel's Economy after 2020: **Lessons Learned**

- High-Tech is an attractive domain for potential employees – computer science had the highest demand among first-degree students in 2021:

Number of Students in First degree Studying at Universities and Collages, 2021



Source: Israel’s Innovation Authority

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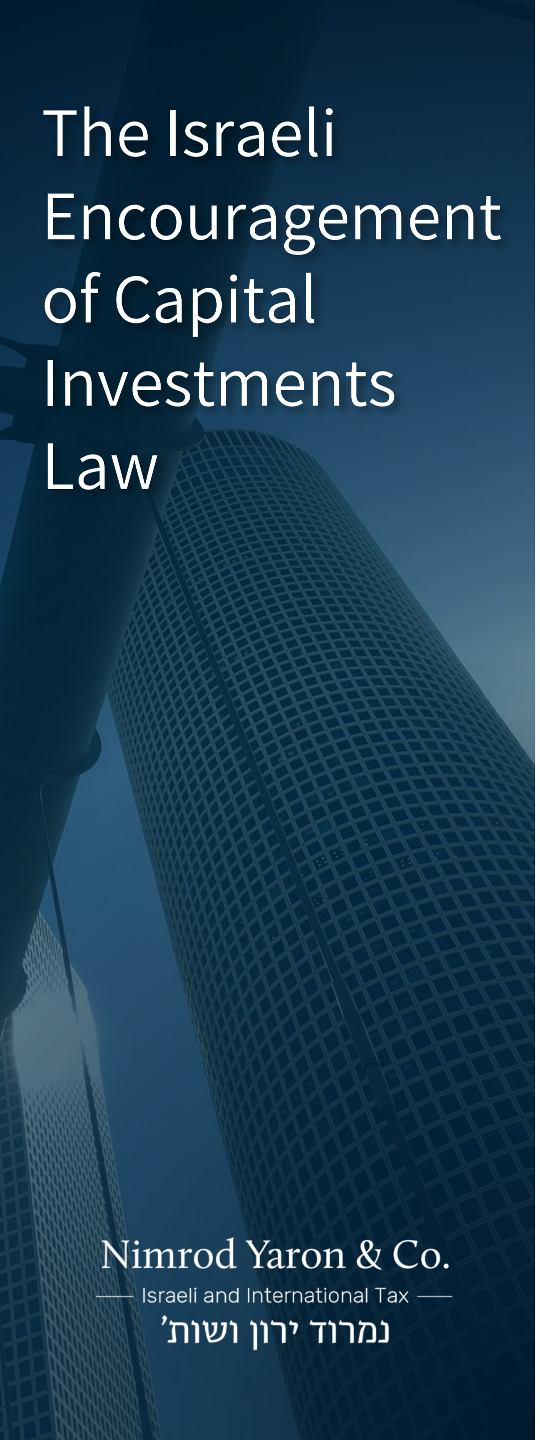
The Israeli
Encouragement
of Capital Investments
Law.



The Encouragement of Capital Investments Law

Under this law, certain companies can qualify as 'Preferred Enterprises' or 'Preferred Technological Enterprises'. The main conditions for qualification are as follows:

- **An Israeli company**.
- **Ownership of IP**: The Israeli company must own the intellectual property rights (IP).
- **Primary Activity**: For a Preferred Enterprise - The primary activity must be production. For a Preferred Technological Enterprise - The primary activity must be technological development.
- **Sales**: The enterprise must have sales. In the case of a Preferred Technological Enterprise, this also includes granting rights of use / software as a service, among other things.
- **International Market Presence**: At least 25% of the company’s income must be derived from a market that has over 15 million residents, as of 2023 (or meet other alternative options that are prescribed).

The Israeli Encouragement of Capital Investments Law

Additional Requirements:

In addition to the main conditions mentioned earlier, there are also other requirements that must be met:

- **Employment:** The company must employ at least three individuals who are involved in production or development activities within the Israeli company.

For Preferred Technological Enterprises specifically, there are further conditions:

- **R&D Expenses:** The Preferred Technological Enterprise must incur Research and Development (R&D) expenses that constitute at least 7% of its income.

Meeting these additional requirements is crucial for a company to qualify as a Preferred Enterprise or a Preferred Technological Enterprise under the Encouragement of Capital Investments Law.

The Israeli Encouragement of Capital Investments Law

The Tax Benefits Under This Law:

Tax Benefits	Corporate Tax Rate		Dividend Tax			Capital Gains from selling IP
	Development Area A	Other Development Areas	Individual	Foreign Company	Israeli Company	
Without the law of encouragement	23%	23%	30%	30%	0%	23%
Preferred Enterprise	7.5%	16%	20%	20%	0%	23%
Preferred Enterprise Above 10 billon	5.0%	8%	20%	5%	0%	23%
Technological Preferred Enterprise	7.50%	12%	20%	4%	0%	12%
Special Preferred Technological Enterprise	6%	6%	20%	4%	0%	6%

Taxation of Venture Capital Funds

Special tax arrangement for venture capital funds investing in Israel in accordance with Section 16A of the Ordinance and Income Tax Circular 9/2018

To encourage foreign investment, a special arrangement exists - foreign investors in venture capital funds, under certain conditions to be specified later, will be exempt from taxes on income derived from the realization of "venture capital investments" (including interest and dividends).

These "venture capital investments" are investments made through the allocation of shares in Israeli companies whose main activity is the establishment or expansion of industries in the fields of manufacturing, agriculture, tourism, transportation, construction (excluding real estate), water, energy, technology, communication, computing, security, medicine, software, biotechnology, nanotechnology, and research and development in these fields.

The main cumulative conditions for obtaining the tax arrangement:

- At least 10 investors who are not related to each other and are not partners with the general partner, except for exceptions.
- Investors in the fund will not hold more than 20% of the fund's rights, except for one single investor in the fund who may hold up to 35% of the fund's rights.
- Possible types of investors in the fund are limited foreign resident investors and limited Israeli resident investors. The exemption in the arrangement applies to foreign investors unless the Israeli investors are tax-exempt institutional Israeli investors.
- The volume of foreign investors is at least 30% of the fund's investors.
- At least $10 million in "privileged investments", provided that at least $6 million of these investments are invested in Israeli resident companies that own the developed knowledge.

Taxation of Venture Capital Funds

- The fund's management will be done solely by the general partner.
- The total investment commitments and investments of the fund will not be less than $10 million, of which at least $5 million will be financed by foreign investors.
- The fund will not invest more than 25% of its fundraising volume (excluding management fees) in one company.
- The fund will invest in activities in the knowledge-intensive industry as detailed above.
- The fund must meet the minimum volume of eligible investments in Israel - invest at least $10 million in investments of the type described above, where at least $6 million of it will be invested in Israeli companies with developed knowledge.
- Limited partners will not have an active part in finding investments or managing the fund's business. The general partner is allowed to invest in the fund as a limited partner, but his investments are limited to 4%.

Taxation of Venture Capital Funds

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Clarification regarding the tax arrangement:

Provided all the conditions, mainly as detailed below, are met, as mentioned, the income of foreign residents from venture capital investments, including income from the realization of investments, interest, and dividends arising from venture capital investments, will be tax-exempt.

The fund and the foreign investors are not liable for tax in Israel for investments in companies not related to Israel.

The fund manager and the general partner must have a permanent place of business in Israel and they will be liable for income/corporate tax according to their nature without benefit. However, their income from success fees will have a benefit as determined in the arrangement between the Income Tax Authority and the Israeli Venture Capital Funds Association.

If not all conditions are met, it is still recommended to try to apply to the tax authorities for a preliminary approval for tax benefits.

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Agreements Signed Between Israel and the Czech Republic:

- Investment Protection and Encouragement Convention.
- Social Insurance Convention.
- Double Taxation Agreement.

Double Taxation Agreement

A Tax Treaty aimed at preventing double taxation was signed between the Czech Republic and Israel. Double Taxation Agreements (DTA) are international treaties between countries that establish the rules for taxing income and assets that have connections to both countries. The Tax Treaty between the Czech Republic and Israel has the following primary objectives:

- To ascertain the residency status of individuals and entities for tax purposes.
- To determine which country will have the primary right to impose taxes (withholding taxes), and to specify the country in which the secondary or residual taxation will occur. The country applying the residual taxation will provide a foreign tax credit to offset the tax already paid in the first country.

Determining an Individual's Residency According to the Tax Treaty:

When applying the tax treaty, an individual's residency is determined based on several criteria:

- **Permanent Home**: The country in which the individual has a permanent home available to him.
- **Personal and Economic Relations**: The country with which the individual has stronger personal and economic ties.
- **Habitual Residence**: The country in which the individual habitually resides.
- **Nationality**: The individual's country of citizenship.
- **Otherwise**: If the aforementioned criteria do not conclusively establish residency, the competent authorities of the countries involved will settle the question through mutual agreement.

Determining a Company's Residency According to the Tax Treaty:

When applying the tax treaty, a company’s residency is determined based on the following criteria:

- **Place of Management:** The country where the company’s main management and decision-making activities take place.
- **Mutual Agreement:** If the place of effective management does not conclusively establish residency, the competent authorities of the countries involved will settle the question through mutual agreement.

Taxation of Business Income:

The profits of a company are generally taxed only in the country where the company is resident. However, if the company conducts business in another contracting state through a permanent establishment located there, the profits attributable to that permanent establishment will also be subject to taxation in that state.

A permanent establishment is defined as a fixed place through which the business of a company is wholly or partly conducted. This includes, but is not limited to:

- A place of management
- A branch
- An office
- A factory
- Services provided for at least half a year within a 12-month period.

It is important to note that a facility used solely for storage is not considered a permanent establishment for tax purposes.

Taxation of Dividends:

Dividends paid by a company that is a resident of one Contracting State to a resident of the other Contracting State are subject to withholding tax first in the country where the company paying the dividends is resident. However, the tax treaty provides for reduced withholding tax rates on dividends:

- 5% of the gross amount of the dividends if the beneficial owner is a company that holds directly at least 15% of the capital of the company paying the dividends.
- 15% of the gross amount of the dividends in all other cases.

These benefits will not apply if a permanent establishment is involved.

Taxation of Capital Gains:

- Capital gains derived by a resident of a Contracting State from the sale of shares in a company resident in the other Contracting State may be taxed first in the country where the company whose shares are being sold is resident.
- For capital gains arising from the sale of assets other than shares in a company (excluding permanent establishments and real estate), the gains will be taxed only in the country of the seller's residency.

Taxation of Royalties:

Royalties will initially be taxed in the Contracting State where they are generated, at a rate of 5% of the gross amount. 'Royalties' refers to payments received in exchange for the use of, or the right to use, any copyright of literary, artistic, or scientific works, including patents, trademarks, designs, models, plans, software, and secret formulas or processes.

Companies - Control and Managements:

For tax purposes, if a company is incorporated outside of Israel but its management and control are exercised from within Israel, it is considered an Israeli company. The following factors are taken into account to determine the management and control:

- Place of Decision Making: The location where the company's significant decisions are made.
- Place of Employees: The location where the company's employees are based.
- Place of Suppliers and Advisers: The location where the company's primary suppliers and advisers operate.

Permanent Establishment: Profits of an enterprise of a Contracting State are generally taxable only in that State. However, if the enterprise conducts business in the other Contracting State through a permanent establishment located there, the profits attributable to that permanent establishment are also subject to taxation in that state.

Tax Rates

Category	Czech Republic	Israel	Withholding rate according to the taxation treaty
Corporate tax	19%	23% *Special rates according to investment benefits (details in next slides)	
Dividends	15% for European residents 35% - paid for other residents	25-30%	5-15%
Royalties	0% for European residents 15%-35% - paid for other residents	47% - 31% / 23%	5%
Capital Gain	Part of income tax 15-23%	25-30% (unless business income)	

Transfer Pricing

- When there is **a business activity** that involves **multiple entities in different countries**, the question as to **which parts of the profits should be taxed in which countries arises**. Transfer pricing are **reporting requirements of international transaction between related parties.**
- Each transaction should be examined by the contractual and operational facts and circumstances pertaining to the Tested transactions in order to provide the group with an arm's length transfer pricing compliance documentation based on:
- The arm's length principle as defined in Section 85A of the Israeli Tax Ordinance and the Regulations thereunder ("Section 85A"); and,
- The arm's length principle as defined in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines").

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Thank you!

For any questions related to Israeli & international taxation,
Please contact us:

www.y-tax.co.il