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Corporate Tax

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Chambers Global Practice Guides

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165 Fleet Street
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Contributed by: Charles Osborne, **Slaughter and May**

Slaughter and May is a leading international law firm with a worldwide corporate, commercial and financing practice. The highly experienced tax group deals with the tax aspects of all corporate, commercial and financial transactions. Alongside a wide range of tax-related services, the team advises on the structuring of the biggest and most complicated mergers and acquisitions, the development of innovative and tax-efficient structures for the full range of financing transactions, the documentation for the implementation of transactions so that the desired tax objectives are met, the tax aspects of private equity transactions and investment funds from initial investment to exit, and tax investigations and disputes from opening enquiries to litigation or settlement.

Contributing Editor

Charles Osborne advises businesses on all areas of tax law. His practice includes advising on tax consultancy matters, a wide range of transactions (including public and private M&A, debt and equity markets transactions, and group reorganisations), as well as on contentious issues (at both enquiry and litigation stages). Charles is a member of the British Venture Capital Association's Tax Committee and is part of Slaughter and May's private equity team.

Slaughter and May

One Bunhill Row
London
Greater London
EC1Y
UK

Tel: +44 20 7600 1200
Fax: +44 20 7090 5000
Email: charles.osborne@slaughterandmay.com
Web: www.slaughterandmay.com

INTRODUCTION

Contributed by: Charles Osborne, **Slaughter and May**

International Tax Policy in the Trump Era: A Turbulent Global Landscape

The main issue on the mind of many international tax practitioners at the time of writing (and I dare say for years to come) is Donald Trump and the impact he is having on the global tax landscape. As noted in the introduction to this excellent guide last year, it is hardly a novel development to find the progress of international tax reform at the mercy of US politics, but the immediate impact that the new US President has had is beyond even what many practitioners expected – whether through his withering statements on the OECD's Pillar One and Pillar Two projects, his introduction of significant tariff regimes, or simply his approach to domestic US tax reform, there is no doubt that we are entering a period of dramatic change in the global tax landscape as a result of US influence.

And yet, as the pages of this guide show, there currently remains a great deal of stability in domestic corporate tax regimes, following trends long established and not yet knocked off course by the influence of Mr Trump.

This guide is divided by jurisdiction before being broken down further into the following sections – (1) types of business entities and their basic tax treatment, (2) key features of the tax regime applicable to incorporate businesses, (3) the division of the tax base between corporations and non-corporate businesses, (4) key features of the taxation of inbound investments, (5) key features of the taxation of non-local corporations, (6) key features of the taxation of foreign income of local corporations, (7) anti-avoidance, (8) audit cycles, and (9) BEPS. Although by no means exhaustive, I hope that these sections provide anyone looking to make an investment into an unfamiliar jurisdiction with sufficient insight into the corporate tax landscape in that jurisdiction and a flavour of the key issues that may be relevant for their business.

At the outset, it is worth setting out a few key themes or trends that are drawn out in the answers of the many practitioners who have contributed a section on their jurisdiction of practice.

Tax competition is alive and kicking

Against the backdrop of various OECD projects to clamp down on different forms of tax competition, and the EU looking to resolve its own conundrum (that it is not a fiscal unity while still being concerned that there is a level tax playing field amongst member states) tax competition nonetheless continues to thrive. Although some of this results in significant attention from the media, such as the introduction of tariffs in the United States, and the various counter-measures that those countries affected have taken in response, it is also playing out through quieter and less flashy methods, such as through the efficiency of a jurisdiction's tax administration and the consistency or certainty in the application of its tax rules. Of course, with an increase in financial demands on governments (due to, for example, national defence obligations), the answer to the question as to whether tax administration budgets remain at their current levels and can continue to provide even their current service levels, or are instead one of the first budgetary casualties, remains to be seen – in the United States, plans are already afoot to reduce the IRS workforce by an estimated 20% this year.

Avoidance crackdown

Still reeling from dealing with COVID-19, the impact on the global economy of the war in Ukraine, and various efforts to restart their economies, the need for many jurisdictions to increase spending on national defence might be the last straw. In any event, tax is likely to play a major part in the success or failure of governments in juggling these various financial issues and obligations. However, as well as the possibility of introducing new taxes, governments are also looking to enforcement as another avenue worth exploring if they are to balance their budgets. For some, that means encouraging fast and early payment of taxes; for others, it involves an aggressive clampdown on evasion and avoidance behaviours. Either way, it is clear that if improved enforcement is to occur, tax administrations will need to devote further resources, whether through more work hours, or through new technological improvements, to the way they enforce and collect tax – something unlikely to be possible if government purse strings are tightened further. The approach that each jurisdiction takes to this thorny issue will be something to watch over the coming years.

Status of OECD reforms

Many jurisdictions have already implemented a version of the OECD's Pillar Two reforms. The introduction of these rules represents the culmination of many years of international engagement at the OECD level and is a reflection of a gradual change in attitude towards tax planning/mitigation over that same period. Yet the impact of their introduction is potentially only just beginning to be felt by taxpayers. The complexity of the rules, the enormous compliance burden of carrying out the required calculations, the practical application of the rules to real-world scenarios, and the interaction of taxpayers with tax authorities on areas of uncertainty, look set to have a significant and long-term impact on the tax landscape for years to come.

Of course, all that is before the wild card thrown into the mix by the new Trump administration, which has expressly disavowed any commitments previously made by US governments with respect to the OECD reforms and has stated that such reforms have no force or effect in the United States in the absence of an Act of Congress. The OECD's Pillar One project has been seen as dead in the water by many practitioners for some time now, long before the new Trump administration, but it is very much a question of "watch this space" to see what impact the US approach now also has on Pillar Two around the world.

Conclusion

Corporate taxation is not immune to the broad changes happening across the world in the political and economic arena. The next few years will prove a significant test to the trends and developments in this space, which have been progressing steadily over the last few years. Whether these trends will survive is anyone's guess, but there will almost certainly be some element of reset or rebalancing in line with broader international political and economic changes.

AUSTRIA

Law and Practice

Contributed by:
Clemens Philipp Schindler and Daniel Kropf
Schindler Attorneys

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Schindler Attorneys is a leading Austrian law firm for transactional work with extensive experience in the fields of M&A, private equity, finance, real estate, corporate, employment, data protection, litigation, tax and securities law. The firm's ambition is to provide top-quality services and to become an instrumental part of its clients' business. Schindler Attorneys seeks long-term, collaborative relationships with clients and partner firms as the team firmly believes that trusted co-operation is the key to success. The firm is frequently involved in cross-border matters and co-ordinates or participates in multi-jurisdictional teams on a regular basis. It has a leading market position for both national as well as cross-border corporate reorganisations. The Schindler Attorneys lawyers who focused on that area were among the first in Austria to implement cross-border mergers, European Companies (SE) structures, and corporate migrations. The firm's legal tax services are provided by one partner, two counsels and one associate.

Authors

Clemens Philipp Schindler is a founding partner of Schindler Attorneys. Before establishing the firm, Clemens spent six years at WOLF THEISS, where he led some of the firm's most prestigious transactions and headed its Brazil operations. Clemens is admitted in Austria as an attorney-at-law and a certified public tax adviser, focusing on corporate and tax advice in relation to public and private M&A, private equity, and corporate reorganisations – most of which have a cross-border element. Furthermore, he specialises in international holding structures, including charter financing and leasing operations. His practice is complemented by private client work (eg, as counsel to families owning stakes in large corporations).

Daniel Kropf is counsel at Schindler Attorneys. Daniel has extensive experience in international tax law, corporate taxation, tax planning and tax advice in connection with M&A, real estate transactions, and representing clients before Austrian courts and authorities in tax and criminal tax proceedings. He is dual-qualified as an attorney and as a certified public tax adviser in Austria. Before joining Schindler Attorneys, Daniel worked with international tax advisory firm BDO and renowned international law firms, including CMS. He has three degrees from the University of Linz and the University of Vienna and completed advanced courses in international tax law and criminal fiscal law at the Chamber of Public Tax Advisers.

Schindler Attorneys

Kohlmarkt 8-10
1010 Vienna
Austria

Tel: +43 1 512 2613
Fax: +43 1 512 2613 888
Email: office@schindlerattorneys.com
Web: www.schindlerattorneys.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Austria are typically carried out via a limited liability company (*Gesellschaft mit beschränkter Haftung*, or GmbH) or – to a lesser extent, typically in the case of a listed company – via a joint stock company (*Aktiengesellschaft*, or AG).

Under a GmbH, the shareholders are authorised to give instructions to a managing director. There is typically a low degree of fungibility of shares and a wider range of possibilities for the design of the articles of association.

Under an AG, a supervisory board and a management board are mandatory, with both operating independently from the shareholders in terms of business decisions. There is typically a higher degree of fungibility of shares.

GmbHs or AGs are separate taxpayers for Austrian corporate income tax (*Körperschaftsteuer*) purposes.

With the Corporate Amendment Act 2023, a new legal form – the so-called flexible company (*"FlexCo"*)- was introduced in 2024. A simplified internal decision-making process of the shareholders and the possible creation of so-called company value shares intends to facilitate the corporate participation of employees. The legislator describes the FlexCo as a hybrid of a GmbH and an AG, as the FlexCo provides the option of holding its own shares as well as certain flexible capital measures.

Generally, shareholders of corporations are not liable for the liabilities of the companies, apart from in very exceptional cases (eg, in the case of effective management of the corporation by a shareholder).

1.2 Transparent Entities

In Austria, the most commonly used tax-transparent entities are the general partnership (*Offene Gesellschaft*, or OG) and the limited partnership (*Kommanditgesellschaft*, or KG).

An OG is a type of partnership entity consisting of at least two individuals or legal entities. Each of the partners in an OG bears personal, unlimited, direct and joint liability to the partnership's creditors for its obligations. In contrast to incorporated entities, OGs may be set up without any initial capital. An OG comes into legal existence as soon as it is entered into the Commercial Register. The OG possesses a legal identity from a civil law perspective (whereas it is transparent from a tax law perspective) and constitutes an independent entity with rights and obligations vis-à-vis external parties.

In contrast to an OG, in a KG not all of the partners bear full and unlimited liability for the partnership's obligations. Rather, it is only required that there be (at least) one general partner (*Komplementär*) who – just as in an OG – bears unlimited liability to the partnership's creditors (the *"general partner"*). The remaining partners can have limited liability vis-à-vis the creditors; they are referred to as *"limited partners"* (*Kommanditisten*). The liability of each limited partner ends as soon as their limited partnership share (liability share) has been fully paid in. Only the liability share is registered and public.

A special form of KG is the *Gesellschaft mit beschränkter Haftung und Compagnie Kommanditgesellschaft* (*"GmbH & Co KG"*). This form is characterised by the fact that its sole personally liable general partner is a GmbH. In a typical set-up, the shareholders of the GmbH are – at the same time – also limited partners of the KG. In a typical GmbH & Co KG, sole management and representation authority over the KG is vested in the GmbH acting as the general partner. The GmbH, in turn, is represented by its managing director(s). This means that the duty of the GmbH's managing director(s) is/are to manage the affairs of the GmbH & Co KG and fulfil all the related obligations.

1.3 Determining Residence of Incorporated Businesses

According to Austrian corporate income tax law, a corporation with its registered seat or place of management in Austria is subject to unlimited tax liability. The registered seat of a corporation is deemed to be located at the place stipulated in the articles of association and registered in the commercial register. The place of management is deemed to be where the corporation's senior management makes its executive decisions.

Double taxation treaties (DTTs) regulate that the place of effective management is decisive in the case of a dual residence of a corporation (the *"tie-breaker rule"*). Important elements for determining this place include the residency of board members and the location of board meetings.

1.4 Tax Rates

Taxation of Corporations

The income of a corporation is qualified as business income that is subject to corporate income tax at a rate of 23% (since 2024). If the remaining income is subsequently distributed to the shareholders (as distribution of profits/dividends), then those already taxed profits are taxed again at the level of the receiving shareholders (principle of separation, or *Trennungsprinzip*).

Taxation of Partnerships

Partnerships such as OGs or KGs are transparent for income tax purposes (no taxation at the level of the partnership) so that profits and losses are directly taxed at the partners' level and the applicable tax rate depends on whether the partner is a corporation (23% corporate income tax) or an individual (progressive tax rate up to 55%). The assets, liabilities and income of the partnership are generally allocated to the partners in proportion to their partnership interests.

Individuals

The taxation of the income of individuals (who own a business or are a partner in a transparent partnership carrying out business) – generated by themselves or through the partnership – generally depends upon their personal tax rate. The progressive tax rates for 2025 range from:

- up to EUR13,308 – 0% tax rate;
- EUR13,309 to EUR21,617 – 20% tax rate;
- EUR21,618 to EUR35,836 – 30% tax rate;
- EUR35,837 to EUR69,166 – 40% tax rate;
- EUR69,167 to EUR103,072 – 48% tax rate;
- EUR103,073 to EUR 1 million – 50% tax rate; and
- more than EUR1 million – 55% tax rate (until 2025).

However, special tax rates apply for income from capital investments and income from the alienation of private real estate, as follows.

- Income from capital investments (eg, dividends or capital gains from the sale of shares in a corporation) are taxed at 27.5%. The application of this special tax rate has the disadvantage that income-related expenses or operating expenses that are directly connected with the income from capital investments may not be deducted.
- Income from the alienation of private real estate is taxed at a 30% real estate sales tax rate (with certain tax exemptions and reductions available).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporations determine their income through the comparison of business assets and annual financial statements. Business profits and expenses are not calculated for the period in which they are actually received or paid but, rather, are attributed to the specific period in which goods are delivered or services rendered (*"accrual method"*).

Corporations are legally obliged to keep books according to the accounting standards set in in commercial law and these standards are generally also binding for tax purposes (*Grundsatz der Maßgeblichkeit*). However, there are some deviations between commercial law rules and tax law rules, especially in terms of the main principles of asset valuation and the depreciation of assets.

2.2 Special Incentives for Technology Investments

In Austria, an R&D tax credit (so-called *Forschungsprämie*) is available for companies that have project-related R&D expenses. The maximum tax credit is EUR1 million per year. Its evaluation is carried out by the Austrian Research Promotion Agency (*Forschungsförderungsgesellschaft*, or FFG), based on the project proposal.

This tax credit is acknowledged as a high incentive to undertake R&D activities by Austrian companies, given that this grant is treated as an immediate cash credit on a company's tax account.

2.3 Other Special Incentives

Austria allows an investment allowance (*Investitionsfreibetrag*) for depreciable fixed assets acquired after 31 December 2022. Pursuant to this rule, 10% of the acquisition or production costs of such assets can be deducted as a tax allowance. If the asset qualifies as being related to greening or environmental measures, the investment allowance is 15%. A maximum of EUR1 million in acquisition or production costs per year can be used as the basis for this allowance.

2.4 Basic Rules on Loss Relief

The utilisation of losses as special expenses is possible for corporations. First, the positive and negative income of one year is netted. Second, corporations may choose to carry forward the losses indefinitely. However, only 75% of the total amount of income of the taxable year is tax deductible and the remaining losses can be carried forward to the following years.

A special restriction for corporations using carried-forward losses exists in the event of buying unprofitable *"shell companies"*. The utilisation of losses will be denied where significant changes are made within a short period of time to:

- the shareholder structure of a corporation (eg, more than 75% of the shares in the corporation are sold);
- the organisational structure of a corporation (eg, new managing board); and
- the economic structure of a corporation (eg, new business model).

As a measure against the COVID-19 crisis, a temporary carry-back of losses was implemented. Operating losses for the year 2020 could be used for the tax assessment of the year 2019 and remaining losses for the year 2020 could be deducted from the income of the year 2019 (up to a maximum of EUR5 million) and 2018 (up to a maximum of EUR2 million). The 75%-limitation rule did not apply.

2.5 Imposed Limits on Deduction of Interest

At arm's length interest expenses are, in principle, deductible for Austrian corporate income tax purposes. A number of interest deduction limitation rules must be observed to determine if interest expenses are deductible in the case at hand. The following are the most important rules.

- Interest arising from the leveraged financing of acquisition of participations is tax deductible, as long as the participation is part of a corporation's business assets. Interest is not deductible if the participation is acquired by a corporation in the same consolidated tax group.
- Interest deduction is not allowed where the corporation receiving the interest payment is a member of the same group of companies or significantly influenced by the same shareholder – for example, where the corporation is paying the interest and at the level of the receiving corporation, the interest income is not subject to taxation at all or only subject to a tax rate of less than 10%.
- With effect from 1 January 2021, Austria implements the EU Anti-Tax Avoidance Directive and introduced a new interest limitation rule (so-called *Zinsschranke*). This new rule caps the deduction of borrowing costs (net interest expenses) at 30% of the taxable result (the tax-relevant EBITDA). The new interest limitation rule covers all borrowing costs, irrespective of whether these are incurred in relation to unrelated third parties or within a group.

2.6 Basic Rules on Consolidated Tax Grouping

Austrian tax law recognises consolidated tax grouping for corporate income tax purposes by enabling groups of corporations to offset the losses and profits within a group of subsidiaries at the parent company level.

Group taxation requires a group parent. Regarding group members, a share in the statutory capital and the voting rights of that group member of more than 50% is necessary. The participation may be either held directly or indirectly through another group member or a partnership. All Austrian corporations, as well as comparable foreign corporations that are resident in the EU or in a state that has concluded an agreement for exchange of information and mutual assistance in the collection of taxes with Austria, may qualify as a group member. An application for group taxation must be submitted to the group parent's competent tax authority and the tax group needs to exist for a period of at least three full years.

As a consequence of group taxation, the total profits or losses of the group members are attributed to the group parent corporation. As regards local group members, the degree of participation of the latter is not relevant – ie, the total profits or losses of a group subsidiary are subject to attribution even if the participation is less than 100%. However, profit attribution rules for foreign group members are different to those for Austrian group members. If a foreign subsidiary generates a loss, this loss has to be allocated to the group parent corporation on a pro rata basis, depending on the percentage of the participation in the foreign subsidiary.

2.7 Capital Gains Taxation

Capital gains (and losses) realised on assets of an Austrian corporation are considered normal business income that is taxable at the statutory tax rate (23% corporate income tax), unless it concerns a capital gain on a shareholding that meets the requirements for the participation exemption to be applied.

Under the international participation exemption, capital gains and dividend income from qualified shareholdings are fully exempt from the Austrian corporate income tax base.

Under the domestic participation exemption, profit distributions of domestic corporations are exempt from taxation and this exemption applies without any minimum holding requirements and holding periods. However, capital gains realised on the alienation of shares in domestic corporations are subject to regular taxation.

2.8 Other Taxes Payable by an Incorporated Business

Enterprises, whether transparent or opaque, may become subject to VAT when providing services or selling goods in Austria.

Real estate transfer tax (RETT) applies to an exhaustive list of domestic real estate transactions. The main rule covers purchase contracts or similar transfer agreements. RETT also applies where the right to dispose of 95% or more of the shares or the accumulation of 95% or more of the shares of a corporation or partnership holding immovable property in Austria is transferred to one shareholder or to a tax group.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are generally subject to VAT. However, they are usually able to claim input VAT as well. The general VAT rate is 20%, but a reduction to 10% is available for some products and services.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses are mostly structured as limited liability companies in Austria.

3.2 Individual Rates and Corporate Rates

The income from self-employment (ie, business profit) is subject to an overall progressive income tax rate of up to 55%.

The income (profit) of a corporation is subject to a 23% corporate income tax rate (first level) and profit distributions are subject to 27.5% capital gains tax rate at shareholder level (second level). If the shareholder also acts as a managing director of the corporation, the directors' fees are subject to the progressive tax rate and only an at arm's length remuneration is deductible at the level of the company. Excessive fees (eg, directors' or management fees) or benefits to shareholders or affiliates are treated as non-deductible hidden profit distributions.

3.3 Accumulating Earnings for Investment Purposes

In Austria, there are currently no measures in place to prevent corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

There are no special taxation rules for closely held corporations in Austria. The general rules apply.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Where shares are part of the private assets of an individual, capital income from dividends and the alienation (eg, sale) of shares are taxed at a flat tax rate of 27.5%. Capital gains on the sale of shares are also taxed at this flat tax rate if the individual's stake is below 1%.

These rules also apply for shareholdings in privately held corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The withholding tax (WHT) is principally levied on dividends at the applicable tax rate for individuals (27.5%) or corporations (23%).

EU corporations that are subject to a limited tax liability benefit from the EU Parent-Subsidiary Directive – under which, they may obtain a 100% tax exemption for dividends.

- There is no obligation to withhold and pay WHT in Austria (so-called relief at source) if:
  - (a) a profit distribution is made by an Austrian corporation;
  - (b) the EU recipient corporation holds at least one tenth of the share capital of the Austrian subsidiary; and
  - (c) a minimum holding period of one year is observed.
- There is nevertheless an obligation to withhold and pay WHT in Austria if there are reasons to suspect abuse. Abuse is assumed, in particular, if the EU recipient corporation has no function and its sole purpose is to avoid Austrian WHT. In order to rule out such a suspicion of abuse, the EU recipient corporation must submit a written declaration to the Austrian corporation that it carries out an activity that goes beyond the scope of asset management, employs its own staff and has

its own business premises (so-called proof of substance). These declarations can be submitted on a form provided by the Austrian Federal Ministry of Finance. On this form, a certificate of residence of the EU recipient corporation must also be obtained from the competent EU tax office promptly after the profit distribution.

- If proof of substance cannot be provided by the EU recipient corporation (which will often be the case with a holding company or an acquisition vehicle), relief at source is generally not possible and the Austrian corporation would have to withhold WHT on the distribution and pay it to the Austrian tax office. The EU recipient corporation would then still have the option to apply to the Austrian tax office for a refund of the WHT from the following year. In such a refund procedure, the Austrian tax office would check whether there actually is abuse or whether the conditions for an exemption from WHT are met and therefore the WHT should be refunded to the EU recipient corporation. As soon as a refund is granted, relief at source can subsequently be granted for three years under certain conditions.

The dividend WHT can also be reduced at source under the applicable DTTs in accordance with the formal requirements laid down in the DTT Relief Regulation (*Doppelbesteuerungsabkommen-Entlastungsverordnung*, or DBAEV). A recipient seeking to reduce the dividend WHT will have to provide a certificate of residence issued on Austrian forms *"ZS-QU1"* (for individuals) or *"ZS-QU2"* (for legal entities). Additionally, legal entities must also satisfy the relevant substance requirements as previously mentioned.

The DTT Relief Regulation limits the dividend WHT exemption at source in certain cases – for example, foreign foundations, trusts and investment funds do not qualify for dividend WHT exemption at source. Austrian corporate income tax law further includes a special provision that allows a foreign entity to apply for a refund of the total Austrian WHT – including the share of WHT that Austria is entitled to tax under the relevant DTTs – if the foreign entity is unable to credit the Austrian WHT in its country of residence (eg, because the dividend income is exempt).

At EU level, further provisions and limitations regarding WHT are expected under the new rules of the Unshell Directive and the Directive on Faster and Safer Relief of Excess Withholding Taxes (the *"FASTER Directive"*).

4.2 Primary Tax Treaty Countries

The most common tax treaty countries are Germany, Luxembourg, Switzerland and the UK.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Austrian tax law has several anti-treaty shopping clauses to prevent the abuse of DTTs. Austrian tax authorities check whether an entity claiming tax relief with reference to a tax treaty generates its income through its own activities and whether there are considerable reasons to act via the tax-privileged entity in question. Furthermore, several Austrian DTTs include subject-to-tax, switch-over and remittance clauses to prevent certain income from not being taxed in either of the two treaty countries.

4.4 Transfer Pricing Issues

The main issue in tax audits regarding transfer pricing is ensuring compliance with the arm's length principle. Other issues are the examination of the transfer pricing methodologies chosen, the assessment of the attribution of beneficial ownership in the companies' assets as declared, and ensuring the fulfilment of formal requirements when issuing the obligatory reports.

The Austrian tax authorities strictly apply the at arm's length principle (as included in Austrian tax law) in most double taxation treaties and elaborated on in the OECD's Transfer Pricing Guidelines, as amended under the OECD/G20 Base Erosion and Profit Shifting Project (BEPS). Therefore, transactions between affiliated companies should be at arm's length, while proper documentation should be available to substantiate the at arm's length nature of the transactions.

4.5 Related-Party Limited Risk Distribution Arrangements

All transactions within a group of companies must meet the requirements of the arm's length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Austria makes explicit reference to the OECD standards in the guidelines issued by the Ministry of Finance.

Austria generally follows the OECD's Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

Austria has concluded DTTs with more than 90 countries. Most of these DTTs follow the OECD Model Convention, which contains provisions on mutual agreement procedures (MAPs). International transfer pricing disputes are usually resolved through a MAP process.

In cases where a taxpayer exercises economic activities in a state with which Austria has not yet concluded a DTT, the Austrian Ministry of Finance may mandate that taxpayers subject to double taxation be partly or fully exempt certain items of taxation.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally, in cases where a transfer pricing claim is settled, the Austrian tax authorities act in accordance with the settlement. However, compensating adjustments must be based on a previously agreed pricing method that is applied in predefined scenarios of uncertainty and must lead to an arm's length result.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches (permanent establishments in fiscal terms) are generally taxed on the basis of the same rules and principles as subsidiaries of non-local corporations. In practice, there are usually problems – or at least discussions – regarding the allocation of income/expenses and assets.

5.3 Capital Gains of Non-Residents

Austrian income tax law differentiates between unlimited and limited tax liability. Non-residents are subject to limited tax liability, with the consequence that only that income that was generated in Austria (including domestic capital gains) is subject to Austrian income taxation. Generally, capital gains are subject to capital gains tax (27.5% for individuals and 23% for corporations).

However, where the shareholder is resident in a country with which Austria has concluded a DTT, Austria may – depending on the specific treaty – be prohibited from levying capital gains taxation.

5.4 Change of Control Provisions

In order to avoid the buying of shell companies to make use of the losses saved up in a corporation, the utilisation of such losses is denied in cases where the identity of the corporation changes owing to a change in the organisational, economical and shareholder structure. Thus, a change of control might result in the forfeiture of tax losses carried forward.

Furthermore, RETT applies where the right to dispose of 95% or more of the shares or the accumulation of 95% or more of the shares of a corporation or partnership holding immovable property in Austria is transferred to one shareholder or to a tax group.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No specific formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services. However, it must be ensured that the determination follows the arm's length principle.

5.6 Deductions for Payments by Local Affiliates

There are no specific rules regarding deductions for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. However, in general, the arm's length principle and the transfer pricing rules must be taken into consideration.

5.7 Constraints on Related-Party Borrowing

Any borrowing between related parties must comply with the arm's length principle.

To distinguish between a shareholder loan recognisable for tax purposes (with interest deduction) and hidden equity, the Austrian Supreme Administrative Court states that agreements between related parties are only recognised if they fulfil the following three criteria (so-called relative case law). The agreement:

- must be sufficiently expressed externally (in writing);
- must have an unambiguous content; and
- must be concluded in accordance with the arm's length principle, meaning on terms that unrelated parties would have agreed upon.

These three criteria must be cumulatively present at the time of the conclusion of the agreement. The lack of one of these three conditions results in the tax invalidity of the agreement (with the consequence that interest is not deductible).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

A corporation with its registered seat or place of management in Austria is subject to unlimited tax liability. This means that the corporation's worldwide income (all domestic and foreign profits) is subject to corporate income tax in Austria.

Foreign income (eg, profits of a permanent establishment) is part of the taxable income in Austria. Given that foreign income will generally also be taxed in the other state, double taxation is avoided through DTTs. If a DTT applies, the regulations laid down therein have priority.

6.2 Non-Deductible Local Expenses

Where foreign income is tax exempt in Austria, the corresponding expenses that are economically directly connected to such income are not deductible in Austria.

6.3 Taxation on Dividends From Foreign Subsidiaries

Under Austrian law, capital gains (eg, profit distributions in the form of dividends) are generally subject to corporate income tax. However, dividends from domestic subsidiaries are tax exempt because of the participation exemption. Foreign dividends,as well as capital gains from foreign subsidiaries, are generally tax exempt under certain conditions.

Under the Austrian participation exemption, dividend income distributed to an Austrian corporation is tax exempt under the following conditions:

- a minimum participation in the foreign subsidiary (which needs to be comparable to an Austrian corporation) of at least 10%; and
- a holding period of one year without interruption.

The exemption is not limited to dividends from EU corporations, as profit distributions from subsidiaries in third states are also exempt if the requirements are met. Austria thereby exceeds the scope of the EU Parent-Subsidiary Directive.

Furthermore, in cases where an Austrian corporation holds less than 10% of a foreign subsidiary and the subsidiary (which needs to be comparable to an Austrian corporation) is resident in the EU or in a jurisdiction with which Austria has agreed on a comprehensive exchange of information, profit distributions (*"portfolio dividends"*) are also exempt from corporate income tax.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles may be transferred or leased (royalties) at arm's length conditions, resulting in taxable income (transfer price or royalties) at standard rates.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

As part of the implementation of the EU Anti-Tax Avoidance Directive, Austria introduced a controlled foreign companies (CFC) regime on 1 January 2019, which leads to the attribution (taxation in Austria) of low-taxed *"passive income"* from foreign subsidiaries under the following conditions.

The CFC rules apply if:

- an Austrian parent corporation (subject to unlimited tax liability) directly or indirectly holds more than 50% of the voting rights or capital of a controlled foreign subsidiary or is entitled to more than 50% of the controlled entity's profit;
- the controlled foreign subsidiary does not conduct *"substantial economic activity"* supported by staff, equipment, assets, and premises; and
- more than a third of the controlled entity's profits stem from low-taxed passive income. *"Passive income"* is defined as:

- interest or any other income generated by financial assets;
- royalties or any other income generated from IP;
- dividends and income from the disposal of shares, insofar as they would be taxable;
- income from financial leasing;

- income from insurance, banking and other financial activities; or
- income from invoicing companies that earn sales and service income derived from goods and services purchased from – and sold to – associated enterprises and which add no or little economic value.

The income is considered low-taxed if it is taxed at an effective tax rate that does not exceed 12.5%.

In addition, Austria also has a so-called switch-over rule for dividends distributed from low-taxed subsidiaries to Austria. Pursuant to this rule, received dividends will not be subject to the participation exemption but – under certain conditions – will be subject to regular corporate income tax and the tax levied in the source state will be credited (ie, a switch from exemption method to credit method). The switch-over rule does not apply if the passive income has already been covered by the above-mentioned CFC rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

The CFC rules described in 6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules only apply where the controlled foreign subsidiary does not conduct *"substantial economic activity"* supported by staff, equipment, assets, and premises. Thus, it would be possible to avoid the attribution of such foreign passive income (and taxation in Austria) by providing evidence of such *"substantial economic activity"* supported by staff, equipment, assets, and premises (ie, the so-called substance test).

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

The gains made by local corporations on the sale of shares in non-local affiliates are tax exempt where the two conditions mentioned in **6.3 Taxation on Dividends From Foreign Subsidiaries** are met – namely, a minimum participation in the foreign subsidiary (which needs to be comparable to an Austrian corporation) of at least 10% and a holding period of one year without interruption.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Section 22 of the Austrian Federal Fiscal Code provides for a general anti-avoidance rule that applies in the case of abusive tax structures.

Tax planning may reach a point beyond which it cannot be tolerated – ie, where transactions are entered into, or entities are established, solely for the purpose of obtaining special tax advantages. A legal structure is inappropriate or unusual and therefore an abusive tax structure if it only makes sense when taking into account the related tax-saving effect, given that the main purpose or one of the main purposes is to obtain a tax advantage that defeats the object or purpose of the applicable tax law.

Individuals are also covered by the general anti-avoidance rule (Section 22 of the Austrian Federal Fiscal Code). A new version of the provision was introduced in 2018 and clearly follows the EU Anti-Tax Avoidance Directive (ATAD) in the decisive passages. The legislative materials for Section 22 also reveal the implementation of the ATAD as the legislator's clear main objective.

In addition, Section 21 of the Austrian Federal Fiscal Code can be considered as another general anti-avoidance rule that provides for the *"substance over form"* approach. Per this approach, the economic substance of facts and circumstances – rather than their formal appearance – is to be taken into consideration when assessing tax questions.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Austria has no periodic routine audit cycle. Tax audits are typically carried out at the discretion of the tax authorities.

9. BEPS

9.1 Recommended Changes

The status of implementation in Austria regarding the BEPS recommended changes can be summarised as follows:

- Action 1 (address the challenges of the digital economy) – not yet implemented, although discussions are ongoing;
- Action 2 (neutralise the effect of hybrid mismatch arrangements) – implemented through the Multilateral Convention to Apply Measures Related to Tax Treaties to Prevent Base Erosion and Profit Shifting (MLI/BEPS/OECD/G20) (the *"Multilateral Instrument"*, or MLI);
- Action 3 (strengthen CFC rules) – implemented through the adoption of the ATAD;
- Action 4 (limit base erosion via interest deductions and other financial payments) – implemented through the adoption of the ATAD;
- Action 5 (counter harmful tax practices more effectively and strengthen transparency) – implemented through Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation and through the adoption of several provisions of the Austrian Federal Fiscal Code;
- Action 6 (prevent treaty abuse) – implemented through the MLI;
- Action 7 (prevent the artificial avoidance of permanent establishment status) – implemented through the MLI;
- Action 8 (assuring that transfer pricing outcomes are in line with value creation: intangibles) – new OECD standards implemented through the transfer pricing guidelines (*Verrechnungspreisrichtlinien* (VPR) 2021);
- Action 9 (ensure that transfer pricing outcomes are in line with value creation: risks and capital) – new OECD standards implemented through the VPR 2021;
- Action 10 (ensure that transfer pricing outcomes are in line with value creation: other high-risk transactions) – new OECD standards implemented through the VPR 2021;
- Action 11 (establish methodologies to collect and analyse data on BEPS and the actions to address it) – the data collected in compliance with the Austrian Transfer Pricing Documentation Act (*Verrechnungspreisdokumentationsgesetz*, or VPDG) could be used for corresponding analysis;
- Action 12 (require taxpayers to report aggressive tax planning arrangements) – implemented through the adoption of DAC6 via the Austrian EU Reporting Requirement Act (*EU-Meldepflichtgesetz*, or EU-MPfG);
- Action 13 (re-examine transfer pricing documentation) – new OECD standards implemented through the VPDG;
- Action 14 (make dispute resolution mechanisms more effective) – implemented through the MLI; and

- Action 15 (develop a multilateral instrument) – implemented through the MLI.

9.2 Government Attitudes

The Austrian government has fully supported the BEPS project at all times.

On 3 October 2023, the Austrian Ministry of Finance has published its draft for a Pillar Two implementation law, the Austrian Minimum Taxation Act (*Mindestbesteuerungsgesetz*, or MinBestG), which came into force at the end of December 2023. Austria implemented Pillar Two by means of a separate law rather than amending the Austrian Corporate Income Tax Act. It includes an Income Inclusion Rule (IIR, applicable for fiscal years starting on or after 31 December 2023) and an Undertaxed Profits Rule (UTPR, applicable for fiscal years staring on or after 31 December 2024), as well as a Qualified Domestic Minimum Top-Up Tax (QDMTT). Moreover, all safe harbours as suggested by the OECD in its various Pillar Two publications (eg, temporary safe harbours, a permanent safe habour for non-material constituent entities, a QDMTT safe harbour, and an temporary UTPR safe harbour) are implemented.

Austrian entities are, in general, required to file a GloBE Information Return (GIR) within 15 months after the end of the reporting fiscal year (18 months for the transitional year). However, the Austrian Minimum Taxation Act also provides the option to transfer the obligation to file the GIR to another Austrian entity.

Failures to comply with the administration of the new rules can be sanctioned with a fine of up to EUR100,000 (EUR50,000 in case of gross negligence).

9.3 Profile of International Tax

Since the publication of LuxLeaks, the Panama Papers and similar reports, public interest in international taxation has grown substantially. As a result, the Austrian business and political press frequently reported on such developments and on scientific contributions concerning how to make taxation more efficient. However, neither the BEPS project nor the implementation of its recommendations receives significant media attention.

9.4 Competitive Tax Policy Objective

The Austrian economy relies to a large extenton foreign markets. Consequently, the Austrian government pursues a competitive tax policy objective. In recent years, the corporate income tax rates have been reduced from 25% to 24% (2023) and 23% (2024 and subsequent years). However, Austria has also introduced several anti-abuse and CFC rules to limit BEPS, as well as introducing statutory provisions to strengthen tax transparency. Austria seeks to achieve international standards for fair and realistic tax competition.

9.5 Features of the Competitive Tax System

Austria does not have a competitive tax system, state aid, or other similar constraints that might be particularly affected by anti-BEPS measures.

9.6 Proposals for Dealing With Hybrid Instruments

The BEPS and ATAD proposals addressing hybrid instruments have been implemented in Austria and as such are included in Austrian tax law and/or Austrian DTTs.

9.7 Territorial Tax Regime

Austria has no territorial tax regime. An Austrian resident corporation is liable to corporate income tax on its worldwide profits (unlimited tax liability), whereas a non-resident corporation is only taxed on its Austrian-source income (limited tax liability).

9.8 Controlled Foreign Corporation Proposals

As part of the implementation of the ATAD, Austria introduced a CFC regime on 1 January 2019, which leads to the attribution (taxation in Austria) of low-taxed passive income from foreign subsidiaries under the conditions described in **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

9.9 Anti-Avoidance Rules

Further to recently adopted anti-avoidance rules (eg, CFC rules and the switch-over rule) driven by BEPS and EU legislation, Section 22 of the Austrian Federal Fiscal Code further provides for a relatively new general anti-avoidance rule that applies in the case of abusive tax structures.

Thus, Austrian tax law already provides adequate regulations to address the abuse of benefits and tax avoidance in general.

9.10 Transfer Pricing Changes

As a result of new amended transfer pricing documentation rules with the implemented country-by-country reporting (CbCR), as well as the master file and the local file, IP must be documented more extensively.

9.11 Transparency and Country-by-Country Reporting

Transfer pricing reporting standards (including CbCR) have been updated and amended recently by the Austrian Transfer Pricing Documentation Act and published guidelines from the Austrian tax administration.

As part of the implementation of EU Directive 2021/2101, there are also new reporting obligations for financial years beginning after 21 June 2024, for the purposes of *"public CbCR"* (*CbCR-Veröffentlichungsgesetz*).

9.12 Taxation of Digital Economy Businesses

No general national statutory changes have been made in Austria yet. However, the government supports the OECD's initiatives in this regard.

9.13 Digital Taxation

The EU Directive on Administrative Cooperation (*"DAC7"*) has already been implemented into Austrian law. DAC7 contains rules on information exchange among digital platforms. The European Council further adopted a directive amending EU rules on administrative co-operation (*"DAC8"*) in 2023. DAC8 introduces rules on the information exchange of crypto-assets and advance tax rulings for the wealthiest individuals. The new rules should be implemented into Austrian law this year, as the deadline for implementation is 31 December 2025.

On a domestic level, Austria took already unilateral action on digital taxation in 2019 by introducing the Digital Tax Act (Digitalsteuergesetz, or DiStG). This legislation imposes a 5% tax on online advertising services provided for consideration within Austria, but only for corporations surpassing defined turnover thresholds from such services.

9.14 Taxation of Offshore IP

Austria has not yet introduced any provisions dealing with the taxation of offshore IP.

BELGIUM

Law and Practice

Contributed by:
Frank De Langhe and Evert Moonen
De Langhe Attorneys

Contents

De Langhe Attorneys acts for a tremendous range of Belgium's most successful privately owned businesses, as well as international companies setting up shop in Belgium. The team of specialised tax attorneys handles Belgian corporate tax matters and tax litigation matters before Belgian courts and European courts. The firm is also dedicated to international tax matters, ranging from handling Belgian corporate tax work for inbound investors and assisting with non-Belgian tax work for outbound corporate clients to handling EU and tax treaty work for all types of corporate clients (mostly advisory, but with some litigious work). The tax team also advises (and litigates) in matters that are directly linked to corporate tax work, such as transfer pricing, employee incentive plans and tax planning for company executives.

Authors

Frank De Langhe is the founder and managing partner of De Langhe Attorneys. His key practice areas are corporate income tax, international tax law, tax litigation, estate planning, M&A and corporate law. His professional memberships include the West Flanders Bar Association, the Ghent Bar Association, the Brussels Dutch-speaking Bar Association (NOAB), the American Chamber of Commerce in Belgium (AmCham) and the Belgian Corporate Finance Association (BCFA). Frank has been a speaker at several corporate and tax seminars, and is the co-author of a variety of articles regarding Belgian tax.

Evert Moonen is a tax partner at De Langhe Attorneys and has extensive experience in all areas of tax law. He handles tax litigation matters with respect to income taxation and VAT, and also advises on all tax aspects relating to M&A transactions, international taxation and estate planning. His professional memberships include the West Flanders Bar Association, the Ghent Bar Association and the Belgian Association of Tax Lawyers (BATL). Evert lectures on tax litigation procedures, international and European taxation, and registration duties and inheritance tax. He mainly advises medium-sized and large privately owned Belgian corporations and high net worth individuals.

De Langhe Attorneys

Koningsstraat 71
B-1000 Brussels
Belgium

Tel: +32 2 880 35 35
Email: contact@de-langhe.be
Web: www.de-langhe.be

DeLanghe
advocaten - attorneys

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Most businesses in Belgium adopt a corporate form, not only for tax reasons but also, and often primarily, for the benefit of limited liability. The most commonly used Belgian corporations offering limited liability are the closely held company (bv in Dutch; sp in French) and the limited liability company on shares (nv in Dutch; sa in French). Businesses not incorporated in the form of a limited liability company are either sole proprietorships or contractual arrangements offering no separate legal personality and no limited liability. These are all tax transparent, whereas corporations – even those that do not have limited liability – are taxed as such under the Corporate Income Tax (CIT) rules, which are part of the Income Tax Code of 1992 (ITC92).

1.2 Transparent Entities

Civil partnerships are often utilised to structure family assets (such as shareholdings, art collections and real estate), with a view to parents keeping control while all or part of the value is transferred to the next generation(s), and also in the construction industry to form a consortium to execute a large construction project.

European Economic Interest Groupings (EEIGs) are utilised to structure the supporting and/or ancillary activities (for the benefit) of two or more taxpayers of several EU member states. If an EEIG is established in Belgium, it should not create a permanent establishment in Belgium for the non-Belgian participants.

1.3 Determining Residence of Incorporated Businesses

Corporations are tax resident in Belgium if either or both of the following is located in Belgium:

- the place of effective management; or
- the principal place of business of the corporation.

Transparent entities are not subject to corporation tax, so the determination of their tax residence is not relevant. For civil law purposes, Belgian law will apply if the entity is governed by the relevant Belgian laws, provided the Belgian conflict-of-law rules do not make any other jurisdiction competent in terms of governing law.

1.4 Tax Rates

Corporate taxpayers are taxed at the rate of 25%. Small and medium-sized enterprises (SMEs) are taxed at a rate of 20% on the first EUR100,000 of net taxable income (subject to certain conditions). Individuals are subject to a progressive scale of Personal Income Tax on the net income of their business: a first tranche of progressively taxable income is taxed at 0%, the next tranche at 25%, and so on. As soon as the total income that is taxable at the progressive rates exceeds approximately EUR48,320 (per annum), the top rate of 50% kicks in. Personal income tax rates are subject to a municipal surcharge of, typically, 5–10%, increasing the aggregate top rates to approximately 52.5–55%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The accounting profits are the basis for determining the taxable income of a corporation.

On the one hand, there is an exhaustive list of non-deductible items, which are added back to the accounting profits (most fines, most local taxes, the CIT itself, the non-deductible part of automobile costs, etc). A number of tax-exempt items are added to the retained earnings measured on the first day of the taxable year, so that the increase of retained earnings diminishes (or the decrease grows) (eg, tax-exempt capital gains on shares that qualify for the participation exemption).

Finally, a number of specific tax attributes and tax incentives are deducted, such as dividends that are deductible by virtue of the participation exemption, net profits of permanent establishments that are exempt in Belgium by virtue of bilateral tax treaties, etc. Corporate taxpayers are taxed on an accruals basis.

2.2 Special Incentives for Technology Investments

The Innovation Income Deduction is a beneficial regime to encourage investment in technology, which allows a deduction of 85% of qualifying innovation income determined in accordance with the OECD's nexus rules.

On wages for qualifying scientific workers, 80% of the statutory amount of Wage Withholding Tax does not need to be transferred to the tax collector, substantially reducing the *"cost to company"* for employing such workers.

2.3 Other Special Incentives

Belgium has an attractive tax regime for the financing of audiovisual and certain other creative works, allowing corporate investors in such projects to deduct their investments from their taxable income, up to certain thresholds. Belgium also has an EU-proof tonnage tax regime in place for the shipping industry. For the diamond industry, Belgium applies a so-called carat tax that offers a relatively low – to some extent notional – tax base for diamond traders. Group finance (or treasury) centres enjoy a beneficial regime for computing the 5:1 thin capitalisation interest limitation (by netting interest owed or paid against interest earned or received).

2.4 Basic Rules on Loss Relief

Belgium allows Net Operating Losses (NOLs) to be carried forward with no time limits (no carry back). However, certain tax deductions go into a basket, including NOLs carried forward from previous tax years, and current-year profits over EUR1 million can be reduced by no more than 70% (limited to the amount of the basket), leading to a minimum taxable income of 30% on income over EUR1 million. With the exception of capital losses on shares, capital losses are deductible from current income, as capital gains are taxable as ordinary income (again, with the exception of capital gains on qualifying shares), although the taxation of capital gains on fixed assets can be deferred, under strict conditions.

2.5 Imposed Limits on Deduction of Interest

Interest on non-mortgage loans with no fixed term – other than those paid to affiliated companies under a framework agreement for centralised treasury management within a group – is limited to the monetary financial institution interest rate published by the National Bank of Belgium (for loans up to EUR1 million with a variable rate and an initial interest rate up to one year provided to non-financial corporations), raised by 2.5%. All other kinds of interest must meet the arm's length standard in order to be fully deductible. Any excessively high interest is not tax-deductible.

Then there is a 5:1 thin capitalisation rule, whereby interest paid or owed, directly or indirectly, to related parties and/or lenders based in tax havens is deductible only to the extent that the tainted loans do not exceed five times the taxpayer's equity.

Finally, an interest limitation rule that is compliant with the Anti-Tax Avoidance Directive (ATAD) has been transposed into Belgian national law, limiting the deduction of the *"exceeding borrowing cost"* (which is the positive difference between (i) all interest and other costs being economically equivalent to interest that are considered as a business expense, and (ii) any interest and other financial income being economically equivalent to interest that is included in the profits of the tax year and not exempt from tax in Belgium by virtue of a tax treaty) to either EUR3 million or 30% of the taxpayer's Belgian earnings before interest, taxes, depreciation and amortisation (EBITDA), whichever is higher.

2.6 Basic Rules on Consolidated Tax Grouping

Under the so-called group contribution regime, corporate taxpayers that are 90% or more directly related (parent and subsidiary; sisters of the same common parent company) will be allowed to form a group, and a profitable member of the group will be allowed to transfer a portion of its profits to a loss-making member of the group, which will then remain effectively untaxed due to compensation with losses by the recipient entity. The entity transferring such profits will be required to pay the recipient company an amount in lieu of the CIT that it would have paid in the absence of the group contribution; this payment is not tax-deductible for the payer and not taxable for the recipient. This compensation has to be actually paid and cannot be booked as a debt. More specific details are explained in a circular letter, providing more certainty on matters such as the treatment of the compensation with foreign losses.

2.7 Capital Gains Taxation

In principle, capital gains are taxed as ordinary profits, with certain exceptions.

The first exception is capital gains on qualifying shareholdings (as part of the participation exemption regime), which are 100% tax-exempt if the shareholding represents at least 10% of the share capital of the underlying company or has an (historic) acquisition value of at least EUR2.5 million, and has been maintained for an uninterrupted period of at least one year immediately preceding the disposal.

The second exception is that capital gains on tangible fixed assets can be deferred, provided that the assets were on the taxpayer's balance sheet and have been depreciated for at least five consecutive taxable periods, and that the entire proceeds of the disposal – not only the capital gain – are invested into qualifying depreciable assets in Belgium or an EEA member state within three (or five) years following the realisation of the gain. The qualifying capital gain is not (immediately) taxed but is deducted from the tax base of the assets in which the proceeds of the disposal are reinvested. Depreciations will then only be allowed on this reduced tax base, resulting in the taxation of the temporarily exempt capital gain over time, as the newly invested assets are depreciated. This temporary exemption regime is usually referred to as *"rollover"*.

2.8 Other Taxes Payable by an Incorporated Business

Belgium applies the EU VAT system. A peculiarity is that, at the option of the lessor and the lessee, new buildings can be leased by VAT taxpayers to VAT taxpayers under the VAT regime, which was previously not possible. As a result, the lessor can deduct the input VAT paid on the development and construction of the building. This option can be of interest whenever the lessee or tenant is a VAT taxpayer with a full or substantial right to deduct input VAT – ie, most regular commercial and industrial businesses other than financial institutions, insurance companies and investment funds.

Other transactional taxes are mostly *"regionalised"* and may differ depending on the region where the transaction is situated (Flanders, Brussels Capital Region or Wallonia). For example, the sale of real estate triggers a real estate transfer tax of 12% in Flanders and 12.5% in Brussels and Wallonia.

The trading (but not the issuance) of shares and bonds and the like is subject to stamp taxes (with a relatively moderate cap per transaction).

Finally, regional and local taxes are due on a variety of business activities, and are sometimes burdensome. For example, many cities and municipalities impose a local tax on hotel rooms, engines, equipment and machinery, etc.

2.9 Incorporated Businesses and Notable Taxes

There are several other taxes that may be due, depending on the business operated by corporations (or unincorporated businesses) and the region where they are operating. For example, businesses selling certain goods packed in plastic or other packaging material (aluminium cans, etc) must pay *"recycling tax"*. Logistical operators may be subject to a special tax on trucks driving through one of the Belgian regions. In the wake of the financial crisis of 2008, banks are subject to a so-called bank tax. The operation of an *"old"* nuclear power plant is also subject to *"nuclear tax"*.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Because of the high marginal tax rates in the personal income tax system (over 50% on any aggregated income in excess of approximately EUR48,320 per year), inter alia, most businesses opt for incorporation, taking advantage of the lower CIT rates of 25% and 20% for the first tranche of EUR100,000 of taxable profits for SMEs.

3.2 Individual Rates and Corporate Rates

The distribution of profits in the form of dividends triggers a dividend withholding tax of 30% (a lower rate may be available under certain conditions), which is the final tax for a Belgian resident individual shareholder.

3.3 Accumulating Earnings for Investment Purposes

In essence, the most significant rule that would discourage the accumulation of earnings in a corporation (instead of distributing earnings in the form of wages/salaries or dividends) is the fact that capital gains on investment assets are taxable in the hands of corporate taxpayers, whereas capital gains on privately held investment assets (shares and other securities, real estate, etc) are normally tax-exempt in the hands of private individual taxpayers.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends, including liquidation gains, are taxed at 30%. If the distributing company is established in Belgium, this 30% will be levied in the form of a dividend withholding tax, which is the final tax for the individual shareholder. For dividends stemming from non-Belgian shares, either the Belgian financial intermediary will levy the 30% withholding tax, or the taxpayer will be required to declare the dividend income in their personal income tax return and pay a flat rate of 30% on this income.

Under certain conditions, a reduced rate of withholding or personal income tax may be available.

Capital gains on shares are normally tax-exempt in the hands of private individuals. Exceptions may apply – for example, if the taxpayer, together with their close family, owned more than 25% of the share capital in a Belgian company at any time during the five-year period immediately preceding the sale, and the shares are sold to a corporate buyer outside the EEA, the capital gains tax rate would be 16.5%. Also, so-called speculative gains are taxable (at a flat 33% rate) if the individual shareholder has bought and sold the shares in a speculative way (short holding period, borrowed funds to buy the shares, etc).

In 2019, the Belgian Constitutional Court quashed the so-called securities account tax, and a new securities account tax of 0.15% on securities accounts held by individual taxpayers was introduced in early 2021. The tax is due on securities accounts with an average value in excess of EUR1 million.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Please see **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The general withholding tax rate is 30%. Lower rates and even exemptions are available – for example, for dividends paid to qualifying parent companies established in countries with which Belgium has a bilateral tax treaty in force or for interest paid to so-called financial holding companies. Subject to certain conditions, a 15% or 20% rate applies to dividends paid by SMEs and related to shares issued in remuneration for a contribution in cash that took place after 1 July 2013.

SMEs can also opt to create a so-called liquidation reserve that gives rise to an extra 10% corporate income tax due from the company, with no additional withholding tax due from the shareholder upon the liquidation of the company. Dividends paid out of this liquidation reserve prior to the liquidation of the company give rise to a 20% withholding tax if the distribution occurs within the five years following the creation of the liquidation reserve, and 5% if the distribution occurs after five years. A 15% rate applies to dividends paid by certain real estate investment companies.

Belgian federal tax authorities draw attention to corporate groups, where the top holding company serves as a cash-pooling company – ie, the lender vis-à-vis the entire group. This is a common practice for construction/promotion companies, for example.

4.2 Primary Tax Treaty Countries

Foreign investors in Belgian stock sometimes make use of (interposed) holding companies in Luxembourg or Hong Kong, among other locations, because a zero rate of Belgian withholding tax is available, and dividends leaving Luxembourg and Hong Kong are exempt from withholding tax, either by default or subject to further planning. The Belgian tax authorities will scrutinise these structures and refuse the zero rate in any case of clear treaty shopping.

For interest-bearing instruments, the Netherlands and Luxembourg are sometimes used for the same reasons, but also with the same caveat for treaty shopping.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Belgian tax authorities will scrutinise these structures and refuse the zero rate in any case of clear treaty shopping. In several advance tax rulings, the Ruling Commission has listed a number of criteria to test the reality and substance of interposed companies in jurisdictions such as Luxembourg.

4.4 Transfer Pricing Issues

Belgium will pay special attention to all significant internal dealings, such as the purchase and sale of raw materials and semi-finished or finished goods by related parties, but also to interest rates on intercompany loans and other financial arrangements and services provided by or to Belgian corporate taxpayers to or by non-Belgian related parties or parties (even unrelated) that are subject to no or low effective taxation.

4.5 Related-Party Limited Risk Distribution Arrangements

In the past, limited risk distribution arrangements (eg, commissionaire structures) were commonly used and not aggressively scrutinised by the Belgian tax authorities, but this is rapidly changing, especially since Belgium decided in 2017 to opt in to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) provision on commissionaire structures (Article 12). Practitioners generally advise taxpayers to apply for an advance tax ruling from the Ruling Commission in order to prevent any dispute with the tax auditors afterwards.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Belgium has adopted a somewhat far-reaching version of the country-by-country reporting standard (BEPS Action 13), inter alia, by imposing CbC reporting for financial years starting on or after 1 January 2016. Other than this, the OECD standards are by and large adopted. Country-by-country reporting will also be important in rolling out the measures under Pillar Two. For more information, please see **9.2 Government Attitudes**.

4.7 International Transfer Pricing Disputes

Compared to previous years, the Belgian federal tax authorities seem to have adopted a different approach of late. For example, more importance is placed on personalised questionnaires rather than standardised questionnaires. Whereas audits previously usually focused on a single entity, today's audits more often focus on several (or even all) Belgian group entities.

Statistics on this are regularly published by the OECD. The latest data pertains to 2023 and reveals that 59 mutual agreement procedures (MAPs) on transfer pricing out of a total of 78 (equal to 76%) were closed in 2023 with an agreement that fully eliminates double taxation or fully resolves taxation that is not in accordance with a tax treaty.

These instruments were promoted by the Belgian federal tax authority as key elements in dispute resolution. Therefore, the Belgian federal tax authority is continuously increasing the capacity of its staff specialising in this matter. MAPs are becoming more and more common but meet the following two major obstacles:

- the initiative lies with the taxpayer; and
- they involve a procedure that takes time, energy and money.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

There is currently little or no experience in Belgium of compensating adjustments in connection with transfer pricing claims; how this will work out in practice remains to be seen.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

By and large, local Belgian branches are taxed on an equal footing with Belgian subsidiaries, with the only major exception being that Belgium does not levy any *"branch profits tax"* in lieu of the dividend withholding tax to which Belgian subsidiaries are subject when distributing dividends to their parent companies or non-resident (corporate) shareholders.

5.3 Capital Gains of Non-Residents

Belgium does not impose (capital gains or other) tax on the sale of stock in a Belgian company by non-resident corporate shareholders. In exceptional circumstances, non-resident individual shareholders may be subject to Belgian capital gains tax on the sale of stock in Belgian companies, but not as a general rule.

5.4 Change of Control Provisions

Belgium does not have any change of control provisions that would apply to the disposal of an indirect holding in a Belgian corporation higher up the non-resident group or parent company. However, Belgium does have change of control provisions limiting the use of certain tax attributes – especially NOLs – by the Belgian corporation itself upon the occurrence of a change of control, unless such change of control is motivated by bona fide financial or economic reasons.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Minimum taxable profit formulas are used for non-resident taxpayers operating in Belgium through a branch only if:

- no tax return is filed;
- the tax return is filed late; or
- the book-keeping is not in accordance with normal business practices.

A comparison will then be made with at least three comparable taxpayers, and an absolute minimum of EUR47,800 of taxable profit per year will be applied.

5.6 Deductions for Payments by Local Affiliates

Belgium does not have specific standards for determining the deduction for payments by local companies for management and administrative expenses incurred by non-local affiliates. Any reasonable formula can be used (based on sales, staff or any other reliable criteria).

5.7 Constraints on Related-Party Borrowing

Belgium has a 5:1 thin capitalisation rule in place to limit the amount of deductible interest paid or owed by a local company – whether foreign-owned or not – to non-local ultimate beneficiaries. The interest on such loans (as well as on direct or indirect loans from lenders based in tax havens) is only deductible to the extent the tainted loans do not exceed five times the Belgian borrower's equity. In addition, for interest paid or owed directly or indirectly to tax-exempt or low-tax lenders, the burden of proof regarding the reality of the loans and the arm's length character of the interest rate is reversed; if the Belgian tax authorities reject the deductibility of such interest, it is up to the taxpayer to prove that the loans are real and genuine, and that the interest rate is at arm's length.

The interest on loans between related parties whose contract was concluded after 17 June 2016 is subject to the new interest deduction limitation based on EBITDA. For more information, please see **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Belgian resident corporations are taxed on their worldwide income, unless Belgium's right to impose tax is limited by any provisions of a bilateral tax treaty. The rule whereby foreign-source income that was not exempt in Belgium by virtue of a bilateral tax treaty was reduced to one quarter of the normal Belgian tax rate was repealed several years ago. Under specific circumstances, Belgium allows a foreign tax credit for dividends, interest and royalties that were subject to withholding tax in the source country.

6.2 Non-Deductible Local Expenses

There are no specific rules in Belgium to attribute costs or expenses to foreign income that is exempt from corporation tax in Belgium pursuant to the application of a bilateral tax treaty provision. For example, interest on a loan to acquire foreign real estate is not non-deductible by default, even though the income from such real estate will normally be exempt in Belgium by virtue of the applicable tax treaty (if any).

6.3 Taxation on Dividends From Foreign Subsidiaries

In principle, dividends from subsidiaries (foreign or Belgian) are taxed in the hands of a Belgian corporate shareholder but, subject to several conditions, such dividends will be 100% deductible by virtue of the dividends-received deduction.

The main conditions for the dividends-received deduction to apply are that the participation must be at least 10% in the share capital of the subsidiary or must have an historic acquisition value of at least EUR2.5 million, and that such participation must have been maintained for an uninterrupted period of at least one year (not necessarily prior to the distribution of the dividend). In addition, a complex subject-to-tax test applies to prevent dividends that have not been sufficiently taxed at the level of the subsidiary being exempt in Belgium.

6.4 Use of Intangibles by Non-Local Subsidiaries

Please see **2.2 Special Incentives for Technology Investments** and **9.4 Competitive Tax Policy Objective** regarding the specific rules on taxing income from intangibles developed by local corporations (and that may or may not be used by foreign subsidiaries). Other than that, the normal transfer pricing rules apply, which require the foreign subsidiaries to pay arm's length royalties or other remuneration for the use of such intangibles (as long as they are owned or licensed by the Belgian corporation). Also, the transfer of a locally developed intangible to a foreign affiliate will be required to be made on arm's length terms, and a (taxable) gain may have to be recognised and will be taxed in Belgium accordingly.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

At the end of 2017, Belgium introduced CFC rules that are mostly in line with the EU's ATAD, opting for the transactional approach. However, practitioners are of the view that those rules will rarely apply because an arm's length attribution of income to Belgium will normally follow from the application of the transfer pricing rules.

As of assessment year 2024, Belgium applies an entity approach, under which certain defined passive income (dividends, etc) of the CFC is taxable in the hands of the controlling company unless (among other things) the CFC has sufficient economic substance. In contrast to the previous regime, it would be much more effective in practice. For more information, please see **9.8 Controlled Foreign Corporation Proposals**.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no specific rules in Belgium to determine the substance of non-local affiliates, except the guidelines derived from a number of advance tax rulings in connection with interposed (mostly finance) companies in Luxembourg or other jurisdictions where interest, dividend or royalty income can be taxed at a low effective rate, with some planning. These criteria are quite formalistic (book-keeping, office space, knowledgeable local directors, complying with local tax and company laws, etc).

This does not mean that the syphoning off of *"Belgian"* profits to letterbox companies in low-tax jurisdictions will not be challenged on the basis of lack of substance in such jurisdiction, or even on the basis that such companies are effectively managed in Belgium and their profits are, therefore, subject to corporation tax in Belgium.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Under appropriate circumstances, Belgium exempts capital gains on shares in Belgian or non-Belgian affiliates. The conditions for this capital gains exemption are, by and large, the same as those that apply to the dividends-received deduction. For more information, please see **6.3 Taxation on Dividends From Foreign Subsidiaries**.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Belgium has a General Anti-Abuse Rule (GAAR) in place, under which transactions that are set up with the sole or predominant aim of benefitting from an advantageous tax rule (a deduction, exemption, deferral, etc) or avoiding the application of a disadvantageous tax rule can be recharacterised by the tax authorities such that the advantageous rule is denied or the disadvantageous rule takes effect. If the tax authorities make such assertion, the taxpayer has the right to demonstrate that they had substantial non-tax motives for entering into the transaction in the way it was set up.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

In principle, Belgian corporate taxpayers are audited every other year. In most instances, corporate tax and VAT audits will be conducted simultaneously. There is expected to be a major focus on taxpayers in an international environment in 2025. Data mining-based audits will play a prominent role here; for larger taxpayers especially, data mining will be used to seek *"suspicious"* elements that would warrant a more thorough audit.

There is a special audit team that focuses on transfer pricing, which can identify potential targets on its own (with the help of data mining) or it can be informed by the local tax inspectorate if the latter believes that a taxpayer may have substantial transfer pricing issues. If there is a suspicion of fraud or aggressive tax abuse, the Special Investigation Service may start its own investigation, independent from the local tax inspectorate.

In addition to audits based on data mining, so-called joint audits with other member states are also being used more frequently. Going forward, it can be assumed that the use of this technique will continue to increase.

9. BEPS

9.1 Recommended Changes

The following BEPS recommended changes have already been implemented:

- Action 2 (anti-hybrid rule and anti-abuse rules);
- Action 3 (CFC regulation);
- Action 4 (financing cost surplus);
- Action 5 (innovation income deduction + common reporting standard);
- Action 6 (prevention of tax treaty abuse, implemented in Belgium through the MLI);
- Action 7 (definition of *"permanent establishment"*)
- Actions 8–10 (transfer pricing);
- Action 12 (mandatory disclosure of aggressive tax planning schemes);
- Action 13 (master file and local file reporting);
- Action 14 (participation in the mutual agreement procedure); and
- Action 15 (the MLI).

9.2 Government Attitudes

The Belgian coalition government is generally in favour of BEPS – and the EU version of BEPS, ATAD I and ATAD II – and is seeking to comply with it without much *"gold plating"*. Belgium wants to stay competitive in order to attract inward investments from the most significant trading partners, such as the USA, Japan, Canada, Germany, France, etc.

Belgium implemented the European Directive on ensuring a global minimum level of taxation for multinational groups at the end of 2023. This fits within the framework of the OECD's Pillar Two initiative and has been applicable since 1 January 2024. In essence, the objective is that a qualifying multinational or *"substantial domestic group"* will pay at least 15% corporate tax on its *"excess profits"* in each jurisdiction in which it operates.

9.3 Profile of International Tax

Since the publication of LuxLeaks, the Panama Papers and similar reports, public interest in international tax has grown substantially, which certainly increases pressure on the present coalition government to close a number of international loopholes (with BEPS-compliant anti-hybrid measures, the introduction of a BEPS-compliant interest limitation rule, etc).

9.4 Competitive Tax Policy Objective

The Belgian legislature has already transposed the BEPS and ATAD measures without much *"gold plating"*, to create a level playing field with other jurisdictions that offer similar non-tax benefits to potential or existing inward investors. A good example is the transformation of the Patent Income Deduction into the Innovation Income Deduction, which includes the nexus rule imposed by BEPS but widens the scope compared to the former regime and covers, inter alia, copyright-protected software (under the former regime, only income from patents was eligible for the beneficial regime, which entailed an 80% exemption of qualifying gross income, whereas the new regime exempts 85% of qualifying net income).

Also, the headline CIT rate has been reduced to 25%, in order to be competitive with jurisdictions such as the Netherlands and Luxembourg, which often compete for the same inward investments as Belgium.

In addition, Belgium has an interesting tax regime in place for employing highly qualified researchers working in the R&D industry in Belgium by allowing the employer to keep 80% of the wage withholding tax that must normally be transferred to the Revenue Service for itself, thereby substantially reducing the gross cost of employing such workers. Only 20% of the normal wage withholding tax has to be effectively transferred to the Revenue Service, while the employees are entitled to credit 100% against their personal income tax liability.

Yet another strong feature of Belgium's international tax system is the participation exemption, which now exempts 100% of qualifying dividends (up from 95%) and capital gains deriving from qualifying participations in other Belgian or non-Belgian companies.

Last but not least, a well-functioning Ruling Commission allows for reliable advance tax rulings on all kinds of anticipated investments and other transactions (including unilateral and multilateral transfer pricing issues), creating advance legal certainty in areas of law where there would otherwise be a relatively high degree of uncertainty and *"litigation risk"*.

9.5 Features of the Competitive Tax System

The most vulnerable feature of the Belgian (international) tax regime that remained after the transposition of BEPS and ATAD I and II was the so-called Expat Regime, which essentially provided for an attractive income tax regime for highly qualified workers temporarily seconded to Belgium. A new tax regime for inbound taxpayers and researchers came into force on 1 January 2022. The benefits of both favourable regimes lie in the exempted reimbursement of certain expenses, recurring additional costs and specific reimbursements, in addition to the salary. Under the new regime, expats will no longer be able to invoke the automatic granting of a non-resident tax status in Belgium, thereby eliminating the situation of tax statelessness.

9.6 Proposals for Dealing With Hybrid Instruments

Belgium has already implemented rules to deal with hybrid instruments, defining what is to be understood by the term *"hybrid mismatch"*.

Tax rules targeting hybrid mismatches cover the following, inter alia.

- Hybrid mismatch arrangements – profits of an EU-based establishment that are realised through such an arrangement and that are not considered taxable in the permanent establishment's jurisdiction will be taxable at the level of the Belgian head office.
- Hybrid entities – such entity incorporated or established in Belgium will be considered to be a taxable entity in Belgium if one or more associated non-resident entities is established in one or more jurisdictions that consider the Belgian entity to be taxable. The hybrid entity's income will be taxed in Belgium to the extent that it is not already taxed under the laws of Belgium or any other jurisdiction. This rule does not apply to collective investment vehicles.
- Hybrid mismatch payments – such payments are considered a non-deductible expense for the Belgian payer if the receipt thereof does not give rise to a corresponding inclusion at the level of the non-Belgian recipient.

While these new rules are very technical and complex, they would seem to be compliant with BEPS and ATAD, without too much overkill, although it remains to be seen how these highly technical rules will pan out in practice. On 22 October 2024, a circular letter was published regarding the rules transposed into Belgian law from the European directives aimed at combatting tax avoidance practices through hybrid mismatches.

9.7 Territorial Tax Regime

Belgium does not have a territorial tax regime. A Belgian resident company is liable to CIT on its worldwide profits and income, while a non-resident company is taxed in Belgium on its Belgian-source income only.

9.8 Controlled Foreign Corporation Proposals

Although Belgium has a worldwide tax system rather than a territorial one, it introduced comprehensive CFC rules at the end of 2017, which are mostly in line with the EU ATAD. Under the new Belgian CFC rules (as of assessment year 2024), there is an entity approach under which certain defined passive income (dividends, etc) of the CFC is taxable in the hands of the controlling company unless (among other things) the CFC has sufficient economic substance. On 13 December 2024, a circular letter was published to clarify the amended CFC rules.

Said CFC rules stay defective in two significant ways:

- practitioners are of the view that the rules will rarely apply because an arm's length attribution of income to Belgium will normally follow from the application of the transfer pricing rules; and
- the above CFC rules may create situations of effective double taxation of the same income with different companies of the group, despite the specific measure to avoid double taxation.

Neither the EU ATAD nor the Belgian implementation thereof determines how double taxation is prevented if Belgium and another member state simultaneously apply their respective CFC legislation.

Multiple arguments can be made against the introduction of a sweeper CFC rule into Belgian law. For example, it seems at least unfair to tax the income of a foreign subsidiary with adequate substance just because it is a resident of a tax haven. In this respect, it must be noted that the Belgian rule excludes the income of the CFC to the extent that it is realised through its own significant people functions.

9.9 Anti-Avoidance Rules

In practice, it remains to be seen whether the double taxation convention limitation of benefit or anti-avoidance rules will have an impact in Belgium. In April 2018, Belgium's highest tax court (the Court of Cassation) ruled that income earned by a Belgian-resident sportsman from activities performed in the Netherlands remains tax exempt in Belgium (by virtue of Article 17 of the 2001 bilateral treaty between Belgium and the Netherlands), although the same income had not effectively been taxed in the Netherlands, and notwithstanding the *"subject-to-tax"* clause in the 2001 treaty. The inclusion of the subject-to-tax provision in Article 23(1) was seen as an anti-abuse provision, which should prevent double non-taxation. Please note that the same Court of Cassation ruled again on 6 September 2024 that such income (this time originating from a pension) must be exempted in Belgium, even if it was not effectively taxed in the Netherlands.

9.10 Transfer Pricing Changes

The Revenue Service has increased its attention on transactions whereby IP assets are transferred out of the country. In a notorious case, the Special Investigation Team of the Belgian Revenue Service challenged the transfer of a patent application to a non-Belgian related entity as *"sham"*. The case was decided in favour of the taxpayer by the Tribunal of First Instance, but the Revenue Service has appealed the case.

The Court of Appeal later ruled again in favour of the taxpayer, stating that the transfer of the patent application had a real substance, rather than being *"sham"*.

9.11 Transparency and Country-by-Country Reporting

Most Belgian practitioners are not opposed to transparency or CbC reporting, with the following stipulations:

- administrative formalities and red tape should be kept within reasonable proportions;
- the additional revenue that is expected to be generated by such systems should lead to a reduction of the headline (corporate) income tax rates and/or the paying off of Belgium's public debt (which currently exceeds 100% of the country's GDP), rather than the creation of additional government spending; and
- when taxpayers comply with transparency and CbC reporting rules for several years in a row, they should earn *"compliant taxpayer"* label and enjoy less cumbersome and time-consuming tax audits in return.

9.12 Taxation of Digital Economy Businesses

No statutory changes have yet been made, but Belgium supports the OECD's initiatives to consider certain *"light"* forms of presence in the country as a permanent establishment to which profit has to be allocated (and taxed).

9.13 Digital Taxation

The Belgian coalition government is in favour of a multilateral approach toward digital taxation, preferably in co-operation with the OECD or EU. In the so-called Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, some countries, including Belgium, decided that the withdrawal of already existing national digital tax regimes in countries that had already individually introduced a national digital tax will be co-ordinated. The European Commission was due to propose a directive on a tax for digital services during mid-2021. Although the rollout of a digital taxation remains high on the European agenda, this proposal is still on hold.

9.14 Taxation of Offshore IP

Belgium has not yet introduced any provisions dealing with the taxation of offshore intellectual property.

Trends and Developments

Contributed by:
Jérôme Terfve, Sabrina Scarnà, Pauline Maufort and Ella Harnett
Tetra Law

Tetra Law was established in 2012 and is a business law firm with offices located in Brussels. It has rapidly emerged as a significant presence in all fields related to corporate and personal taxes, tax litigation and white-collar crime, corporate law, M&A, and labour law.

Authors

Jérôme Terfve is a highly regarded lawyer in the field of corporate and tax law and a partner at Tetra Law. Jérôme focuses on the economic activity of businesses. He advises them on tax, accounting and corporate law issues. He assists in the planning and implementing of structuring and restructuring strategies, in developing M&A operations and in setting up remuneration and planning policies intended for their executives and managers. He also assists clients with the obtaining of advance rulings and in litigation. He is the author of various publications, a lecturer and is frequently invited to speak at conferences.

Sabrina Scarnà is a widely recognised lawyer who specialises in tax law and white-collar crime and is a partner at Tetra Law. Her practice includes assisting clients with their estate planning, tax audits, compliance with the anti-money laundering laws and with the repatriation of funds. She is also an expert in white-collar crime and assists her clients in financial criminal proceedings. She acts at all stages of the procedure: administrative and judicial. She has a strong reputation and has successfully achieved precedent-setting decisions. Sabrina contributes to various publications, is a lecturer and is frequently invited to speak at conferences.

Pauline Maufort is counsel at Tetra Law and a promising talent and rising star in her fields of expertise. She advises and assists clients in all fields related to tax law (including asset structuring and estate planning in a national and cross border context) and white-collar crime. She offers counsel and assists clients in litigation, at every stage of the procedure (administrative and judicial). Pauline also specialises in the Cayman tax and is well versed in its practical impact and how it applies to those concerned. Pauline regularly publishes scientific articles in specialised publications.

Ella Harnett is a lawyer and associate at Tetra Law. She provides tax and legal assistance to individuals and/or companies in national and cross-border situations with the planning, structuring and transfer of their assets. She also defends their interest in litigation, at all stages of the procedure. Ella has authored various publications in her areas of expertise.

Tetra Law

Avenue Louise 240/3
1050 Brussels
Belgium

Tel: +32 2 535 73 28
Email: ss@tetralaw.com
Web: www.tetralaw.com

TETRALAW

Contributed by: Jérôme Terfve, Sabrina Scarnà, Pauline Maufort and Ella Harnett, **Tetra Law**

Belgium Reinforces its Arsenal Against Foreign Low-Taxed Entities… and Risks Further Frustrating EU Freedom of Movement

Introduction

Disregarding entities for tax purposes when they benefit from foreign low-taxed regimes is the latest trend in the Belgian set of rules to fight tax evasion.

A bill of 22 December 2023 illustrates this tendency perfectly. It introduces amendments to two existing measures which will sensibly change Belgium's approach to look-through taxation:

- the bill reinforces Belgium's so-called controlled foreign company regime (CFC) which allows the tax authorities to disregard foreign entities controlled by Belgian companies by taxing their passive income directly to the Belgian controlling entity as if it were its own; and
- the bill also makes considerable changes to the Belgian so-called *"Cayman Tax"* which applies to natural persons who reside in Belgium and hold interest in a low-taxed foreign entity.

If the CFC regime is a well-known anti-abuse provision that Belgian law incorporated under EU pressure when it transposed the ATAD Directive, the Cayman Tax is a Belgian invention which aims to make ineffective the holding, by natural persons, of private assets through *"offshore"* entities which are little to not taxed (referred to as *"floating estates"*).

This tax was introduced in the Belgian income tax Code by a law of 10 August 2015 and has since undergone several changes, the last of which came with the aforementioned bill which entered into force on 1 January 2024.

This bill was intended to amend the Cayman Tax in areas identified as lacking to reach its purpose. In practice, however, this translates into a system which reaches far beyond this purpose and could entail material breaches of EU Law. Belgian resident shareholders of entities which were never intended to avoid taxes are likely to be impacted.

The Cayman tax in a nutshell

Entities that qualify as legal structures

Entities that fall under the purview of the Cayman tax are referred to as *"legal structures"*. The Cayman Tax knows three categories of legal structures:

- Category 1: trusts;
- Category 2: low- or non-taxed entities with legal personality; and
- Category 3: an entity of category 1 or 2 combined with an insurance contract.

The present contribution will concentrate on category 2 structures (companies and associations).

Entities that are established in a non-EEA state qualify as a low or non-taxed entities of category 2 when they undergo taxation in their state of residence at a level lower than 15% of a taxable base determined under Belgian law. This rate is lowered to 1% when the entity is established in the EEA.

Belgium based companies and associations, by definition, exceed these minima and will therefore never qualify as legal structures. Entities based outside of Belgium may very well fall under its purview, if only because of country differences in the calculation of taxable bases.

A common example of these differences is the implementation of the participation exemption in the different EU member states, with certain States requiring companies to meet lower thresholds to benefit from the regime than those applicable in Belgium. The Soparfi can be a striking example of such a situation if, for a given year, its sole income is tax exempt dividends distributed by its daughter company in which it holds a participation which meets the Luxembourg minimum of EUR1.2 million but not the Belgian minimum of EUR2.5 million

Other differences could lead to the same result, such as the difference in rules regarding disallowed expenses or abnormal or gratuitous benefits.

Accordingly, Belgian residents who hold shares in foreign companies should in theory assess every year whether these can be considered *"reasonably taxed"* under the Cayman Tax. In practice, this assessment is not always carried out, especially for companies which carry out an economic activity as these are excluded from the Cayman Tax's effects.

Look-through taxation

Legal structures are treated as transparent for fiscal purposes: their income is taxed to their Belgian resident founder – in the meaning provided for in the law – as if it were their own (ie, no conversion of the income's nature).

Excluded from the look-through regime are entities:

- established in a state which exchanges information with Belgium;
- that exercise an economic activity (except management of their founders' assets); and
- that have premises, staff and equipment at their disposal.

This exception is referred to as the substance-based exception.

The applicability of the look-through regime versus a double tax treaty (DTT) remains uncertain. An entity qualifying as *"person"* and *"resident"* under the DTT could argue for its application, avoiding transparent taxation – one reason taxpayers do not systematically conduct the annual Cayman Tax assessment. While one taxpayer reached an agreement with the tax authorities on this issue, their official position, published in late 2024, contradicts that agreement.

Taxation of distributions as dividends

Any and all distributions made by legal structures are taxable as dividends. The legal structure, considered non-existent when it receives income, therefore regains a fiscal reality when it makes distributions.

To prevent double taxation of the same income (first upon receipt and then upon distribution), the Cayman Tax provides that income which has already been taxed transparently in Belgium is exempt from taxes when it is distributed. The oldest income is presumed to be distributed first to ensure that an entity's accumulated reserves prior to becoming a legal structure are used up first (the *"first in, first out"* or *"fifo"* rule).

Distributions made by entities with sufficient substance do not fall under the aforementioned rule.

Other implications

Other consequences arise when an entity qualifies as a legal structure.

The existence of the legal structure has to be mentioned by the relevant tax payer in their tax return. Not doing so could lead to a EUR6,250 fine, applicable per tax year and per legal structure.

When the tax payer's return mentions/should mention the existence of a legal structure, the statute of limitations to tax an incorrect or incomplete filing is automatically extended to ten years.

The Cayman tax: unpredictable, penalising and contrary to EU freedom of movement

The Cayman Tax's unpredictable application to foreign category 2 entities, especially holding companies which cannot claim the substance-based exclusion, is an ongoing issue. A reasonably-taxed foreign holding structure could, from one year to the next, qualify as a legal structure, or not, simply because of country differences in calculation of taxable bases. Applied to EU-based companies and associations, this unpredictable scope of application has raised serious questions of conformity with EU laws and the four principles of freedom of movement: persons, capital, goods and services.

One would have hoped the new bill of 22 December 2023 would have resolved the issue. In pursuit of strengthening the Cayman Tax, the Belgian legislator seems to have lost sight of the tax's objective, extending the existing issue of predictability and – in some situations – penalising the use of legal structures with no legitimate reason. This can be illustrated by the following amendments.

The existing issue of predictability

If the European case law allows for restrictions to the freedom of movement, these must be based on a legitimate objective and be proportionate to that objective. One aspect of a provision's proportionality is its legal certainty: is it clear, precise and predictable with regard to its effects, in particular where it may have unfavourable consequences for individuals and undertakings? When a rule of law is unpredictable, it is not proportionate to the legitimate objective it pursues as it risks targeting situations that are outside that objective.

The European Court of Justice confirmed the application of these principles to tax provisions seeking to prevent tax evasion/avoidance. The Court confirmed a tax provision is unpredictable and therefore never proportionate to its legitimate anti-tax avoidance objective when its scope of application is not circumscribed with sufficient precision at the outset and its application remains a matter of uncertainty.

The Cayman Tax's uncertain application to EU based holding companies from year-to-year raises a real question of compliance with these principles and can have important implications in practice. Take for instance the situation of a holding company which from one year to the next qualifies as a legal structure. Its income and its distributions will qualify as taxable dividends. If it no longer qualifies as such when it distributes the income taxed transparently, the Belgian resident shareholder will never be able to mitigate double taxation: they cannot claim the exemption on the basis of the past transparent taxation as it only applies to legal structures. In such a situation, the Cayman Tax's unpredictable application leads to double taxation of the same income.

A new imperfect look-through regime

One of the major changes to the Cayman Tax pertains to the aforementioned exemption of distributions when the distributed income has already been taxed transparently in Belgium. Starting 1 January 2024, the exemption of distributions will only apply to income which, when it was taxed transparently in Belgium, has effectively led to payment of taxes in Belgium.

Prior to this change, effective taxation was not required, as long as the income had undergone its normal tax regime in Belgium. This meant a 30% flat tax rate for interest and dividends and an income tax exemption for most capital gains on shares. The look-through regime was *"perfect"* in the sense that it acted as if the legal structure did not exist.

Moving forward, all distributions of dividends and interest will be exempt but distributions of tax exempt capital gains will qualify as a taxable dividend. The entire Cayman Tax's logic is turned on its head: rather than treating income placed in low or non-taxed foreign entities as if they didn't exist, they are now treated more harshly.

An illustration of the harsh nature of this rule can be found in its combination with the new presumption applicable to dedicated UCIs. From 1 January 2024 onwards, foreign UCIs are presumed to constitute legal structures when they are *"not collective"* or *"dedicated"*. Other UCIs are excluded from the Cayman Tax's scope of application provided they meet the requirements of the UCITS directive 2009/65/CE or their manager meets the requirements of the AIFM directive 2011/61/UE.

A UCI is dedicated when more than 50% of its shares are held by a single person or by several persons linked to each other. A person is considered linked:

- to relatives to the fourth degree;
- spouses;
- legal cohabitants;
- individuals domiciled at the same address; and
- individuals or entities that exercise control over another entity (eg, majority of voting rights).

Except if proven otherwise, a UCI is presumed to be dedicated when its manager receives instructions from the UCI's shareholders or when no independent asset manager has been appointed.

The legislator did not want the fiscal advantages generally granted to UCIs to be misused for purposes that are not linked to promoting and facilitating investment, say by families who might be tempted to make use of these types of structures and their fiscal advantages to retain their assets.

If the perfect look-through regime could reach that objective, the new imperfect regime goes far beyond. All capital gains on shares realised by foreign dedicated UCIs are from now on taxable – if not upon receipt, upon distribution. This includes capital gains realised and reserved before 1 January 2024 and distributed after.

But why should investing via a foreign dedicated UCI be more heavily taxed? The dedicated UCI does not facilitate avoidance of taxes on capital gains – there would have been none had the assets been held directly. Rather than counteract tax avoidance, the Cayman Tax now penalises, with no legitimate reason, the use of foreign structures such as foreign dedicated UCIs.

The use of dedicated UCIs is generally justified by a family's wish to professionalise their investment taking into account their shareholder structure (only members of the same family) and investment type (not limited to listed transferable securities).

Belgium does not offer the legislative framework to reach these families' objective: Belgian investment vehicles either don't allow the shareholder structure to be exclusively composed of members of the same family (the Belgian private Pricaf) or, when they do, their investment category is exclusively limited to real estate (the Belgian FIIS). In the absence of a Belgian solution, families have looked elsewhere for a legislative framework which matches their needs. The Luxembourg RAIF is one such example.

There are many other reasons a Belgian resident tax payer may have opted for a foreign structure at a given time. For instance, expatriates might hold shares in foreign holding companies according to a set up that is perfectly common in their home country but could qualify as legal structures under the Cayman Tax.

These tax payers made a choice at a given time which suited their personal needs and situation. If a perfect look-through regime can be justified to some extent, there is no legitimate reason an additional tax burden should now be imposed on them. When the foreign dedicated UCI or holding company is a EU-based entity, this is a clear violation of EU freedom of movement.

The newly adopted government agreement reveals a plan to introduce a 10% tax on capital gains, set to take effect in 2026, with a general exemption for:

- all gains below EUR10,000;
- all gains accrued before the measure's entry into force; and
- participations exceeding 10%.

A key question is how this tax will interact with the Cayman tax and whether it will resolve capital gains taxation upon distribution. In principle, taxed gains should be eligible for tax-free distribution, but this may not apply universally – for instance to gains accrued before the law, creating an evidentiary challenge in distinguishing pre- and post-reform gains.

The new notion of intermediary structure

Starting 1 January 2024, the notion of intermediary structure is introduced in the Cayman Tax. This is, according to the legislator, to prevent avoidance of the Cayman Tax through the addition of a reasonably taxed entity between the Belgian resident founder and the legal structure.

Accordingly, a company, regardless of where it is located and whether or not it is itself a legal structure, is considered an intermediary structure when there is a legal structure at any level further down the chain of ownership. The intermediary structure will itself not be subject to the Cayman Tax, however, its existence will not prevent the fiscal transparency and taxation of distributions of any and all entities further down the chain of ownership which qualify as legal structures.

Again, this is inconsistent with the Cayman Tax's objective. When a company does not fall within the scope of the Cayman Tax, it is precisely because it is reasonably taxed and, therefore, the income it would receive from a daughter entity will be taxable to it, as the parent company, and, when it distributes the income to its own shareholders, the income will again be taxable to these shareholders. There is no taxation void which needs to be filled with the introduction of this new notion of intermediary structure.

With EU-based companies, any risk of tax evasion or avoidance is further covered by the CFC regime and the mother-daughter regime exclusion that applies to non-genuine entities. Thankfully, to prevent dual application of transparency regimes, an exclusion is provided for when the entity is already taxable transparently to its parent company under the Belgian CFC regulations.

No valid reason explains why this exception only applies when the intermediary structure is a company subject to Belgian income taxes. The CFC regime, derived from an EU directive, is transposed across member states, meaning a CFC held by a parent in another member state should also qualify for exclusion. Any other conclusion violates EU freedom of movement principles.

The new notion of intermediary structure introduces a new look-through layer of taxation: the daughter company's income is taxable transparently to the Belgian resident founder as if it were their own, even if their share in said entity is held through another, reasonably taxed, entity. In addition to exceeding the Cayman Tax's objective, this new notion is likely to be highly penalising for Belgian income tax residents.

Not only will they be exposed to a risk any entity in a group could randomly fall under the Cayman Tax (issue of legal certainty), when an entity does qualify as a legal structure, its income will be taxable to the Belgian shareholder and that shareholder will be faced with the practical issue of mitigating the double taxation he suffers from this new and unforeseen look-through taxation.

In theory, mitigation is achieved by allowing the transparently taxed income to flow up the chain of ownership to be distributed to shareholders tax free. In practice however, for shareholders, this entails having full knowledge of the chain of ownership as well as having access to all of the data which will allow them to know whether an underlying entity is a legal structure or not, what income it receives, and what it distributes to its parent company.

When asked about this issue, the Finance Minister confirmed publicly listed companies and (non-dedicated) UCIs would never constitute intermediary structures as it is impossible for their shareholders to obtain the necessary information. Confirmation cannot be found in the text itself but is included in the bill's preparatory works.

For unlisted companies, on the other hand, shareholders – even those with a minority shareholding – are considered able to gather all the necessary data. In our opinion, this conclusion is presumptuous and, if they can't obtain it, they won't be able to mitigate the new look-through taxation. What of a group with a listed entity further down the chain of ownership for instance?

Even if the information can be obtained, there is also the additional issue of shared jurisdiction to levy taxes on dividends distributed by foreign intermediary structures: if the Belgian taxes on the dividend can be mitigated, what about the foreign withholding tax (widely allowed at a reduced rate by DTTs)? Will the applicable DTT offer a solution? It is highly doubtful: how could these international treaties foresee a situation which was created after their adoption?

As for the absence of a grandfathering clause, it creates yet another predictability issue. All legal structures which, until now, have not been taxed transparently (because they were held through an intermediary structure) will see their distributions taxed as dividends, at least until the reserves they have accumulated prior to qualifying as legal structures have been entirely drained (fifo).

Exit tax

As part of the Cayman Tax's measures to prevent tax payers from avoiding its application and to encourage the repatriation of assets to Belgium, the new law introduces two cases in which an exit tax is due.

All of a structure's *"accumulated profits"* is *"deemed to have been distributed"* to its founder when:

- the economic rights, shares or assets of the legal structure are transferred to another legal structure or entity or are transferred to another state (other than Belgium); and
- the legal structure's founder transfers their fiscal residence to another state.

A fictional dividend is therefore deemed distributed which means, in the absence of a grandfathering clause, that all accumulated reserves will be taxable as dividends, even when they were constituted before the founder became a resident of Belgium and even if, at that time, the entity was not a legal structure.

The text does not provide for any possibility to exclude the application of the exit tax by proving the transfer does not occur for tax purposes. The text also does not provide for the possibility to take into account a situation *"upon entrance"*.

For instance, what of the situation of the shareholder of a Luxembourg Soparfi who intends to move to another state? If the move occurs in a year when the Soparfi qualifies as a legal structure, all of its undistributed profits would qualify as a taxable dividend, irrespective of the fact that it might not have qualified as a legal structure in the years prior to the move or that the move is not driven by any fiscal motives. When the transfer occurs within the EU, this is in our opinion another clear violation of EU freedom of movement.

This is a major issue for Belgium. Any person who moves to Belgium for professional or personal reasons for a couple of years before moving elsewhere could fall under this rule if they are the founder of – directly or through an intermediary structure – an entity that qualifies as a legal structure.

Fortunately, the liquidation fiction does not apply when the exceptions to transparent taxation are met, in particular the exception applicable to foreign entities with sufficient substance. The notion of intermediary structure however complicates things: it is not sufficient to prove the company the Belgian resident holds shares in has sufficient substance, all further entities have to meet this requirement to also benefit from the exclusion.

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With these newly adopted amendments, the Cayman tax is not only unpredictable in its application, it is disproportionate to its purpose. It is expected that the Cayman tax's numerous EU law violations will be addressed by the competent courts.

BRAZIL

Law and Practice

Contributed by:
Júlio de Oliveira, Stephanie Makin and Antonio Carlos Harada
Machado Associados

Contents

Machado Associados is a leading Brazilian law firm with a particular specialisation in tax, assisting clients across diverse business sectors in strategic tax issues. The firm's tax department is divided into three areas: (i) advice on direct taxes, transfer pricing and international taxation; (ii) advice on indirect taxes and customs duties; and (iii) tax litigation. Despite this administrative division, all areas work in a coordinated manner to offer a comprehensive service to clients. Machado Associados has offices in São Paulo (headquarters), Brasília, and Rio de Janeiro. The tax team has multidisciplinary training, with graduates in law, accounting, and business administration. This is of particular importance in highly complex cases involving business, economic, operational, and logistical aspects that need to be properly addressed in tax advice and litigation strategies.

Authors

Júlio de Oliveira is the leading partner of the indirect tax and tax litigation practice areas at Machado Associados, with more than 30 years' experience. He advises large domestic and international companies, with a particular focus on the cosmetics industry. He regularly advises multinationals on a range of direct and indirect tax matters. Júlio is part of several committees and associations made up of companies that seek to improve the Brazilian tax system. He is a regular speaker and author of several books and articles in Brazil and abroad.

Stephanie Makin is a partner in the tax consulting area at Machado Associados, focused on direct taxes, international taxation and transfer pricing. She has worked on major corporate restructuring cases and M&A transactions involving several countries and also assists clients making foreign investments and doing business in Brazil, as well as Brazilian clients investing abroad, with a strong focus on the impacts of Brazilian CFC rules and the effects of the double tax treaties signed by Brazil. Her practice also focuses on the preparation/review of transfer pricing calculations and solving transfer pricing issues for clients doing business internationally.

Antonio Carlos Harada has broad experience in tax consulting, particularly in tax, estate and succession planning; transnational transactions; corporate reorganisations; M&A; and corporate and social security legislation. He has extensive experience in tax and corporate structuring focused on the development of real estate transactions with shopping malls, real estate developments, real estate investment funds, *"built to suit"*, and securitisation of receivables. He has acted for renowned accounting/audit firms, where he had the opportunity to consolidate his knowledge of tax operations across various sectors.

Machado Associados

Avenida Brigadeiro Faria Lima, 1656
11th floor
01451-918
São Paulo/SP
Brazil

Tel: +55 11 3819 4855
Fax: +55 11 3819 4855
Email: machado@machadoassociados.com.br
Web: www.machadoassociados.com.br/en/

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form in order to perform their economic activities in Brazil. The main corporate forms used by businesses are corporations (*sociedade anônima*) and limited liability companies (*limitada*).

Sociedade Anônima

As a rule, a *sociedade anônima* must have at least two shareholders, which can be individuals or legal entities, residents or non-residents. However, the Brazilian Corporations Law establishes that exceptionally a *sociedade anônima* can be (i) incorporated as a wholly owned subsidiary, by public deed, as long as the sole shareholder of the corporation is a Brazilian company; or (ii) converted into a wholly-owned subsidiary as a consequence of the acquisition of its shares by a Brazilian company or merger of its shares into a Brazilian company.

There is no minimum capital requirement, and the liability of shareholders is limited to the price of the shares subscribed or acquired by them.

A *sociedade anônima* can be publicly held, if the securities issued are admitted for trade in capital markets, or closely-held, if the securities issued are not admitted for trade in capital markets.

Limitada

There is no minimum number of partners required to incorporate a *limitada*. As such, it is possible to incorporate a *limitada* with only one partner (*limitada unipessoal*).

There is also no minimum capital requirement and the liability of the quotaholders is limited to the amount of their respective quotas, but all quotaholders are jointly liable for the paying up any unpaid portion of the quota capital.

Limitadas cannot be publicly held.

Brazilian legislation also allows foreign companies to incorporate branches in Brazil and establishes that such a branch shall be treated as a Brazilian legal entity for tax purposes. The tax deductibility of expenses not associated with the activities of the branch in Brazil is accordingly restricted.

The establishment of a foreign company's branch depends on a special permit granted by the federal government of Brazil and any amendment to the company by-laws or its articles of association requires the approval of the federal government in order to be valid in Brazil. In view of this, it is not common for foreign companies to incorporate branches in Brazil.

1.2 Transparent Entities

The most commonly used transparent entities in Brazil are consortiums and investment funds.

Consortium

Commonly used to explore public concessions, a consortium is an association set up by two or more companies for a predetermined amount of time to carry out a specific project or undertaking.

The member companies of a consortium are liable for their obligations as established in the consortium agreement, which must be registered in the Commercial Registry. As a rule, there is no joint responsibility between the member companies of a consortium, unless required in specific legislation.

Revenues, costs and expenses registered by the consortium shall be shared according to the provisions of the consortium agreement and the member companies must include such revenues, costs and expenses in their own results, according to their percentage of ownership in the consortium.

Investment Funds

As transparent entities, the income generated by investment funds is taxed at the level of the investors, and the fund manager is liable for withholding the income tax due.

The taxation of the investors in investment funds will vary according to the type of fund, the area of investment and the length of the investment (ie, long-term or short-term).

1.3 Determining Residence of Incorporated Businesses

In order to determine the residence of a legal entity for tax purposes, Brazilian tax legislation takes into consideration only the place of incorporation of the legal entity, meaning that any kind of legal entity that is incorporated in Brazil will be considered as a Brazilian resident and taxed as such, regardless of its place of effective management.

1.4 Tax Rates

Businesses in Brazil, even if they are owned directly by individuals, are subject to corporate income tax (IRPJ) at a 15% rate. A surcharge of 10% is applicable for taxable income exceeding BRL240,000 per year (approximately USD40,000).

In addition to the IRPJ, a social contribution on net profit (CSLL) is also due by Brazilian companies at a 9% rate, except for financial entities, which are currently subject to 15% or 20% rates, depending on the financial activity performed.

In the context of the implementation of Pillar 2 rules in Brazil, an additional contribution to the CSLL has been created, in force as of 2025, to meet the requirements of a Qualified Domestic Top-up Tax (QDMTT). Although still referred to as CSLL, the characteristics of the additional CSLL are quite different from the ordinary CSLL.

In line with Pillar 2 rules, the additional CSLL may be due by companies that are part of a multinational group and that have generated annual revenues of EUR750,000,000.00 or more, reflected in the consolidated financial statements of the Ultimate Parent Entity (UPE) in at least two of the four fiscal years immediately preceding the year under analysis.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Brazil legal entities may be subject to the calculation of IRPJ and CSLL based on the following two main regimes: actual profit or deemed profit.

Actual Profit System

Under the actual profit system, the taxable income corresponds to the accounting profit accrued by the company adjusted in accordance with the additions and exclusions set forth by tax legislation, minus the offsetting of accumulated tax losses from previous years (limited to 30% of the adjusted profit). The main tax adjustments are:

- permanent additions – eg, non-deductible expenses, profits earned abroad and losses resulting from the equity pick-up method of accounting;
- permanent deductions – eg, profits resulting from the equity pick-up method of accounting, interest on net equity and tax benefits;
- temporary additions – eg, provisions; and
- temporary deductions – eg, differences in depreciation between tax and accounting criteria

Deemed Profit System

The deemed profit system may apply to companies with yearly revenues of up to BRL78 million (approximately USD13 million) or companies that are not mandatorily subject to the actual profit system. Under the deemed profit regime, the taxable basis corresponds to deemed percentages of the gross revenues of the company (such percentages vary from 1.6% to 32% depending on the activities of the company) plus other taxable revenues, without any deductions for costs and expenses or tax losses carried forward. Accrual or cash basis may apply.

2.2 Special Incentives for Technology Investments

Lei do Bem

A special incentive for technological innovation (the lei do bem) is applicable to legal entities that carry out research on new products and manufacturing processes, and improvements in quality, productivity and competitiveness of existing products and manufacturing processes. This technological innovation incentive provides for the following benefits.

IRPJ and CSLL benefits:

- deduction of expenses related to technological innovation R&D;
- additional exclusion from the IRPJ and CSLL taxable basis of percentages varying from 60% to 100% of the expenses related to technological innovation R&D (conditions must be met);
- full depreciation in the year of acquisition of new assets used in technological innovation R&D; and
- accelerated amortisation of costs with the acquisition of intangibles linked to the technology innovation R&D.

Other benefits:

- 0% withholding tax on payments or credits to non-residents for the registration and maintenance of trade marks, patents, and cultivars abroad;
- 50% reduction of the excise tax (IPI) levied on the purchase of assets destined for technological R&D; and
- government subvention of up to 60% of the value of the remuneration of researchers holding master's or PhD degrees.

Companies in the automotive sector that invest in R&D or in the production of technology in the country may benefit from financial credits corresponding to 50% of the amounts disbursed with these R&D investments, limited to 5% of the total gross revenue from the sale of goods and services in the second calendar month prior to the month in which the credit is calculated. Such financial credits will be granted in the form of CSLL credits that may be offset against federal taxes due by the companies or be refunded in cash.

2.3 Other Special Incentives

Brazilian tax legislation provides for IRPJ incentives in order to promote the development of certain regions' economic sectors.

Incentives for Regional Development

Companies in the North and Northeast of Brazil may benefit from a 75% IRPJ reduction if their activities are considered as a priority (such activities are defined by Presidential Decrees). In general terms, taxpayers may benefit from this reduction for a ten-year period provided they apply and have their projects approved before 31 December 2028. The benefit shall be approved by the Brazilian Federal Revenue Service based on a prior technical analysis of the regional Superintendencies (SUDAM/SUDENE).

The IRPJ reduction only applies to profits directly related to certain encouraged economic activities (eg, infrastructure related to energy, telecommunications, transportation, pipeline installation, gas production, water supply, and sanitation services projects; tourism; manufacturing industry in several areas including machinery and equipment, food and beverages, and pharmaceuticals; electro-electronic, mechatronics, information technology, and biotechnology; and the component industry).

Oil and Gas Sector Incentives

Companies that act in the oil and gas sector in Brazil may fully deduct from the IRPJ and CSLL taxable basis expenses and depreciation/exhaustion charges related to the exploitation of oil and gas. In some situations, an exemption of withholding income tax may apply.

Agricultural Sector Incentives

Companies that act in the agricultural sector in Brazil are allowed to fully offset their tax losses carried forward, without the need to comply with the 30% limitation mentioned in **2.4 Basic Rules on Loss Relief**, as well as to benefit from accelerated depreciation of goods acquired for use in agricultural activities for IRPJ/CSLL purposes.

Incentives for the Modernisation of Equipment

In order to encourage the modernisation of machinery and equipment used by Brazilian companies in their production processes, a new incentive was created in 2024 allowing the option for accelerated depreciation quotas for new goods destined for the fixed assets of companies in specific economic sectors.

Companies in the economic sectors in question will be able to consider depreciation of:

- up to 50% of the value of the asset in the year in which the asset is installed or put into service or in a condition to produce; or
- up to 50% of the value of the asset in the year following that in which the asset is installed or put into service or in a position to produce.

The sectors and machinery and equipment that can benefit are defined by administrative regulations.

2.4 Basic Rules on Loss Relief

Under the actual profit regime, tax losses can be carried forward without any statute of limitations, provided that the offsetting does not exceed 30% of the taxable basis of any given period. No carry-back is allowed.

Non-operating tax losses may be offset only against non-operating profits.

A restriction to the offsetting of tax losses is imposed where there is a change (i) of control, and (ii) in the business activities pursued by a Brazilian company. Accordingly, a company cannot offset its tax losses if, from the date of the accrual of such losses to the date of their offsetting, a change in the control of the company and in the company's business activities has occurred concurrently.

In the case of a spin-off, the company forfeits tax losses proportionally to the value of the spun-off part of its net worth. In the case of a merger, the merged company's tax losses cannot be offset against the profits of the surviving company.

2.5 Imposed Limits on Deduction of Interest

The general rule for the deduction of interest paid by local corporations is that the interest paid will only be considered deductible for tax purposes if it can be demonstrated that the loan to which the interest is related was necessary to the maintenance of the company's activity.

In addition to the general rule, the deduction of interest derived from loans with related parties and/or parties resident in tax havens or subject to privileged tax regimes, are subject to compliance with thin capitalisation and transfer pricing rules.

Regarding the thin capitalisation rules:

- if the creditor is a related party, the total debt amount shall not exceed twice the value of the equity stake held by the related party in the Brazilian company's net worth;
- if there is more than one creditor that is a related party, the total debt amount shall not exceed twice the value of the equity stake of all the related parties abroad in the Brazilian company's net worth; or
- if the creditor (related party or not) is located in a tax haven or subject to a privileged tax regime, the total debt amount shall not exceed 30% of the Brazilian company's net worth.

Regarding the transfer pricing rules, as of 2024, the interest rate of the loan must comply with the arm's length principle.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated group taxation is not applicable in Brazil and, as a rule, group companies are not allowed to utilise separate company losses.

Exceptionally, there are some tax settlement programmes provided by the federal government that allow companies to offset tax losses accrued by group companies against federal taxes due.

2.7 Capital Gains Taxation

The capital gains accrued by a Brazilian company will be included in the IRPJ/CSLL taxable base, subject to general rates described in **1.4 Tax Rates**.

2.8 Other Taxes Payable by an Incorporated Business

VAT on Sales and Services (ICMS)

VAT is a state tax levied on the imports of goods, the domestic circulation of goods, inter-municipal or interstate transport services, and communication services.

Generally ICMS rates are:

- 17% to 21% (rates vary depending on the goods) on imports and circulation of goods within the same state;
- 17% to 21% on communication services;
- 12% on transportation services;
- 4% on interstate transactions involving imported goods that do not undergo a manufacturing process after their customs clearance or involving goods submitted to manufacturing if that manufacturing results in

a final product more than 40% of the value of which is in its imported content;
- 7% on shipments from taxpayers based in the South/Southeast to taxpayers based in the North/ Northeast/Central West and the state of Espírito Santo; and
- 12% on other interstate transactions.

Tax on Services (ISS)

ISS is a municipal tax on services levied on the import and the domestic rendering of services listed in a Federal Supplementary Law. The ISS minimum and maximum rates are, respectively, 2% and 5%. The ISS rates vary in accordance with the service provided and the municipality competent to charge the tax.

IPI

IPI is a federal tax charged on the domestic shipment of goods from a manufacturing entity (or from an entity that the IPI legislation qualifies as a manufacturing entity even if there is no direct manufacturing, such as entities that import products for resale in Brazil), or on the import of goods (upon customs clearance of manufactured products). IPI rates vary according to the nature of the good (pharmaceutical products, for instance, are subject to zero rates as they are considered essential, whereas luxury or superfluous articles can be taxed at rates of up to 300%) and its classification under the IPI Table of Rates. IPI rates generally range from 3.25% to 19.5%.

PIS and COFINS are also due upon import of goods (rates of 2.1% and 9.65% respectively) and services (rates of 1.65% and 7.6% respectively).

Social Security Contributions on Revenues (PIS/COFINS)

PIS and COFINS are federal social security contributions levied on revenues earned by legal entities. Exceptions apply (eg, dividends and revenues derived from exports of goods or services). As a rule, PIS and COFINS rates are 1.65% and 7.6% respectively, if the company is subject to the non-cumulative system, and 0.65% and 3% respectively, if the company is subject to the cumulative system.

Customs Duty (II)

The customs duty (II) is a federal tax due on Brazilian importers levied on imports of goods and charged for the clearance of such goods from customs. Applicable rates vary per imported item and may range from 0% to 35%. II is not a VAT.

Consumption Tax Reform (IBS, CBS and Selective Tax)

In December 2023, the Brazilian Federal Constitution was amended to implement consumption tax reform, aiming to simplify indirect taxes in Brazil. The main change provided by this amendment is the replacement of the ISS and ICMS with the Tax on Goods and Services (IBS), and the PIS/COFINS with the Contributions on Goods and Services (CBS). It is intended the CBS and IBS will work as a dual VAT, providing simplification, with unified laws, and aligning the Brazilian tax system with international practice.

Further, the current IPI will be eliminated (except for some products that have an equal product manufactured in the Manaus Free Trade Zone), and a new Selective Tax will be created to apply to transactions (domestic and imports) with goods and services that are harmful to the environment or health.

The amendment also establishes a transition period of ten years in which the ISS, ICMS, PIS/COFINS and IPI will coexist with the IBS and CBS until they are eliminated in 2033. PIS, COFINS and IPI (for most products) are intended to be phased out as of 2027, and ICMS and ISS rates will be gradually reduced while IBS and CBS rates gradually increase.

Supplementary Law 214/2025 created IBS, CBS and the new Selective Tax, and provided for detailed regulation on such taxes. Applicable IBS, CBS and Selective Tax rates still depend on further regulation.

2.9 Incorporated Businesses and Notable Taxes

Tax on Financial Transactions (IOF)

A tax is levied on credit transactions at a 0.0041% daily rate plus a 0.38% surcharge, and on exchange transactions generally at a rate of 0.38% and insurance transactions at rates varying from 0% to 7.38%, as well as on securities at variable rates.

Urban Property Tax (IPTU)

A municipal tax is levied annually on the ownership or possession of any real estate located in urban areas. The rates vary according to the municipality. In the city of São Paulo, the rates range from 1% to 1.5% with discounts or additions granted based on the market value and use of the relevant property.

Tax on Vehicle Ownership (IPVA)

A state tax is levied annually on the ownership of land, water and air motor vehicles. The applicable rate may vary according to each state. In São Paulo, the tax rate varies from 1.5% to 4%.

Tax on Real Estate and Related Rights Transfer (ITBI)

A municipal tax is levied on inter vivos and remunerated transfers of ownership or in rem rights over real estate. The applicable rate may vary according to the municipality. In the city of São Paulo, the general rate is 3%.

Social Security Contributions

Social security contributions due by companies are generally composed of a fixed rate of 20%, which is supplemented by rates generally varying from 0.5% to 6% in the case of compensation paid to employees. The contributions to support welfare services (which are in addition to social security contributions) comprise rates of up to 5.8% over the compensation paid to employees.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses usually operates in corporate form.

3.2 Individual Rates and Corporate Rates

Income earned by individual professionals is subject to progressive rates up to 27.5%.

In principle, the 34% corporate rate (25% IRPJ rate plus the 9% CSLL rate) is higher than the individual rate. However, if the company is subject to the deemed profit regime, there are some situations in which the effective corporate rate could be lower than the individual rate.

In view of this situation, if the Brazilian tax authorities understand that a company has been incorporated with the sole purpose of allowing the individual to earn income at a lower tax rate with little to no substance (eg, offices and employees), Brazilian tax authorities may challenge the existence of the company and tax the income as if it had been earned by the individual.

3.3 Accumulating Earnings for Investment Purposes

Brazilian tax legislation does not provide for any taxation on the distribution of dividends. In view of this, Brazil does not have rules preventing closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Distributions of dividends from Brazilian Companies is exempt from income tax, regardless of the beneficiary (individual or legal entity and resident or non-resident).

If an individual sells it shares in a Brazilian closely held corporation, the positive difference between the sale price and the acquisition cost will be taxed as capital gains and therefore subject to progressive rates of 15% to 22.5%. If the beneficiary of the capital gain is domiciled in a tax haven, a 25% withholding income tax applies, regardless of the amount of the capital gain.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Distributions of dividends from Brazilian companies is exempt from income tax, regardless of the beneficiary (individual or legal entity and resident or non-resident).

The gain on the sale of shares by Brazilian individuals in publicly traded corporations is subject to taxation at a 15% rate, as a rule. However, gains in day trade operations are subject to a tax rate of 20%.

The gains on the sale of shares in publicly traded corporations by non-residents are, in principle, tax exempt. If the non-resident investor is located in a tax haven the gains will be taxed according to the rules applicable to investors resident in Brazil.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Distributions of dividends from Brazilian companies is exempt from income tax, regardless of the beneficiary (individual or legal entity and resident or non-resident).

In general, royalties and interest paid by Brazilian residents to non-resident companies is subject to withholding tax at a rate of 15%. If the non-resident company is a resident of a tax haven, a higher tax rate of 25% is applicable. With regard to interest, certain specific cases involving investment funds may be subject to a zero rate.

Tax authorities in Brazil have shown themselves to be determined to collect withholding taxes on the import of services. Local legislation has a broad concept of technical services – considering any service provided through the use of specific knowledge or that involves administrative assistance or consultancy, irrespective of any transfer of technology to be technical in nature – and the tax authorities' interpretation is that withholding tax is due regardless of the place where the services are provided. Tax authorities also seek to frame the import of services as royalties for treaty purposes. Most recent treaties have specific provisions for technical services that generally allow Brazil to charge the withholding tax on amounts paid by Brazilian residents.

In addition, a contribution for the intervention in the economic domain (CIDE) is also due at a 10% rate by Brazilian residents on royalties and compensation for technical services paid to non-resident companies. CIDE is borne by the Brazilian resident (it is not a withholding tax).

4.2 Primary Tax Treaty Countries

Considering that dividends are exempt in Brazil and that the double tax treaties signed by Brazil allow the taxation of capital gains, there is generally no reason for foreign investors to use specific tax treaty countries to make investments in Brazil. However, the countries with which Brazil has signed a tax treaty and which have the highest amount of investments in Brazil are the Netherlands, Luxembourg and Spain.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Due to the Brazilian IRPJ/CSLL particularities and to the fact that dividends are exempt in Brazil, it is not usual for Brazilian tax authorities to challenge the use of treaty country entities by non-treaty country residents. Nevertheless, the most recent double tax treaties signed by Brazil provide for limitations on the entities that are entitled to the benefits of a double tax treaty.

4.4 Transfer Pricing Issues

As of 2024, when Brazilian transfer pricing rules were substantially changed for the purposes of alignment with the OECD transfer pricing guidelines, the biggest issue for inbound investors operating in Brazil is the adaptation of their transactions to the new transfer pricing rules, mainly in regard to uncertainty about tax treatment to be given by the Brazilian tax authorities in relation to customs duties when the taxpayer performs a year-end adjustment.

Another relevant transfer pricing issue in Brazil is that double tax treaties signed by Brazil do not provide for compensating adjustments.

4.5 Related-Party Limited Risk Distribution Arrangements

Considering that the new Brazilian transfer pricing rules, mandatorily in force as of 2024, are based on the arm's length principle, it is possible that discussions on the use of such arrangements will arise in the coming years.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Brazilian transfer pricing rules have been substantially revised to align with the OECD transfer pricing guidelines. As these only came into force in 2024, potential issues relates to difficulties in obtaining local comparables and timing issues with performing year-end adjustments. Local legislation requires that the year-end adjustment is made until the end of the calendar year to which it refers.

4.7 International Transfer Pricing Disputes

Historically, the Brazilian tax authorities have tended to be aggressive regarding transfer pricing rules, even using secret comparables.

Transfer pricing disputes are generally settled in administrative tax courts. Brazil does not include compensating adjustments in double tax treaties (Article 9.2 of the OECD Model Tax Convention). As such, double tax treaties are not used to settle transfer pricing disputes.

Although the mutual agreement procedure (MAP) is regulated in local legislation, this procedure is not yet common in Brazil.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The Brazilian transfer pricing legislation in force as of 2024 provides for compensating adjustments when the transfer pricing adjustment is performed spontaneously by the taxpayer, as long as certain requirements are complied with. Compensating adjustments are not allowed when a transfer pricing claim is settled.

Although MAPs are provided for in local legislation, Brazil does not have significant practical experience with them; instead, transfer pricing issues have historically been resolved through administrative and/or judicial discussions.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches and subsidiaries of non-local corporations are subject to the same tax treatment.

5.3 Capital Gains of Non-Residents

Capital gains acquired by non-resident individuals and legal entities on the sale of stock in local corporations are subject to withholding tax at progressive rates of 15% to 22.5%. If the beneficiary of the capital gain is domiciled in a tax haven, a withholding tax of 25% applies, regardless of the amount of the capital gain.

There are no rules providing for the taxation on the indirect sale of stock of a Brazilian company.

5.4 Change of Control Provisions

Brazilian tax legislation does not provide any rules for the taxation on the indirect sale of stock of a Brazilian company. However, if the Brazilian tax authorities understand that a foreign holding company was used to avoid the triggering of taxation on capital gains in Brazil, they could disregard the holding company and consider that the price was paid for the acquisition of local company stock and thus subject to capital gain taxation as described in **5.3 Capital Gains of Non-residents**. There was an attempt to include change of control provisions in Brazilian tax legislation in the past, but it was unsuccessful.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Brazilian subsidiaries and branches are subject to same rules for determining taxable income as described in **2.1 Calculation for Taxable Profits**, regardless of being locally or foreign owned.

5.6 Deductions for Payments by Local Affiliates

As a general rule, in order for an expense to be deductible it is necessary to prove that such expense is necessary, usual and normal for the performance of the company's activities/undertakings and that it relates to services that were actually performed.

As for payments for management and administrative expenses incurred by a non-resident affiliate, since they are transactions with related parties, it is also necessary to comply with transfer pricing rules. As such, if expenses correspond to back office services, they probably fall under the definition of low value-added intragroup services thus being subject to a simplified approach for transfer pricing (5% margin on costs).

5.7 Constraints on Related-Party Borrowing

The constraints applicable to related-party borrowing are transfer pricing and thin capitalisation rules, described in **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Brazilian companies are taxed on their worldwide income.

Capital gains and income earned abroad, as well as the profits accrued by branches, affiliated companies or direct and indirect controlled companies abroad, are included in the taxable basis of IRPJ/CSLL, at a general rate of 34%, in the year they are accrued, regardless of their distribution or availability to the Brazilian controlling company.

In order to avoid double taxation, Brazilian legislation allows Brazilian companies to offset the income tax paid abroad with the IRPJ and CSLL due in Brazil, up to the limit of IRPJ and CSLL levied in Brazil on such income.

6.2 Non-Deductible Local Expenses

Foreign income is not exempt in Brazil, so there are no rules limiting the deduction of local expenses because of attribution to exempt foreign income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Due to the fact that profits earned by foreign subsidiaries are included in the taxable basis of IRPJ/CSLL of the controlling Brazilian company in the year that such profits are accrued, dividends paid by subsidiaries are not taxed at the moment of their distribution.

6.4 Use of Intangibles by Non-Local Subsidiaries

The licensing of an intangible developed by a Brazilian company to a related party abroad is subject to Brazilian transfer pricing rules and thus should be compensated according to the arm's length principle. Corresponding compensation or transfer pricing adjustment is subject to IRPJ/CSLL.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Brazilian worldwide taxation rules tax profits earned by any subsidiary, affiliate or branch abroad. In view of this broad application of worldwide taxation, it is arguable that the Brazilian rules could be considered as a CFC-type rules.

Nevertheless, Law 15.079 of December 2024 determined that a bill of law providing for changes in Brazilian worldwide taxation rules should be presented by the Federal Executive Branch in the first half of 2025, including the introduction of a CFC regime.

6.6 Rules Related to the Substance of Non-Local Affiliates

Brazilian tax legislation does not provide for any rules related to substance of non-resident companies. However, Brazilian courts have already issued decisions stating that if the non-resident company's substance is not verified it could be disregarded for tax purposes.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

The capital gains are included in the IRPJ/CSLL taxable basis, similarly to capital gains from local from local investments (see **2.7 Capital Gains Taxation**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Brazilian National Tax Code (CTN) provides for a general anti-avoidance rule stating that Brazilian tax authorities may disregard acts and transactions carried out with the sole purpose of masking the occurrence of the tax triggering event or the nature of the elements constituting the tax obligation. Although controversial, Brazilian tax authorities tend to disregard acts and transactions when they identify a lack of a valid economic purpose.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no regular routine audit cycle in Brazil. The only requirement related to tax audits established in Brazilian legislation is that they need to be concluded within the statute of limitations of five years.

9. BEPS

9.1 Recommended Changes

Brazil has already implemented the following recommended changes based on the OECD's Base Erosion and Profit Shifting actions:

- action 1 – taxation on remittances related to digital economy;
- action 3 – implementation of CFC rules;
- action 4 – implementation of thin capitalisation rules;
- action 5 – list of tax havens and privileged tax regimes;
- action 6 – implementation of anti-abuse clauses in the recent tax treaties signed;
- actions 8–10 – alignment of the local transfer pricing rules with the OECD guidelines;
- action 13 – implementation of the country-by-country report; and
- action 14 – implementation of the mutual agreement procedure (MAP).

9.2 Government Attitudes

As an active member of the OECD/BEPS Framework, Brazil intends to implement most of the BEPS' actions. However, the government has already stated that some of the actions will not be implemented (eg, MLI and disclosure of aggressive tax planning). Brazil is in the process of implementing Pillar 2, having already implemented a QDMTT and an Income Inclusion Rule (IIR), which is expected to be proposed in the first half of 2025.

9.3 Profile of International Tax

International taxes have a high public profile in Brazil, as the country has already implemented CFC rules and aligned its transfer pricing rules with the OECD guidelines. This should have a positive influence on the implementation of BEPS recommendations.

9.4 Competitive Tax Policy Objective

The Brazilian state has shown interest in having an internationally competitive tax policy in order to attract foreign investments. However, in recent years, the main focus of the tax administration has been to maximise the country's tax collection. This focus is in line with most BEPS action plans.

9.5 Features of the Competitive Tax System

The Brazilian tax system is complex and provides for several different taxes and tax incentives, mainly in the indirect tax area, which have led to long-standing disputes between taxpayers and tax authorities. A tax reform aimed at simplifying the system, minimising the number of taxes, limiting different tax treatments and reducing tax litigation, was approved in the National Congress and the relevant laws and regulations are under strong debate. In this sense, Supplementary Law 214/2025 has been recently published to create the new taxes IBS, CBS and the Selective Tax, although their effects will still gradually begin as of 2026. At this point, it is still uncertain whether objectives of the consumption tax reform will be met.

As the recent main focus of the administration has been to maximise the tax collection, some measures have been taken to restrict the exclusion of tax incentives in the calculation of the IRPJ/CSLL and PIS/COFINS taxable bases.

9.6 Proposals for Dealing With Hybrid Instruments

Brazilian tax legislation provides for the tax deduction of a type of remuneration paid to shareholders (calculated on the net worth), known as interest on net equity (JCP) – there has been some discussion on whether this could be considered as a hybrid instrument. Changes were recently introduced to legislation aiming to limit the amount of this deduction.

9.7 Territorial Tax Regime

Brazil does not have a territorial tax regime.

Brazil has had rules limiting the deduction on interest for quite some time and this has not adversely affected investment.

9.8 Controlled Foreign Corporation Proposals

Brazil does not have a territorial tax regime.

9.9 Anti-Avoidance Rules

Considering that Brazilian tax authorities already adopt a substance over form approach and tend to disregard contracts, structures and transactions where they believe there to be a strong case for doing so based on a lack of substance argument, it is not likely that the new double tax convention limitations will have any impact on inbound and outbound Brazilian investors.

9.10 Transfer Pricing Changes

In June 2023, Brazil modified its transfer pricing rules for the purposes of alignment with the OECD transfer pricing guidelines.

Given that the transfer pricing rules in force until the end of 2023 were different from the OECD guidelines as they were based on fixed margins provided for in the legislation, the introduction of more subjective rules based on the arm's length principle substantially changed the transfer pricing regime in Brazil.

As the new transfer pricing rules were only recently implemented in Brazilian legislation (January 2024) and they have not been fully regulated by the tax authorities, it is not yet possible to determine whether the taxation of profits from intellectual property will be a source of controversy under the new regime.

9.11 Transparency and Country-by-Country Reporting

Brazil has adopted a very favourable position on transparency in international taxation matters, being part of the information exchange network provided for in BEPS action 14 and having implemented the country-by-country report rules.

9.12 Taxation of Digital Economy Businesses

Although Brazil has not implemented changes in the legislation regarding digital economy businesses, Brazilian tax authorities have significantly changed their approach regarding the taxation of remittances made abroad related to the digital economy, taxing transactions that were not taxed before (or were subject to lower taxation).

9.13 Digital Taxation

A few proposals related to digital taxation have been discussed in the National Congress, but none of these have been successful yet. Nevertheless, Brazilian tax authorities adopt an aggressive approach aiming to tax almost all digital transactions at source.

9.14 Taxation of Offshore IP

Royalty payments related to offshore intellectual property deployed in Brazil is subject to withholding tax at a general rate of 15%. Payments made to tax havens are subject to an increased rate of 25%.

Trends and Developments

Contributed by:
Paolo Honorio, Rodrigo Pires and Bruno Feitosa
William Freire Advogados

William Freire Advogados is renowned for its expertise in tax matters applicable to the mining, steelmaking, agribusiness, energy and infrastructure sectors, offering comprehensive tax services and swift responses to client demands. Led by Paulo Honório, alongside Rodrigo Pires and Bruno Feitosa, the firm's tax consultancy department provides support in a variety of areas including tax planning, asset restructuring, investment structuring, tax review, and legal opinions. In tax litigation, William Freire Advogados has a strong presence before the CARF (the Federal Administrative Court) and the Brazilian Mining Agency (in cases involving mining royalties), and is known for handling disputes with expertise and diligence. Key work areas include international tax planning for foreign investors, advisory on tax effects arising from M&A operations in Brazil, and handling tax disputes before the administrative and judicial courts.

Authors

Paolo Honorio is a partner and head of the tax practice at William Freire Advogados. He holds a Master's degree in Economic, Financial, and Tax Law from the University of São Paulo (USP) and a Master's degree in Tax Law from the Federal University of Minas Gerais (UFMG). Paolo is President of the Tax Law Institute of Minas Gerais (IMDT), and Professor of Tax and Financial Law at Pontifícia Universidade Católica de Minas (PUC Minas) and Centro de Direito Internacional (CEDIN). He is a recognised expert in his field, and prepares legal opinions for significant cases in the mineral, infrastructure, energy, and agribusiness sectors.

Rodrigo Pires is the co-ordinator of the tax litigation department at William Freire Advogados. He holds a Master's degree in public law, with an emphasis on taxation, from PUC Minas. He is also Professor of Tax Law at PUC Minas and Centro de Direito Internacional CEDIN.

Bruno Feitosa is the co-ordinator of the tax advisory department at William Freire Advogados. He has ten years' experience at KPMG, including time in Thailand. Bruno is a professor of tax law at CEDIN.

Contributed by: Paolo Honorio, Rodrigo Pires and Bruno Feitosa, **William Freire Advogados**

William Freire Advogados

Avenida Afonso Pena,
4.100 – 12º andar
Edificio Atlântico
Cruzeiro
CEP 30130-009

Tel: +31 3261-7747
Email: paulo@wfaa.com.br
Web: www.williamfreire.com.br

Tax Reform on Consumption (Dual VAT and Selective Tax)

Corporate taxation in Brazil has undergone profound transformations in recent months. Following a constitutional reform that allowed the creation of a new tax regime on consumption (Dual VAT and Selective Tax), the country created a new legal regime for transfer pricing rules, aligned with the OECD, as well as implementing its Qualified Domestic Minimum Top-Up Tax (QDMTT) within the scope of Pillar 2.

This document aims to present the current scenario of tax reform on consumption, due to the recent enactment of Complementary Law No 214, of 16 January 2025, called the General Law of IBS, CBS and Selective Tax.

I) The constitutional bases of the reform: Constitutional Amendment No 132/2023

Constitutional Amendment No 132/2023 was approved with the aim of bringing the Brazilian tax system closer to that observed in most developed and developing countries. Its new features are:

- the creation of a dual VAT – the Tax on Goods and Services (IBS), under shared jurisdiction between States and Municipalities, and the Contribution on Goods and Services (CBS), under jurisdiction of the Federal Union;
- the creation of a Selective Tax, levied on activities that are harmful to health or the environment, with a primarily extra-fiscal purpose;
- authorisation for some Brazilian states to create an unprecedented tax on primary and semi-finished products, mainly affecting mining, agribusiness and the oil and gas sector, which may even be charged on exports; and
- in return, the gradual elimination of current taxes on consumption at all federal levels was foreseen by 2033: Tax on Services (municipal VAT), Tax on Goods and Transport and Telecommunications Services (State VAT), Contributions on Gross Revenue and Tax on Industrialised Products (Federal VAT).

VAT is a non-cumulative tax levied at all stages of the production process, ensuring, at each stage, the credit corresponding to the tax paid in the previous stage. This characteristic of VAT makes it a neutral tax – the incidence of which is independent of the way in which production and circulation are organised, so that the tax paid by the consumer at the final stage of sale corresponds exactly to what was collected throughout the entire production chain.

For this reason, the following characteristics are part of the nature of a VAT: (1) broad tax base; (2) full appropriation of credits from previous stages, leading to tax neutrality throughout a production chain; and (3) few or no exceptions to the general taxation rule (tax incentives or beneficial sectoral treatments).

The tax will be levied at the destination, and its rates will be set by the entities receiving the goods and services. Thus, the CBS rate will be set by the Union, and the IBS rate will be the sum of the state and municipal rates, set according to the tax policy of each federative entity.

As a rule, tax rates should be the same for all goods and services. However, there are exceptions authorised by the constitutional text.

The hypotheses for reducing the dual VAT rate by 60% are as follows:

- education services;
- health services;
- medical devices;
- accessibility devices for people with disabilities;
- medicines;
- basic menstrual health care products;
- urban, semi-urban and metropolitan public road and metro passenger transport services, which may also be exempt, in accordance with the law;
- food intended for human consumption;
- personal hygiene and cleaning products mostly consumed by low-income families;
- agricultural, aquaculture, fishing, forestry and extractive plant products in natura;
- agricultural and aquaculture inputs;
- national artistic, cultural, event, journalistic and audiovisual productions, sports activities and institutional communication; and
- goods and services related to sovereignty and national security, information security and cybersecurity.

The Constitution authorised a 30% reduction in dual VAT rates for the provision of intellectual, scientific, literary or artistic services, provided that they are subject to supervision by a professional council. This is the case for lawyers, doctors, engineers, accountants and other independent professionals. Likewise, it authorised a 100% reduction, in accordance with the law, for the following cases: (1) vegetables, fruits and eggs; (2) medical and accessibility devices for people with disabilities; (3) medicines and basic menstrual health care products; (4) services provided by non-profit Scientific, Technological and Innovation Institutions (ICT); (5) passenger cars, when purchased by people with disabilities or by professional taxi drivers; (6) higher education services under the University for All Program (Prouni); and (7) urban rehabilitation activities in historic areas and critical areas for urban recovery and reconversion.

Alongside dual VAT, Constitutional Amendment No 132/2023 authorised the Union to establish a tax with a markedly extra-fiscal, rather than revenue-raising, nature to discourage certain acts of consumption that would, theoretically, be *"harmful to health and the environment"*: the Selective Tax.

The Selective Tax will have the following characteristics:

- its creation must occur by complementary law, and the setting of its rates may be done by ordinary law;
- extraction was included among the temporal criteria, alongside the production, marketing and import of goods and services;

- operations involving electricity and telecommunications were immunised;
- when charged at the time of extraction, the tax will have a maximum rate of 1% on the market value of the extracted product and will be levied regardless of its destination;
- it will be a single-phase tax; and
- its rates may be specific, per unit of measurement adopted, or ad valorem.

In this context, Dual VAT and Selective Tax were effectively created.

II) The General Law of IBS, CBS and Selective Tax: Complementary Law No 214/2025

II) i) The transition to the new tax regime

The new taxes will effectively become a reality in the routine of companies and individual taxpayers through a transition process, which will begin in 2026 and culminate in 2033.

The main points of the transition are as follows.

In 2026:

- IBS at 0.1% and CBS at 0.9%.
- Those who comply with the additional obligations provided for in the legislation are exempt from paying IBS and CBS.
- If there is no exemption, the 1% of IBS/CBS can be deducted from Cofins (without increasing the burden) and, from 2027 to 2028, the 0.1% of IBS will be deducted from CBS.
- If the taxpayer does not have sufficient debts to make the Cofins deduction, the amount collected may be offset against any other federal tax or be reimbursed within 60 days.

In 2027:

- CBS full implemented. PIS and Cofins are abolished, and IPI is at a rate of 0%, except for industrialised products in the Manaus Free Trade Zone.
- Selective Tax is now charged.

From 2029 to 2032:

- ICMS and ISS are reduced by 10% per year, until 2033, when they will be extinguished.
- ICMS tax benefits will be maintained until 2032 (in the ICMS/IBS ratio).
- IBS and CBS reference rates during this period will be set by Senate resolution.
- Individuals or legal entities entitled to generous benefits related to ICMS, due to the reduction in the level of these benefits between 1 January 2029 and 31 December 2032, will be compensated by resources from the Tax or Financial-Fiscal Benefits Compensation Fund.
- ICMS, ISS and IPI will be extinguished in 2033.
- With respect to ICMS credit balance accumulated in 2032, provided that they are approved by the States (expressly or tacitly), the credits may be:
  - (a) compensated with IBS;
  - (b) transferred to third parties;
  - (c) reimbursed by the management committee, if no compensation is possible;
  - (d) in the case of fixed assets, for the remaining term;
  - (e) in other cases, in 240 months; and
  - (f) credits will be adjusted by IPCA from 2033.
- Cofins credits, including those presumed, not appropriated or not used until the termination of contributions, may be used to offset the

amount due from the CBS, provided they are duly registered before 2027.

The implementation of this new legislation will bring significant challenges and opportunities for companies and taxpayers, requiring careful analysis of the approved provisions, demanding strategic actions and operational adjustments to ensure compliance and efficiency.

II) ii) Dual VAT

II) ii) a) Incidence hypothesis

Dual VAT will have the following incidence hypothesis.

- *Material criterion* onerous transactions involving goods or services (any supply with consideration), as well as non-onerous transactions involving goods or services expressly provided for in the Complementary Law.
- *Time criterion* at the time of supply or payment, even if partial, whichever occurs first, with supply understood as the start of transportation, in the provision of transportation services initiated in the Country; the end of transportation, in the provision of transportation services initiated abroad; and the end of supply, in the case of other services.
- *Spatial criterion*
  (a) tangible movable property, the place of delivery or provision of the property to the recipient, understood, if not in person, as the final destination indicated by the purchaser to the supplier, if the transportation service is the responsibility of the supplier (CIF), or to the third party responsible for the transportation, if the transportation service is the responsibility of the purchaser (FOB);
  (b) real estate, intangible movable property, including rights, related to real estate and services physically provided on real estate, the place where the property is located;
  (c) cargo transportation service, the place of delivery or provision of the property to the recipient; and
  (d) other services and other intangible movable property, including rights, the place of the recipient's main residence - place registered in the registry with unique identification (CNPJ).
- *Quantitative criterion*
  (a) the calculation basis is the value of the transaction, equivalent to the full amount charged by the supplier for any reason, including amounts corresponding to increases resulting from adjustments to the value of the transaction, interest, fines, increases and charges, discounts granted under condition, transportation value charged as part of the value of the transaction, taxes and public prices, including tariffs, levied on the transaction or borne by the supplier (except IBS/CBS, IPI, ICMS, ISSQN, PIS and Cofins), other amounts charged or received as part of the value of the transaction, including insurance and fees;
  (b) sum of the rates of the federative entities of destination (location of the transaction/ spatial criterion), with an estimated reference rate of 28%.
- *Personal criterion* the passive subject is the supplier who carries out operations (i) in the development of economic activity, in a habitual manner, (ii) in a volume that characterises economic activity, or (iii) in a professional manner, even if the profession is not regulated; and that are expressly provided for in other cases in the Complementary Law; the active subject is the Management Committee and the Union.

- *Suppliers* whether resident or domiciled abroad, regular contributors to IBS and CBS and are required to register with regard to transactions carried out in the country.
- *Platform* the digital platform, even if domiciled abroad, is responsible for paying the IBS and CBS relating to material goods subject to international shipment whose operation was carried out through it.
- *Recipient liability* The recipient of an international shipment is jointly and severally liable for the payment of the IBS and CBS relating to the material goods subject to the international shipment if: (i) the supplier resident or domiciled abroad is not registered; or (ii) the taxes have not been paid by the taxpayer resident or domiciled abroad, even if registered, or via a digital platform.
- *Purchaser* the purchaser of goods or services who is a taxpayer of the IBS and CBS under the regular regime may pay the IBS and CBS levied on the transaction if payment to the supplier is made using a payment instrument that does not allow segregation (split payment).
- *Split payment* split payment will be applicable to all transactions, except cash or check. It will operate concurrently with the other payment hypotheses: compensation and payment by the taxable person (supplier). Future regulation may establish a transition period or non-obligation for certain situations.

The calculation of Dual VAT will be centralised in a single establishment, on a monthly basis. A positive balance generates payment and a negative balance generates credit to be refunded.

II) ii) b) Compensation and reimbursement

Taxpayers who have a credit balance at the end of the assessment period may request full or partial reimbursement.

Deadlines are as follows:

- Up to 30 days, for requests from taxpayers included in compliance programmes developed by the IBS Management Committee and the RFB in relation to:
  - (a) fixed assets; and
  - (b) reimbursement requests whose value is equal to or less than 150% of the average monthly value of the difference between IBS and CBS credits and debits.
- Up to 60 days, for other cases of compliance programs.
- Up to 180 days, in other cases.
- Up to 360 days, if a credit inspection procedure is initiated.

Exports:

- Exports of goods and services abroad are exempt from IBS and CBS, ensuring that the exporter is entitled to appropriate and use credits relating to transactions in which he or she is the purchaser of goods or services, subject to the restrictions on credit provided for by law.
- In indirect exports (commercial exporters), IBS/CBS is suspended and converted to a 0% rate, provided that the commercial exporter is certified in the OAE Program and meets other legal requirements.

Non-cumulativity:

- The taxpayer subject to the regular regime may appropriate IBS and CBS credits when there is the extinction, by any of the modalities provided for, of the debts related to the transactions in which he is a purchaser, with the exclusive exception of those considered for personal use or consumption.

- In other words, the values of the appropriated credits will correspond to the amounts of IBS and CBS actually paid or extinguished by compensation in relation to the acquisitions.
- This is a controversial aspect, since the Constitution did not link the right to IBS and CBS credit to the extinction of the previous obligation (payment in the broad sense). This may lead to an unconstitutionality dispute before courts. However, it is in the interests of most of the private sector to have the lowest possible rate of default, since default would imply a risk of nominal increases in the rates of new taxes. Therefore, despite the unconstitutionality, it is not certain that the linking of credit to payment will be challenged in court.
- Transactions that are immune, exempt or subject to a zero rate, deferral or suspension will not allow the appropriation of credits by purchasers of goods and services.
- Immunity and exemption will result in the cancellation of credits relating to previous transactions. In the case of transactions subject to a zero rate, credits relating to previous transactions will be maintained.

Exceptions to non-cumulativity:

- There will be an exception to the non-cumulative nature, with a prohibition on crediting, for goods and services considered for personal use and consumption. The law provides an exemplary list for this purpose:
  - (a) jewellery, precious stones and metals;
  - (b) works of art and antiques of historical or archaeological value;
  - (c) alcoholic beverages;
  - (d) tobacco derivatives;
  - (e) weapons and ammunition; and
  - (f) recreational, sporting and aesthetic goods and services.
- Goods and services acquired or produced by the taxpayer and provided free of charge or at a value below market value to individuals, including employees of the taxpayers.
- Other goods and services considered for personal use and consumption:
  - (a) residential real estate and other goods and services related to its acquisition and maintenance; and
  - (b) vehicle and other goods and services related to its acquisition and maintenance, including insurance and fuel.
- Goods and services used predominantly in the taxpayer's economic activity are not considered to be for personal use or consumption.
- The law also lists goods and services that are not considered for personal use or consumption:
  - (a) uniforms;
  - (b) personal protective equipment;
  - (c) food and non-alcoholic beverages made available at the taxpayer's establishment for its employees and managers during the working day;
  - (d) health services made available at the taxpayer's establishment to its employees and managers during the working day; and
  - (e) daycare services provided at the taxpayer's establishment for its employees and managers during working hours.
- Benefits regulated as a result of a collective bargaining agreement or convention are also not goods and services that are considered for personal use or consumption. This includes the following:
  - (a) Health care plan services and provision of:
    - (i) transportation vouchers;
    - (ii) meal vouchers; and
    - (iii) food vouchers.

(b) Educational benefits for employees and dependents, arising from a collective bargaining agreement or convention, including:
   (i) granting of scholarships;
   (ii) discounts on consideration, provided they are offered to all employees, with the possibility of differentiation for:

- low-income employees; and
- employees with a larger family nucleus.
- Other goods and services in accordance with criteria established in regulations.

II) iii) Selective tax

This tax is under the jurisdiction of the Union, established by complementary law, the rates of which will be defined in ordinary law. Its management will be the responsibility of the Brazilian Federal Revenue Service and its litigation will be before the Administrative Council of Tax Appeals.

The law states that the following are harmful to health or the environment: vehicles; vessels and aircraft; smoking products; alcoholic beverages; sugary drinks; mineral goods and coal; gambling and fantasy sport.

The tax will be levied on production, extraction, marketing or import.

II) iii) a) Minerals

Regarding mineral goods, the following stand out:

- Iron ore was listed alongside oil and gas as the only ones subject to tax due to acts of extraction, with a rate limited to 0.25%.
- The incidence will occur at the time of extraction. The calculation basis will be the reference value of the extracted raw product. Even if the product is exported, there will be incidence.
- Coal was included without it having been formally classified as *"mineral good"*. This could generate controversy over the application of the 0.25% tax rate, restricted to mineral goods extracted in the country.
- The triggering event occurs at the time of extraction and its calculation basis will be the reference value of the raw extracted mineral asset. An act by the head of the Executive Branch of the Union will define the methodology for calculating the reference value, based on market indexes.

If the Constitution only authorises the levy of tax on mineral goods at the market value of the extracted raw product, and if there is no specific market value in a given case, the only legally possible consequence is non-incidence.

II) iii) b) Exports

The Selective Tax, due to the Constitution, does not apply to exports. The version approved by the National Congress, reflecting constitutional immunity, listed in item I of Article 413 the non-incidence of the tax on exports.

The Executive Branch chose to veto section I of Article 413, understanding that it would also apply to extracted mineral goods, in alleged disagreement with §6 of Article 153 of the Constitution, which determines the incidence on mineral goods in extraction *"regardless of their destination"*.

If the intention of the Executive Branch, in vetoing item I of Article 413, was to determine that the tax would be levied on mineral exports, this would be a useless veto.

Exports of these products will be economically burdened by the tax levied at the time of extraction, even though they will not be subject to a new incidence at the time of exportation itself. The approval of the bill was merely a change in the calculation basis in relation to the version originally approved by the House of Deputies. The final version determined that the market value of the extracted product would be the calculation basis, whereas the House previously determined that the basis would be the market value of the exported mineral product, the consumed mineral product or the mineral product transferred in a non-burdensome transaction.

This normative dynamic was not affected by the vetoed clause, which was an expletive rule, as it merely reproduced a fully effective constitutional mandate (immunity).

However, there will certainly be litigation in this regard, as tax authorities are not authorised to charge the Selective Tax on exports of mineral goods.

The fact that the tax is levied at the time of extraction – and not at the time of export – is not a reason to set aside the general immunity provided for in the Constitution. The interpretation of constitutional immunities must be broad and generous, giving them maximum effectiveness. Allowing the levy of the tax on the extraction of a product that is exported implies, in practical terms, taxing the export, in violation of the constitutional norm.

II) iv) Points of attention and tax planning

The following issues merit particular attention for corporate taxpayers in Brazil.

- Corporate restructuring for tax purposes:
  - (a) sales and services to companies in the same economic group will be subject to transfer pricing testing, which may be waived in future regulations; and
  - (b) reassessment of existing corporate and tax plans based on: (a) use of credits or flow of accumulated credits; (b) use of tax incentives in certain states and/or municipalities; (c) other tax savings hypotheses.
- Supplier selection: credit linked to payment.
- Customer and market selection: possible tax rate reduction with credit maintenance.
- Cautious assessment of the loss of tax benefits as the transition progresses (2029 to 2032).
- Review of contracts and commercial arrangements:
  - (a) contracts, particularly long-term contracts, will need to include provisions on Selective Tax, IBS and CBS: pricing, joint liability, economic-financial rebalancing, etc; and
  - (b) reassessment of capex and opex in investment projections.
- For possible acquisitions (M&A), reassessment of valuation.

CANADA

Law and Practice

Contributed by:
Marc-André Godard, Pierre Allard, Isabelle Gagnon and Mehrez Houacine
BCF Business Law LLP

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BCF Business Law LLP has nearly 300 professionals and is the go-to firm for mid-market Quebec businesses and well-established global corporations. The tax group is composed of a multidisciplinary team of 30 lawyers, notaries and accountants. BCF's tax practitioners are called upon to advise public and private corporations in their most complex transactions, tax and estate planning, and tax disputes. The firm's key practice areas include M&A, business succession tax planning, the taxation of financial instruments, SR&ED tax credits and international taxation. A team of notaries also specialises in wealth protection, notably estate settlement, common law and marital relationship planning, and asset protection.

Authors

Marc-André Godard is head of BCF's tax group and has been a member of the Barreau du Québec since 2000. He specialises in the tax aspects of M&A, national and international restructurings, and in tax planning for both public and private corporations. His understanding of the business world helps him advise executives on making the best commercial decisions. Over his 25 years of practice, Marc-André has represented several companies in the financial, manufacturing, aluminium and natural resources sectors, as well as some of the largest institutional investors in Quebec. He also has extensive experience in private equity and fund formation.

Pierre Allard is a partner at BCF and chairman of the board. He has been a member of the Barreau du Québec since 1996, and has established himself over the past 25 years as one of the best tax lawyers of his generation. He advises executives on major transactions, including business sales or acquisitions, incentives and the retention of key employees and business succession tax planning. He has in-depth expertise in the taxation of financial products. Pierre is regularly called upon to contribute to specialised journals and to speak at conferences for Canada's largest financial institutions and accounting firms.

Isabelle Gagnon is a partner at BCF and has been a member of the Order of CPAs since 1994. Her extensive expertise in Canadian taxation enables her to counsel any company, from large corporations to the most promising start-ups. She specialises in M&A and business succession transactions, and implements innovative and effective solutions for the businesses she advises, regardless of the complexity of their structures and tax issues. With over 30 years of experience, Isabelle never loses sight of her clients' main objective, advising entrepreneurs and their families on making informed decisions at various stages of their professional and personal lives.

Mehrez Houacine is a partner at BCF and has been a member of the Order of CPAs since 2012. He specialises in M&A, corporate reorganisations, business transfers and key employee stock incentive plans. Mehrez is known for his thoroughness, technical abilities and listening skills, and helps SMEs by offering tax solutions tailored to their needs. Over his ten years of experience in major accounting firms, Mehrez developed sound business relationships with clients in a wide range of activity sectors. He regularly publishes articles and speaks at conferences for the Canadian Tax Foundation and the Association de planification financière et fiscale.

BCF Business Law LLP

1100 René-Lévesque Blvd. West
25th Floor
Montreal
Quebec H3B 5C9
Canada

Tel: +514 397 8500
Fax: +514 397 8515
Email: info.bcf@bcf.ca
Web: www.bcf.ca/en

BCF

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

There are several options available when doing business in Canada. The choice of structure is generally dictated by a number of factors, based mainly on tax and liability considerations. The most used structures are:

- corporations;
- unlimited liability companies (ULCs);
- partnerships;
- joint ventures; and
- sole proprietorships.

Corporations

Businesses are generally carried on by corporations, which are legal entities with a patrimony distinct from their shareholders'. Such entity may be incorporated under the Canada Business Corporations Act or under an equivalent law of a province or territory. Corporations' popularity stems from two main factors:

- the shareholders' liability exposure is limited to their investment in the corporation; and
- the corporation is taxed as a separate entity, generally at lower rates than individuals.

ULCs

ULCs are a form of corporation that is only available in three provinces of Canada (Alberta, Nova Scotia and British Columbia), and the specificities may vary between each jurisdiction. ULCs are distinct legal entities, but in some situations the shareholders' liability is unlimited. Under Canadian tax laws, ULCs are considered corporations and are taxed as separate entities. They are sometimes used where there are US shareholders, since ULCs may be treated as *"disregarded entities"* under US tax laws, therefore allowing taxation of the ULC's income in the US shareholders' hands directly for US tax purposes.

Partnerships

Both general partnerships and limited partnerships are relationships governed by provincial legislation between two or more persons who carry on a business.

In a general partnership, each partner is liable for the partnership's liabilities in relation to third parties.

In a limited partnership, there are two kinds of partners:

- general partners, who are exposed to unlimited liability; and
- limited partners, whose liability is limited to their capital investment if the limited partners take no part in the management or control of the business.

A partnership is not subject to income tax as a separate entity. Rather, the partnership acts as *"flow-through"* entity where the net income is calculated at the partnership level and allocated to its partners, who are liable for the taxes on such income.

Joint Ventures

Joint ventures share some similarities with partnerships but, unlike the latter where two or more partners conduct business together, a joint venture is created when two or more persons wish to collaborate for a specific project. A joint venture is not taxed as a separate entity, and the liability of each partner is set out in the joint venture agreement. Such agreement usually clearly states that the parties do not wish to form a partnership, or the joint venture could be considered as such.

Sole Proprietorships

Sole proprietorships are unincorporated businesses owned by a single individual. Such individual's liability is unlimited, and the income generated by the business is added to the individual's other income, if any, and taxed at the personal rates.

1.2 Transparent Entities

Partnerships are commonly used to create investment funds, as the potential limitation of liability and the absence of taxation at the entity level are valuable advantages to the partners.

Since the income and loss are calculated jointly for the parties in a joint venture, such entity is popular in real estate investments as the joint parties may personally determine the depreciation expense that will be utilised when calculating their income, instead of having it calculated at the partnership level.

1.3 Determining Residence of Incorporated Businesses

The residence of an incorporated business is determined in two steps:

- first, by reviewing the deeming provisions of the Income Tax Act (ITA); and
- if none are applicable, by application of the common law.

The ITA deems a corporation to be a Canadian resident throughout a tax year if the corporation was incorporated in Canada after 26 April 1965. Where the corporation was not incorporated in Canada or was incorporated in Canada prior to 26 April 1965, its residency status for Canadian tax purposes will depend on where its central management and control is located.

The aforementioned deeming provisions will not apply if the corporation is deemed to be resident in another country, pursuant to a tax treaty between Canada and the other country.

A partnership with one or more non-resident partners is not *"Canadian partnership"* and is therefore treated as a non-resident partnership for income tax purposes. The partnership may then need to withhold taxes prior to allocating income to certain partners.

1.4 Tax Rates

The federal tax rates applicable to incorporated businesses resident in Canada vary depending on the type of income earned, whether the corporation is a private corporation, and whether the corporation is controlled by Canadian residents for income tax purposes. A private corporation that is resident in Canada and controlled by Canadian residents qualifies as a Canadian controlled private corporation (CCPC). As of 1 January 2024, the federal tax rates for CCPCs are as follows:

- active small business income (up to CAD500,000): 9%;
- active business income (above CAD500,000): 15%; and
- investment income (other than dividends): 38.67%, a portion of which (representing 30.67% of said investment income) is refundable upon the payment of taxable dividends by the corporation at a rate of CAD1 of tax reimbursed to the corporation for each CAD2.61 of dividends paid to its shareholders.

The federal tax rate applicable to corporations that do not qualify as CCPCs is 15% for business and investment income, as of 1 January 2024. The active small business income rate is not available to corporations that do not qualify as CCPCs.

As for dividend income, taxable dividends received by corporations resident in Canada are generally deductible for the purpose of computing their taxable income. However, private corporations may be subject to a refundable tax on dividends received from corporations that are not *"connected"*, or on dividends received that entitled the payer corporation to a dividend refund. The dividends received would then be subject to a 38.33% tax, which is refundable upon the payment of taxable dividends at a rate of CAD1 of tax reimbursed to the receiver corporation for each CAD2.61 of dividends paid to its shareholders.

A payer corporation is *"connected"* to the receiver corporation if the latter (or persons not dealing at arm's length with the latter) controls the payer corporation or if the receiver corporation owns more than 10% of the shares of the payer corporation in votes and value.

As of 2025, the federal tax rates applicable to individuals are as follows:

- 15% on the first CAD57,375 of taxable income; plus
- 20.5% on the portion of taxable income between CAD57,375 and CAD114,750; plus
- 26% on the portion of taxable income between CAD114,750 and CAD177,882; plus
- 29% on the portion of taxable income between CAD177,882 and CAD253,414; plus
- 33% on the portion of taxable income over CAD253,414.

The net income of a partnership is taxable at the partner's level at the rates applicable to the partner, since it is a flow-through entity.

Corporations and individuals are also subject to provincial income tax.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable income of a corporation is composed of business income, property income (interest, rent, royalties and dividends) and 50% of capital gains (see **2.7 Capital Gains Taxation**), and is the result of its income for the year minus allowable deductions. The deductions a corporation is allowed to claim are expenses incurred for the purpose of earning business or property income. This usually covers salaries, insurance expenses, maintenance and repairs, licences, accounting and legal fees and advertising expenses.

The net income reported on financial statements will often not be the same as the net income calculated for tax purposes, since some income and expenses reported in financial statements may not be used in the calculation of net income for tax purposes. Income is generally reported using the accrual method – only farmers, fishermen and self-employed commission sales agents may use the cash method.

2.2 Special Incentives for Technology Investments

The Scientific Research and Experimental Development Program (SR&ED) encourages all Canadian businesses, regardless of their size or sector, to develop new, improved or technologically advanced products by using three tax incentives:

- an income tax deduction;
- an investment tax credit (ITC); and
- a refund, in specific circumstances.

The ITC amount and the availability of a refund under the SR&ED depend on whether the corporation qualifies as a CCPC, and on the qualified expenditures incurred in Canada (wages, machinery, equipment, etc). Unused ITCs may be carried back three years or forward for 20 years. Provincial incentives are also available.

2.3 Other Special Incentives

Canadian film or video production tax credits are available for certain expenses for certified films or videos.

Also, an accelerated investment incentive was introduced in 2018 that provides for an enhanced first-year depreciation deduction on certain depreciable properties, and for the immediate write-off of the full cost of machinery and equipment for manufacturing and processing businesses and of the full cost of specified clean energy equipment for clean energy businesses. Those deductions are in their phase-out period and will be progressively reduced from 2024 to 2027.

Canadian taxable corporations have access to four refundable tax credits forming the clean economy ITCs, which aim to support the transition to net zero emissions. Those credits are:

- Carbon Capture, Utilization and Storage (CCUS) ITC;
- Clean Technology ITC;
- Clean Hydrogen ITC; and
- Clean Technology Manufacturing ITC.

Those ITCs apply to eligible expenditures or property that is acquired and becomes available for use before 31 December 2034 (with the exception of the CCUS ITC, which ends on 31 December 2040). It is generally only possible to claim one of the clean economy ITCs for the same eligible property.

Canada has implemented a temporary measure to reduce corporate income tax rates by 50% for qualifying zero-emission technology manufacturers.

Provinces may also offer targeted incentives for specific industries (the production of multimedia titles, to support digital transformation in print media companies, etc).

2.4 Basic Rules on Loss Relief

A corporation may incur two types of losses:

- capital losses; and
- non-capital losses.

Capital Losses

Capital losses occur upon the disposal of a capital property for an amount that is less than its cost. Generally, a capital loss may only offset capital gains – it cannot be applied to other income unless it qualifies as an allowable business investment loss (ABIL). Capital losses may be carried back three years or carried forward indefinitely.

An ABIL is a capital loss incurred on the sale of shares of a small business corporation to a third party, or upon the bankruptcy, insolvency or winding-up of a small business corporation. ABILs may offset income from all sources. They can be carried back three years or carried forward for ten years, after which they are converted into capital losses and may be carried forward indefinitely.

Non-Capital Losses

Generally, a non-capital loss is any loss incurred from carrying on a business. Non-capital losses may offset income from all sources. They can be carried back three years or carried forward for 20 years.

When a business is carried on through a limited partnership, a limited partner's share of the limited partnership's loss from a business or property may only be deducted by the limited partner if such loss does not exceed the limited partner's *"at-risk amount"* (generally the amount of capital contributed by the partner to the partnership) for the year. The excess loss can be carried forward indefinitely.

2.5 Imposed Limits on Deduction of Interest

Generally, interest expense is considered a capital expenditure and is not deductible unless it meets specific requirements in the ITA, which include that the amount must be payable in the year under a legal obligation to pay interest, and that the amount must be reasonable.

Where the above conditions are fulfilled, the ITA nevertheless restricts the deduction for interest paid or payable by certain corporations resident in Canada in a taxation year on debts owing to specified non-residents if the ratio of these debts to the corporation's equity exceeds 1.5:1.

Furthermore, for taxation years beginning after 30 September 2023, the ITA restricts the deduction for excessive interest and financing expenses. The rules adopt an *"earnings stripping"* approach, which restricts a taxpayer's deductions for interest expense and other financing costs to an amount that is proportionate with the taxable income generated by its activities in Canada. The rules limit the amount of net interest and financing expenses that may be deducted in computing a taxpayer's income to no more than a fixed ratio of earnings before interest, taxes, depreciation and amortisation (EBITDA). The ratio is 40% for taxation years beginning after 30 September 2023 and before 1 January 2024, and is lowered to 30% for taxation years beginning after 31 December 2023.

Certain entities may be exempt from these rules, either because they do not meet the de minimis thresholds or because they operate almost entirely in Canada and meet the conditions prescribed under the ITA. Other sector-specific exclusions may apply in respect of borrowings made for certain projects.

2.6 Basic Rules on Consolidated Tax Grouping

Unlike other jurisdictions, Canada does not have a formal system providing for the consolidated taxation of corporate groups.

A corporation's losses may be used by other members of the corporate group through reorganisations or financing arrangements, but such transactions require thoughtful planning, and may even require advanced tax rulings.

2.7 Capital Gains Taxation

Only 50% of the capital gain of a corporation is taxable, and the resulting amount is taxed as investment income. The tax rate will depend on whether the corporation qualifies as a CCPC (see **1.4 Tax Rates** for additional information on tax rates paid by corporations).

There are no exemptions or reliefs on the taxation of capital gains for corporations.

2.8 Other Taxes Payable by an Incorporated Business

In addition to the federal income tax, corporations may be subject to goods and services tax, municipal taxes, land transfer taxes, federal and provincial social security contributions and provincial payroll taxes.

Corporations are also subject to provincial income tax.

2.9 Incorporated Businesses and Notable Taxes

See **2.8 Other Taxes Payable by an Incorporated Business**.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most businesses are carried on by corporations.

3.2 Individual Rates and Corporate Rates

One of the main advantages of providing services through a corporation is the ability to benefit from the small business deduction, which provides a preferential tax rate of 9% at the federal level on the first CAD500,000 of active business income earned by a corporation that qualifies as a CCPC. Active business income above CAD500,000 is taxed at a federal rate of 15%.

However, this preferential tax rate does not apply to personal services businesses carried on by a corporation. A personal services business is one that provides services where the individual who performs the services on behalf of the corporation (ie, the incorporated employee) would reasonably be regarded as an employee of the person or partnership to which the services were provided, but for the existence of the corporation. These rules are not restricted to professionals.

The taxable income of a personal services business is taxed at a flat rate equal to the top marginal personal tax rate, thus removing the advantage afforded by the lower corporate tax rates.

3.3 Accumulating Earnings for Investment Purposes

Passive income rules provide for a gradual reduction of the small business active income limit of CAD500,000 available to CCPCs (the Business Limit) on which the preferential tax rate of 9% applies where a corporation, together with its associated corporations, earned investment income of between CAD50,000 and CAD150,000 in a year. The reduction effectively decreases the annual Business Limit by CAD5 for each CAD1 of investment income earned in excess of CAD50,000.

Pursuant to such rules, when the aggregate investment income of a CCPC earning active income and its associated corporations is CAD150,000 or higher for a given year, the CCPC will not have access to the preferential tax rate of 9% applicable to active business income and will therefore be taxed at the regular rate of 15%.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends From Private Corporations

Three types of dividends can be paid by a corporation resident in Canada in favour of an individual resident in Canada:

- eligible dividends (dividends paid by a corporation taxed at the 15% rate);
- non-eligible dividends (dividends paid by a corporation taxed at the 9% rate); and

• capital dividends.

At the federal level, if an individual receives an eligible dividend, a grossed-up amount equal to 138% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 15.02% of the grossed-up amount, the whole resulting in an eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 24.81%.

At the federal level, if an individual receives a non-eligible dividend, a grossed-up amount equal to 115% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 9.03% of the grossed-up amount, the whole resulting in a non-eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 27.57%.

Eligible and non-eligible dividends are also taxable at the provincial level.

A capital dividend is a dividend paid by a corporation out of its capital dividend account (which is essentially composed of the non-taxable portion of capital gains realised by the corporation) and is not taxable in the hands of the individual.

Gain on the Sale of Shares in Private Corporations

50% of a capital gain realised by an individual is taxable at the individual's applicable federal and provincial income tax rate, including a capital gain realised on shares of a private corporation. This results in an effective federal marginal tax rate for capital gains of 16.5% and an effective total marginal tax rate for capital gains of between 22.25% and 27.40%, depending on the applicable provincial rate (see **2.7 Capital Gains Taxation**).

An eligible individual resident in Canada is entitled to a lifetime capital gains exemption on gains realised on the disposal of qualified small business corporation shares. If the capital gain realised by the individual qualifies under these rules, the capital gain – up to the limit – will be exempt from income tax. The lifetime capital gains exemption limit is indexed annually and is set at CAD1,044,291 for 2025. This amount has been calculated based on the CAD1,016,836 limit for 2024 and the indexation increase of 2.7% for 2025 announced by the Canadian Revenue Agency. The 2024 federal budget proposed to increase the limit after 24 June 2024, and for the entirety of 2025 to CAD1,250,000.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends From Publicly Traded Corporations

Dividends received from a Canadian public corporation are eligible dividends. Therefore, at the federal level, a grossed-up amount equal to 138% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 15.02% of the grossed-up amount, the whole resulting in an eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 24.81%.

Dividends received from a company residing in another country are not subject to the gross-up nor the dividend credit. The entire dividend amount is taxable in Canada and may be subject to withholding in the other country.

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BCF Business Law LLP

Gain on the Sale of Shares in Publicly Traded Corporations

50% of a capital gain realised by an individual is taxable at the individual's applicable federal and provincial income tax rate, including a capital gain realised on shares of a publicly traded corporation (see **2.7 Capital Gains Taxation**).

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Canada imposes a federal 25% withholding tax on certain types of passive income from Canadian sources, such as interests, dividends and royalties paid or credited to non-residents.

Subject to limited statutory exemptions, the Canadian payer is required to withhold tax from the gross amount paid or credited to the non-resident payee, and to remit it to the tax authorities on its behalf. The withholding tax rate can often be reduced to 15%, 10% or even 0% under Canada's tax treaties. However, before withholding less than 25%, the Canadian payer will normally require a completed declaration of eligibility for benefits under a tax treaty (ie, Form NR301, NR302 for a partnership, or NR303 for a hybrid entity such as a US LLC).

4.2 Primary Tax Treaty Countries

Canada currently has 94 tax treaties in force with foreign countries, which mainly follow the OECD Model Tax Convention (subject to exceptions).

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The OECD Multilateral Instrument (MLI) entered into force in Canada on 1 December 2019 and introduces *"principal purpose test"* into most of Canada's tax treaties, which will deny the benefits of the applicable treaty where one of the principal purposes of the arrangement or transaction is to obtain the benefits of the treaty. For example, if determination is made that one of the principal purposes for using a subsidiary in a particular treaty jurisdiction is to access the benefits of that treaty, then the benefits of that treaty are denied.

The tax authorities' position is that, in certain circumstances, Canada's General Anti-Avoidance Rule (GAAR) could be applied to transactions that are undertaken primarily to secure a tax benefit afforded by a tax treaty.

4.4 Transfer Pricing Issues

Transactions regarding goods, services (ie, management) and intangibles (ie, patents, trade marks) with non-arm's length non-residents are required to occur under arm's length terms and conditions. Otherwise, adjustments will be made to ensure that the Canadian payer's transfer prices or cost allocations reflect arm's length terms and conditions.

Should the Canadian tax authorities adjust transfer pricing, penalties could apply if the taxpayer has not made reasonable efforts to determine and use arm's length transfer prices. Prescribed documentation must be maintained, since a taxpayer who fails to do so will not be considered to have made *"reasonable efforts"* to determine and use arm's length transfer prices.

Multinational business groups with more than EUR750 million in annual consolidated revenues must file a country-by-country report containing various financial and operational information. Country-by-country reporting requirements in Canada were added in congruence with recommendations made as part of the OECD Base Erosion and Profit Shifting (BEPS) project.

4.5 Related-Party Limited Risk Distribution Arrangements

Related-party limited risk distribution arrangements should reflect arm's length terms and conditions in line with the transfer pricing principles outlined in **4.4 Transfer Pricing Issues**.

In addition, consideration should be given to Article 12 of the OECD MLI regarding the avoidance of permanent establishment status through the use of an agent that is not independent.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Canadian transfer pricing rules are generally in line with the OECD principles.

4.7 International Transfer Pricing Disputes

The Canada Revenue Agency (CRA) encourages taxpayers who are subject to double taxation to consider the Mutual Agreement Procedure (MAP) programme.

In its 2024 Consolidated Information on Mutual Agreement Procedures, the OECD mentions that:

- the CRA had 203 negotiable MAP cases on 1 January 2023;
- the CRA accepted 61 new MAP cases during 2023, and closed 86 MAP cases;
- the average time to complete a negotiable MAP case was 27.57 months;
- of the 86 MAP cases closed in 2023, 59 (68.60%) resulted in full relief from double taxation upon negotiation, three (3.49%) had objections not justified, and eight (9.30%) were resolved through unilateral relief – the remaining 16 cases (18.60%) were withdrawn by the taxpayer, were resolved via domestic remedy or without relief, resulted in partial relief of double taxation upon negotiation, resulted in no agreement, were denied MAP access or had another unmentioned outcome; and
- as of 31 December 2023, the CRA is engaged in negotiable MAP cases involving taxpayers from different jurisdictions, with the United States representing 41.57% of these MAP cases.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Under domestic law, upward and downward adjustments can be made to transfer pricing disputes. It should be noted that downward adjustments are made only if, in the opinion of the tax authorities, the circumstances indicate the adjustments are appropriate.

The CRA has mentioned that it may decide not to exercise its discretion with regards to downward adjustments where the taxpayer's request has been prompted by the actions of a foreign tax authority and the taxpayer has the right to request relief under the MAP article of the applicable treaty, or where such request can be considered abusive.

Unless the issue is one that the CRA has decided not to consider, as a matter of policy, the CRA is willing to negotiate MAP cases when taxpayers themselves initiate a downward transfer pricing adjustment in Canada within the treaty time limits. The CRA will engage in the MAP process if the other jurisdiction is willing to make a corresponding upward adjustment, provide a position statement and engage in negotiations. This approach is said to be consistent in avoiding both double taxation and double non-taxation.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

A non-Canadian entity may operate in Canada through a subsidiary or a branch.

Through a Canadian Subsidiary

Assuming it is a resident of Canada for tax purposes, a Canadian subsidiary will be taxed on its worldwide income from all domestic law sources. In general, a corporation is a Canadian resident if it is incorporated or has its central management and control in Canada.

Subject to treaty relief, the Canadian subsidiary will have to withhold tax on several types of payments to non-residents, including dividend distributions, interest paid to non-arm's length parties, participating interest, certain management or administration fees and rents, royalties and similar payments.

Through a Canadian Branch

Under the branch scenario, the non-resident corporation will be liable for income tax on its Canadian-source business income at the same rates as Canadian resident corporations.

Moreover, and as a general rule, a 25% branch tax (which may be reduced under certain tax treaties to the rate applicable to dividend distributions) will apply to the after-tax profits of a non-resident corporation that are not reinvested in Canada.

The branch tax is intended to approximate the withholding tax that would have applied to taxable dividends from a Canadian subsidiary if the non-resident corporation had incorporated a Canadian subsidiary to carry on business in Canada instead of using a branch.

5.3 Capital Gains of Non-Residents

Generally, Canada does not tax the capital gains realised by a non-resident on the disposal of shares in a Canadian resident corporation.

An exception to that principle applies if the disposed shares qualify as *"taxable Canadian property"*, which generally includes shares of corporations that are not listed on a designated stock exchange if more than 50% of the fair market value of the shares was derived from one or any combination of the following at any time in the previous 60-month period:

- real or immovable property located in Canada;
- resource property located in Canada;
- timber resource property located in Canada; or
- options or interests in any of the above.

In general, tax on the disposal of taxable Canadian property should not result in double taxation for a non-resident residing in a jurisdiction with which Canada has a tax treaty.

5.4 Change of Control Provisions

Change of control provisions will not trigger immediate tax or duty charges. However, the following occurs when there is a change of control:

- the taxation year of the corporation is deemed to end, and a new taxation year is deemed to begin;
- the corporation cannot deduct non-capital loss carry-forwards unless it carries on the business that gave rise to the loss for a profit or with a reasonable expectation of profit, in which case the losses are deductible only

against the corporation's income from the same or a similar business;
- the corporation's net capital loss carry-forwards expire;
- accrued capital losses cannot be carried forward; and
- the carry-forward of ITCs is restricted following the change of control.

The disposal of an indirect holding in a Canadian corporation higher up the foreign group could trigger the change of control provisions because *"indirect control"* has to be considered, as well as *"direct control"*.

A decision of the Supreme Court of Canada (SCC) has also introduced the concept of *"effective control"*, which has been described by the SCC as including *"forms of de jure and de facto control"*.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There is no mandatory formula to determine the income of a foreign-owned local affiliate selling goods or providing services in Canada. Transactions with the corporate group's foreign entities should rely on the *"arm's length principle"* of the transfer pricing rules.

5.6 Deductions for Payments by Local Affiliates

Generally, a local affiliate's expenses are non-deductible, unless they are made or incurred for the purposes of earning income from a business or property. Therefore, local affiliate expenses that are made or incurred for the purposes of earning foreign business or property income would normally be deductible to reduce the taxpayer's net income.

5.7 Constraints on Related-Party Borrowing

Canada has a set of thin capitalisation rules that may apply where the lender to a Canadian corporation is a non-resident person who, alone or with other related persons, owns more than 25% of the Canadian corporation's shares (by vote or value). The interest expense on the loan would otherwise be deductible to the Canadian corporation. These rules may also apply to trusts and to partnerships of which a Canadian-resident corporation is a member.

The acceptable level of non-arm's length interest-bearing debt allowed for the Canadian thin capitalisation rules is a debt-to-equity ratio of 1.5:1. Interest deduction will be limited proportionally if a debtor's outstanding debts to *"specified non-resident shareholder"* exceed that ratio.

Any non-deductible *"excess"* interest is treated as a dividend for withholding tax purposes and would trigger withholding tax at a rate of 25% (which may be reduced under certain tax treaties).

Debt financing provided by a Canadian corporation to its non-resident shareholders or any other non-resident persons connected to the non-resident shareholders is generally deemed to be a dividend paid to the non-resident, and is subject to Canadian withholding tax at a rate of 25% (which may be reduced under certain tax treaties).

Notable exceptions are where the loan is repaid within one year after the end of the lender's taxation year and the repayment is not part of a series of loans and repayments, or where the loan is considered *"pertinent loan or indebtedness"* (PLOI) under the PLOI regime. In such a scenario, the Canadian corporation must include a deemed interest income in its taxable income.

Canada also has *"excessive interest and financing expense limitation rules"*, the purpose of which is to restrict interest and financing deductions to a proportion of the profits of certain taxpayers. In general terms, interest expenses are required not to exceed 30% of taxable income calculated before interest income, interest expense, income taxes and depreciation expense. Any portion of an interest expense in excess of such percentage is generally not deductible in computing income. A deduction so denied may be carried back for three years and carried forward indefinitely, provided that it is within the above percentage in the year the deduction is claimed. Also, an election may be made to transfer unused cumulative excess deductions within a group of eligible corporations in Canada.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

A Canadian resident corporation is subject to Canadian corporate income tax on worldwide income. Foreign income is taxed in Canada at the same federal and provincial corporate tax rates as local income.

However, if a corporation has income sourced from another country and is taxed in that other country, it could be entitled to apply for foreign tax credits against its tax payable in Canada, to prevent double taxation on the same income. Separate foreign tax credit calculations are prescribed for business and non-business income on a country-by-country basis.

6.2 Non-Deductible Local Expenses

Generally, local expenses are non-deductible unless they are made or incurred to earn income from a business or property. Therefore, local expenses made or incurred for the purpose of earning foreign business or property income would normally be deductible to reduce the taxpayer's net income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Canadian taxation of a dividend received from a foreign corporation will depend on the foreign corporation's qualification. As a general rule, dividends must be included in computing the recipient's taxable income. If the foreign corporation is not a foreign affiliate (FA) of the dividend recipient, no relief will be available for the foreign corporation's underlying taxes. An FA is a foreign corporation of which a Canadian corporation owns an equity percentage of at least 1% of any class of its outstanding shares, and the same Canadian corporation owns – alone or together with related persons (individuals or corporations) – an equity percentage of at least 10% of any class of its outstanding shares, in which the notion of *"equity percentage"* refers to shares held directly or indirectly, through another entity.

When an FA pays a dividend to a Canadian corporation, the FA's surplus account must be determined. The four different surplus accounts (exempt surplus, taxable surplus, hybrid surplus and pre-acquisition surplus) accumulate differently.

Exempt Surplus Treatment

An exempt surplus is generally active business income earned by an FA that carries on an active business in a country with which Canada has signed a tax treaty. A dividend from this surplus account is fully deductible to the Canadian parent corporation receiving it. If the FA is in a non-treaty country, the dividend paid to the Canadian parent may also qualify as exempt surplus if the foreign country has entered into a tax information exchange agreement with Canada.

Hybrid Surplus Treatment

Hybrid surplus will generally include 100% of any gains from the sale of shares of an FA and/or partnership interest by another FA. Dividends out of hybrid surplus are only included in the Canadian corporation's taxable income at a rate of 50%.

Taxable Surplus Treatment

Taxable surplus generally captures *"net earnings"* from an active business carried on by the FA in a country with which Canada does not have a tax treaty and in respect of its foreign accrual property income (FAPI – see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**). Dividends paid out of this surplus account will be taxable in Canada if the FA's foreign tax rate is lower than Canada's tax rate.

Pre-Acquisition Surplus Treatment

Finally, a dividend from a pre-acquisition surplus is a fully deductible capital return that reduces the cost of the shares in the FA.

6.4 Use of Intangibles by Non-Local Subsidiaries

Non-Canadian subsidiaries can use intangibles developed by Canadian corporations. However, the Canadian corporation that owns and markets the intellectual property must charge an arm's length price to the related entity for the use of the intangible under the transfer pricing rules. The income earned from this agreement with the foreign subsidiary, such as royalties from a licensing agreement, is taxable in Canada for the Canadian parent.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Canadian corporations are taxed on the FAPI of an FA controlled by the Canadian taxpayer (controlled foreign affiliate – CFA) in the proportion of ownership in the CFA. FAPI is essentially passive income earned by the CFA, notably property income and capital gains. For example, if a Canadian corporation controls 80% of the CFA, 80% of the FAPI earned in the CFA at the end of each taxation year will have to be reported in the controlling Canadian corporation's tax return.

If the CFA is taxed in the foreign jurisdiction, the Canadian parent is allowed an equivalent deduction, based on the foreign accrual tax multiplied by the relevant tax factor in order to avoid double taxation. The relevant tax factor varies depending on the corporate structure of the Canadian parent. Generally, a corporation is allowed an equivalent deduction to the full FAPI income where the foreign accrual tax was 25% or higher. A tax-deferral advantage was previously available to CCPCs but the 2022 Budget proposed to eliminate this advantage by applying the tax factor of individuals instead of the tax factor of corporations to CCPCs, thus incentivising CCPCs to distribute the funds to their shareholders on a current basis. It is also possible to generate a foreign accrual property loss, which can apply against FAPI.

This position is no different for foreign branches of Canadian corporations, since the Canadian resident taxpayer is subject to tax on its worldwide income, subject to foreign tax credits to which it may be entitled.

6.6 Rules Related to the Substance of Non-Local Affiliates

Canadian domestic legislation does not directly require substance in foreign subsidiaries. However, where an FA carries on an *"investment business"* that does not employ more than five full-time employees in the active conduct of its business, the income of such business will generally constitute FAPI of the FA.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

A Canadian resident corporation is taxable in Canada on its worldwide sources of income, including capital gains from the sale of FAs. Only half of the capital gain

is included in the taxpayer's net income in Canada (as described in detail under **2.7 Capital Gains Taxation**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The ITA contains a GAAR that applies to abusive tax avoidance cases where the ITA provisions result in a tax benefit outside of their original purpose. A transaction is considered an avoidance transaction when all three of the following conditions are met:

- tax benefit must result from one transaction or a series of transactions – namely a reduction, avoidance or deferral of tax or an increased tax refund;
- tax benefit results directly or indirectly from a transaction that is considered an avoidance transaction, unless the transaction can reasonably be undertaken or arranged primarily for business purposes other than to obtain a tax benefit; and
- tax avoidance as a result of not being able to reasonably conclude that the tax benefit is consistent with the object, spirit or purpose of the provision invoked by the taxpayer.

It is incumbent on the taxpayer to establish that the first two conditions do not apply, while the burden for the third condition lies with the tax authorities.

Any GAAR issued assessment will have to be reviewed by a committee established by the CRA. If the CRA establishes abusive tax avoidance, the GAAR will apply and the tax benefit will be denied. If there is ambiguity with respect to abusive tax avoidance, the taxpayer is given the benefit of the doubt.

Recently, amendments were made to broaden the definition of *"tax benefit"* to ensure that the GAAR will apply to transactions that affect tax attributes that have not yet become relevant to the computation of tax (eg, a tax loss that has not yet been used to offset taxable income). Furthermore, stricter rules applying for GAAR purposes have been implemented as of 2024, in order to:

- lower the *"avoidance transaction"* standard;
- increase the reassessment period by an additional three years (unless the transaction was disclosed to CRA); and

- introduce a new economic substance rule to target transactions that lack economic substance.

In addition, a 25% penalty has been introduced for transactions subject to the GAAR. This penalty is applied to the denied tax benefit and is effective for transactions entered into on or after 20 June 2024. However, the penalty can be avoided if the transaction was disclosed to the CRA or if it was reasonable to conclude that the GAAR would not apply based on existing guidance or court decisions.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Canadian tax law does not outline specific rules regarding audit cycles, so Canada has no periodic routine audit cycle. Tax audits are typically carried out at the tax authorities' discretion; as such, an audit of a timely filed tax return can be conducted at any time by the Canadian tax authorities with all due dispatch.

Audit Process

Auditors have consequential investigative powers and may require the filing and disclosure of documents and information necessary for the assessment.

In general, the audit may begin with a formal demand letter requesting access to specific information, a physical visit to the place of business and/or a meeting with the individual taxpayer. In addition, the auditor may request, and be granted, access to third-party information, including banking and supplier documents and, to a limited extent, accountant files.

The process usually results in a draft or preliminary assessment, allowing for a 21-day window for the taxpayer to submit new information regarding the draft assessment issues. The formal time limit for issuing a reassessment notice is generally three or four years following the initial assessment notice for a given year depending on the status of the taxpayer, except in cases of negligence, fraud or failure to disclose transactions as required under the newly expanded mandatory disclosure rules. The reassessment period has also been extended by an unless the transaction was disclosed to the CRA. Some corporations will also face varying deadlines, depending on the nature of the audit.

9. BEPS

9.1 Recommended Changes

Canada has implemented the BEPS recommended changes, as follows.

Action 1 *"Address the Tax Challenges of the Digital Economy"*

Since 1 July 2021, foreign-based vendors selling digital products or services to Canadian consumers are required to register for, collect and remit sales tax on their taxable sales. Canada has also implemented a corporate tax on corporations providing digital services. Canada's Digital Services Tax was enacted on 20 June 2024 and came into force on 28 June 2024, with retroactive effect to 1 January 2022. The first year of application of the Digital Services Tax is the 2024 calendar year, which applies to taxable Canadian digital services revenue earned since 1 January 2022.

In October 2021, a statement of the OECD/G20 Inclusive Framework on BEPS on a Two-Pillar solution to further this action was proposed and accepted by more than 130 countries, including Canada. Pillar One is focused on nexus and profit allocation, applying to certain multinational enterprises (MNEs) that have consolidated revenues of more than EUR20 billion and profitability margins exceeding 10%. This pillar indicates that, whether or not an MNE has a physical presence in a country where it earns revenues, a portion of its profits is to be reallocated from the MNE's home country to the countries where the MNE earns profits. Canada has a strong preference for the multilateral approach, which has yet to be adopted by OECD members. In the interim, Canada has implemented a Digital Services Tax to protect its interests.

Pillar Two is focused on a global minimum corporate tax rate of 15% on profits for MNEs with revenues of more than EUR750 million. Canada has enacted new legislation to implement Pillar Two in its legislation, imposing a global minimum corporate tax rate of 15% on profits for MNEs with revenues above EUR750 million. The new Global Minimum Tax Act legislates an income inclusion rule and a qualified domestic minimum top-up tax, and applies retroactively for fiscal years of MNEs that begin on or after 31 December 2023. The undertaxed profit rule is expected to come into effect for fiscal years commencing on or after 31 December 2024.

Actions 2–10 and 12–15

- Action 2 *"Neutralise the effects of hybrid mismatch arrangements"* Canada has implemented the recommendations made by the OECD, with appropriate adaptations to the Canadian income tax context.
- Action 3 *"Strengthen CFC Rules"* Canada has adopted controlled foreign corporation (CFC) rules and applies a rather wide definition of CFC and legal and economic control tests to define a CFC.
- Action 4 *"Limit base erosion via interest deductions and other financial payments"* effective 1 October 2023, Canada has introduced new earnings-stripping rules that limit interest deductions by certain Canadian entities and branches of non-resident taxpayers to a proportion of their tax EBITDA, subject to certain transitory rules.
- Action 5 *"Counter harmful tax practices more effectively, taking into account transparency and substance"* Canada agreed to exchange information regarding cross-border rulings relating to preferential regimes, transfer pricing legislation, downward adjustment not directly reflected in the taxpayers' accounts, permanent establishment determination, and related-party conduit rulings.
- Action 6 *"Prevent treaty abuse"* Canada announced that it would adopt the principal purpose test to address treaty abuse in 2017, according to the OECD's minimum standard. The principal purpose test is an anti-abuse provision that seeks to deny treaty benefits where one of the main objectives of an arrangement or transaction is to obtain treaty benefits.
- Action 7 *"Preventing the artificial avoidance of permanent establishment status"* Canada has chosen not to adopt the expanded definition of a permanent establishment in most of its tax treaties, to reflect the recommendations set out in this Action 7.
- Actions 8 to 10 *"Transfer pricing"* Canada's transfer pricing guidelines are consistent with those established by the OECD.
- Action 12 *"Disclosure of aggressive tax planning"* Canada has amended its legislation to widen the range of transactions that are to be reported. For example, this requirement extends to reporting uncertain tax treatments for specified corporations. The reporting requirements for reportable transactions and

notifiable transactions have been in effect since 22 June 2023 and apply to transactions that straddle that date. The reporting requirement for uncertain tax treatments applies to taxation years beginning after 2022, with penalties only applying for taxation years beginning on or after 22 June 2023.

- Action 13 *"Re-examine transfer pricing documentation"* Canada implemented country-by-country reporting as of 1 January 2016. This reporting applies to multinational corporations whose total annual consolidated group revenue is EUR750 million or more. Such corporations will be required to file a country-by-country report with the CRA within one year of the end of the fiscal year to which the report relates.
- Action 14 *"Dispute resolution"* Canada has reviewed stage two of Action 14 and has made recommendations. Canada opted for the mandatory binding agreement as proposed by BEPS Action 14.
- Action 15 *"Develop a multilateral instrument"* Canada ratified the MLI in 2019. The MLI applies to some of Canada's tax treaties, effective as early as 1 January 2020, for Canada's treaty partners that have also ratified the MLI.

Where Canada has not implemented specific legislative changes concerning the above-mentioned BEPS Actions, it can generally be explained by the fact that it has introduced a series of domestic measures over the past decade to prevent perceived abuses also targeted by the BEPS Actions.

9.2 Government Attitudes

Canada has been actively involved in the BEPS project deployed by the G20 and OECD, and continues to work with the international community to ensure a coherent and consistent response to BEPS. Canada has endorsed all the recommendations developed under the BEPS project. Canada and other G20 members believe that broad and consistent implementation will be critical to the project's effectiveness. While some BEPS Actions have already been implemented, Canada continues to analyse recommendations related to other aspects of BEPS.

9.3 Profile of International Tax

International taxation has gained a high public profile in Canada, with the government taking active steps in the fight against aggressive international tax avoidance, protecting the Canadian tax base and enhancing the overall fairness and transparency of Canada's tax administration.

9.4 Competitive Tax Policy Objective

Canada recognises the significance of business income tax in improving the country's international competitiveness, believing that certain BEPS Actions will enhance Canada's international competitiveness. Canada remains committed to ensuring that its tax policies are aligned with international standards to attract foreign investment and prevent base erosion.

9.5 Features of the Competitive Tax System

Canada has implemented several tax incentives for Canadian businesses, such as income tax credits for activities relating to research and development, which has stimulated the Canadian economy and increased investments.

9.6 Proposals for Dealing With Hybrid Instruments

BEPS Action 2 seeks to neutralise the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction.

Canada implemented new hybrid mismatch rules in line with the recommendations in, and generally consistent with, BEPS Action 2; these rules came into effect on 1 July 2022. Under these rules, payments made by Canadian residents under hybrid mismatch arrangements would not be deductible for Canadian income tax purposes to the extent that they give rise to a further deduction in another country or are not included in the ordinary income of a non-resident recipient. Conversely, to the extent that a payment made under such an arrangement by a non-resident of Canada is deductible for foreign income tax purposes, no deduction in respect of the payment would be permitted against the income of a Canadian resident. Any amount of the payment received by a Canadian resident would also be included in income, and, if the payment is a dividend, it would not be eligible for the deduction otherwise available for certain dividends received from foreign affiliates.

Canada also relies on the GAAR to prevent undue tax benefits.

9.7 Territorial Tax Regime

Canada has a worldwide tax regime for resident corporations' income but has some aspects of a territorial tax regime for its FAs. For example, all dividends derived from active income earned by an FA will be fully exempt from tax in Canada if the FA is a resident of and earns active income in a country with which Canada has a tax treaty or a tax information exchange agreement.

However, passive investment income earned by an FA – typically interests, royalties and rents – will be taxable in Canada regardless of whether or not the profits are repatriated. These FAPI rules ensure that passive income is taxed on a current basis to mitigate the tax advantage of shifting domestic income to low-tax jurisdictions.

9.8 Controlled Foreign Corporation Proposals

This question is not applicable in Canada. Canada's existing CFC rules are considered comprehensive and align with BEPS principles.

9.9 Anti-Avoidance Rules

Recent case law on the application of the GAAR to perceived abuse of a tax treaty concluded that whether or not the income is subject to taxation in a foreign jurisdiction (double non-taxation situation) and the residence of the ultimate shareholder were irrelevant in determining if a transaction is abusive, and that treaty shopping arrangements are not inherently abusive for Canadian tax purposes.

9.10 Transfer Pricing Changes

BEPS Actions 8 to 10 addressed several transfer pricing areas related to the arm's length principle, and introduced significantly revised guidance in the form of amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Canada has played an important role in developing additional guidance on issues identified in the course of the BEPS Project and believes that its current practices are consistent with the OECD transfer pricing guidelines.

9.11 Transparency and Country-by-Country Reporting

Canadian country-by-country reporting legislation generally conforms to the OECD model legislation, with the notable exceptions that it has not adopted the OECD's master or local file requirements. Under domestic law, contemporaneous transfer pricing documentation is required in place of the local file requirements.

As recommended by BEPS Action 13, country-by-country reporting applies to MNEs with an annual consolidated group revenue equal to or exceeding EUR750 million in the previous year, and applies for fiscal years beginning on or after 1 January 2016.

Filed reports are automatically exchanged with other jurisdictions in which the multinational business group operates, provided that:

- the other jurisdiction has implemented country-by-country reporting legislation;
- both Canada and the other jurisdiction have a legal framework in place for the automatic exchange of information; and
- both Canada and the other jurisdiction have entered into a qualifying competent authority agreement.

9.12 Taxation of Digital Economy Businesses

Canada has implemented a tax on corporations providing digital services, which applies to revenue earned since 1 January 2022; see **9.1 Recommended Changes**. Canada remains committed to a multilateral solution but is concerned about the delay in arriving at a consensus.

Canada's Digital Services Tax applies at a rate of 3% on certain revenue earned by large businesses from certain digital services reliant on the engagement, data and content contributions of Canadian users, as well as on certain sales or licensing of Canadian user data.

The Digital Services Tax applies to large businesses, both foreign and domestic, that meet both of the following revenue thresholds:

- a total revenue threshold of EUR750 million; and
- a Canadian in-scope revenue threshold of CAD20 million.

If a taxpayer is a member of a consolidated group, these thresholds would be calculated on a group basis.

With regard to in-scope revenue, the four categories are:

- online marketplace services revenue;
- online advertising services revenue;
- social media services revenue; and
- user data revenue.

In addition, Canada has enacted new legislation to implement Pillar Two in its legislation; see **9.1 Recommended Changes**.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Offshore intellectual property deployed within Canada may result in taxation under generally applicable Canadian principles. Royalties paid to foreign recipients are among the categories of income subject to withholding tax. The 25% withholding rate may be reduced by treaty.

CHILE

Law and Practice

Contributed by:
Rodrigo Benítez, Christian Poulsen and Joaquín Ugarte
SW Consulting

Contents

Contributed by: Rodrigo Benítez, Christian Poulsen and Joaquín Ugarte, **SW Consulting**

SW Consulting is a legal and consulting company and an independent firm that is part of ShineWing International Limited (SW International), a global professional services network with deep roots in Asia-Pacific, which has become one of the 20 largest firms in the world. SW Chile comprises a multidisciplinary team of more than 100 professionals, who are characterised by being decisive, proactive and approachable and by providing personalised services in audit, tax, legal, accounting, remuneration and advisory matters. SW Chile represents the union between prominent national professionals and SW International – an integration that seeks to build increasingly solid bridges between Latin America and one of the largest economies in the world. As part of SW International, the firm serves as a business partner that creates cross-border growth opportunities.

Authors

Rodrigo Benítez is SW Chile's managing partner and graduated as a lawyer from the University of Chile. Rodrigo holds a Master of Laws in taxation from Georgetown University Law Center in Washington, DC, where he was a Fulbright Scholar in 2001, and holds a postgraduate degree in economics and finance from the University of Chile. Rodrigo is a member of the Chilean Institute of Tax Law – of which he was president from 2013-17 – and is a member of the Chilean Bar Association and the International Fiscal Association. Rodrigo is a professor at the University of Santiago (USACH) and Pontificia Universidad Catolica de Chile. He speaks Spanish and English.

Christian Poulsen is a senior associate at SW Chile, where he specialises in private international law. Christian graduated as a lawyer from the University of Chile, going on to obtain a postgraduate degree in structures, financing and corporate taxation from the same university. During 2019, he participated as a researcher in a legal publication entitled *"Construction and Arbitration"* and also published in the Chilean Private International Law Review. Christian speaks both Spanish and English and his practice focuses mainly on local and foreign tax advisory and corporate law.

Joaquín Ugarte is an associate at SW Chile and graduated summa cum laude as a lawyer from the University of Chile, having won Chile's Constitutional Court Prize with an honourable mention for his undergraduate thesis. Joaquín is a teaching assistant at the Universidad de Chile, teaching constitutional law and law principles. His practice is focused mainly on local and foreign tax advisory and corporate law. Joaquín speaks both English and Spanish.

SW Chile

Andres Bello 2687
Floor 23
Las Condes
Santiago de Chile
Chile

Tel: +56 2 4367 2600
Email: contacto@sw-chile.com
Web: www.sw-chile.com

Contributed by: Rodrigo Benítez, Christian Poulsen and Joaquín Ugarte, **SW Consulting**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses usually adopt the following corporate forms:

- corporations (*sociedades anonimas*, or SAs);
- limited liability companies (*sociedades de responsabilidad limitada*, or SRLs);
- *agencia de una empresa extranjera* (a Chilean branch of a foreign corporation); and
- joint stock companies (*sociedades por acciones*, or SpAs).

Notwithstanding the foregoing, other corporate vehicles used to incorporate certain businesses include:

- limited companies (*sociedades en comandita*), which can be simple limited companies or companies limited by shares);
- contractual mining companies (*sociedades contractuales mineras*); and
- individual limited liability companies (ILLCs) (*empresas individuales de responsabilidad limitada*).

Generally, the same tax treatment applies to these legal entities: up to a 27% corporate income tax rate and a withholding tax rate of up to 35%. All these entities are taxed as separate legal entities and provide limited liability to their shareholders. Only in certain exceptional cases of bankruptcy or fraud (ie, in the fields of labour and tax law) may equity holders be held liable for the legal entity's obligations.

Division of Corporate Capital

The corporate capital of an SA and an SpA is divided into shares, whereas -in the case of an SRL – it is divided into quotas (the owners of the equity are named quotaholders). An SRL and an SA require the existence of at least two quotaholders or two shareholders, respectively. An SpA can be formed by one or more shareholders. Additionally, single-shareholder companies can be shareholders of other single-shareholder companies.

There is no minimum registered capital for creating an SA, SpA or SRL. However, depending on the activity to be engaged in by the company (eg, banking or insurance), it must have the approval of the Financial Markets Commission (*Comisión para el Mercado Financiero*, or CMF) and/or the Superintendency of Banks and Financial Institutions (*Superintendencia de Bancos e Instituciones Financieras*, or SBIF) to legally exist and this requires a minimum registered capital.

There are no restrictions with regard to the nationality of the partners, nor are foreign partners required to have their residence in Chile. However, an attorney domiciled or resident in Chile must be appointed for tax purposes.

Corporate Bodies

Legal entities have three corporate bodies:

- a management body (composed of directors or managers);
- a governing body (meetings of equity holders or quotaholders); and
- an audit body (external auditors or account inspectors, depending on the nature of the legal entity to be formed).

An SA, by legal mandate, is managed by a board comprising at least three directors in the case of closed corporations. Meanwhile, in the case of open corporations, the minimum number of directors on each corporation's board is five. Open corporations with assets in the stock exchange that are equivalent to or exceed the amount of UF1.5 million (approximately USD60 million) must have seven directors on each corporation's board. UF stands for *Unidad de Fomento* UF1 was approximately equivalent to USD40 in March 2025.

The board directors are essentially removable. The board of directors also exercises the judicial and extrajudicial representation of the corporation, without prejudice to the judicial representation that may be exercised by general managers (if general managers are appointed).

The initial management of a corporation is entrusted to a board of directors, which – upon the company's incorporation – is unanimously elected by the founding shareholders. Such board of directors only lasts until the first shareholders' meeting is held, whereupon the same directors may be confirmed or an entirely new board may be elected.

Directors may hold office for a tenure of up to three years when such term is mentioned in the company's by-laws. However, at the end of the tenure, they can be re-elected indefinitely. If the company's by-laws do not mention the duration of the director's term, the law states that such director's term may only last one year – following which, a shareholders' meeting will be necessary to elect a new board.

The management of an SRL is performed by one or more managers, who can act individually, jointly or organised as a board, depending on the provisions established in the SRL by-laws. Managers may hold office indefinitely.

The management of an SpA can be conducted by managers or a board of directors, depending on the provisions established in the SpA's by-laws. Managers may hold office indefinitely. One of the managers must be appointed as the legal representative, especially before the Chilean Internal Revenue Service (Servicio de Impuestos Internos, or SII).

In all cases, the members of the management are not required to be equity holders.

Meetings

At least annually, the equity holders of a legal entity will hold a meeting to:

- examine the company's situation and the reports of the auditors and external auditors and the approval or rejection of the annual report, balance sheet and financial statements submitted by the directors or liquidators of the company;
- see to the distribution of profits for each financial year and, in particular, the distribution of dividends;
- elect or dismiss members and alternates of the board of directors, liquidators, and supervisors of the administration; and
- in general, discuss any matter of corporate interest that is not the subject of an extraordinary meeting.

Decisions of the equity holders of an SpA or an SRL may be obtained through written consent or in a public deed.

1.2 Transparent Entities

As a general principle, companies are legal persons and taxable entities. Therefore, there are no transparent entities for tax purposes under Chilean law, except for private investment funds or SMEs that opt to be treated as transparent.

Private investment funds are usually not subject to corporate income tax; this is to encourage the asset management and financial advisory industry for investors and national and foreign securities issuers, offering new financial products for investors under a common legal frame (Law 20,712).

1.3 Determining Residence of Incorporated Businesses

Companies incorporated in Chile are treated as residents. Companies and other legal entities organised abroad are treated as non-residents. Permanent establishments in Chile of non-residents are treated as separate entities for income tax purposes; they are also considered non-residents.

1.4 Tax Rates

In general, the corporate income tax in Chile (*impuesto de primera categoría*, or IDPC) of the entity can be (partially or fully) credited against the shareholder's or quotaholder's tax liability. According to the tax reform introduced by law, corporate tax has several regimes according to the size, billings, assets or investments allocation of the business, as follows.

- Large businesses (Article 14A of the Income Tax Law (*Ley Impuesto a la Renta*, or LIR) – this tax regime is based on full accounting records where the shareholders or quotaholders are taxed on an accrual basis. They can deduct a partial amount (65%) of the corporate income tax paid up by the company as tax credit against its individual tax liability (eg, personal income tax (*impuesto global complementario*, or IGC) for Chilean tax residents or withholding tax (*impuesto adicional*, or IA) for non-residents).
- SMEs (Article 14D(3) of the LIR) – this allows taxpayers to choose between simple and complete accounting records, with a fixed 25% corporate tax rate. Shareholders and/or quotaholders are taxed on a receipt basis and may deduct 100% of the business income tax paid by the enterprise as a tax credit against its personal tax liability (IGC for Chilean tax residents or IA for non-residents). It should be noted that SMEs during the Tax Years (TYs) 2025, 2026, 2027 and 2028 should be subject to a corporate income tax rate of 12.5%(*"Tax Bill"*). As of TY 2029, the regular IDPC rate of 25% should resume.
- Fiscal transparency regime (Article 14D(8) of the LIR) – this tax regime is also focused on SMEs whose owners are final taxpayers (individuals with or without tax residence in Chile or non-resident companies established abroad). In this case, the company shall be exempt from corporate income tax and the taxpayers shall be subject to personal income tax according to their residence status in Chile or abroad.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable income is defined as gross income minus the direct costs of goods and services and necessary expenses to produce that income, adjusted for inflation and corrected as provided by law. Chilean-sourced income is calculated on cash or accrual basis. Foreign-sourced income is generally calculated on a received basis; however, income derived by permanent establishments of resident companies located abroad is calculated on an accrual basis under controlled foreign company (CFC) rules if the Chilean resident has an equity interest of 50% or more in the foreign corporation.

On a general basis, taxable profits are calculated on an accrual basis in the case of an incorporated business. Exceptionally, for SMEs (subject to the SME tax regime), profits are calculated on a receipt basis.

2.2 Special Incentives for Technology Investments

Law 20,241 (2008), as amended by Law 20,570 (2012), establishes that business income taxpayers reporting their taxable income based on full accounting records and investing in R&D may credit amounts invested in R&D against the business income tax liability.

The R&D investment must be made under a written R&D contract with a registered research centre (which must comply with certain conditions under Law 20,241 and Law 20,570) for an amount exceeding 100 monthly tax units (one monthly tax unit (*unidad tributaria mensual*, or UTM) equals approximately USD70, as of May 2024).

The corporate tax credit is 35% of payments made in the tax year under the R&D contracts. The annual credit is limited to 15,000 UTMs per year. Payments exceeding the maximum annual credit are considered deductible expenses. Any excess credit may be carried forward. Taxpayers can apply this benefit, complying with the legal procedures.

Partial payments, which are considered as credits or deductible expenses, shall not be considered as non-deductible expenses under Article 21 of the LIR.

Finally, Chilean tax law does not consider the establishment of a patent box or a special corporate tax regime for R&D investments with regard to the tax rate applied to those expenditures.

2.3 Other Special Incentives

Under Chilean law, there are several incentives that apply to certain industries and transactions, such as:

- several taxation incentives from capital gains (eg, immovable property, shares);
- special regimes for income from bonds;
- R&D credit;
- regional incentives;
- financial leasing;
- credit for investments in tangible fixed assets; and
- training credits from the National Training and Employment Service (*Servicio Nacional de Capacitación y Empleo*, or SENCE).

2.4 Basic Rules on Loss Relief

In general, losses are deductible as an expense against the profits of the tax year and could be set off against undistributed profits. If the profits were not sufficient to offset the losses, the losses can be carried forward indefinitely. However, carry-back of losses is no longer available.

If losses were set off against non-distributed profits, the business income tax paid on such profits was treated as an advance payment and could be set off against income taxes (corporate income tax, individual income tax or non-resident income tax) or refunded.

Losses incurred by a company before the transfer of its shares or its rights to participate in the profits may not be set off against the income accrued or received after the transfer if:

- as a result of the transfer or during the 12 months before or after the transfer, the company changes its principal business purpose;

- at the time of the transfer, the capital assets or other assets of the company are not sufficient to carry out the company's activity;
- the value of the assets is not proportional to the transfer price; or
- the company's income will be derived only from its participation as a partner of, or shareholders in, other companies or from the reinvestment of its profits.

Finally, losses arising from the disposal of securities cannot be deducted from taxable income if gains arising from the disposal of the securities would be excluded from taxable income.

2.5 Imposed Limits on Deduction of Interest

In general, there are no limits for the deduction of interests for a company, except for the excess indebtedness provision (*"thin capitalisation rule"*) of Article 41F of the LIR, which states that a company incorporated in Chile is deemed to be in such position when the company has a debt ratio of 3:1 in relation to its financial equity.

However, the payment of interests abroad for the concept of royalties is subject to withholding tax established in Article 59(1°) of the LIR of up to 4% of the company's annual income.

2.6 Basic Rules on Consolidated Tax Grouping

Chilean tax law does not include provisions concerning taxation on a consolidated basis. Nevertheless, business group taxation is addressed through certain modifications enacted by Law No 20.713, such as the obligation to designate a common attorney for the business group and the option for such group to select a tax auditor or audit group from the Chilean Internal Revenue Service for all of the companies belonging to the group. These two new obligations to be fulfilled by the business group could lead to progress in the field of consolidated taxation of business groups, which does not yet exist under Chilean law.

2.7 Capital Gains Taxation

Capital gains arising from the transfer of shares when derived by persons that are subject to business income tax on actual net income are subject to tax under the general rules. However, capital gains from the transfer of shares acquired before 1 January 1984 are never considered income for tax purposes and thus are not subject to income tax.

The LIR defines the taxable base for capital gains essentially as the *"sale price"* minus the *"tax cost"* of the shares. Tax cost is defined as the cost of acquisition of the shares adjusted for any capital increase or capital reduction, as appropriate.

Each amount involved in the determination of the tax cost should be indexed according to the Consumer Price Index (*Indice de Precios al Consumidor*, or IPC).

Rather than reliefs or exemptions, companies can be subject to a restructuring process (eg, mergers, acquisitions or a spin-off between related companies of an entrepreneurial group) in which shareholders can acquire shares from a company without taxation on possible capital gains accrued.

2.8 Other Taxes Payable by an Incorporated Business

Incorporated businesses are subject to the following taxes on certain transactions, such as:

- VAT (*impuesto a las ventas y servicios*, or IVA);

- inheritance and gift taxes (*impuesto a las herencias, asignaciones y donaciones*, or IHAD);
- real estate tax (*impuesto territorial*);
- stamp duty (*impuesto de timbres y estampillas*);
- business licence (*patente comercial*) fee; or
- custom duties (*impuestos aduaneros*).

As of October 2025, the VAT exemption for imports under USD41 will be eliminated, following recent tax reform approved by Law No 21.713. Meanwhile, customs duties will only be paid for products whose value is greater than USD500.

It is worth bearing in mind that Chilean law does not consider the following aspects of incorporated businesses to be taxable, as there is:

- no capital duty on the formation of companies – notwithstanding this, a business licence fee calculated on the company's capital is required to be paid on an annual basis for tax purposes; and
- no net wealth tax.

2.9 Incorporated Businesses and Notable Taxes

Finally, in determined transactions, incorporated businesses are subject to the following taxes:

- a surtax on the real estate tax for owners of properties with a fiscal value of more than USD500,000; and
- a tax on luxury assets (such as helicopters, aircrafts, cars and yachts), which applies a 2% tax rate on the fiscal value.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Although closely held local businesses are formed by small groups of partners related by family or business bonds, they usually operate under a corporate form. Owing to the nature of these businesses' partners or shareholders, they usually operate under one of the following corporate structures:

- an SRL;
- a closed corporation;
- a simple joint stock company.

The above-mentioned corporate vehicles are usually chosen because of their flexibility when it comes to corporate administration and their ability to establish provisions in the by-laws that include the shareholders or partners in matters such as dividend distribution, partner liability, and dispute resolution.

3.2 Individual Rates and Corporate Rates

Residents or domiciled persons are liable to income tax on their worldwide income.

If individual professionals choose to be subject to corporate tax instead of taxing at individual rates under the personal income tax, they can organise their activities under one of the following corporate structures:

- individual limited liability company;
- simple joint stock company (SpA); or
- limited liability company (SRL).

Legal entities structured as SRLs formed solely by individuals performing exclusively professional services or consultancy are not subject to VAT taxes. Additionally, they may choose – within the first three months of the commercial year – to report their income under business income tax rules instead of the personal income tax rules. Once made, the election is irrevocable.

Notwithstanding the foregoing, if the corporate form used by the individual professional is deemed to be a scheme to conceal an employment or labour relation, the Chilean Internal Revenue Service can requalify the operation and liquidate the respective taxes on the individual under the general anti-avoidance rules. Also, there is a rule of deemed dividend for non-deductible expenses, subject to 40% to 50% of taxes.

3.3 Accumulating Earnings for Investment Purposes

As a general principle, there are no rules that prevent closely held corporations from accumulating earnings for investments purposes.

However, professional partnerships – due to their purely business purpose – can occasionally allocate earnings for the purpose of maintaining the available cash flow stock.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends and capital gains derived from the sale of shares or quotas held by individuals in partnerships or other corporate structures are taxed under the general rules of the income tax law.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Capital gains derived from the sale of shares or held by individuals in publicly traded corporations are taxed at a 10% rate, under the special rule established in Article 107 of the LIR. Dividends from publicly traded companies obtained by individuals are taxed under the general rules established in the LIR.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest, dividends and royalties are subject to withholding tax under different rates according to several hypothesis established in the LIR. In this regard, interest paid up to non-residents is subject to withholding tax at the general 35% rate. Interest on loans granted by foreign banks or financial institutions is subject to a reduced withholding tax of 4%.

Royalties paid to non-residents are subject to a withholding tax rate of 30%. Royalty payments in connection to software are subject to a reduced 15% withholding rate, unless the software is non-customised or standard – in which case, the full amount paid up is exempted from withholding tax. Such rate is increased if the beneficiary of the payment is resident in a tax haven.

Finally, dividends paid to non-resident recipients are subject to a 35% withholding tax. The foreign tax credit paid at the corporate level is totally or partially creditable against this withholding tax, depending on the income tax system to which the source entity is subject to.

Consequently, the tax burden for a non-resident recipient of dividends, including taxes at the company level, is:

- 35% if subject to the SME regime or resident in a DTT country; and

- 44-45% if subject to a partially integrated system (PIS) regime and not resident in a treaty country.

4.2 Primary Tax Treaty Countries

In order for foreign investors to invest in local corporate stock or debt, Chile has a wide range of DTTs available to foreign investors. The provisions established in the following DTTs usually apply:

- Chile-Argentina (2017);
- Chile-Australia (2014);
- Chile-Austria (2016);
- Chile-Belgium (2011);
- Chile-Brazil (2004);
- Chile-Canada (2000);
- Chile-China (2017);
- Chile-Colombia (2010);
- Chile-Croatia (2005);
- Chile-Denmark (2005);
- Chile-Ecuador (2004);
- Chile-United Arab Emirates (2023);
- Chile-Spain (2004);
- Chile-USA (2024);
- Chile-France (2007);
- Chile-India (2023);
- Chile-Ireland (2009);
- Chile-Italy (2017);
- Chile-Japan (2017);
- Chile-Malaysia (2009);
- Chile-Mexico (2004);
- Chile-Norway (2004);
- Chile-New Zeland (2007);
- Chile-Netherlands (2023);
- Chile-Paraguay (2009);
- Chile-Perú (2004);
- Chile-Poland (2004);
- Chile-Portugal (2009);
- Chile-United Kingdom (2005);
- Chile-Czech Republic (2017);
- Chile-Russia (2017);
- Chile-Sweden (2006);
- Chile-Switzerland (2011);
- Chile-Thailand (2011); and
- Chile-Uruguay (2019).

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

As a general principle, if a person or company considers itself to be a tax resident of a certain state that has a standing DTT with Chile and has a residence certificate, Chile usually accepts such qualification as a tax resident – even though that person was previously a tax resident of a state without a standing DTT with Chile.

Notwithstanding the foregoing, if Chile considers that such person does not comply with such conditions to be considered a tax resident (*"beneficial owner"*), Chile can challenge that qualification via the mutual agreement procedure established in the corresponding DTT with the other state.

4.4 Transfer Pricing Issues

Law No 21.210 introduced certain modifications to the Chilean transfer pricing (TP) regulations as of 1 January 2020.

In order to ensure that transactions between related parties are valued at market prices and to avoid tax base erosion, the Chilean Internal Revenue Service has strengthened its enforcement capacity through the Large Taxpayers Division, conducting audits on high-risk transactions with foreign related parties.

Penalties for non-compliance include significant fines, which can reach up to 300% of the evaded tax for the submission of false statements. In this regard, taxpayers are obliged to issue information regarding the so-called local file (DDJJ

1951), tax characterisation (DDJJ 1913) and the master file (DDJJ 1950), as well as the annual transfer pricing statement (DDJJ 1907).

Finally, according to the recent tax reform enacted by Law No 20.713, taxpayers are allowed to proceed with transfer pricing adjustments to values without affecting VAT and customs – as long as the adjustment is made before the end of the calendar year.

4.5 Related-Party Limited Risk Distribution Arrangements

Among the control actions usually deployed by the Chilean Internal Revenue Service, it frequently questions the use of related-party limited risk distribution agreements. The Chilean Internal Revenue Service carefully examines whether the income allocation reflects the risks, functions and assets involved in each case, so as to ensure its correspondence with the arm's length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

In general, Chilean legislation has implemented transfer pricing rules according to the OECD standards. Nevertheless, it contemplates certain related-party rules and new types of transfer pricing methods (residual or alternate models of determining transfer pricing).

4.7 International Transfer Pricing Disputes

During the past year, the Chilean Internal Revenue Service's approach towards transfer pricing has been more co-operative and oriented towards reducing the probability of certain liabilities regarding transfer pricing of intangibles and the market transfer of shares by taxpayers in certain economic sectors, such as private or public investment funds.

Also, the current tax administration is promoting the subscription of advanced transfer pricing agreements (APAs) in order to resolve transfer pricing issues with taxpayers and mutually agree on a market value price according to the risks, assets and functions involved in the transactions between related parties.

Notwithstanding the foregoing, since the establishment of the APAs through the tax reform of 2012, this tool has not been used much by taxpayers.

On the other hand, mutually agreed procedures have been promoted by the Chilean authorities, particularly through the establishment of instructions by the Chilean Internal Revenue Service to resolve transfer pricing disputes between taxpayers and the respective tax administration.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The taxpayer must ensure to the satisfaction of the tax administration that its operations are carried out based on the arm's length principle. Therefore, self-adjustments in price transfers are allowed in Chile.

If this is not the case, the tax administration is empowered to make transfer pricing adjustments, by which means the Chilean Internal Revenue Service can increase the taxable base to a final tax rate of 40%. In addition, they can impose a fine equal to 5% of the balance.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches of non-local corporations are not generally taxed differently to local subsidiaries of non-local corporations.

5.3 Capital Gains of Non-Residents

Non-residents are subject to non-resident income tax on their Chilean-sourced income. In general, Chilean-sourced income is income from assets located in Chile or activities carried out therein, including direct capital gains from the sale or transfer of shares.

However, Chilean-sourced income also covers capital gains from the indirect disposal of Chilean assets (shares of a non-local holding company that owns the stock of local corporations directly) made between non-residents that are taxed under very specific conditions.

This income is subject to a withholding tax at the rate of 35% when one of the following scenarios are met:

- when at least 20% of the market value of the shares or quotas that the transferor possesses (directly or indirectly) in the foreign entity – at the time of the transfer or during the previous 12 months to the transfer – is derived from one or more underlying assets established in a), b) or c) and in corresponding proportion to the direct or indirect interest possessed by the foreign transferor valued at market price:
  - (a) shares, rights, quotas or other shareholding titles in the property, control or profits of a company, fund or entity incorporated in Chile;
  - (b) an agency or other permanent establishment in Chile of a non-resident or non-domiciled taxpayer in Chile, considering that such permanent establishment for tax purposes is an independent entity from its main office or parent company; and
  - (c) any type of movable or immovable property located in Chile (or the titles regarding such properties) whose owner is a non-resident company or legal entity; and
- when the alienated shares, quotas, rights or foreign titles have been issued by a company or legal entity located in a preferential tax regime jurisdiction.

DTTs to which Chile is a party do not specifically resolve the taxation on capital gains from the indirect disposal of Chilean assets. In this regard, a case-by-case analysis should be done by the foreign investor according to the applicable DTT between Chile and the other state.

5.4 Change of Control Provisions

Under Chilean law, there are no change of control provisions. In this regard, indirect capital gains will be taxed regardless of how many companies there are in between the holding and the Chilean local corporation, if the transfer complies with the requirements stated in **5.3 Capital Gains of Non-Residents**. Please also refer to the change of control provisions for loss relief in **2.4 Basic Rules on Loss Relief**.

Nonetheless, the amendments to the new restructuring appraisal provision include:

- the incorporation of a definition of market value into the standard;
- the option for parties to submit valuation reports; and
- the incorporation of international restructuring in cases that are not recognised for tax purposes.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are mainly used in transfer pricing rules to provide an estimated arm's length price for transactions between related companies or with entities located in preferential tax regime jurisdictions.

However, it is important to remember that these are just transfer pricing methodologies. Each company still needs to prepare its own independent financial statements for tax compliance and financial reporting purposes.

5.6 Deductions for Payments by Local Affiliates

Usually, the standard applied is the *"arm's length principle"*. Additionally, the deduction shall only be allowed once the payments are effectively made on a receipt basis. Expenses accrued with related parties abroad can only be deducted for the effective payment of such expenses on a cash basis.

5.7 Constraints on Related-Party Borrowing

Thin capitalisation rules apply to related-party borrowing by foreign-owned local affiliates paid to non-local affiliates at a 3:1 debt-to-equity ratio. When the taxpayer is in an excess of indebtedness position, a 35% sole penalty tax is levied on interests, commissions, services or any other financial disbursement associated with loans that are subject to withholding tax at a rate lower than 35% (eg, interest paid up from loans granted by foreign banks) or that have not been taxed under domestic law or owing to the application of a reduced rate under a DTT.

The excess of indebtedness is calculated on an annual basis. To determine whether the taxpayer is in an excess of indebtedness position, its total annual indebtedness takes into consideration all loans – domestic or foreign – from related parties or otherwise.

Finally, in the event that the company is in an excess of indebtedness position, the tax will apply only to cross-border loans granted by related parties and subject to the 4% withholding tax rate at a rate lower than 35% or that have not been taxed under domestic law or owing to the application of a reduced rate under a DTT.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Chile has a worldwide residence-based tax regime. In this respect, foreign income accrued or received by local corporations is subject to the corporate income tax (25-27%).

6.2 Non-Deductible Local Expenses

Under Chilean law, there are no limitations imposed on local corporations regarding the deductible expenses attributed to income obtained from abroad.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are taxed under the corporate income tax regime. Generally, taxes paid abroad for such distribution (or in the event the corporate income tax is paid by the foreign subsidiary) will be offset as a tax credit against Chilean corporate income tax, within certain limits and conditions according to the tax regime of the receiving company (foreign tax credit).

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by local corporations can be used by non-local subsidiaries throughout the duration of a licensing arrangement. Transfer pricing rules apply for determining the adequate price of the transference of the intangible or licence to related parties.

The fees paid up by the non-local subsidiaries to the local corporations are taxed under the corporate income tax. The amounts used in the R&D required to develop the intangible can be deducted by the local corporation as necessary expenses to determine their corporate income tax.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Effectively (but only with regard to the passive income obtained by local corporations from their non-local subsidiaries), if the local corporation has at least a 50% shareholding interest in the capital, profits or control of such company, the income from the non-resident companies shall be taxed on an accrual basis.

Additionally, profits derived by foreign branches are generally considered as foreign-sourced income for the local corporation, to which foreign tax credits may apply.

6.6 Rules Related to the Substance of Non-Local Affiliates

Chilean income tax law does not define such a concept nor establish any rules in that respect, unless general anti-avoidance rules apply in the case of lack of substance. Chile also applies the rules of the DTT, as well as the treaty shopping provisions of the OECD.

It has been understood that the substance of an affiliate consists of the organisation of human and material resources necessary for a company to conduct its economic activities.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Gains on the sale of shares in foreign subsidiaries by local corporations are subject to corporate income tax up to 27% – the rate of which shall depend on the tax regime of such local corporation (SME or PIS). Tax credits rules will depend on the tax regime and whether a tax treaty applies.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Chilean law establishes a wide variety of local anti-avoidance rules, from general anti-avoidance rules to special anti-avoidance hypotheses, as follows.

General Anti-Avoidance Rules

Under Law No 20.713, the General Anti-Avoidance Rules (GAAR) (Articles 4.3 and 4.4 of the Tax Code) and their application have been amended. The main changes are as follows.

- GAAR application hypothesis – prior to Law No 20.713, the GAAR only applied when there was simulation or abuse of legal forms. Following Law No 20.713, abuse or simulation can also be committed through *"legal facts"* (ie, not only acts or contracts of any kind, but any fact of legal relevance, such as death or birth).
- Specialty principle – prior to Law No 20.713, where a special anti-avoidance rule was applicable, it was not possible for the Chilean

Internal Revenue Service to apply the GAAR. Following Law No 20.713, the Chilean Internal Revenue Service can choose whether to use the general anti-evasion rule (*norma general antielusiva*, or NGA) or use the special anti-avoidance rules (*normas especiales antielusivas*, or NEA) at its discretion.
- Burden of proof – prior to Law No 20.713, the burden of proof was on the Chilean Internal Revenue Service. Following Law No 20.713, the Chilean Internal Revenue Service must prove the elements that constitute the evasive act and the taxpayer must prove the economic reasons that justify such a scheme (*"business purpose test"*).
- Statute of limitations – prior to Law No 20.713, as a general rule, there was a three-year limitation period (Article 200, paragraph 1 of the Tax Code). Following Law No 20.713, three years is still the general rule. However, in the case of a set or series of acts, the limitation period will be counted from the last act.
- Fines – prior to Law No 20.713, only consultants who designed or planned the structure sanctioned under the GAAR could be fined. Following Law No 20.713, the taxpayer can also be fined in certain cases and there is now joint and several liability for corporate governance (directors, managers, principal executives, etc, can face a maximum fine of approximately USD200,000).

The new procedure for applying the GAAR under Law No 20.713 is as follows.

- The procedure is triggered by a mandatory prior summons to the taxpayer and the audit will be carried out by the Chilean Internal Revenue Service's Department of General Anti-Avoidance Rules.
- The taxpayer must prove the economic and legal reasonableness of the operation or the *"economy of option"*.
- The Department of General Anti-Avoidance Rules prepares a report with its conclusions and recommendations, classifying the facts as constituting avoidance or not.
- The report is submitted to the Chilean Internal Revenue Service's Anti-Avoidance Committee, who will have 15 days in which to analyse the report and issue an opinion.
- The Chilean Internal Revenue Service's Anti-Avoidance Committee may request the opinion of the Advisory Council.
- The Advisory Council will have 60 days to issue its (non-binding) opinion.
- The Chilean Internal Revenue Service's Anti-Avoidance Committee then makes its decision. If it concludes that tax evasion has taken place, the Director of the Chilean Internal Revenue Service's Anti-Avoidance Committee shall compel the tax court to declare the existence of a tax-avoiding scheme.
- There then follows a special claim process under Chilean law at the tax courts, whereby this is a possibility of conciliation.

Special Anti-Avoidance Rules

Special anti-avoidance rules have been established mainly in the LIR, including:

- CFC rules indicated in Article 41G of the LIR;
- transfer pricing rules established in Article 41E of the LIR;
- thin capitalisation rules indicated in Article 41F of the LIR;
- tax haven rules in Article 41H of the LIR; and
- indirect capital gains tax.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Generally, the Chilean tax system is one of self-assessment. The Chilean tax administration sets its audit policies according to each economic activity and, in particular, to each tax.

These policies are generally set at the beginning of each year and are made public by the Chilean tax administration. These audits are focused on large economic groups and other businesses with relevant revenue from both national and foreign sources.

As regards individuals, audits are generally conducted after the Chilean tax administration finds inconsistencies between the proposed tax returns and the information collected via several automatic information regimes, mainly through withholding agents such as banks, financial institutions, insurance companies, and employers.

9. BEPS

9.1 Recommended Changes

Chile has implemented several of the base erosion and profit shifting (BEPS) recommendations recommendations issued by the OECD/G20 Inclusive Framework on BEPS, including the following.

- Action 3: Limiting Base Erosion Through Controlled Foreign Company (CFC) Rules – Chile has adopted CFC rules and taxes income of foreign subsidiaries controlled by Chilean residents that is considered low taxed or not taxed, on an accrual basis where certain conditions are met.
- Action 5: Countering Harmful Tax Practices More Effectively – Chile has taken steps to address harmful tax practices identified by the OECD, such as preferential tax regimes and lack of transparency. Among such measures, Chile has established under recent tax reform enacted by Law No 20.713 the enforcement of the Tax Avoidance Schemes Catalog (published annually by the Chilean Internal Revenue Service), providing a legal recognition for such catalog.
- Action 13: Country-by-Country Reporting (CbC) – Chile has completely adopted CbC reporting requirements, requiring multinational companies to report financial and tax information on a CbC basis.

Action 15: Multilateral Instrument – Chile has ratified the Multilateral Convention to Apply Measures Related to Tax Treaties to Prevent Base Erosion and Profit Shifting (MLI/BEPS/OECD/G20) (the *"Multilateral Instrument"*, or MLI) and has proceeded to gradually implement the BEP recommendations.

Actions in Progress

Chile is still in the process of implementing the following recommendations.

- Action 1: Addressing the Tax Challenges of the Digital Economy – Chile has already established a special taxable event in order to tax (with VAT) services provided by digital B2C platforms and other tech companies (such as Netflix and Spotify). In this regard, foreign non-resident companies are also subject to a voluntary registry (digital service providers must register with the Chilean Internal Revenue Service).
- Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements – the main actions in this regard have been related to the pre-

vention of structured deals in the case of payments of interest by national banks or financial institutions to non-resident foreign banks. The absence of such structured deal is deemed as a sine qua non condition for the withholding tax reduction under Chilean law.
- Action 6: Prevention of Tax Treaty Abuses – Chile has signed tax information exchange agreements with various countries and the MLI.
- Action 7: Permanent Establishment Status – following the enactment of Law No 21.210, Chilean legislation incorporates a clear definition of permanent establishment, which is based on the concept established in DTTs entered into by Chile with several states.
- Action 11: BEPS Data Analysis – the Chilean Internal Revenue Service and other government agencies keep track of the necessary data that allows the adoption and implementation of BEPS recommendations at legislative and regulatory level.
- Action 12: Mandatary Disclosure Rules – the tax reform approved by congress (Law No 20.713) during October 2024 includes provisions that enforce the burden of proof on taxpayers where the Chilean Internal Revenue Services declares the existence of a tax-avoiding scheme. In this regard, Chilean Internal Revenue Services requires certification of the existence of the acts configuring the avoidance scheme and the taxpayer must prove that such structure complies with their economic and financial background and was not only motivated by mere tax purposes.
- Action 14: Mutual Agreement Procedure – such procedure has been established by administrative rulings and resolutions that indicate the conditions for taxpayers dealing with the tax administrations of both states involved in a DTT.

Non-Initiated Actions

The following actions have yet to be initiated in Chile.

- Action 4: Limitation on Interest Deductions – Chile is implementing these actions via establishment of thin capitalisation rules indicated in the LIR.
- Actions 8-10: Transfer Pricing Documentation and CbC Reporting for Tax Authorities – Chile is implementing these actions through several reports that must be submitted by the taxpayers annually, especially information regarding multinational enterprises.

9.2 Government Attitudes

In May 2010, Chile became a full member of the OECD after a two-year period of compliance with the organisation's mandates and rules. In this regard, the Chilean government has a generally positive attitude towards the BEPS recommendations. It has passed BEPS-related legislation and has ratified the MLI.

Such provisions have also entered into effect between Chile and countries such as Australia, Austria, Canada, South Korea, Croatia, Denmark, Spain, France, Ireland, Mexico, Norway, New Zealand, Poland, Portugal, South Africa, Thailand and Uruguay.

The reason behind such policies is to continue the permanent opening-up of Chile to international markets. This is why Pillar One and Pillar Two are within the purview of Chilean authorities. Nevertheless, to date, no Pillar Two provisions have been implemented by the Chilean government.

9.3 Profile of International Tax

International tax has a high public profile in Chile, especially after the *"Panama Papers"* and *"Pandora Papers"* leaks and various investigations into non-declared offshore accounts. These issues are likely to influence the further implementation of BEPS recommendations.

The information that the Chilean Internal Revenue Service receives under Common Reporting Standard (CRS) and Foreign Account Tax Compliance Act (FATCA) agreements is quite relevant, owing to the prominent data that can be used to identify and pursue international tax evasion. (The Chilean Internal Revenue Service, through the provisions established under tax information exchange agreements, has obtained information regarding the set-up of financial accounts by Chilean taxpayers with investments abroad. Accordingly, the Chilean Internal Revenue Service has detected the existence of USD32 billion in financial accounts in which Chilean investors hold their investments abroad.)

9.4 Competitive Tax Policy Objective

Although Chile has passed several tax reforms that have increased tax rates levied up on corporations and high net worth individuals, it has yet to become a competitive jurisdiction for tax purposes, especially for foreign investor. This is due to the free foreign exchange market and the wide range of DTTs signed with several OECD and G20 members.

Despite the tendency of these measures to attract foreign investment and promote tax competitiveness, Chile has incorporated several BEPS principles into its legislation, such as thin capitalisation rules, CFC rules and transfer pricing rules.

9.5 Features of the Competitive Tax System

Chile has terminated or reformed several DTTs that were vulnerable to treaty abuse by taxpayers, such as those with Argentina and the USA. This demonstrates the country's commitment to preventing tax evasion and avoidance.

In addition, Chile participates in international tax information exchange arrangements. This has resulted in increased transparency in tax matters.

9.6 Proposals for Dealing With Hybrid Instruments

The best policy options for addressing hybrid instruments (such as convertible bonds, preferred shares and convertible notes) are the specific anti-avoidance rules and the rules specifically addressing hybrid mismatch arrangements, as recommended by the OECD. The GAAR could also be useful in this matter.

9.7 Territorial Tax Regime

Chile has a residence-based, worldwide income tax regime. Chile has thin capitalisation rules established in Article 41F of the LIR, so as to discourage an excessive interest deductibility by the foreign corporation that invests in the local corporation. In that sense, it restricts the amount of debt on which interest is tax deductible to a predefined debt-to-equity ratio (3:1). Expenses accrued from related parties abroad are only deductible when they are effectively paid (cash basis).

9.8 Controlled Foreign Corporation Proposals

Chile has a residence-based, worldwide income tax regime, but has transparency or CFC rules that make deferral clearly more cumbersome. However, in broad terms, companies with no Chilean controlling shareholders will not be subject to this rule.

9.9 Anti-Avoidance Rules

The proposed DTT *"limitation on benefits"* or anti-avoidance rules were included in the recently approved DTT between Chile and USA, in treaties with other countries, and in the MLI.

9.10 Transfer Pricing Changes

Prior to the BEPS recommendations, Chile had certain transfer pricing rules in place since 1998. However, since 2012, Chilean transfer pricing legislation has been widely altered in accordance with OECD guidelines. IP is particularly difficult to price adequately, mainly because it is difficult to find an adequate comparison.

9.11 Transparency and Country-by-Country Reporting

As a general principle, proposals for transparency and CbC reporting are favoured. As mentioned in **9.8 Controlled Foreign Corporation Proposals**, Chile has already included transparency rules in its local legislation. The CbC reports provide more detailed information to the Chilean tax administration, forcing the transfer pricing reports to be more thorough and to include other related-party transactions that would otherwise not be dealt with for these purposes.

9.12 Taxation of Digital Economy Businesses

The digital economy business is taxed under the VAT legislation (Article 8N), which has included clauses to tax B2C businesses operating from abroad (such as Netflix and Spotify).

9.13 Digital Taxation

Although the Chilean government is promoting a comprehensive tax reform bill, the project does not include new proposals relating to digital taxation.

9.14 Taxation of Offshore IP

There are no other provisions dealing with the taxation of offshore IP that is deployed within Chile. For the payment of royalties to non-resident beneficiaries (which could be reduced if a DTT applies), please see **4.1 Withholding Taxes**.

CHINA

Law and Practice

Contributed by:
Sean Wang
Beijing Dacheng Law Offices, LLP

Contents

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Author

Sean Wang (TEP) is a highly respected tax specialist renowned for his expertise in tax planning, dispute resolution, wealth management, and cross-border investment. He holds law degrees from both China and the United Kingdom. As a partner and Chairman of the Global Wealth Security Legal Centre at Dacheng, he plays a pivotal role in advising top corporations and top-tier financial institutions – including major banks such as HSBC, BOC (Bank of China), and SPD – on complex legal and tax matters. Fluent in both Chinese and cross-border tax affairs, Sean has earned an outstanding reputation, particularly among foreign investors navigating China's intricate tax landscape. Sean is frequently invited to teach taxation courses at many of China's top universities. He is a Council Member of the China Region of STEP (Society of Trust and Estate Practitioners). He is recognised in the 2024 Chambers and Partners High Net Worth Wealth Guide, and is also a bestselling author on trusts and taxation.

Beijing Dacheng Law Offices, LLP

15-21F Tower B
ZT International Center
No.10 Chaoyangmen Nandajie Chaoyang District
100020
Beijing
China

Tel: +86 13671232807
Fax: +86 10-58137788
Email: wang.xu@dentons.cn
Web: www.dacheng.com

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In China, businesses generally adopt a corporate form due to their operational and legal advantages. Common structures include:

- Limited Liability Company (LLC): Shareholders' liability is limited to their capital contributions. This is the most popular form due to its flexibility and liability protection.
- Joint Stock Company (JSC): This structure is suitable for larger enterprises requiring access to capital markets. Shareholders' liability is limited to their shareholdings.

These entities are taxed as separate legal entities under the Corporate Income Tax (CIT) system.

However, in China, not all enterprises generally adopt the company form. There are also other forms like sole proprietorships and partnerships.

- Sole Proprietorships: These are set up by one natural person. The owner has unlimited liability for the business's debts and it is managed flexibly by the owner or appointed persons.
- Partnerships: These comprise general partnerships and limited partnerships. Partners in general partnerships have unlimited joint and several liability, while in limited ones, limited partners' liability is limited to their contributions.

These entities are not taxed as separate legal entities under the Corporate Income Tax (CIT) system. Instead, the owner of a sole proprietorship pays individual income tax on business income, and partners in a partnership are taxed according to their nature: individual partners pay individual income tax, while entity partners are subject to corporate income tax.

1.2 Transparent Entities

In China, transparent entities are not taxed at the entity level; income is passed through to partners or investors, who are taxed individually. Common types include general partnerships (GPs), limited partnerships (LPs).

- GPs are commonly used by law firms, accounting firms, and consulting businesses, where all partners actively participate in management and bear unlimited liability for the partnership's obligations.
- LPs are favoured in private equity and venture capital, consist of general partners who manage the entity and bear unlimited liability, while limited partners provide capital but have limited liability.

Advantages of Transparent Entities

- Tax Efficiency: They avoid corporate-level taxation and prevent double taxation on investment income.
- Flexible Profit Distribution: Investors and fund managers can tailor profit allocation strategies.
- Limited Liability for Investors: LPs provide liability protection for investors, restricting risk exposure to their capital contributions.
- Management and Liability Flexibility: The GP-LP model allows professionals (such as fund managers) to perform as a GP to assume unlimited liability, while passive investors only bear liability up to their capital contribution and have no management obligations.

It should be noted that trusts in China are not defined as transparent entities.

1.3 Determining Residence of Incorporated Businesses

An incorporated business is considered a Chinese resident enterprise if:

- it is lawfully incorporated in China, meaning it is established in accordance with Chinese laws and administrative regulations and has completed the corporate registration process with the Chinese government; and
- its *"place of effective management"* is located in China, referring to where substantial and overall business operations, management, and decision-making occur.

For transparent entities (eg, partnerships), Chinese tax authorities generally determine tax residence based on where the partners or actual management reside. If the entity's effective management is in China, it may be deemed a Chinese tax resident.

However, residency determinations for incorporated businesses and transparent entities are also subject to double taxation treaties (DTTs).

China's DTTs generally follow the OECD Model Tax Convention or the UN Model, providing tie-breaker rules to resolve dual tax residency conflicts. When both China and another country treat a company as a tax resident, the place of effective management (PoEM) typically determines the final residence status. For instance, under the China-Singapore DTT, if a company is considered a resident in both jurisdictions, its PoEM decides its residence. Certain treaties, such as the China-Hong Kong DTT, may provide a more detailed definition of PoEM, sometimes requiring the company's board of directors or top-level management to have a permanent establishment in the jurisdiction.

1.4 Tax Rates

Incorporated Businesses

Chinese incorporated businesses are generally subject to multiple taxes administered at both national and local levels. The primary categories include corporate income tax, value-added tax, and various local surcharges. Other taxes may apply depending on the company's business activities, industry, and location.

Corporate income tax (CIT)

- The standard rate is 25% for most enterprises.
- Preferential rates, such as 15%, are available for specific enterprises, including high and new technology enterprises (HNTEs) and businesses engaged in encouraged industries in certain regions, such as Hainan.
- Eligible small low-profit enterprises can benefit from an effective tax rate as low as 5%.

Value-added tax (VAT)

- General VAT rates usually range from 6% to 13%, with 13% being the most common.
- Certain goods or services fall under a lower 9% rate or a 6% category.
- Small-scale taxpayers may pay a simplified rate of 3%.

Consumption tax

- This tax targets specific goods like tobacco, alcohol, and luxury items.
- They may be subject to an ad valorem rate (ranging from approximately 5% to 56%) or a specific rate based on the quantity of goods (charging a fixed amount per unit), and in some cases, a combination of both methods.

Local surcharges and other taxes

- Urban Maintenance and Construction Tax: This is calculated as a percentage (1%–7%) of the VAT or consumption tax payable.

- Stamp Duty: This is levied on certain contracts or documents, with rates typically between 0.03% and 0.1%.
- Property Tax and Land Use Tax: This is applied to real estate and land, with specific rates varying by locality.

Tax Rates for Businesses Owned by Individuals or Through Transparent Entities

In China, businesses owned by individuals directly or through transparent entities (such as sole proprietorships, general partnerships, or limited partnerships) are generally subject to individual income tax (IIT) rather than corporate income tax (CIT). IIT applies on a progressive scale, typically ranging from 5% to 35%, depending on the amount of taxable income. Some local incentives and special policies may further reduce the effective tax burden.

Because income flows through to individual owners, no separate CIT is imposed on these structures. Investors or partners report their share of the operating profits as personal income, and any tax due is determined by their applicable IIT brackets. This pass-through system helps avoid a double layer of taxation but can result in higher tax liability if the individual's total income places them in a higher tax bracket.

Similarly, businesses owned directly by individuals or through transparent entities must also pay transaction-based taxes such as VAT and consumption tax, just like incorporated businesses. However, the applicable tax rates may differ depending on specific circumstances.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits in China are calculated based on accounting profits, with adjustments for tax purposes, including:

- Non-deductible Expenses: Certain expenses, such as fines, penalties, and excess entertainment costs, are not tax-deductible.
- Exempt or Preferential Income: Certain income, like qualified dividends from resident enterprises, may be exempt or eligible for preferential treatment. Profits are taxed on an accrual basis, meaning income is recognised when earned, and expenses when incurred.
- Specific Deductions/Allowances: Some expenditures (for instance, eligible research and development expenses) can be deducted at a higher percentage than recorded in the accounting books.

China primarily adopts an accrual-based system for tax purposes. Income is recognised when earned, and expenses when incurred, rather than upon actual cash receipt or payment.

Although the accrual method is standard, certain industries or transactions may be subject to special rules or industry-specific guidance from the tax authorities.

2.2 Special Incentives for Technology Investments

China does not operate a formal patent box regime; however, it provides a super deduction for R&D expenses, allowing eligible costs to be deducted at 200%.

Other special incentives for technology are outlined below.

HNTE Status

Qualifying HNTEs enjoy a reduced CIT rate of 15%, compared to the standard 25%.

Software Industry Incentives

- CIT: Encouraged software enterprises may be eligible for *"two-year exemption and three-year half reduction"* policy, beginning from their first profitable year under the standard 25% statutory rate. Particularly crucial enterprises may qualify for a five-year exemption followed by a 10% tax rate.
- VAT: Businesses selling self-developed software products can receive a VAT refund for the portion where the actual VAT burden exceeds 3% after paying the standard 13% VAT.

Additional Local Support

Certain regions in China provide extra incentives, such as tax rebates, subsidies, and grants, to attract technology-focused businesses.

2.3 Other Special Incentives

Free Trade Zones (FTZs)

China's FTZs, such as the Shanghai Free Trade Zone and the Hainan Free Trade Port, offer tax and customs incentives designed to boost international trade and investment.

Benefits often include reduced import duties on certain goods, and, in some cases, a lower CIT rate of 15% for companies in encouraged industries.

Western Region Development Programme

Companies operating in designated western provinces may qualify for a reduced CIT rate of 15% if they engage in encouraged industries (eg, infrastructure, advanced manufacturing).

Eligible Small Low-Profit Enterprises

From 1 January 2023 to 31 December 2027, small and low-profit enterprises with annual taxable income of up to RMB3 million may include only 25% of that portion in their taxable income. CIT is then calculated at 20% on the reduced amount, resulting in an effective tax burden of 5%.

Enterprises Engaged in Pollution Prevention and Control

From 1 January 2019 to 31 December 2027, qualified enterprises focused on pollution prevention and control are eligible for a reduced CIT rate of 15%.

The incentives described above represent only some of the core special incentives available in China. The government periodically releases targeted policies for sectors such as biotechnology, semiconductors, and high-end manufacturing. These policies may provide tax credits, grants, or accelerated depreciation for qualified equipment purchases, all aiming to stimulate development and enhance China's global competitiveness in key industries.

2.4 Basic Rules on Loss Relief

Enterprises can carry forward losses for up to five years to offset future profits. High-tech enterprises may carry forward losses for up to ten years. There is no provision for loss carryback in China. Business income and capital gains are generally consolidated into overall profits or losses. Income losses can be offset against capital gains and vice versa.

2.5 Imposed Limits on Deduction of Interest

Thin Capitalisation Rules

- China enforces thin capitalisation rules, which limit the deduction of interest expenses on loans from related parties.
- Generally, the debt-to-equity ratio should not exceed 2:1 for most enterprises and 5:1 for financial institutions.
- If the ratio exceeds these thresholds, the excess interest may not be deductible for CIT purposes unless the enterprise can prove that the financing was conducted on an arm's length basis.

Related-Party Loan Interest Deduction

- Interest on loans from related parties must comply with transfer pricing rules to ensure that interest rates and terms reflect fair market conditions.
- The tax authorities may adjust interest deductions if they consider the interest rate excessive or not at arm's length.

Anti-Tax Avoidance Provisions

If an enterprise structures debt arrangements in a way that aims to erode the tax base artificially (eg, excessive intra-group interest payments), the tax authorities have the right to re-characterise the transaction and limit deductions under general anti-avoidance rules (GAAR).

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax filings are generally not permitted in China, and each company must file taxes separately. Losses cannot be transferred between entities. However, businesses can optimise tax efficiency within a group through strategic structuring, transfer pricing compliance, and M&A arrangements while ensuring regulatory compliance.

Although parent companies and their subsidiaries cannot file consolidated tax returns, headquarters and branches can do so because branches are not separate legal entities from their headquarters.

2.7 Capital Gains Taxation

In China, corporate capital gains are taxed as ordinary income, typically at 25% CIT, with no separate capital gains tax regime. However, dividends from resident companies are exempt, and tax deferrals may apply to qualified restructurings; however, for publicly issued and traded shares, dividend and profit distributions are exempt from tax only if the shares have been continuously held for more than 12 months.

Capital gains from selling shares are not exempt and remain taxable. Foreign investors selling Chinese shares may face a 10% withholding tax, subject to treaty relief.

2.8 Other Taxes Payable by an Incorporated Business

The main taxes are outlined below.

VAT

- General VAT rates usually range from 6% to 13%, with 13% being the most common.
- Certain goods or services fall under a lower 9% rate or a 6% category.
- Small-scale taxpayers may pay a simplified rate of 3%.

Consumption Tax

- This tax targets specific goods like tobacco, alcohol, and luxury items.
- They may be subject to an ad valorem rate (ranging from approximately 5% to 56%) or a specific rate based on the quantity of goods (charging a fixed amount per unit), and in some cases, a combination of both methods.

Local Surcharges and Other Taxes

- Urban maintenance and construction tax is calculated as a percentage (1%–7%) of the VAT or consumption tax payable.

Stamp Duty

This is levied on certain contracts or documents, with rates typically between 0.03% and 0.1%.

Land Appreciation Tax (LAT)

This tax is imposed on gains from real estate transactions, such as the sale of land use rights or buildings. Progressive tax rates range from 30% to 60% based on the appreciation value.

Deed Tax

This tax applies to the transfer of land use rights and real estate transactions. Rates generally range from 3% to 5% of the transaction value.

2.9 Incorporated Businesses and Notable Taxes

Notable taxes applicable to incorporated businesses may include:

- environmental protection tax, which is levied on pollutants discharged into the environment;
- real estate-related taxes, such as land use tax and real estate tax, depending on property ownership and usage; and
- resource tax (businesses engaged in exploiting taxable natural resources like minerals are liable for resource tax; the tax is based on the quantity or value of the resources exploited, and rates differ according to different resource categories).

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

According to data released by the Chinese government, business entities in China are primarily sole proprietorships (individual industrial and commercial households) rather than corporate entities. This structure offers simpler registration procedures and lower operational costs. In most cases, non-corporate businesses are not required to maintain full accounting records, making them a more cost-effective option for small entrepreneurs.

3.2 Individual Rates and Corporate Rates

In China, IIT rates range from 3% to 45%, with certain types of income, such as capital gains and dividends, taxed at a fixed 20% rate. CIT is commonly levied at 25%, and profits distributed from companies to individuals are generally subject to a 20% tax. As a result, CIT rates are not necessarily lower than individual income tax rates, and the overall tax burden depends on income structure and tax planning strategies.

3.3 Accumulating Earnings for Investment Purposes

In China, there are no specific anti-accumulation tax rules that explicitly prevent closely held corporations from retaining earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends from closely held corporations are taxed at a fixed 20% IIT, withheld at the corporate level.

Capital gains from selling shares in private corporations are taxed at 20% IIT, with the seller responsible for reporting.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Tax on Dividends

For secondary market shares (publicly traded shares bought on stock exchanges)

Dividends are subject to IIT based on the holding period:

- held for ≤1 month: 20% tax;
- held for >1 month but ≤1 year: 10% tax; and
- held for >1 year: exempt from IIT.

The listed company withholds and remits the tax before distributing the dividends.

For restricted shares (lock-up shares in a listed company)

Before the lock-up period ends

Dividends are taxed at an effective rate of 10%, as only 50% of the dividend amount is included in taxable income and taxed at 20% IIT.

After the lock-up period ends

Dividends are taxed the same as non-restricted shares, based on the standard holding period-based tax rates (0%, 10%, or 20%) as above. The holding period starts from the date of the share unlock (not the original acquisition date).

Tax on the Gains of the Sale of Shares

For secondary market shares (shares bought on the stock exchange)

Capital gains from selling A-shares (Mainland-listed stocks) are exempt from IIT, but a 0.1% securities transaction tax (STT) applies to the selling side.

Capital gains from selling restricted shares after unlocking are subject to a 20% IIT, the same as other private equity transactions.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of income tax treaties, China imposes a 10% withholding tax on interest, dividends, and royalties, with limited domestic relief options. If a tax treaty is in place, the withholding tax rate may be reduced.

The local tax authority closely monitors cross-border payments, especially for related-party transactions and royalty arrangements, and employs stringent enforcement measures to ensure compliance. The government's strict monitoring is driven not only by tax enforcement considerations but also by China's foreign exchange control measures, aiming to prevent companies from exploiting payments of interest, dividends, and royalties as loopholes to circumvent foreign exchange regulations and transfer funds overseas.

4.2 Primary Tax Treaty Countries

Hong Kong is the most commonly used jurisdiction (not a country) due to its favourable double tax treaties with China.

Under the China-Hong Kong Double Tax Agreement, withholding tax rates on dividends and interest may be reduced to 5%, subject to specific conditions. Hong Kong's relatively simple tax system and strong financial infrastructure make it a preferred platform for investments into Chinese corporations.

In addition to Hong Kong, the Chinese government has signed DTTs with over 100 countries and regions, many of which include tax incentives related to investment.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Chinese local tax authorities often examine cross-border arrangements that appear to exploit treaty benefits without meeting the required conditions. In particular, they focus on whether the entity in the treaty country qualifies as the *"beneficial owner"* of the income.

Relevant Treaty Provisions and Interpretations

Certain double tax treaties include the concept of *"beneficial ownership"* as a criterion for enjoying preferential withholding tax rates on dividends, interest, or royalties. If a non-resident entity cannot demonstrate that it is the true beneficial owner of the income, local tax authorities may deny treaty benefits.

General Anti-Avoidance Rules (GAAR)

In addition to treaty-specific provisions, China's Corporate Income Tax Law and its implementing regulations contain GAAR provisions. If an arrangement is primarily tax-driven and lacks a valid commercial purpose, tax authorities have the right to adjust the transaction. Non-treaty country residents using treaty country entities purely for tax benefits may have their structures recharacterised, resulting in the denial of treaty benefits and the application of standard withholding tax rates.

4.4 Transfer Pricing Issues

Inbound investors face challenges ensuring cross-border related-party transactions meet the arm's length principle. Key issues include financing arrangements, intellectual property payments, management fees, intercompany pricing, and documentation compliance.

Related-Party Financing

- The main concern is whether cross-border loans and interest rates are at arm's length.
- Non-compliance can lead to denied deductions and higher taxable income.

Intellectual Property Royalties

- The main concern relates to royalty rates and their alignment with market value.
- If deemed excessive, tax authorities may make adjustments and question the substance of the arrangement.

Service and Management Fees

- The main concern is whether services were provided and properly documented.
- Improperly supported fees can be disallowed or adjusted.

Profit Shifting and Intercompany Pricing

- The main concern is preventing profit shifting through related-party transactions.
- Disputes can result in additional taxes, penalties, and interest.

Documentation Compliance

- The main concern is meeting China's strict transfer pricing documentation standards.
- Poor compliance can trigger audits, increase costs, and lead to adjustments.

4.5 Related-Party Limited Risk Distribution Arrangements

Local tax authorities in China may challenge related-party limited risk distribution arrangements if they believe these arrangements do not comply with the arm's length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

While China's transfer pricing regulations are generally based on OECD guidelines, key differences exist in enforcement practices, the emphasis on local economic substance, and the treatment of location-specific advantages. These distinctions can result in outcomes that vary from OECD standards, especially in how profits are allocated to Chinese entities and the documentation burden placed on taxpayers.

4.7 International Transfer Pricing Disputes

In recent years, local tax authorities in China have stepped up their efforts on transfer pricing enforcement. They closely monitor transactions between related parties, especially those involving significant amounts or complex structures. They are willing to make new inquiries and to re-examine earlier tax years if fresh information or documentation suggests that past transfer pricing arrangements might not have been at arm's length.

Meanwhile, the Chinese tax authorities have been actively participating in MAP negotiations to resolve related disputes and to enhance China's reputation as a reliable investment destination. MAPs are becoming more common in China. The rise in cross-border transactions, coupled with more frequent audits and tighter transfer pricing scrutiny, has led to a growing number of disputes that taxpayers prefer to resolve through MAP. This trend is further reinforced by China's commitment to implementing OECD recommendations, including enhanced dispute resolution mechanisms under the Base Erosion and Profit Shifting (BEPS) framework. As a result, MAPs are likely to play an increasingly important role in addressing complex transfer pricing issues and mitigating double taxation in China.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments can be made when a transfer pricing dispute is resolved.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

The local branches of non-local corporations are taxed differently to local subsidiaries of non-local corporations. The primary differences arise from their legal structure. A local branch is an extension of the foreign corporation and does not have a separate legal identity, while a local subsidiary is an independent legal entity.

5.3 Capital Gains of Non-Residents

Capital gains tax is generally imposed on non-residents who sell Chinese stock. Indirect transfers through foreign holding companies can also be taxed under China's indirect transfer rules, and treaties may provide relief, but only if certain criteria – including economic substance and anti-abuse standards – are satisfied.

5.4 Change of Control Provisions

Chinese tax laws include provisions that could trigger tax charges in the event of a change of control, particularly under the rules governing indirect transfers of Chinese taxable assets.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In general, China does not rely on fixed formulas to determine the income of foreign-owned local affiliates that sell goods or provide services. Instead, the tax authorities primarily follow thearm's length principle as outlined in transfer pricing regulations.

5.6 Deductions for Payments by Local Affiliates

In China, the deductibility of payments made by local affiliates to non-local affiliates for management and administrative expenses is subject to strict transfer pricing and documentation requirements. The key standard applied is the arm's length principle.

Key Conditions for Deductibility

Economic substance and necessity

- The local affiliate must demonstrate that the management or administrative services were actually provided and that they directly benefitted the local affiliate's business.
- Payments for services that do not provide a measurable benefit or that duplicate the local affiliate's existing capabilities are generally not deductible.

Reasonableness of charges

- The amount charged for the services must be reasonable, reflecting what independent parties would have agreed upon in a comparable transaction.
- Excessive charges or fees unrelated to actual services rendered may be disallowed.

Adequate documentation

- The local affiliate must maintain comprehensive documentation, including service agreements, invoices, and proof of services performed.
- Authorities may require a detailed breakdown of the nature of the services, the basis for the charges, and evidence that the costs were incurred at arm's length.

5.7 Constraints on Related-Party Borrowing

China imposes constraints on related-party borrowing by foreign-owned local affiliates, primarily through thin capitalisation rules and transfer pricing regulations. For more details, see **2.5 Imposed Limits on Deduction of Interest**.

At the same time, when the foreign-owned local affiliates pay to non-local affiliates, they must also comply with China's foreign exchange controls.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Foreign income earned by local corporations is generally not exempt from corporate tax. Instead, it is included in the global taxable income of the corporation and subject to the same tax rates as local income. However, double taxation may be alleviated through foreign tax credits and applicable tax treaties.

6.2 Non-Deductible Local Expenses

If certain foreign income is exempt from Chinese CIT, any local expenses that directly relate to earning that exempt income become non-deductible under Chinese tax rules. This ensures that businesses do not receive both an income tax exemption and a deduction for expenses incurred in earning that exempt income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by a Chinese resident corporation from foreign subsidiaries are generally subject to CIT. These dividends are considered part of the company's global taxable income and taxed at the standard rate of 25% (unless the company is a government-designated low-tax-rate entity, such as a high-tech enterprise, which qualifies for a 15% tax rate).

Special rules apply, as described below.

Tax Credits for Foreign Taxes Paid

To avoid double taxation, China allows a foreign tax credit for taxes already paid on the profits from which the dividends are distributed. The foreign tax credit is limited to the Chinese CIT payable on that same income. If the foreign withholding tax rate is higher than the Chinese CIT rate, the excess cannot be refunded or carried forward.

Tax Treaties

If a relevant tax treaty applies, it may lower the foreign withholding tax rate on the dividends, thereby reducing the foreign tax credit calculation.

Local Policy Incentives

Hainan Free Trade Port, for example, offers tax exemptions on foreign-sourced income for qualified enterprises. According to relevant regulations, from 1 January 2020 to 31 December 2024, tourism, modern services, and high-tech enterprises that are established and substantially operating in Hainan Free Trade Port can be exempt from corporate income tax on newly acquired foreign direct investment income. This means that, during the specified period, qualified Hainan enterprises can enjoy tax exemptions on dividends received from overseas subsidiaries that correspond to newly added foreign direct investments. Whether this benefit will be extended beyond 31 December 2024 has not yet been officially confirmed by the government.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by Chinese local corporations are generally taxed when used by non-local subsidiaries, and must adhere to the arm's length principle.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

CFC rules come into effect when a Chinese resident enterprise or individual (referred to as Chinese resident shareholders) has control over a foreign enterprise established in a low-tax jurisdiction and that enterprise does not distribute profits or significantly reduces profit distributions without valid business reasons.

A foreign enterprise can be classified as a controlled foreign corporation (CFC) if:

- the Chinese resident shareholder holds over 50% of the total voting shares, either directly or indirectly, or has substantive control over the enterprise's operations, finances, or procurement and sales;
- the foreign enterprise's actual tax burden is less than 50% of China's statutory corporate income tax rate;
- the foreign enterprise does not distribute profits or reduces distributions without a legitimate business rationale.

If these conditions are met, the tax authorities can attribute the undistributed profits of the non-local subsidiary to the local parent corporation as if they had been distributed. However, if the adjustment has been made, no additional tax will be levied when these profits are eventually distributed.

CFC rules do not apply in the following situations:

- The foreign enterprise is located in a jurisdiction recognised by the State Taxation Administration (STA) as a non-low-tax country. For example, the STA lists 12 such countries, including the United States, the United Kingdom, France, Germany, Japan, Italy, Canada, Australia, India, South Africa, New Zealand, and Norway.
- The foreign enterprise earns most of its income from active business activities rather than passive or investment income.
- The foreign enterprise has annual profits under RMB5 million, which are considered insignificant for CFC purposes.

Treatment of Non-Local Branches

- Non-local branches are not separate legal entities.
- Unlike subsidiaries, the income of a foreign branch is immediately included in the local corporation's worldwide income and taxed as part of the parent company's overall taxable base. This means branches do not fall under CFC rules, as their income is already accounted for in the local corporation's tax filings.

6.6 Rules Related to the Substance of Non-Local Affiliates

China's tax regulations require non-local affiliates to have sufficient substance to qualify for treaty benefits and maintain favourable transfer pricing outcomes. Without demonstrable substance, affiliates risk losing treaty benefits, facing tax recharacterisations, or triggering CFC rules.

Economic Substance and Tax Treaties

To benefit from reduced withholding tax rates on dividends, interest, or royalties under double tax treaties, a non-local affiliate must often demonstrate substantial business activities in the treaty country.

Controlled Foreign Corporation (CFC) Rules

CFC regulations also emphasise economic substance. A foreign affiliate in a low-tax jurisdiction may be subject to Chinese tax if it lacks substantive operations and primarily holds passive income.

Transfer Pricing and Related-Party Transactions

Transfer pricing rules in China require that intercompany transactions reflect market conditions and align with the actual functions, risks, and assets of the entities involved.

Non-local affiliates must demonstrate that their substance – such as their role in value creation, decision-making, and operational activities – justifies the transfer pricing arrangements.

Tax authorities may challenge structures that appear to lack substance, and reallocate profits to reflect the actual economic activities.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Local corporations are taxed at the standard CIT rate (25%) on the gain from selling shares in non-local affiliates, with the gain calculated based on the difference between the sale proceeds and the tax basis. Foreign tax credits and treaty benefits may reduce the overall tax burden, but proper documentation and compliance with transfer pricing rules are essential.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

China has established a comprehensive framework to combat tax avoidance, ensuring compliance with tax laws. These rules are designed to prevent businesses and individuals from exploiting loopholes to reduce their tax liabilities. Below is a breakdown of the key anti-avoidance measures in China.

General Anti-Avoidance Rule (GAAR)

The GAAR is a broad provision that allows tax authorities to challenge transactions or arrangements that lack commercial substance and are primarily aimed at reducing taxes. Key points include:

- Purpose: To prevent artificial or abusive tax arrangements.
- Application: Tax authorities can adjust taxable income if they determine a transaction was structured mainly for tax avoidance.
- Implications: Businesses must ensure their transactions have genuine economic purposes and are properly documented.

Transfer Pricing Rules

China has strict transfer pricing regulations to prevent profit shifting through related-party transactions. Key aspects include:

- Arm's Length Principle: Transactions between related parties must be conducted as if they were between independent entities.
- Documentation Requirements: Companies must maintain detailed records to demonstrate compliance.
- Enforcement: Tax authorities actively monitor cross-border transactions and may adjust profits if they suspect non-compliance.

Controlled Foreign Company (CFC) Rules

The CFC rules target profits retained in low-tax jurisdictions by Chinese residents. For more details, see the discussion in **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

Thin Capitalisation Rules

These rules limit excessive interest deductions on loans from related parties. For more details, see the discussion in **2.5 Imposed Limits on Deduction of Interest**.

Beneficial Ownership Rules

China has rules to deny treaty benefits if the recipient of income is not the *"beneficial owner"*.

Special Tax Adjustments

Tax authorities have the power to make adjustments in cases of non-compliance. Key points include:

- The scope covers transfer pricing, thin capitalisation, and other anti-avoidance measures.
- Non-compliance can result in additional taxes, interest, and penalties.
- Authorities are increasingly vigilant in auditing cross-border transactions.

Practical Tips for Compliance

The Chinese government has established a comprehensive anti-avoidance rule system. In addition to the core rules mentioned above, the Chinese government has introduced other anti-avoidance regulations. Meanwhile, China has been actively aligning its tax policies with international standards. To navigate China's anti-avoidance rules effectively, corporations who should:

- ensure transactions have genuine commercial substance;

- maintain thorough documentation to support compliance;
- seek professional advice for complex cross-border arrangements; and
- stay updated on evolving regulations and enforcement trends.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

China does not have a standardised, routine audit cycle like some other jurisdictions. Instead, audits are conducted on a case-by-case basis, often triggered by specific circumstances.

9. BEPS

9.1 Recommended Changes

China has made significant progress in implementing BEPS recommendations, particularly in areas such as transfer pricing, treaty abuse, and harmful tax practices. These changes have enhanced the transparency and fairness of China's tax system while increasing the compliance burden for businesses. Companies operating in China must stay informed about these developments and ensure they meet the new requirements to avoid penalties and disputes.

9.2 Government Attitudes

The Chinese government views BEPS as a critical initiative to ensure fair taxation, combat tax avoidance, and align its tax system with international standards. China's attitude can be summarised as follows:

- Supportive and Collaborative: China has actively engaged in BEPS discussions and implemented many of its recommendations.
- Focused on Sovereignty: While supporting global co-operation, China is keen to protect its tax base and ensure that multinational enterprises pay their fair share of taxes.
- Balancing Act: China aims to balance the need for robust tax rules with maintaining an attractive environment for foreign investment.

Given the US government's wavering stance on the two-pillar principle, its implementation in China and globally may be correspondingly affected.

If both Pillars One and Two are given effect in China, it will have the most significant impact on the digital economy, multinational enterprises, and regions with large consumer markets.

Pillar One Reallocation of Taxing Rights

- The objective is to reallocate taxing rights to market jurisdictions, ensuring that multinational enterprises pay taxes where they generate revenue, regardless of physical presence.
- Companies like Alibaba, Tencent, and foreign tech giants operating in China will need to adapt to new taxing rules.
- Provinces and cities with significant consumer markets may see increased tax revenues.
- Businesses will face additional reporting and compliance requirements.

Pillar Two Global Minimum Tax

- The objective is to establish a global minimum corporate tax rate of 15% to prevent profit shifting to low-tax jurisdictions.
- Chinese multinationals with subsidiaries in low-tax countries may need to restructure their operations.
- The global minimum tax could increase tax revenues from multinational enterprises operating in China.

9.3 Profile of International Tax

International tax issues do not have a high public profile in China, but they have gained increasing attention in recent years. This environment enables the government to implement BEPS measures decisively, with relatively little public debate.

9.4 Competitive Tax Policy Objective

China, like other jurisdictions, seeks to maintain a competitive tax policy to attract foreign investment and support domestic economic growth.

Competitive Tax Policy

- Special Economic Zones (SEZs) and free trade ports (eg, Hainan) offer reduced CIT rates of 15%.
- The standard corporate tax rate is maintained at 25%, which is well above the 15% floor set by Pillar Two, but China offers credits and exemptions for qualifying activities, such as those undertaken by high-tech enterprises, which are taxed at 15%.
- For more incentives, see the discussion in **2 Key General Features of the Tax Regime**.

Increasing Pressure to Implement BEPS

China is also facing increasing pressure to implement BEPS measures to ensure tax fairness and prevent base erosion. The government is expected to balance these two objectives by leveraging the tax incentives permitted under the BEPS framework, selectively extending or designing its own preferential tax policies, while simultaneously strengthening the regulation of eligibility criteria to prevent the misuse of tax benefits.

9.5 Features of the Competitive Tax System

Since 2008, China has abolished the general corporate income tax exemption for foreign enterprises and fully unified the tax treatment of domestic and foreign enterprises by 2013. Currently, there are no significant features of China's competitive tax system that are more vulnerable than other areas of its tax regime. China is also not bound by EU-style *"state aid"* or other similar rules.

9.6 Proposals for Dealing With Hybrid Instruments

The BEPS Action 2 Report specifically targets hybrid mismatch arrangements to eliminate tax benefits derived from these structures. These instruments can be used by multinational enterprises (MNEs) to exploit mismatches between tax systems, often resulting in double non-taxation, excessive deductions, or tax deferral.

While China does not yet have dedicated hybrid mismatch rules under BEPS Action 2, existing GAAR, thin capitalisation, transfer pricing, and withholding tax rules already limit the impact of hybrid instruments. Looking ahead, China is likely to tighten anti-hybrid provisions, ensuring that hybrid instruments do not result in tax avoidance.

9.7 Territorial Tax Regime

While China does not operate a territorial tax regime, it already has interest deductibility restrictions through thin capitalisation, anti-avoidance, and transfer pricing rules. If China further aligns with BEPS Action 4, companies investing in and from China may face stricter limits on interest deductions, making it crucial to optimise financing structures and ensure compliance with evolving regulations.

9.8 Controlled Foreign Corporation Proposals

China generally agrees with the principles behind controlled foreign corporation (CFC) rules, as they help prevent profit shifting to low-tax jurisdictions and ensure that Chinese MNEs pay a fair share of taxes. China's existing CFC framework aligns with the global BEPS Action 3 recommendations.

9.9 Anti-Avoidance Rules

Impact on Inbound Investors (Foreign Investors in China)

Double Taxation Convention (DTC) Limitation on Benefits (LOB) provisions and anti-avoidance rules are likely to impact both inbound and outbound investors in China. As China strengthens its tax enforcement under BEPS and OECD frameworks, businesses must ensure they meet substance and anti-abuse requirements to continue benefiting from tax treaties.

Increased scrutiny on treaty benefits (LOB Rules)

Many of China's tax treaties include LOB provisions, which restrict preferential withholding tax rates on dividends, interest, and royalties unless the recipient meets certain criteria. If a foreign company does not have substantial business operations in the treaty jurisdiction and is merely a conduit (eg, a shell company in Hong Kong or Singapore), China's tax authorities may deny treaty benefits.

Anti-avoidance and beneficial ownership rules

China's beneficial ownership rules require proof that an entity claiming treaty benefits (eg, lower withholding tax rates) is the true owner of the income. If a foreign investor routes funds through an intermediary without substantial business functions, Chinese tax authorities may deny treaty benefits and impose the standard tax rate.

Impact on Outbound Investors (Chinese Companies Expanding Abroad)

Challenges in using offshore structures for tax planning

Foreign tax authorities are, at the same time, increasingly applying LOB rules and anti-abuse provisions to deny treaty benefits if the Chinese entity lacks sufficient substance in the intermediary country.

Chinese outbound investors must ensure their offshore entities have real business functions beyond just holding investments. Transactions may face higher withholding tax rates in foreign jurisdictions if the LOB test is not met.

Transfer pricing and substance requirements

BEPS-driven rules mean that offshore structures used for profit shifting or tax deferral could be scrutinised by tax authorities in foreign jurisdictions. Chinese companies with foreign subsidiaries must enhance transfer pricing documentation to justify cross-border payments.

9.10 Transfer Pricing Changes

China was already strengthening its transfer pricing enforcement. The BEPS initiative has significantly influenced China's transfer pricing regime, but the changes have been more of an evolution rather than a radical transformation, and do not fundamentally alter China's transfer pricing system.

IP taxation is particularly complex and a major source of disputes, as China seeks to ensure that profits from IP-related activities performed in China remain within its tax jurisdiction. Companies must carefully document IP ownership, licensing, and profit allocation to avoid transfer pricing disputes and tax adjustments.

Moving forward, BEPS will likely further reshape IP taxation in China, reinforcing the country's focus on substance-based profit allocation and market-driven tax rights.

9.11 Transparency and Country-by-Country Reporting

Provisions for transparency and country-by-country reporting play a crucial role in combating profit shifting, tax avoidance, and base erosion by MNEs.

9.12 Taxation of Digital Economy Businesses

China has already implemented VAT and withholding tax rules for foreign digital businesses and is actively discussing new taxation frameworks aligned with BEPS Pillar One and possible DST mechanisms.

9.13 Digital Taxation

China has not yet introduced a specific digital services tax (DST) like some countries. However, it has taken a cautious but supportive approach toward OECD-led reforms, particularly under BEPS Pillar One. Rather than introducing a unilateral DST, China relies on VAT and withholding tax rules while awaiting a global digital tax framework.

Several proposals related to digital taxation issues have already been introduced in China. The core discussions and recommendations focus on:

- Potential Implementation of BEPS Pillar One in China: China is exploring how to integrate BEPS Pillar One into its domestic tax framework.
- Stricter Permanent Establishment (PE) Rules for Digital Businesses: Currently, China taxes foreign businesses only if they have a PE in the country. There are discussions about updating PE rules to cover digital platforms that operate in China without a physical presence.
- *"Significant Economic Presence"* threshold may be introduced, allowing China to tax companies based on user engagement, data collection, or transaction volume.
- Increased Enforcement of VAT on Cross-Border Digital Transactions: China already requires foreign digital service providers to pay VAT if they sell services to Chinese consumers. Future reforms may include more rigorous enforcement and compliance checks to prevent tax leakage.
- Potential for a Sector-Specific Digital Tax: Some policymakers have proposed targeted taxation on specific digital economy sectors, such as foreign social media platforms, e-commerce marketplaces, and data-driven businesses. However, no official proposal has been introduced yet.

9.14 Taxation of Offshore IP

China has implemented both withholding tax and direct assessment rules to ensure fair taxation of offshore IP income. The tax treatment depends on:

- whether the IP owner is in a treaty country or a tax haven;
- whether the entity qualifies as *"beneficial owner"* under treaty rules; and
- whether the transaction is structured in a way that artificially avoids taxation.

Foreign companies licensing or selling IP in China should carefully structure their royalty arrangements and IP ownership structures to comply with China's evolving tax enforcement rules while optimising tax efficiency.

Trends and Developments

Contributed by:
Yingchuan Chen, Zhaohui Wang, Yuanyuan Xu and Yujie Liu
Jincheng Tongda & Neal Law Firm

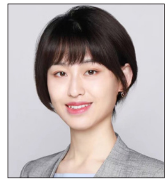
Jincheng Tongda & Neal Law Firm (JT&N) has one of the most pre-eminent tax practices in China. JT&N's tax law and tax planning practice provides tax-related legal advice to a broad range of domestic and international clients, including those engaged in aviation, energy, transportation, and technology, among others. JT&N tax lawyers have taken part in numerous transactions and litigation involving both past and current tax issues, and have extensive experience as tax administrators of and advisers to domestic and transnational corporations. The firm has also directly participated in the development of China's tax law, deriving highly relevant experience and unique insights. JT&N is especially well known in terms of responding to tax authority investigations, handling corporate and individual tax planning, and advising on taxes relating to transactions. The JT&N tax law and tax planning practice team closely monitors updated and new legal policies delivered by national, regional and local authorities, and also follows academic trends in related areas, ensuring that JT&N maintains up-to-the-minute awareness and understanding of emerging developments in relevant aspects of China's regulatory regime.

Authors

Yingchuan Chen primarily focuses on corporate and tax compliance, with a particular emphasis on export and import tax, investment and financing, as well as trade and dispute resolution. He has served many Fortune 500 companies and listed companies. He has participated in a number of national research projects and won a number of national awards. He is now a member of the Fiscal and Taxation Law Research Society of the Chinese Law Society, a member of the Fiscal and Taxation Practice Committee of the Shanghai Bar Association, and serves as a practice mentor at Fudan University Law School.

Zhaohui Wang graduated from Capital University of Economics and Business in July 1991. He worked in Beijing tax authorities and Deloitte Touche Tohmatsu. Since April 1998, he has been working as a lawyer. Mr Wang has accumulated rich experience from different working experiences, and is good at analysing and handling tax-related dispute cases from different perspectives, providing professional tax legal services for clients. Zhaohui Wang has served successively as secretary-general (6th), Deputy Director (8th) and Director (7th, 9th, 10th and 11th) of the Tax Law Committee of the Beijing Lawyers Association since 2002.

Yuanyuan Xu joined JT&N in 2006 and obtained the lawyer practice qualification in 2011. She has been engaged in tax, corporate, litigation and arbitration for a long time. She is familiar with the processing process of tax-related cases, providing clients with tax-related business consultation, case analysis and risk assessment, formulating case response strategies, litigation agency and other legal services. She provides special tax legal advisory services to many film and television companies and studios, and participates in contract review and modification, contract negotiation, enterprise legal risk control and management and other legal services.



Yujie Liu graduated from Zhejiang University and the Chinese University of Hong Kong. She joined JT&N in 2021 and has the professional qualification of lawyer. Her professional fields include tax, corporate, investment and financing and other legal fields. Yujie Liu mainly provides tax-related business consultation, tax-related litigation and other legal services for clients. In addition, Yujie Liu also has extensive experience in general corporate business, and investment and financing business. She has participated in several private equity investment projects, including due diligence and the design and production of transaction documents, as well as providing clients with legal consulting and contract review and other legal services.

Jincheng Tongda & Neal Law Firm

18th Floor
Jinmao Tower
No. 88 Century Avenue
Pudong New District
Shanghai

Tel: +86-21-13052222902
Fax: +86-21-60798759
Email: chenyingchuan@jtn.com
Web: www.jtn.com

JT&N
金诚同达律师事务所
JINCHENG TONGDA & NEAL LAW FIRM

Contributed by: Yingchuan Chen, Zhaohui Wang, Yuanyuan Xu and Yujie Liu,
Jincheng Tongda & Neal Law Firm

The Changes and Challenges Brought by DeepSeek in China's Corporate Income Tax Field

In 2025, China is deploying and accessing DeepSeek on a large scale. As a domestically developed general artificial intelligence system, DeepSeek is reshaping the tax ecosystem, including the corporate income tax (CIT) ecosystem. From the collection and administration effectiveness of tax authorities to the compliance system of CIT taxpayers to the service model of tax-related lawyers, the widespread application of DeepSeek marks the entry of a new intelligent era in China's CIT field.

DeepSeek supports the "CIT Strengthening Foundation Project"

In January 2025, the National Tax Work Conference clearly proposed the implementation of *"strong foundation project"* for tax and fee collection and administration under the conditions of digital transformation. The project focuses on the core reform tasks of data-based collection and administration, precise risk prevention and control, process simplification and service upgrading, and regulatory penetration enhancement. The year 2025 serves as the opening year for this project. Tax authorities at all levels have actively responded and carried out innovative practices in line with local realities. For example, Baoqing County Taxation Bureau, a local tax bureau of Heilongjiang province, has developed the Digital Intelligence Assistant using the open-source DeepSeek to vigorously promote the construction of *"Digital Intelligence Taxation"*; Hengqin Taxation Bureau in Guangdong province has completed the local deployment of DeepSeek; and AI digital employees such as *"TaxXiao AI"* and *"TaxZhiXing"* have been successively put into service. Under the premise of ensuring data security, they provide efficient, secure, and customised AI application support for tax authorities and taxpayers. These innovative practices indicate that tax authorities across the country will accelerate the deployment and application of large models like DeepSeek to support the Strengthening Foundation Project and comprehensively improve the efficiency of tax collection and administration.

However, DeepSeek also brings new challenges to tax authorities. On the one hand, data security and privacy protection have become critical issues. Tax data involves a large amount of sensitive information, and any leakage could trigger serious legal and economic consequences. Therefore, tax authorities need to enhance data security measures to ensure the stability and reliability of AI systems. On the other hand, the *"black box"* nature of AI may make the decision-making process difficult to explain, which to some extent affects the transparency of tax enforcement. To address this challenge, tax authorities need to establish a human review mechanism to ensure the legality and rationality of AI-driven decisions.

In conclusion, DeepSeek has enhanced the efficiency and digitalisation level of tax authorities, further propelling them towards becoming intelligent and service-oriented institutions. However, tax authorities also need to strike a balance between efficiency and security, as well as automation and transparency in the application of technology, in order to achieve high-quality development in tax administration.

The impact of DeepSeek on CIT taxpayers: empowerment and risks coexist

Compliance benefits in the efficiency revolution

DeepSeek has brought unprecedented efficiency improvements and compliance conveniences to CIT taxpayers, specifically in the following areas:

- Exponential Efficiency Improvement: DeepSeek can automate a large number of repetitive tax tasks and significantly improve work efficiency. Taking invoice affairs as an example, with DeepSeek's advanced deep learning technology, enterprises can extract key information quickly and accurately, and automatically complete invoice issuance, verification, duplication checks, and input tax matching, etc, whether through voice commands, photo capture, list import, or chat record sharing. In addition, simple inquiries from CIT taxpayers can be responded to quickly. DeepSeek acts like a portable library, providing timely responses to CIT taxpayers' questions and significantly reducing time costs.
- Full-Process Intelligent Monitoring and Risk Warning: With the increasing efficiency of tax collection and administration by tax authorities, compliance requirements for CIT taxpayers will become stringent. Manual monitoring and prevention are prone to oversights, while DeepSeek, through multimodal data fusion and deep learning technology, can achieve intelligent monitoring throughout the entire tax management process, identifying potential tax risks in advance and helping enterprises proactively defend against them. For example, it can establish a library of CIT health indicators (eg, tax burden rate, gross profit rate, expense ratio, etc) and compare them with industry averages and historical data to identify abnormal fluctuations in real time; or it can update the policy interpretation in real time, dynamically track the changes in regulations and carry out a health diagnosis on CIT, etc.

New risks spawned by technological dependence

As convenient as technology is, over-reliance can also give rise to new risks, as described below:

- Algorithmic Black Box Leading to Compliance Blind Spots: Despite DeepSeek's efforts to address the traditional *"black box"* dilemma of large models through open-source strategies, explainability technologies, visualisation of decision paths, and public documentation, some *"black box"* issues may still exist in practical applications. The underlying deep learning models (such as neural networks) may not be fully understandable, and data processing and privacy protection mechanisms may lack transparency. Under certain sensitive instructions, the model may generate non-compliant suggestions, posing ethical and compliance risks. Moreover, tax laws are complex and difficult for non-specialists to understand. Even if the algorithmic black box issue is resolved, taxpayers may still struggle to implement DeepSeek's proposed solutions. A minor oversight could inadvertently lead to non-compliance, exposing taxpayers to legal and financial risks.
- High Risk of Data Breaches: DeepSeek faces a significant risk of data breaches during data collection and processing. On the one hand, DeepSeek has deficiencies in data processing and privacy protection, such as databases not properly protected and sensitive user and device data transmitted without encryption found by cybersecurity firms; on the other hand, DeepSeek has been the target of cyberattacks on several occasions and has been subject to malicious exploitation. For medium- to large-sized organisations, tax information contains a lot of financial data

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Jincheng Tongda & Neal Law Firm

points, and insufficient security measures could result in substantial losses.

High deployment costs for SME users

DeepSeek's technical advantages and cost-effectiveness have been widely recognised in enterprise-level applications. However, for small and medium-sized enterprise (SME) users, to experience the full suite of technologies requires substantial investments in high-performance GPUs, storage devices, cooling systems, etc. Also, cloud services (for computing power and bandwidth) costs, technical barriers and maintenance costs, data security and privacy protection costs, and learning costs are necessary.

To sum up, while DeepSeek empowers taxpayers, it also introduces risks, and a good product experience comes at a high cost, not to mention customised services. Regardless of whether DeepSeek is used or to what extent it is utilised, CIT taxpayers need to understand that tax regulation is tightening, and the establishment of an *"AI-friendly"* internal control system is imperative.

The impact of DeepSeek on tax lawyers: challenges and opportunities coexist

Direct impact: deconstruction of traditional service models

With the support of DeepSeek, the traditional service models of tax lawyers are being deconstructed.

On the one hand, DeepSeek is breaking down traditional knowledge barriers at an accelerated pace. CIT taxpayers can obtain solutions to simple issues directly through DeepSeek without consulting lawyers. Meanwhile, intelligent tax customer services deployed by tax authorities can also answer these simple questions. The convenience of tax policies and facilities makes it easier for taxpayers to handle tax matters on their own. The traditional legal consultations and non-litigation tax services provided by tax lawyers are significantly impacted by DeepSeek.

On the other hand, DeepSeek's powerful capabilities in legal research, document processing, and strategy analysis mean that some basic legal tasks are being replaced by algorithms. In terms of legal research, DeepSeek can rapidly scan through vast amounts of laws, regulations, cases, and academic literature to precisely locate relevant information, with an efficiency far surpassing that of traditional manual research methods. In document processing, DeepSeek can automatically identify and extract key information from tax-related legal documents, generate standardised initial drafts, and even conduct preliminary analysis and refinement of complex tax-related legal documents. In the realm of strategy analysis, it can provide case win-rate predictions and analyses of points of contention based on big data analysis, thereby offering references for lawyers to formulate litigation strategies.

The integration of DeepSeek in these areas is driving the standardisation and digital transformation of legal services. At the same time, it also implies that some basic and repetitive job positions may be impacted.

Transformational opportunities: upgrading value creation

The rise of AI has prompted two distinct reactions within the tax law profession: some lawyers are chasing the illusory promise of *"one-click service solutions"* driven by technology, while others are gripped by a doomsday fear of machines rendering their roles obsolete. However, these seemingly opposing forces are, in fact, interconnected. Given the undeniable momentum of AI,

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Jincheng Tongda & Neal Law Firm

tax lawyers should instead focus on identifying opportunities within the challenges it presents.

Consequently, a growing number of practitioners advocate viewing AI, such as DeepSeek, as a valuable tool to augment their work. They argue that the synergy of *"large model logic and efficiency"* combined with the *"professional judgement of lawyers"* can deliver an effect greater than the sum of its parts. This perspective has resonated strongly with peers, particularly when tackling intricate tax planning and compliance matters. The combination of AI's efficiency and lawyers' professional insights can provide clients with more precise and comprehensive solutions. For example, in the tax planning of multinational corporations, DeepSeek can quickly analyse tax policies and regulations of different countries, while lawyers can provide customised strategic recommendations based on the actual situation and business objectives of the enterprise. This collaborative effort greatly enhances service quality and client satisfaction.

Other lawyers, however, have recognised the limitations of the tool and adjusted their business focus, capitalising on areas such as compliance blind spots caused by algorithmic black boxes. With the widespread application of AI technology, the issue of algorithmic black boxes has become increasingly prominent, especially in complex tax compliance and legal risk assessments, where the decision-making processes of AI models are often difficult to fully understand and explain. This has created new business opportunities for tax lawyers, who can use their expertise to review and verify AI-generated solutions to ensure they comply with legal and ethical requirements. For example, when dealing with tax issues involving the application of tax-preferential policies or cross-border transactions, lawyers need to conduct in-depth analyses of the logic and data sources of AI models to identify potential compliance risks and provide corresponding legal opinions.

Still, other lawyers, after analysis, suggest that this is an opportunity to reshape the structure of professional capabilities. They argue that while AI can efficiently process data, search for regulations, and generate documents, it cannot replace the core value of tax lawyers – their insight into the essence of taxation. Taxation is not a game of numbers but a legal reflection of economic behaviour.

This view emphasises the irreplaceability of tax lawyers in legal services, especially when dealing with complex economic transactions and emerging legal issues, where lawyers' professional judgement and understanding of the essence of law are crucial. For example, when handling new types of tax issues in the digital economy or the application of tax policies in emerging industries, AI may not be able to provide comprehensive solutions, while lawyers can offer forward-looking legal advice through in-depth research and analysis, combining industry practices and legal principles.

Each viewpoint has its merits, but the commonality is that regardless of the direction of transformation, the opportunity for tax lawyers lies in creating higher-level professional value. In the AI era, tax lawyers need to transform from traditional *"knowledge repositories"* to *"algorithm auditors"* and *"legal strategy experts"*, focusing more on the ability to analyse and solve complex problems, as well as research and exploration in emerging legal fields.

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Jincheng Tongda & Neal Law Firm

Conclusion: seeking a new balance in the symbiosis of humans and machines

The tax ecosystem transformation triggered by DeepSeek is, in essence, an efficiency revolution that reconstructs professional value. For tax authorities, it will further enhance the efficiency of tax collection and administration. For corporate taxpayers, establishing an *"AI-friendly"* internal control system will become the new benchmark for compliance management. For tax lawyers, the transition from *"knowledge repositories"* to *"algorithm auditors"* and *"legal strategy experts"*, is imminent. To gain greater competitiveness, they must focus on the scarcity of capabilities and elevate value creation.

The year 2025 may not entirely rewrite the underlying logic of tax rules, but it is destined to be a historical milestone in reshaping the tax service value chain. Market participants who can ride the wave of technological change instead of being overwhelmed by it will gain the upper hand in the new round of industrial transformation.

COLOMBIA

Law and Practice

Contributed by:
Federico Lewin and Juan Andrés Palacios
Lewin & Wills

Contents

Lewin & Wills is a boutique firm with international reach and more than 45 years of experience in the Colombian market. The firm's corporate tax practice focuses on international and domestic transactions and tax litigation. The firm is a member and founder of Lataxnet, a network that covers more than 17 jurisdictions in Latin America. It is also a member of WTS, a specialised global tax network. These alliances enable the firm to offer co-ordinated advice in multi-jurisdictional matters, and to keep its practice updated on trending international tax topics.

Authors

Federico Lewin is a partner at Lewin & Wills. His practice mainly focuses on tax disputes, cross-border taxation and corporate tax law. He has an MSc in taxation from the University of Oxford and a Master of Law and Business from the Bucerius Law School.

Juan Andrés Palacios is a partner at Lewin & Wills, where he has worked for over a decade. His practice focuses on both domestic and international taxation. He also has broad experience in tax litigation before the Colombian tax courts in various tax-related matters, including transfer pricing controversies. He holds a postgraduate advanced taxation degree and an LLM in International Taxation from King's College in London.

Lewin & Wills

Calle 72A 4-03
Bogotá
Colombia

Tel: +57 601 312 5577
Fax: +57 601 2117626
Email: lyw@lewinywills.com
Web: www.lewinywills.com

LEWIN & WILLS
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Contributed by: Federico Lewin and Juan Andrés Palacios, **Lewin & Wills**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form in Colombia. Colombian commercial legislation currently establishes different types of legal entities and classifies them into general partnerships (*sociedades de personas*) and capital companies (*sociedades de capital*). The main difference between the types of legal entities in Colombia is the requirements and procedures that must be fulfilled to incorporate each type of corporation, with certain restrictions for some types, eg, only *sociedad anónima* (S.A.) and *sociedad por acciones simplificada* (S.A.S.) companies can be offered in stock exchange markets.

Partnerships are conceived as closed legal entities, where the intuito personae element is the most important. In addition, in these types of companies the management is assumed jointly and directly by the partners, whose liability to third parties is subsidiary.

In contrast, in capital companies, the administration is often delegated to a board of directors. In addition, the associates or shareholders are released from any direct liability to third parties, so creditors cannot pursue their personal assets. Nonetheless, the corporate veil may be pierced under certain circumstances (eg, tax abuse, fraud illegality or detriment of third parties).

In general, legal entities are taxed as separate entities from their shareholders.

In some particular cases, foreign entities opt to operate in Colombia through branches. In this scenario, branches are taxed in Colombia over their attributable income.

Reasons for the Adoption of a Corporate Form in Colombia

The corporate form most frequently used in Colombia is the simplified joint stock company (S.A.S.), which is a capital company that allows shareholders to:

- incorporate the entity in an expeditious manner: the S.A.S. can be incorporated by private document without the need to notarise the act by public deed;
- limit their liability: the liability of the partners and shareholders in an S.A.S. is limited to their contributions;
- set the rules that will govern the operation of the company with flexibility; and
- defer the payment of capital contributions for up to two years.

1.2 Transparent Entities

As a general rule, all entities are considered independent corporate income taxpayers, so the income obtained is not attributed to their members, partners, shareholders or beneficiaries. As an exception, the Colombian CFC regime (*régimen ECE*) treats passive income derived by foreign companies controlled by Colombian residents as transparent.

There are also specific transparent entity arrangements that are commonly used in the construction sector and for the development of infrastructure projects, such as:

- *fideicomisos* (fiduciary arrangements); and
- *contratos de colaboración empresarial, consorcios and uniones temporales* (joint ventures or JVs).

These are not regarded as corporate income taxpayers, and the partners, participants and/or beneficiaries are obliged to report income derived by the entities under certain specific rules, depending on the kind of JV or arrangement.

Private equity funds and collective funds are also transparent for Colombian tax purposes. If certain requirements are fulfilled, the beneficiaries of the funds can defer their income to the moment when the profits are distributed.

Generally, Colombia's biggest financial investors are retirement funds that invest through private equities and other types of funds, which are transparent for tax purposes.

1.3 Determining Residence of Incorporated Businesses

Colombian rules for the determination of the tax residence of legal entities follow OECD standards. Corporations and legal entities are deemed resident for Colombian tax purposes when:

- they have been incorporated in Colombia;
- they have their principal domicile in Colombia; or
- their place of effective management is located in Colombia.

Cases of dual tax residence of incorporated businesses can be resolved whenever a tax treaty concluded by Colombia is applicable.

1.4 Tax Rates

Corporate Income Tax Rates

The general statutory corporate income tax (CIT) rate applicable to Colombian companies and to foreign corporate entities receiving Colombian source income, regardless of whether or not it is attributable to a permanent establishment in Colombia, is 35%. Since 2023, a 15% minimum tax rate has also applied to Colombian companies.

A reduced 20% CIT rate applies to eligible companies in free trade zones, and a special 15% CIT rate applies to certain activities, such as hotel services rendered in newly built or refurbished facilities, eco-tourism services and book publishing.

From 2023 to 2027, a 5% surcharge will be levied on financial entities, insurance companies and stockbrokers with a taxable income equal to approximately COP5.976 million. Non-renewable extractive industries are subject to a surcharge of up to 15%, depending on the price of the commodities. From 2023 to 2026, hydroelectric power generators will be subject to a 3% surcharge.

Individual Income Tax Rates

Resident individuals doing business directly or through transparent entities are subject to income tax at progressive marginal rates of up to 39% while non-resident individuals are subject to a flat rate of 35%. However, compared to companies, individuals doing business directly have limited deductions (depreciation, amortisation, etc) so their taxable bases are usually higher.

Simple Tax Regime

Small and medium-sized enterprises with an annual turnover of approximately COP4.980 million maximum can be eligible for the simple tax regime, which replaces CIT, local turnover tax and consumption tax. The simple tax establishes fixed rates applicable to the gross income, which vary depending on the economic sector and the annual gross income and may range between

1.2% and 14.5%. Incorporated businesses and some individuals can opt into this regime.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

In general terms, taxable profits are calculated based on the accounting profits, based on the financial information deriving from the accounting records kept under the International Financial Reporting Standards (IFRS). Adjustments should be made to avoid the taxpayer being obliged to pay tax on theoretical income or being allowed to deduct theoretical expenses. Other adjustments include items of exempted and untaxable income, statutory allowances such as depreciation and amortisation (among other fiscal incentives), transfer pricing limitations, thin capitalisation restrictions and certain other limitations on the deductions of expenses incurred abroad.

Taxable profits for corporations are calculated on an accrual basis, whereas taxable profits for individuals are generally calculated on a receipt basis.

The taxable profits of incorporated businesses are calculated as follows: gross income – excluded items of income = gross taxable income; gross taxable income – allowed reductions = net taxable income.

2.2 Special Incentives for Technology Investments

Research and Technological Investment Special Deduction and Income Tax Credit

Taxpayers are granted an income tax credit equivalent to 30% of the amount invested in research, technological development and innovation projects approved by the government.

Until 2022, taxpayers were also allowed to deduct their investments in research and technological projects.

Selected VAT Incentives

Equipment that is imported by research or technological development centres recognised by Colciencias (the National Department of Science, Technology and Innovation) and by institutions of basic primary, secondary, middle or higher education recognised by the Colombian Ministry of Education is exempt from VAT if it is intended for the development of scientific, technological or innovation projects meeting the criteria and conditions defined by the National Council of Tax Benefits.

2.3 Other Special Incentives

Certain Exempt Items of Income

Subject to eligibility and compliance with the statutory requirements by the taxpayer, available CIT exemptions include a 15-year exemption on:

- income from power-generation activities based on wind, biomass and agricultural waste technologies;
- certain types of income related to projects for the construction of social interest and priority interest housing; and
- income received by authors and translators, for copyright related to scientific or cultural books edited and printed in Colombia.

The 2022 tax reform abolished CIT exemptions, including a five-year income tax exemption for *"orange"* businesses (ie, those developing creative and technological value-added industries) and a ten-year exemption for income derived from investments that increase productivity in the agricultural sector.

Selected VAT Incentives

The Colombian legal framework provides for several VAT incentives that apply to specific industry sectors, such as:

- VAT exemption on the temporary importation of *"heavy"* machinery and equipment not produced in Colombia and effectively used in *"basic industry"* in Colombia;
- VAT exclusion on certain services (not all) rendered in Colombia or abroad, as well as the purchase of certain goods, equipment and merchandise, related to investment and pre-investment in projects aimed at the generation or utilisation of renewable energy;
- VAT exclusion on imported machinery and equipment not produced in Colombia used in the recycling and processing of garbage or waste, and in the depuration or treatment of atmospheric emissions; and
- VAT exclusion on the sale of machinery and equipment for the development of projects or activities that are registered in the National Registry for the Reduction of Greenhouse Gas Emissions (RENARE).

2.4 Basic Rules on Loss Relief

Since 2017, the tax loss carry forward has been limited to the 12 fiscal years following the year in which the tax loss is accrued. Tax loss carry back is not available.

The cross-offsetting of regular tax losses against capital gains and vice versa is not possible.

Tax losses are not transferrable to share or quotaholders, nor to other taxpayers, except as provided for reorganisations.

2.5 Imposed Limits on Deduction of Interest

As a general rule, interest paid is deductible if it is related, proportional and necessary to the taxpayer's income-producing activity. A thin capitalisation set of rules is enforced, under which only interest derived from indebtedness between related parties with an average value not exceeding two times the entity's net equity (on December 31 of the preceding year) is deductible. This limitation does not apply to cases when the debtor is a financial entity or when the loan is obtained to finance infrastructure projects related to activities that are of public interest.

2.6 Basic Rules on Consolidated Tax Grouping

Group taxation or group consolidation is not permitted for CIT. The use of tax losses from a company that is part of a group can therefore only be done through a reorganisation process (usually M&A). However, this often results in a reduction in the available losses that can be used.

2.7 Capital Gains Taxation

Since 2023, corporations have been taxed on capital gains at a general statutory rate of 15%. The costs related to these gains can be offset. Short-term capital gains (assets held for less than two years) are deemed a regular item of income subject to income tax.

Certain adjustments to the costs can be made as a relief, and certain capital gains may not be taxable (eg, gains from the sale of shares of corporations listed in a Colombian Stock Exchange). The sale of shares in Colombian holding companies (CHCs) is exempted from capital gains except for the value corresponding to profits obtained from activities carried out in Colombia, as is the sale of shares of foreign companies by a CHC.

2.8 Other Taxes Payable by an Incorporated Business

In addition to CIT, other taxes are payable by incorporated businesses on transactions as follows.

VAT

The sale and importation of movable tangible property, the sale and licensing of intangible assets associated with the industrial property (eg, trade marks, industrial designs and patents for inventions) and the provision of services in Colombia or from abroad are subject to VAT. As a general rule, the sale of fixed assets does not incur VAT. Certain public entities on a national and local territorial level are not subject to VAT.

The general rate of VAT is 19%. A reduced 5% rate applies for certain goods and services.

A reverse charge applies for most services provided to a Colombian party from abroad, so it is the Colombian party that is obliged to perform VAT back-up withholdings and pay 100% of the accrued VAT directly to the tax authorities.

Certain goods and services are exempted (zero-rated with the right to credit paid VAT and ask for a refund) or are not subject to VAT (*"excluded"*).

Consumption Tax

Certain economic activities are subject to a non-creditable consumption tax at a general statutory rate of 8%, and not to VAT.

Services taxed at the general 8% consumption tax rate include restaurant services, bars, grills and pubs. The sale of beverages and food under the franchise model is subject to VAT.

Mobile internet services provided by carriers are subject to consumption tax at a reduced rate of 4%.

Bank Debits Tax

The bank debits tax is levied on any withdrawal or transfer of funds from a bank account at a rate of 0.4%. Colombian banks (and other savings institutions) must withhold the tax. There are very limited exemptions to this tax.

Local Turnover Tax on Industrial, Commercial and Service Activities

This is a municipal (local) level tax applicable to income deriving from all industrial, commercial and service activities performed in the territory of a district or municipality. The taxable base is the sum of the taxpayer's gross revenue from the activity carried out in the relevant municipality. The tax rates vary from one district or municipality and start at 0.2%. This tax is usually paid and a return is filed annually, except for some municipalities that have adopted a two-month taxable period (eg, Bogotá). Incentives for this tax are created and regulated by each district or municipality.

2.9 Incorporated Businesses and Notable Taxes

Property Taxes

There are municipal (local) level taxes on real estate and vehicles. Each district or municipality adopts its own tax rate, so they vary from one municipality to another. Real estate tax rates usually range between 0.5% and 1.6%, although certain exceptions may apply. Motor vehicle tax rates range between 1.5% and 3.5%.

Registration Taxes

This tax applies to taxpayers registering acts and documents with the cadastral registry or Chamber of Commerce. Depending on the type of act or document, the tax rate ranges from 0.5% to 1% when the registration is with the cadastral registry office, and from 0.1% to 0.7% when the registration is with the Chamber of Commerce.

National Stamp Tax

The 2022 tax reform reintroduced a national stamp tax levied on public deeds for the transfer of immovable property with a price of more than approximately COP996 million. A progressive tax rate of up to 3% is applicable, depending on the price of the sale of the property.

Local Stamp Taxes

Certain laws authorise departments and municipalities to enact local stamp taxes to support investments in hospitals, universities and other public entities and activities. These local stamp taxes are usually levied at a rate of 1% on the gross income attached to the taxable event.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a corporate form.

3.2 Individual Rates and Corporate Rates

While the CIT rate is flat at 35% and distributions are taxed with dividend tax, individual income tax rates vary between 0% and 39%, depending on the annual income, but with severely limited deductions. Individual income over approximately COP36 million a month is taxed at a marginal tax rate that may vary between 35% and 39% (ie, a greater tax burden than corporate taxation).

Despite the distortions created by the two regimes, the Colombian legal system does not contemplate specific mechanisms to prevent the situation whereby individual professionals earn income through companies.

3.3 Accumulating Earnings for Investment Purposes

As a general rule, the Colombian tax system does not differentiate between active and passive income and does not contain mechanisms to prevent closely held legal entities from accumulating earnings for investment purposes. However, the Colombian CFC regime (*régimen ECE*), which applies to foreign companies controlled by Colombian tax residents, taxes passive income derived by the controlled foreign company as if it was directly derived by the Colombian tax resident, preventing the tax deferral in Colombia.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends Tax

Since 2023, dividends distributed to residents are subject to dividends tax at an effective rate of up to 20%, depending on the annual income of the individual.

Dividends paid out of profits that were not taxed at the corporate level are subject to dividends tax, at a rate that recaptures the tax not paid at the corporate level plus the dividends tax rate (between 35% and 48%).

Capital Gains Tax

The sale of shares in closely held legal entities is taxed in the same way as all other companies. Therefore, if shares were held for two years or more, a 15% capital gains tax is accrued.

On the contrary, if shares were held for less than two years, income derived from them will be taxed at the general income tax rate applicable to individuals (marginal rates of between 0% and 39%).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends Tax

Individuals are taxed on dividends distributed by publicly traded corporations in the same way that they would be taxed if the dividend was paid by a closely held company.

Capital Gains Tax

The sale of shares of publicly held companies registered in the Colombian Stock Exchange is not taxable, provided that the sale does not exceed 3% of the outstanding shares of the company.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

When Colombian-sourced income is remitted abroad to a beneficiary that is a non-resident individual or entity, the payment should be subject to a withholding tax. The applicable rates for interest, dividends and royalties are as follows:

- interest: 20%, unless the term of the agreement is longer than a year, in which case the rate is 15%;
- dividends: 20% if profits were taxed at the corporate level, and 48% if profits were untaxed at the corporate level; and
- royalties: 20%.

Double tax treaties (DTTs) generally bring relief to the above treatment.

Considering that technical services, technical assistance, consulting and management services rendered from abroad are subject to a 20% withholding tax as they produce Colombian-sourced income, the tax authorities tend to discuss the nature of services rendered to Colombian taxpayers to determine whether a withholding tax is mandatory in these cases.

4.2 Primary Tax Treaty Countries

Colombia's belated development of a network of OECD-like treaties has led to the execution of income tax treaties with:

- most countries in Western Europe (the UK, Spain, France, Italy, Switzerland, the Netherlands, Portugal, the Czech Republic and Luxembourg), with the notable exception of Germany;
- some Latin American countries (such as Brazil, Chile, Mexico and Uruguay); and
- other countries around the world (Canada, India, South Korea, Japan and the UAE).

All these treaties are already enforceable, except those with Brazil, the Netherlands, Luxembourg, Uruguay and the UAE.

Colombia is also a member of the Andean Pact, so it benefits from the Andean Pact Tax Directive 578/2004 to avoid double income taxation. With isolated exceptions, this Tax Directive provides for exclusive source taxation among member countries (Colombia, Peru, Ecuador and Bolivia).

The treaty employed is determined according to the fiscal residence and main place of business of the respective parties of the operation (OECD-like tax treaties) or to the origin of the investment resources (the Andean Pact Tax Directive 578/2004), which should be studied on a case-by-case basis.

Foreign investors often seek to invest in local companies through debt instruments rather than stock.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Even though Colombia has a set of tax provisions to challenge the use of treaty country entities by non-treaty country residents (such as the domestic GAAR and the MLI, which limit treaty shopping), there is currently no substantial precedent of local tax authorities challenging the use of these treaties.

4.4 Transfer Pricing Issues

In general terms, the biggest transfer pricing issues presented for inbound investors operating through a local corporation are those regarding services and royalties derived from rights of use and the exploitation of intangible assets paid to parent legal entities and foreign affiliates.

Transfer pricing disputes have recently arisen relating to medium-range adjustments made by Colombian taxpayers for services rendered by related parties abroad and the comparability analysis.

4.5 Related-Party Limited Risk Distribution Arrangements

The Colombian tax system does not have specific provisions to challenge limited risk distribution arrangements locally. However, the use of these arrangements could be challenged using the domestic GAAR.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Colombia's transfer pricing rules do not vary significantly from the OECD set of rules.

4.7 International Transfer Pricing Disputes

International transfer pricing disputes are not frequently resolved through DTTs or mutual agreement procedures (MAPs). Very few cases have been subject to the MAP process.

The DIAN (the National Directorate of Taxes and Customs) currently supports the use of the MAP process, with the first provisions to establish a proceeding to request assistance from the DIAN concerning a MAP being issued in 2020. However, it requires taxpayers to withdraw domestic administrative and judicial remedies to resolve MAP cases. It also stops MAP discussions if the taxpayer does not reimburse extraordinary expenses during the process.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Adjustments should be made if a difference with comparables must be amended. Decisions issued under the MAP are mandatory.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

While local branches of foreign corporations are taxed on their attributable income, local subsidiaries are taxed on their global-sourced income. From 2020, permanent establishments including branches of foreign companies are taxed on their attributable income, regardless of whether the income is sourced in Colombia or abroad.

5.3 Capital Gains of Non-Residents

Non-residents' capital gains on the sale of shares in local companies are subject to capital gains tax in Colombia.

Indirect sales or transfers in any form of shares in local companies through the sale of shares of foreign companies are also subject to tax in Colombia as if the sale of the underlying asset had been done directly.

Certain DTTs limit the capital gains for non-residents selling stocks of a Colombian company, subject to conditions.

5.4 Change of Control Provisions

There are currently no change of control provisions that could apply to trigger tax or duty charges in Colombia.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

The deduction of payments by local affiliates for management and administrative expenses incurred by a non-local affiliate is permitted, given the corresponding withholding income tax is applied over the gross payment. The transaction must comply with the arm's length principle and the overall transfer pricing regime.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing by foreign-owned local affiliates paid to non-local affiliates must comply with the thin capitalisation provisions, as stated in **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local legal entities is taxed. A foreign tax credit applies to taxes paid abroad on non-Colombian-sourced income, provided that the amount to be credited does not exceed the CIT liability in Colombia.

Income tax treaties signed by Colombia contemplate additional tax credit provisions.

6.2 Non-Deductible Local Expenses

As a general rule, foreign income is not exempt. Local expenses are deductible if they are related, proportional and necessary to the taxpayer's income-producing activity.

In the very few cases where foreign income is exempt (not because of its source but because of other tax benefits), attributable expenses are not deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends distributed to local legal entities from foreign subsidiaries are deemed to be a regular item of income subject to income tax. However, direct and indirect foreign tax credits are available, and certain DTTs may restrict Colombia's taxation of these dividends.

In exceptional cases, dividend distributions from foreign companies to CHCs are exempted, provided that the income out of which the dividends were distributed is attributable to activities carried out by foreign entities and that certain other requirements are met.

6.4 Use of Intangibles by Non-Local Subsidiaries

Local transfer pricing rules oblige the Colombian company and owner of the intangible to determine an arm's length remuneration for income tax purposes.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Local legal entities can be taxed on the income of their non-local subsidiaries under the Colombia CFC rules. Income, costs and deductions relating to passive income obtained by the CFC (non-local corporation) are deemed to be accrued at the level of the local corporation that directly or indirectly controls the non-local subsidiary therefore, in the same taxable year in which the income, costs and deductions accrued in the CFC. Income received by non-local branches of local legal entities is also taxed under these regulations.

6.6 Rules Related to the Substance of Non-Local Affiliates

Non-local affiliates are deemed to be national tax residents if their effective seat of management is located in Colombia.

The passive income of controlled foreign companies is taxable in Colombia as if it were directly derived from the Colombian tax resident.

Payments made to beneficiaries located in tax havens are subject to an increased withholding tax.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Gains on the sale of shares in non-local affiliates by local corporations are taxed as foreign-sourced income taxable in Colombia but benefit from foreign tax credits and limitations set by DTTs.

Gains on the sale of shares in non-local affiliates by a CHC are exempted.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Colombia enforces a GAAR that allows the tax administration to recharacterise, for tax purposes, transactions that lack an apparent economic or commercial purpose and are carried out to obtain a tax benefit.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The only routine audits made in Colombia are those conducted by the administration when a taxpayer requests tax refunds. Audits are usually triggered by mismatches between the information reported by third parties and the figures reported by the taxpayer, or by audit programmes implemented by the tax authority based on data that evidences repetitive tax inconsistencies on one issue.

9. BEPS

9.1 Recommended Changes

Colombia has taken an active role in implementing several BEPS Actions, mainly as part of its process of accession to the OECD. The following measures were adopted following the BEPS Actions:

- BEPS Action 3: CFC regime and norms regarding international tax transparency (including the declaration of assets held abroad and the regularisation of tax rules);
- BEPS Action 4: thin capitalisation rules;
- BEPS Action 6: GAAR rules and anti-abuse provisions in some tax treaties signed by Colombia, and beneficial ownership rules;
- BEPS Action 7: permanent establishment legal framework;
- BEPS Actions 8–11: transfer pricing rules (regarding commodity transactions, country-by-country reports, preferential tax regimes, tax havens and intangibles) and corporate restructuring rules;
- BEPS Action 13: country-by-country reporting and transfer pricing regime documentation;
- BEPS Action 14: MAPs; and
- BEPS Action 15: MLI, which Colombia has signed but is not yet in force, as it is still going through the domestic legal processes required to enter into force.

9.2 Government Attitudes

Colombia has played an active role in the implementation of BEPS. So far, it has sought to be perceived as a country that is interested in following the OECD recommendations in several fields, including tax matters. The 2022 tax reform implemented provisions that reflect the current global discussions related to Pillar One and Pillar Two, although there is not yet any intention to implement both Pillars.

On the one hand, a 15% minimum CIT is established for local companies. On the other hand, the concept of *"significant economic presence"* (SEP) has been introduced, seeking to tax foreign taxpayers who have a deliberate and systematic presence in the country or who render digital services to the Colombian market without a physical nexus with the country.

Both Pillars are likely to be given effect in Colombia if a global consensus is reached. Considering the thresholds for the application of Pillar One, no Colombian business is likely to be affected by the new rules on nexus, and the tax revenue of the country can increase.

The implementation of Pillar Two (global anti-base erosion – GloBE) should not have a major economic impact in Colombia. Considering that the country does not have a very large number of multinational enterprises (MNEs) that meet the threshold for the application of the minimum tax under GloBE, the fiscal impact in Colombia would not be substantial. However, the Colombian MNEs that would be covered by this new provision would probably have to incur higher tax compliance burdens.

9.3 Profile of International Tax

While taxation traditionally has a high public profile in Colombia, international tax has attracted substantial attention in recent years due to the expansion of the Colombia DTT network, the adoption of BEPS Actions and, in particular, the international exchange of information.

There is currently consensus in Colombia on the convenience of following OECD policies, including international tax measures. However, in the short-term, the government might adopt positions that reflect the interests of emerging economies. In any case, it is expected that most or all of the BEPS recommendations will continue to be implemented.

9.4 Competitive Tax Policy Objective

Colombia currently faces more pressure to raise revenue due to the significant increase in public spending under the current government than pressure to seek a competitive tax policy in terms of lowering the corporate tax burden.

There is therefore currently very little incentive to boost tax competitiveness by disregarding BEPS recommendations.

One of the major problems in the Colombian tax system is tax evasion, which artificially reduces the number of taxpayers and increases tax burden pressures. A competitive tax policy is therefore triggered partly by the implementation of efficient tax evasion rules that allow for the reduction of the effective tax burden for taxpayers. Fostering international tax transparency that allows local tax administrations to increase tax collection and fiscal resources may contribute to reducing the overall tax burden for taxpayers in the long run, balancing the pressures that BEPS will bring.

9.5 Features of the Competitive Tax System

The Colombian corporate tax system faces two problems that damage its competitiveness:

- the capacity to raise revenue relies disproportionately on CIT; and
- several tax benefits lack coherency and justification, propitiating tax inefficiencies.

To enhance the tax system's efficiency, the tax authority must increase its capacity to audit individuals, so the system does not rely heavily on CIT. Regarding tax benefits, a special commission issued a Tax Expenditures Report in 2021 and the government and Congress are expected to follow its recommendations.

9.6 Proposals for Dealing With Hybrid Instruments

BEPS Action 2, which seeks to neutralise the effects of hybrid mechanisms, has not yet been implemented in Colombia. There is no substantial progress on the discussions related to this matter. However, if the country starts to implement domestic provisions to adopt Action 2, it is foreseeable that one of the first measures to be implemented will be the limitation of the deduction of interest generated by operations that, due to a mismatch, are not taxable in another jurisdiction.

9.7 Territorial Tax Regime

The Colombian corporate tax regime taxes corporations on their worldwide income, while it relieves foreign-sourced income by providing a tax credit on taxes paid abroad associated with non-Colombian-sourced income.

Interest is deductible, if the corresponding withholding tax is made and within the limitations imposed by the thin capitalisation rule.

9.8 Controlled Foreign Corporation Proposals

The CFC regime implemented in Colombia is consistent with the taxation of Colombian residents on their worldwide income, as it is intended to make the passive income derived by Colombian residents through CFCs transparent.

9.9 Anti-Avoidance Rules

DTT limitations of benefits (typically a principal purpose test) and general and targeted anti-avoidance rules are not likely to adversely impact inbound and outbound investments.

9.10 Transfer Pricing Changes

The 2016 tax reform introduced changes to the transfer pricing regime that are respondent to BEPS, but it did not radically alter the existing regime. The most notable changes are related to the introduction of new formal obligations, such as country-by-country reporting.

BEPS recommendations related to value creation and the method to determine the value of intangibles have not yet been adopted in Colombian legislation, resulting in a source of potential controversy.

9.11 Transparency and Country-by-Country Reporting

The introduction of country-by-country reporting enhances transparency and aligns Colombian reporting obligations with international standards.

9.12 Taxation of Digital Economy Businesses

Colombia did not initially adopt digital services taxes but subsequently reformed the VAT regime to tax services rendered from abroad, including digital services.

The 2022 tax reform introduced the concept of SEP to the legislation, seeking to tax foreign enterprises that have deliberate and systematic interaction with the Colombian market or that provide digital services to clients in the country.

9.13 Digital Taxation

As of 1 January 2024, foreign companies have a SEP when they:

- maintain deliberate and systematic interaction with users or clients located in Colombia: this requirement is presumed if the foreign company displays prices in Colombian pesos or allows payments in Colombian pesos and interacts with more than 300,000 Colombian users during the fiscal year; and
- obtain gross income equal to or greater than approximately COP1.560 billion (USD364,000).

Providers of mobile applications, electronic books, online services on intermediation platforms, and digital subscriptions to audiovisual media, among other digital services, are also subject to the tax if they meet these requirements.

Foreign companies with a SEP in Colombia may opt-in for filing and paying income tax at a 3% rate of the gross income derived from the sale of goods and/or provision of digital services from abroad, sold or rendered to users in Colombia, or a 10% withholding tax on the total payment amount.

It is notable that the provisions that establish the SEP concept expressly state that the SEP legislation will cease to be applicable if an international agreement that prohibits this type of taxation is approved and signed by Colombia.

9.14 Taxation of Offshore IP

Royalty payments related to IP directed to non-Colombian tax residents are subject to a 20% income withholding tax. Special withholding tax rates may apply to outbound royalty payments on certain DTTs signed by Colombia. Royalty payments directed to a tax haven beneficiary, corresponding to items of income deemed from a Colombian source, are subject to withholding tax at a rate of 35%.

CYPRUS

Law and Practice

Contributed by:
Stella Strati
Patrikios Legal

Contents

Patrikios Legal is one of the largest law firms in Cyprus, where it is highly recommended for its professional legal services and exceptional client service. With more than 60 years of experience in the local and international legal market, the firm is renowned for its involvement in some of the largest cross-border transactions, as well as in complex litigation and arbitration matters. The highly qualified team is experienced in offering legal advice in any sphere; however, the firm's tax department offers advice in establishing and implementing robust tax planning structures and assists with all Cyprus-related tax matters. In association with Patricianserve Ltd, Patrikios Legal advises on the tax treatment of specific transactions/agreements and the calculation of provisional tax, as well as the preparation and submission of tax forms. The firm's international profile comprises strong alliances with reputable law firms (particularly in Europe, Asia and the USA), memberships in various global organisations, and a worldwide loyal clientele.

Author

Stella Strati is the corporate finance, tax and private client partner at Patrikios Legal. She provides specialised legal advice regarding all tax matters involving trusts, M&A, and private clients, as well as corporate restructurings and reorganisations. Stella has completed the advanced diploma in international tax (ADIT) at the Chartered Institute of Taxation and is a member of the Society of Trust and Estate Practitioners (STEP) and the International Bar Association (IBA). Additionally, she led Pagecorp Group to becoming the tax (private client) member of IR Global.

Patrikios Legal

332 Agiou Andreou Street
3035 Limassol
Cyprus

Tel: +357 25 871 599
Fax: +357 25 344 548
Email: info@pavlaw.com
Web: www.pavlaw.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Cyprus generally adopt a corporate form. The most common type of corporate form is that of a private (or public) limited liability company with shares. A Cypriot company is fiscally opaque for tax purposes; therefore, it is taxed as a separate legal entity.

Pursuant to Cypriot law, a company is a legal person with a separate legal personality, distinct from its members and its directors. Thus, its shareholders are not personally liable for the obligations of the company and the liability of the shareholders is limited to the share capital contributed. The existence of the company does not depend on the existence or continuation of its members.

Additionally, a Cypriot company may be limited by guarantee. Usually, companies limited by guarantee are incorporated as non-profit organisations in order to pursue charitable purposes.

1.2 Transparent Entities

Cypriot law allows for the establishment of general and limited partnerships. A partnership is not treated as a separate taxable person. It is a transparent entity and the tax is imposed on the partners and not on the partnership. Partnerships are widely used in joint venture projects and in smaller (usually family-owned) enterprises.

1.3 Determining Residence of Incorporated Businesses

The test used in Cyprus for determining the residence of incorporated businesses and transparent entities is the so-called management and control test. Cyprus' income tax legislation does not include a clear provision on how an entity becomes a Cyprus tax resident. General practice looks at the management and control thereof.

The minimum requirements for an entity to be considered a Cyprus tax resident are quite general and include:

- the place of residence of the majority of the directors;
- the place where the meetings of the board of directors are held; and
- the place where the general policy of the entity is formulated.

1.4 Tax Rates

Tax Rates Paid by Incorporated Businesses

The corporation tax rate is 12.5%. Business profits of Cyprus tax-resident companies, adjusted in relation to allowances and exemptions, are subject to a flat tax rate of 12.5%.

Individual Tax Rates

Income for individuals is subject to progressive tax rates. The first EUR19,500 is tax-free, the next EUR8,500 is subject to a tax rate of 20%, the next EUR8,300 is taxed at 25%, the next EUR23,500 at 30% and any amount above EUR60,000 at 35%. A number of deductions and personal allowances are available.

On 15 November 2024, the Council of Ministers of Cyprus exempted individuals whose total gross annual income is below EUR19,500 from the obligation to submit a personal income tax return for the tax year 2024.

Businesses owned directly by individuals are subject to the individual tax rates. The same applies to businesses owned through transparent entities.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Business profits of a Cypriot company, adjusted for various disallowances and exemptions, are subject to tax at 12.5%. Cyprus tax residents are taxed on their worldwide income. Profits are taxed on an accrual basis and the International Financial Reporting Standards are followed.

Generally, expenses wholly and exclusively incurred by a company in the production of taxable income are allowable. Private expenses, expenses not matched to taxable income or not validated through proper supporting documentation, provisions (depreciation, amortisation, impairment, and obsolete stock), expenses linked to non-taxable assets, and exchange differences are considered as non-deductible expenses. However, capital allowances, balancing allowance calculated on the disposal of a non-current asset, notional interest deduction, and notional loss in related-party transactions are also deductible.

2.2 Special Incentives for Technology Investments

The current IP tax regime in Cyprus is applicable as of 1 July 2016. This follows the nexus approach – according to which, a direct link between qualifying income and own qualifying expenses is essential for the IP to qualify. The level of the qualifying profits is positively correlated to the extent that R&D activities are performed by the same entity.

Under the previous IP box regime that applied in Cyprus, an overall 80% deduction on profits was granted. Under the current IP tax rules, 80% of the overall income derived from the qualifying intangible asset is treated as a deductible expense.

A qualifying intangible asset is defined as an asset that, as a result of R&D activities, has been acquired, developed or exploited by a person within the course of carrying out their business. Such assets specifically include:

- patents;
- computer software; and
- other IP that is legally protected and comprises:
  - (a) utility models;
  - (b) IP assets that provide protection to plants and genetic material or orphan drug destinations, in addition to extensions of protection for patents; or
  - (c) non-obvious, useful and novel IP assets (which are certified as such by an appropriate authority) where the person utilising such does not generate annual gross revenues in excess of EUR7.5 million from all intangible assets (or EUR50 million for groups).

Qualifying intangible assets specifically exclude trade marks, business names, brand image rights, and other IP rights used for the marketing of products and services.

Persons that may benefit from Cyprus' IP tax regime include Cyprus tax-resident taxpayers, tax-resident permanent establishments of non-tax resident persons, and foreign permanent establishments that are subject to tax in Cyprus.

2.3 Other Special Incentives

In addition to the IP tax regime explained in **2.2 Special Incentives for Technology Investments**, there are a number of special incentives that apply generally – as well as to particular industries – in Cyprus.

Cyprus Holding Companies

Cyprus represents an attractive jurisdiction in which to set up a holding company. Specifically, dividend income received by a Cypriot holding company is generally exempt from any income tax in Cyprus (subject to the hybrid instrument exception explained in **9.6 Proposals for Dealing With Hybrid Instruments**) and from special defence contribution (SDC) (subject to the passive dividend rule explained in **6.3 Tax on Dividends From Foreign Subsidiaries**). Also, no withholding tax applies to any outgoing dividend or other profit distributions or interest, irrespective of the existence of a double tax treaty (DTT). Furthermore, profits from the sale of shares are tax-exempt. In general, no restrictions on foreign share ownership exist and, as a result, a foreign investor is allowed to be the sole shareholder of a Cypriot company.

Tonnage Tax System

Cyprus tax-resident ship-owners or ship management companies that qualify under the relevant legislation with regard to qualifying ships (as defined therein) engaged in qualifying shipping activities (as defined therein) can fall under the tonnage tax system (TTS). The TTS refers to flat given rates of tax based on the net tonnage of the ship – ie, no requirement for a computation of tax-adjusted profits exists. It is also important to note that there is no tax levied on the disposal of qualifying ships and that dividends distributed out of companies under the TTS are not subject to the SDC.

Incentives for Individuals

Special incentives are also provided to individuals. A tax incentive was introduced in 2022 and amended on 30 June 2023 that provides that a natural person employed in Cyprus (as of 1 January 2022) enjoys a tax exemption of 50% for a period of 17 years from the date of employment, irrespective of whether the individual changed employers during the relevant 17-year period – provided they have previously not been resident in Cyprus for a period of at least 15 consecutive years and earn more than EUR55,000 per year. Previously (ie, before the June 2023 amendment), the exemption was only granted for the first employment of the individual in Cyprus.

Furthermore, individuals who first take up employment in Cyprus after 26 July 2022, with annual emoluments lower than EUR55,000, will be eligible for a 20% or EUR8,550 exemption (whichever is lower) for a maximum period of seven years. An individual must have been employed abroad for at least three consecutive years prior to the commencement of employment in Cyprus in order to claim this exemption, which can be claimed from the year after taking up employment in Cyprus.

Non-doms

In addition, individuals who are not tax-resident in Cyprus or individuals who are tax-resident but non-domiciled in Cyprus are not subject to the SDC on dividends, interest or rents.

Innovative SMEs

A qualifying person that makes an investment in an innovative SME (as defined by the Cypriot Income Tax Law) may deduct the costs of the investment from the taxable income subject to limitations imposed by the law, such as:

- the tax deduction is limited to 50% of the investor's taxable income in the year in which the investment is made;
- the deductible amount cannot be more than EUR150,000 within a tax year; and
- the investor must retain the relevant investment in the innovative SME for at least three years.

This incentive is available until 31 December 2026.

Start-up visa

On 19 December 2024, the Deputy Ministry of Research and Digital Policy announced the approval of a revised start-up visa scheme, which is applicable as of 1 January 2025. This scheme enables owners and senior executives from third countries to enter, reside and work in Cyprus for the purposes of establishing a new start-up in Cyprus or transferring an existing start-up into Cyprus.

2.4 Basic Rules on Loss Relief

On a company level, tax-adjusted losses can be carried forward and be set off against tax-adjusted profits for the next five years. Losses cannot be carried back.

On a group level (subject to the existence of certain criteria and the formation of a tax group), group members may surrender losses from one loss-making member to another profitable one. A direct or indirect holding of at least 75% for the entire tax year is necessary for a company to be considered as forming part of a tax group.

As of 2015, the interception of companies established in the EU – or in countries that either have a DDT with Cyprus or have signed the OECD terms for exchange of information – can be taken into consideration for the calculation of an indirect holding. Furthermore, group relief is available between companies established in EU member states, provided that the EU subsidiary has exhausted all means of surrendering or carrying forward the losses in its own state.

2.5 Imposed Limits on Deduction of Interest

The Cypriot Income Tax Law provides that any interest relating to (or that is deemed to relate to) the cost of acquiring a private motor vehicle – irrespective of whether it is used in the business – or to the cost of acquiring any other asset not used in the business is not deductible for a period of seven years.

The Commissioner of Taxation has taken the position that shares are not an asset used in the business and, as such, any interest on loans to acquire shares is not deductible for a seven-year period. This position is justified on the grounds that any income from the holding of shares (ie, dividends and capital gains) is exempt from corporation tax.

As of 1 January 2012, the above-mentioned provision does not apply in cases where new shares are acquired directly or indirectly in a wholly owned subsidiary – provided that this subsidiary does not own any assets that are not used in the business. If this subsidiary owns assets that are not used in the business, the restriction of interest will only correspond to the percentage of assets not used in the business.

Also, from 1 January 2020, Cyprus' tax legislation contains an interest limitation rule (ILR) that limits the otherwise deductible-exceeding borrowing costs of the Cypriot taxpayer/Cypriot group to 30% of adjusted taxable profit (taxable EBITDA). The ILR contains an annual EUR3 million safe harbour threshold.

2.6 Basic Rules on Consolidated Tax Grouping

No rules for tax grouping exist, apart from the basic rules for group tax relief described in **2.4 Basic Rules on Loss Relief**.

2.7 Capital Gains Taxation

In Cyprus, no capital gains tax exists, apart from the taxation of gains from the disposal of immovable property situated in Cyprus. The profits from the sale of shares are exempt from any taxation.

Capital gains tax applies only to direct and indirect disposals of real estate situated in Cyprus. The applicable rate is 20% and is applied on gains from the disposal of immovable property or gains from the disposal of shares that directly or indirectly own immovable property situated in Cyprus.

2.8 Other Taxes Payable by an Incorporated Business

A stamp duty fee may be payable by an incorporated business on a transaction. Stamp duty is payable on any document that concerns any property located in Cyprus or on matters to be executed in Cyprus.

For contracts with a value of between EUR5,001 and EUR170,000, the current rate of stamp duty is 1.50% for every EUR1,000 or part thereof. For contracts with a value of more than EUR170,000, the current rate of stamp duty is EUR2 for every EUR1,000 or part thereof, with a ceiling of EUR20,000. This maximum amount is payable on any document or on any transaction that has several documents; in such case, the parties may choose which of the transaction documents is the main document and only that main transaction document will be subject to the full stamp duty. The other transaction documents may be stamped as secondary documents, in the amount of EUR2 each – provided they are dated the same day (or very close) as the main transaction document.

A number of instruments carry a fixed stamped duty, as per the provisions of the Cypriot Stamp Duty Law.

2.9 Incorporated Businesses and Notable Taxes

VAT

Incorporated businesses may be subject to VAT. The standard rate of VAT is 19%; however, reduced rates of 5% and 9% apply to certain supplies.

SDC

The SDC is payable on passive income – namely, rents, dividends, and passive interest income – by Cyprus tax-resident companies and individuals who are both tax residents and domiciled in Cyprus.

Dividends received by individuals (resident and domiciled in Cyprus) are subject to an SDC rate of 17%. Dividends received by Cyprus tax-resident companies are not subject to the SDC (subject to specific exceptions mentioned in **6.3 Taxation on Dividends From Foreign Subsidiaries**). The SDC rate on interest for both natural and legal persons is 17% as of 1 January 2024. Rent received by companies and by tax-resident and domiciled individuals is subject to the SDC at the effective rate of 2.25% (3% on gross rents less 25%).

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses usually operate in corporate form – namely, as private limited liability companies with shares. The main reason for this is the lower corporate tax rate compared with the tax rates applicable to individuals or with the tax treatment of partnerships.

3.2 Individual Rates and Corporate Rates

The corporate and individual tax rates are included in **1.4 Tax Rates**.

No particular rules exist to prevent individual professionals from earning income at corporate rates. Such professionals have the right to incorporate legal entities and conduct their business through such. If income is earned through such companies, it is taxed at the corporate tax rate. If the individual conducts business in their name, such individual is taxed at individual rates.

For specific professions (eg, advocates and doctors), an authorisation from the relevant regulator (eg, the Legal Council) is required prior to the incorporation of a special purpose company (such as a lawyers' limited company).

3.3 Accumulating Earnings for Investment Purposes

Currently, there are no rules to prevent a Cypriot company from accumulating earnings – provided that the beneficial owner of the same is not a Cyprus tax resident or is a Cyprus tax resident but non-domiciled.

If the beneficial owner is a Cyprus tax resident and domiciled, the deemed distribution rules will come into effect, which provide that 70% of the accounting profits after the deduction of tax must be distributed two years from the end of the year in which the profits were earned. On such a deemed distribution, a 17% SDC and a 2.65% national health contribution must be withheld and paid to the tax authorities.

3.4 Sales of Shares by Individuals in Closely Held Corporations

The gains on the sale of shares are exempt from any taxation in Cyprus. Dividends received by individuals (resident and domiciled in Cyprus) are not subject to income tax but are subject to an SDC rate of 17%. A natural person who is a Cyprus tax resident but non-domiciled in Cyprus is exempt from the obligation to pay the SDC. This also applies to individuals who are foreign tax residents.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Cyprus does not apply any withholding tax on dividends or interest paid to non-residents (or to Cyprus tax residents who are non-domiciled). Regarding the payment of royalties to a non-Cyprus tax resident, a maximum 10% withholding tax applies on the gross amount of such payment if the royalty rights were used in Cyprus (5% in relation to films). Also, in relation to dividends, interest and royalties paid to entities incorporated in another EU member state, the provisions of the relevant EU Directives apply.

Furthermore, the gross income derived by an individual who is not tax-resident in Cyprus from the exercise in Cyprus of any profession or public entertainment is subject to a maximum withholding tax of 10% (reduced by any DTT favourable rate). The obligation to withhold the tax lies on the Cyprus tax-resident person that has invited the non-resident professional/entertainer.

The maximum withholding tax for services regarding the exploration, extraction or exploitation of the continental shelf – as well as the establishment and use of pipelines and other installations on the ground, seabed and/or the surface of the sea – is 5%.

Also, no withholding tax applies on any outgoing dividend or other profit distributions or interest, irrespective of the existence of a DTT. Furthermore, profits arising from the disposal of titles (shares) are tax-exempt. Non-Cyprus tax residents or non-domiciled Cyprus tax residents who are shareholders of a Cypriot company are not subject to any SDC.

Since 31 December 2022, Cyprus has applied withholding tax on certain outbound payments of dividends, interest and royalties – subject to specific conditions – in cases where the recipient is a legal entity that has tax residency in a jurisdiction included in the EU list of non-co-operative jurisdictions or is incorporated there but not a tax resident in any other jurisdiction.

4.2 Primary Tax Treaty Countries

Cyprus enjoys a wide network of DTTs, as it has entered into such with 69 countries. The majority of these treaties follow the OECD Model Tax Convention on Income and on Capital (the *"OECD Model"*) – with the exception of the DTT with the USA, which follows the most recent model of US agreements. Foreign investors usually use Cypriot companies to make investments in local corporate stock or debts.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The author is not aware of any cases in which the local tax authorities have challenged the use of treaty-country entities by residents of non-treaty countries.

4.4 Transfer Pricing Issues

The Cyprus transfer pricing rules (as such rules apply from 1 January 2022 onwards) cover all types of transactions between related parties in excess of EUR750,000 per category of transaction. The types of transaction include sale and purchase of goods, provision and receipt of services, financing transactions and any IP-related transaction, as well as other transactions between related parties. In relation to the definition of the connection between related parties, the 25% relationship test applies.

On 1 February 2024, Cyprus' tax department issued an announcement clarifying that – as from the tax year 2022 onwards – the threshold for financing transactions is EUR5 million and for all other transactions is EUR1 million.

Moreover, transfer pricing documentation compliance requirements have been introduced in relation to Cyprus tax-resident persons and/or permanent establishments of non-Cyprus tax-resident entities located in Cyprus that are engaging in local or cross-border transactions. Such transfer pricing documentation must be prepared on an annual basis, prior to the income tax return submission for the relevant tax year, and it must include the master file, the local file and the summary information table.

The new transfer pricing rules have also introduced advanced pricing agreement procedures.

4.5 Related-Party Limited Risk Distribution Arrangements

Tax authorities do challenge related-party transactions in general. As already mentioned in **4.4 Transfer Pricing Issues**, Cyprus has re-enforced its transfer pricing regulations by introducing the requirement for performing transfer pricing studies for all related-party transactions.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

As mentioned in **4.4 Transfer Pricing Issues**, Cyprus introduced new transfer pricing rules in 2022. Such rules, which are effective as of 2 January 2022, do not deviate from OECD standards. Transactions between related companies are obliged to follow the arm's length principle as set out in the OECD Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

Transfer pricing rules have been adopted since 2017 (and updated in 2022) and, given that this is something relatively new in Cyprus, the author is not aware of any disputes resolved by local authorities. However, owing to the fact that extensive reform of the applicable transfer pricing rules in Cyprus took place in 2022, the local tax authorities are expected to be more aggressive when it comes to transfer pricing matters from now on.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The tax authorities in Cyprus do not have any experience of mutual agreement procedures under a transfer pricing arrangement. Therefore, if an adjustment is made by a foreign tax authority, the corresponding adjustment will not be allowed/made for Cyprus tax purposes. The reason for this is the absence of a relevant regulatory framework.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

The taxation of local branches of foreign corporations is no different to that of local subsidiaries of foreign corporations.

5.3 Capital Gains of Non-Residents

There is no capital gains tax applicable in Cyprus in relation to profits from the sale of shares. Profits from the disposal of titles are exempt from any tax in Cyprus. Titles are defined as shares, bonds, debentures, founders' shares, and other titles of companies or other legal persons incorporated in Cyprus or abroad (and rights thereon).

5.4 Change of Control Provisions

Any disposal to related parties should be executed on an arm's length basis. Moreover, Cyprus introduced exit taxation rules in 2020, within the wider implementation of the EU Anti-Tax Avoidance Directive (ATAD).

The relevant provisions stipulate that corporate taxpayers that move assets or their tax residency out of Cyprus will be subject to tax at an amount equal to the market value of the transferred assets at the time of exit – minus their value for tax purposes – in any of the following circumstances:

- a Cyprus tax-resident company transfers assets from its head office in Cyprus to its permanent establishment in another member state or in a third country so that Cyprus does not have the right to tax the transferred assets owing to the transfer;
- a non-Cyprus tax-resident company with a permanent establishment in Cyprus transfers assets from its Cypriot permanent establishment to its head office or another permanent establishment in another EU member state or third country so that Cyprus does not have the right to tax the transferred assets owing to the transfer;
- a Cyprus tax-resident company transfers its tax residence from Cyprus to another EU member state or to a third country, apart from those assets that remain effectively connected to a permanent establishment in Cyprus; and
- a non-Cyprus tax-resident company with a permanent establishment in Cyprus transfers the business carried out by its permanent establishment from Cyprus to another EU member state or to a third country so that Cyprus does not have the right to tax the transferred assets owing to the transfer.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The tax treatment of a foreign-owned local affiliate is the same as that of any other Cypriot company. No separate rules or formulas exist to determine their income. As will be discussed, Cypriot companies are taxed on their worldwide income and any foreign tax incurred is credited against the equivalent Cyprus tax on the foreign income.

5.6 Deductions for Payments by Local Affiliates

The general principle pursuant to the Cypriot Income Tax Law is that for an expense to be allowed as a deduction, it must have been incurred wholly and exclusively for the production of taxable income for the specific taxpayer – something that needs to be supported by the relevant documentation.

Therefore, any expenses paid by Cypriot companies on behalf of foreign affiliates will be treated as non-tax-deductible expenses. In addition, the tax authorities in Cyprus could assess that a deemed receivable from the foreign affiliate exists in the Cypriot company's books, represented by the value of the expenses paid – on which, they will seek to impose and tax deemed interest at market interest rates.

5.7 Constraints on Related-Party Borrowing

Pursuant to Section 33 of the Cypriot Income Tax Law, all transactions between related parties must – for tax purposes – be carried out on an arm's length basis (ie, at fair values and on reasonable commercial terms). This is described as the *"arm's length principle"*.

More specifically, under the arm's length principle, where conditions are made or imposed upon the commercial or financial relations between two businesses that differ from those that would have been made between independent parties, any profits that would have accrued to one of the parties had the two businesses been independent – but have not so accrued – may be included in the profits of that business and taxed accordingly. These provisions also apply to any transactions between related parties.

Pursuant to the applicable transfer pricing rules (see **4.4 Transfer Pricing Issues**), a transfer pricing study is required for all transactions between related entities in excess of EUR1 million per category of transaction. For financing transactions between related parties, the threshold is EUR5 million. The 25% relationship test applies to define the concept of related parties.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Local corporations are taxed on their worldwide income. However, any foreign tax incurred is credited against the equivalent Cyprus tax on the foreign income. The tax credit in respect of the foreign tax cannot exceed the equivalent Cyprus tax in any circumstances. Credit is always granted to Cyprus tax residents on foreign tax incurred on foreign income, irrespective of the existence of a DTT.

6.2 Non-Deductible Local Expenses

As mentioned in **6.1 Foreign Income of Local Corporations**, Cyprus tax-resident companies are taxed on their worldwide taxable income, as taxation in Cyprus is based on the management and control of the company and not on the source of the income.

If an income is exempt (eg, dividends under conditions, sale or disposal of shares), any direct expenses associated with the specific activity are not allowed for tax purposes. Also, any indirect expenses should be allocated to each activity of the Cypriot company and be part of such activity. If the activity will generate exempt income, then the corresponding allocation of the indirect expenses will not be treated as tax-allowable.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by Cypriot companies from foreign subsidiaries are not subject to corporation tax in Cyprus. Nevertheless, an exception applies in that dividends received from a foreign company will be subject to corporation tax if paid out from hybrid instruments.

Moreover, dividends received by Cyprus tax-resident companies from foreign entities are not subject to the SDC, unless the passive dividend rule applies. According to this rule, the SDC is applicable if:

- the company distributing the dividend engages directly or indirectly in more than 50% of activities leading to investment income; and
- the foreign tax burden on the income of the paying company is substantially lower (less than 6.25%) than the Cypriot tax burden.

The SDC does not apply to dividends received by a Cypriot company from a local company, subject to the four-year non-exemption rule. However, a dividend indirectly paid after four years from the end of the year in which the profits were generated is subject to the SDC.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by local corporations can be used by non-local subsidiaries in their business, provided that such intangibles are licensed to the non-local subsidiaries on an arm's length basis. Withholding taxes apply (10%) if the intangible is used in Cyprus by the non-local subsidiaries.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

The controlled foreign companies (CFC) rule is applicable in Cyprus as of 1 January 2019. The application of this rule results in the re-attribution of the income of a low-taxed controlled non-Cyprus subsidiary to its parent company in order to avoid revenue diversion to a jurisdiction with a more favourable tax regime. The CFC rules apply to Cyprus tax-resident companies and non-Cyprus tax-resident companies with a Cyprus permanent establishment.

A CFC is defined as a low-taxed non-Cyprus tax-resident company or permanent establishment in which:

- the Cypriot taxpayer, alone or together with its associated enterprises, holds a direct or indirect interest of more than 50%; and
- the actual corporate tax paid on the profits of the company or the permanent establishment is lower than 50% of the tax that would be paid in Cyprus.

The non-distributed income of a CFC that results from non-genuine arrangements is added to the taxable income of the Cyprus tax-resident controlling company. The CFC rule is not applicable when the company or the foreign permanent establishment has either:

- accounting profits of no more than EUR750,000 and non-trading income of no more than EUR75,000; or
- accounting profits of no more than 10% of its operating costs for the tax period.

In any case, the Cypriot controlling entity can claim credit for any foreign tax imposed on the CFC profits that are included in its tax base.

6.6 Rules Related to the Substance of Non-Local Affiliates

No rules related to the substance of non-local affiliates apply in Cyprus.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

As mentioned in **5.3 Capital Gains of Non-Residents**, the definition of titles under Cypriot law includes shares, bonds, debentures, founders' shares, and other titles of companies or other legal persons incorporated in Cyprus or abroad (and rights thereon). Therefore, the gains on the sale of shares in non-local affiliates will be exempt from any taxes in Cyprus.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

A general anti-abuse rule has applied since 1 January 2019 and was introduced as part of the general implementation of the ATAD. This rule provides that non-genuine arrangements – the main purpose of which is to procure a tax advantage – are ignored. Such arrangements are considered to be *"non-genuine"*, as their mere existence does not reflect valid commercial reasons or economic reality.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Cyprus companies are obliged to submit an annual tax declaration, which is prepared based on audited financial statements. Such financial statements should be audited and signed by a Cypriot-qualified and licensed auditor. Currently, the deadline for the submission of such declaration is 15 months from the end of the relevant tax year. A tax year is the same as a calendar year – ie, for the tax year of 2022, the annual tax declaration must be submitted by 31 March 2024.

9. BEPS

9.1 Recommended Changes

The commitment of Cyprus to follow the recommendations of the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) is evident, given that it has already implemented various changes in line with the BEPS recommendations.

As per BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements, Cyprus has introduced hybrid mismatch rules (see **9.6 Proposals for Dealing With Hybrid Instruments** for further details).

Furthermore, by implementing the BEPS recommendations and the ATAD, Cyprus has introduced the CFC rule and the ILR.

Pursuant to BEPS Action 5: Harmful Tax Practices, Cyprus has abolished the old IP box regime. It has also introduced new rules regarding tax benefits granted towards genuine IP activity, as per the nexus approach.

In order to prevent the granting of treaty benefits in inappropriate circumstances, Cyprus has opted for the principal purpose test (see **9.9 Anti-Avoidance Rules** for more details).

Moreover, in light of the BEPS recommendations to prevent artificial avoidance of permanent establishment status, Cyprus has transposed all relevant new definitions into its legislation, including definitions of commissionaire and similar arrangements.

Cyprus has also introduced transfer pricing rules, legislated country-by-country (CbC) reporting and signed the Multilateral Convention to Apply Measures Related to Tax Treaties to Prevent Base Erosion and Profit Shifting (MLI/BEPS/OECD/G20) (the *"Multilateral Instrument"*, or MLI).

9.2 Government Attitudes

The general attitude of the Cypriot government is to effectuate the BEPS recommendations by improving transparency but at the same time maintain the competitiveness of the Cypriot tax regime by providing various incentives to Cyprus tax residents (both domiciled and non-domiciled).

It is anticipated that both Pillar One (reallocation of profits) and Pillar Two (global minimum tax) will come into effect in Cyprus. On 12 December 2024, the House of Representatives of Cyprus approved the implementation of Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union (the *"Pillar Two Directive"*) into domestic legislation (the *"GMT Law"*). Furthermore, a public consultation is in place within the framework of a wider tax reform.

At the same time, the Cypriot government intends to provide – and has already provided – further incentives to attract inward investment. This strategy commenced in 2021. As mentioned in **2.3 Other Special Incentives**, the start-up visa scheme has been revised, and is now more effective and flexible. The main goal of the Cypriot government is to enhance innovation and to develop an entrepreneurship-friendly landscape at the local level.

Furthermore, a digital nomad visa for third-country nationals wishing to live in Cyprus yet work for companies operating from abroad is available. The ceiling for people to benefit from this digital nomad visa scheme is 500 resident permits.

Also, the tax benefit provided in relation to investments in innovative SMEs has been extended until 31 December 2026 (see **2.3 Other Special Incentives**).

Further key reforms include:

- the provision of tax exemptions to highly skilled foreign employees;
- the provision of incentives for highly skilled foreign employees to apply for naturalisation after five years of residence and work in Cyprus; and
- the establishment of a Business Facilitation Unit that will operate as the focal point of contact for:
  (a) companies with foreign interests wishing to relocate to Cyprus; and
  (b) businesses operating in specific areas of economic activity (eg, hi-tech or innovation companies, pharmaceutical and shipping companies, and companies operating in the field of biogenetics and biotechnology).

9.3 Profile of International Tax

There is currently an ongoing public consultation in relation to the upcoming tax reform of the Cypriot tax system. In February 2025, the key proposed tax amendments were announced. As mentioned in **9.2 Government Attitudes**, the GMT Law was passed by the House of Representatives of Cyprus in December 2024.

One of the main proposals of the upcoming tax reform is the increase of the corporate tax rate from 12.5% to 15%. Nevertheless, for the purpose of maintaining the competitiveness of the Cyprus tax regime, the Cyprus government intends to adopt other measures to mitigate and counteract the proposed increase of the corporate tax rate (ie, the reduction of the SDC rate on dividends to 5%, the elimination of the 3% SDC on rental income, the increase of the tax-free threshold for individuals, and the adjustments to the intermediary personal income tax bands, with the highest 35% tax rate applying to income of more than EUR80,000). Green tax reform measures are also expected and, at the same time, the main benefits provided under the current tax legislation will be maintained. The draft bills are expected to be ready for public consultation in May 2025.

This is not likely to influence any of the BEPS recommendations, given that Cyprus has introduced numerous changes aiming to incorporate such recommendations in the local tax legislation.

9.4 Competitive Tax Policy Objective

Cyprus is viewed as having a competitive tax system that offers a number of incentives and advantages. The benefits of the Cypriot tax regime include:

- an absence of restrictions on foreign share ownership;
- lack of withholding taxes on dividends or interest;
- the sale of shares and other titles is exempt from tax;
- one of the lowest corporate tax rates in the EU; and
- a number of tax exemptions for non-Cyprus tax residents (or non-domiciled).

Moreover, as from October 2021, the Cypriot government is implementing an action plan designed to attract foreign companies to operate from – or expand their activities in – the country (see **9.2 Government Attitudes**).

However, as has been analysed in **9.1 Recommended Changes**, Cyprus has shown its commitment to follow the BEPS recommendations and remain OECD-compliant. The implementation of the BEPS recommendations on a local level has so far been balanced against the various advantages provided by the Cypriot tax system. Such implementation has, in fact, contributed to the proper development of the Cypriot tax regime by enhancing transparency.

9.5 Features of the Competitive Tax System

As outlined in **9.4 Competitive Tax Policy Objective**, Cyprus has a competitive tax system offering various incentives to local and foreign investors. The more vulnerable areas of the Cypriot tax regime (such as the old IP box regime) have been abolished or modernised. Also, a wide reform of the Cyprus tax system is now being discussed – pursuant to which, the corporate tax rate will be revised to 15%. However, at the same time, other applicable taxes (such as the SDC) might be reduced or abolished. The reduction of the SDC rate on interest has already taken place.

The aim of the Cypriot government is to promote the creation of substance and transparency while simultaneously providing incentives to foreign business to relocate their headquarters to Cyprus.

There are limited approved state aid schemes in Cyprus. However, such schemes cannot be considered constraints on the tax system, given that the majority of them aim to enhance productivity in specific areas (eg, rural tourism and hi-tech and innovative enterprises).

9.6 Proposals for Dealing With Hybrid Instruments

As mentioned in **9.1 Recommended Changes**, Cyprus has had legislation dealing with hybrid instruments in place since 2016. Specifically, an exception applies in that dividends received from a foreign company will be subject to corporation tax if paid out from hybrid instruments.

Furthermore, as of January 2020, hybrid mismatch rules apply that aim to tackle the usual tax effects of hybrid mismatches, including a double deduction or a deduction with no inclusion. These new provisions apply only where there is sufficient connection between the parties. This includes mismatches that arise between:

- a taxpayer and its associated enterprises;
- associated enterprises;
- a head office and a permanent establishment;
- two or more permanent establishments of the same entity; and
- mismatches resulting from a structured arrangement involving a taxpayer.

The reverse hybrid entity rule is also effective as of 1 January 2022.

9.7 Territorial Tax Regime

Cyprus does not have a territorial tax system. All companies that are tax residents in Cyprus are taxed on income accrued or derived from all sources in Cyprus and abroad. Cyprus always grants credit to Cyprus tax residents on foreign tax suffered on foreign income, irrespective of the existence of a DTT. Effectively, a comparison is made between the equivalent Cypriot tax on the foreign-sourced income and the foreign tax incurred – with credit granted being the lower of the two.

In any case, the ILR was introduced in 2019 as part of the wider implementation of the ATAD. The aim of the ILR is to limit the provision of financing facilities to companies (which are based in high-tax jurisdictions) in low-tax jurisdictions through subsidiaries belonging to the same group. The ILR requires that the excess borrowing cost (EBC) that is greater than 30% of taxable income before EBITDA is not deductible for income tax purposes. As such, it limits the otherwise deductible EBCs to 30% of taxable EBITDA. However, the ECB is deducted up to a de minimis threshold of EUR3 million per fiscal year. Standalone entities (not part of a group) are excluded from the ILR. In any case, grandfathering has been provided for loans concluded before 17 June 2016.

Moreover, a group equity *"escape"* or *"carve-out"* is provided. If the Cyprus-resident company is part of a consolidated group for financial reporting purposes, the taxpayer may be given the right to fully deduct its EBCs – provided that the ratio of its equity over its total assets is equal to (or even up to 2% lower or higher than) the equivalent ratio of the group.

9.8 Controlled Foreign Corporation Proposals

As already mentioned in **9.7 Territorial Tax Regime**, Cyprus does not have a territorial tax regime. However, it has implemented the CFC rule, as part of the wider implementation of the ATAD. The CFC rule has been explained in **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

This CFC rule applies as from 1 January 2019 both to Cyprus tax-resident companies and non-Cyprus tax-resident companies having a permanent establishment in Cyprus. The CFC rule results in the re-attribution of the income of a low-taxed controlled non-Cypriot subsidiary to its parent company in order to avoid revenue diversion to a jurisdiction with a more favourable tax regime.

9.9 Anti-Avoidance Rules

As previously mentioned in **7.1 Overarching Anti-Avoidance Provisions**, a general anti-avoidance rule is applicable in Cyprus as of 1 January 2019.

Also, further to the signing of the MLI, Cyprus has opted for the principal purpose test. Such test is incorporated in the latest double taxation conventions (DTCs) entered into by Cyprus. Specifically, the DTT between Cyprus and the Netherlands signed on 1 June 2021 provides that a benefit under the relevant DTC shall not be granted if it is reasonable to conclude – having regard to all relevant facts and circumstances – that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in such benefit. The only DTC entered into by Cyprus that includes the *"limitation of benefits"* test is the one with the USA.

These rules do not have any impact on inbound and outbound investors operating through Cypriot entities, owing to the fact that various incentives and benefits offered by the Cypriot tax system apply irrespective of the existence of any DTC.

9.10 Transfer Pricing Changes

New transfer pricing rules were introduced in 2022 and were applicable from 1 January 2022 (as explained in **4.4 Transfer Pricing Issues**). Such rules include the requirement for related parties to maintain documentation files in relation to intra-group transactions.

On 1 February 2024, Cyprus' tax department issued a circular revising the applicable thresholds regarding the obligations to prepare a local file. Under the 2022 rules, this requirement applied if the value of transactions between related parties was more than EUR750,000 per year per type of activity and if the Cyprus tax-resident entity is the ultimate parent or surrogate parent entity of a multinational enterprise falling under the scope of CbC reporting. Pursuant to the 1 February 2024 circular, the threshold has been increased from EUR750,000 to EUR5 million for connected financing transactions and to EUR1 million for all other categories. The revised thresholds are applicable from 1 January 2022. Furthermore, the new rules provide the chance to apply for advance pricing arrangements.

9.11 Transparency and Country-by-Country Reporting

In general, Cyprus has implemented a number of OECD and BEPS recommendations to promote transparency. As per the BEPS Action 13: Final Report, Cyprus has implemented CbC reporting by amending the applicable tax legislation pursuant to the Assessment and Collection of Taxes Law (Exchange of Information in the context of the Multilateral Competent Authority Agreement for the exchange of Country-by-Country reports) Decree of 2017.

Generally, the OECD guidance on the implementation of CbC reporting issued from time to time is used to interpret Cyprus' CbC reporting legislation for the purposes of ensuring a consistent and standard approach to CbC reporting. CbC reporting requirements apply in Cyprus as of 1 January 2016. However, in the event of conflict, Cyprus' CbC reporting legislation takes precedence.

9.12 Taxation of Digital Economy Businesses

Cyprus has not implemented any reforms addressing the taxation of digital businesses apart from the implementation, in November 2023, of the Council Directive (EU) 2021/514 (known as *"DAC 7"*) amending Directive 2011/16/EU on Administrative Cooperation and Automatic Exchange of Information in the Field of Taxation. This provided for an automatic exchange of information on certain data to be reported by online platform operators.

The matter of taxation of digital businesses has been under discussion at EU level for many years. Since March 2018, the EC has proposed the adoption of new rules on the imposition of a digital service tax (DST) in order to tax digital business activities in a fairer and more growth-friendly way between all EU members.

The general principle is that profits generated in a territory – even without the businesses' physical presence there – are to be taxed in the EU member state within which companies engage in such digital activities. There are several thresholds proposed on revenues and what will be taxable where it is envisaged that profit attribution will consider the market values of profits from user data and services connecting users online, as well as other more *"traditional"* online digital services (such as subscriptions to streaming services).

In general, a DST is expected to apply on revenues created from activities where users are an important part of the creation of value. Also, a second proposal affecting indirect taxation is the application of interim tax on certain revenues arising from digital activities that currently elude current/traditional tax frameworks. This is expected to include revenues from selling online advertising space, intermediary activities, and sales of data. Certain EU member states have already implemented the above-mentioned proposals and it is expected that other EU countries will follow.

9.13 Digital Taxation

A consultation regarding the adoption of digital taxation in Cyprus was initiated in August 2019; however, the DST itself has yet to be adopted. It is expected that digital taxation in Cyprus will be enacted (along with the introduction of other developments) as part of a much wider tax reform, aimed at further simplifying the taxation of individuals and entities in Cyprus.

9.14 Taxation of Offshore IP

As mentioned in **4.1 Withholding Taxes**, the payment of royalties to a non-Cyprus tax resident is subject to a maximum 10% withholding tax on the gross amount of such payment if the royalty rights were used in Cyprus.

DOMINICAN REPUBLIC

Law and Practice

Contributed by:
Luis Miguel Pereyra
Pereyra & Asociados

Contents

Pereyra & Asociados was originally established in 1990 and is a full-service law firm with a well-earned reputation for rendering cost-effective and efficient services for its clients. The firm has 17 lawyers and qualified personnel who provide the high-quality and personalised services it is known for, thanks to their breadth of legal expertise. Pereyra & Asociados' portfolio of clients mostly comprises Dominican and foreign corporations (American, Asian and European), within practically all areas of the economy, such as free zones, telecommunications, tourism, banking, energy, aerospace, media, pharmaceuticals, insurance, mining, consumer products, construction and agriculture. With ample experience in assisting foreign and national corporations and individuals, the firm renders services to its clientele based on a vast scope of expertise in such areas as general civil and commercial practice, corporate law, international trade, business law, antitrust and trade regulation, foreign investment, banking, insurance, government procurement, free zones, taxation, and litigation.

Author

Luis Miguel Pereyra is the founder and managing partner of Pereyra & Asociados, where he practises in the areas of civil law, commercial law, foreign investment, free trade zones, banking law, mining, telecommunications, tax law, energy law and competition law, among others. With 30 years of professional experience, Luis has also had a long career as an arbitration practitioner, and served as a professor of law at various universities in the Dominican Republic.

Pereyra & Asociados

Torre Ejecutiva Sonora
Floors 701 and 801
Avenida Abraham Lincoln No 1069
Santo Domingo
Distrito Nacional
Dominican Republic

Tel: +1 809 472 4106
Fax: +1 809 567 4102
Email: pereyra.law@pereyralaw.com
Web: www.pereyralaw.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt corporate forms in the Dominican Republic, with the most commonly used being shareholding companies, limited liability entities, and branches of foreign entities. There are also individual limited liability entities – each of which is owned by a single individual (single-owner business). Finally, there are de facto entities (ie, consortiums) that may operate as a separate entity (from the entities that form them) from the tax point of view, subject to registration requirements. The tax obligations of all entities are basically the same, with certain exceptions.

The differences between the most utilised corporations are mainly to do with minimum capital requirements, governance and/or liabilities vis-à-vis third parties.

- Limited liability companies (LLCs) – these companies are formed by two or more people or entities with contributions made by each of the partners. In this type of company, partners are not personally liable for the debts of the company. LLCs are classed as intuitu personae entities because the quotas (equivalent of shares) are not considered to be freely marketable but, rather, company partners must approve a potential sale of quotas. In this case, the minimum amount of paid capital is DOP100,000 (aproximately USD1,650) and the position of vigilance officer (an external officer who supervises the company's financial situation) is optional. The company is managed by general managers, who have ample authority to represent the company in its commercial transactions.
- Stock companies (SCs or *sociétés anonyme* (SAs)) – these companies have two or more shareholders operating under a single commercial name, with the contributions of such shareholders forming the company's capital. This type of company is characterised by the fact that the shareholders are liable for the debts of the company, albeit only up to the amount of their contribution to the company's capital. The authorised capital must be set to DOP30 million (approximately USD500,000), of which at least 10% must be fully subscribed and paid. The company is managed by a board of at least three members. One or more vigilance officers will have to be designated, who must be authorised public accountants with at least three years of experience in the auditing of companies. The capital of the company is divided in freely negotiable shares.
- Simplified stock companies (SSCs or *sociétés par actions simplifiée* (SASs)) – these are somewhat of a hybrid of the previous two companies. The minimum authorised social capital of the company is DOP3 million (approximately USD50,000) or its equivalent in a freely exchangeable foreign currency, such as US dollars. At least 10% of said capital must be fully subscribed and paid. The capital of the company is divided in freely negotiable shares. SSCs can be administered either by a board of directors or by a single president. If the shareholders decide to have the company administered by a board of directors, the same rules established by law that are applicable to the board of directors of SAs would apply to the SAS. SSCs can freely decide whether or not to name a vigilance officer. If the company were to decide to name a vigilance officer then the same rules

applicable to vigilance officers in SCs would apply

It is possible to operate through a branch of a foreign entity or through a consortium, except in very specific cases in which the formation of the local entity is required; albeit without general restrictions as to the nationality of the shareholders or participants. Nonetheless, the following should be noted.

- A branch of a foreign entity shall be a permanent establishment, but must be registered and taxed for income generate locally, is obligated to keep separate books from those of its parents, and essentially has the same obligations (and treatment) as a local entity.
- The fact that a foreign entity operates through a local subsidiary does not mean that such foreign entity has a local permanent establishment for tax purposes. Said foreign entity will be solely taxed (withholding tax) on dividends distributed by the local entity in which it is a shareholder, to the extent the foreign entity does not engage directly in any of the activities that might trigger a permanent establishment status.
- Similar to the foregoing should be the case of forming a consortium – although technically not a separate legal entity (from the entities that form it) from the tax point of view, once registered, it is treated as such.

1.2 Transparent Entities

There are no true transparent entities. Generally regarded transparent entities such as partnerships and trusts are recognised as taxable entities under Dominican Republic regulations. However, trusts incorporated in accordance with Law No 189-11 on the Development of Trust Funds and the Mortgage Market in the Dominican Republic are subject to a special tax regime.

1.3 Determining Residence of Incorporated Businesses

The Dominican Republic taxes primarily on a territorial basis. Business income derived from activities performed in property situated or economically used in or the economic rights to which are used in the country is taxed, regardless of the domicile or residence of the participants or regardless of the contracting location.

A company is resident if it is incorporated under the laws of the Dominican Republic or if the Dominican Republic is the place where the entity mainly carries out its activities or where the entity's main business headquarters or effective management is located. Holding an interest in a Dominican Republic entity does not necessarily entail local tax residence for a foreign entity.

As regards foreign entities, a permanent establishment is defined as a fixed place of business in which a foreign legal entity carries out all or part of its activity – such as headquarters, offices, branches, commercial agencies, factories, workshops, oil or gas wells, quarries or any other place where the extraction of natural resources (including supervision activities thereof), construction or supervision activities derived from the sale of machinery or equipment (when their cost exceeds 10% of the sale price of said goods), or business consulting services (provided they exceed six months within an annual period) are performed – or has dependent representatives or agents, when the latter carry out all or almost all of their activities on behalf of the company.

In order to assess whether there is a permanent establishment, the tax administration has the authority to request documents that include proof of residence (eg, service agreements, corporate documents, and invoices).

It should be noted that the Dominican Republic is a party to only two double taxation treaties (DTTs) – namely, with Canada (1976) and with Spain (2011) – with specific rules related to permanent establishments and tax residency.

1.4 Tax Rates

Resident or branch corporations (or consortiums) are subject to Dominican corporate income tax (*impuesto sobre la renta*, or ISR) on their local income (only) or income coming from activities within the country. The income tax rate is 27%.

Non-resident companies also pay corporate income tax on income sourced in Dominican territories in the absence of a permanent business. The resident corporation in the Dominican Republic will withhold 27% of the payment made to such non-resident entities for services, including publicity, royalties, and technical assistance.

The withholding tax on dividends paid to a resident or a non-resident is 10%. The same withholding tax applies to dividends or benefit remittances by free trade zone entities (under a special tax regime).

Withholding taxes on non-resident lenders are 10% on interest payable to such lenders.

Capital gains derived from the sale of assets, immovable property or shares are included in gross income and are subject to the standard corporate income tax rate of 27%.

Also 1% asset tax applies to the value of a corporation's total assets according to the company's financial statements. The asset tax, which is paid in two installments, is considered a minimum tax payable when it is higher than the company's corporate income tax liability. Certain assets are excluded from the taxable base

Capital duty is levied on the formation of a corporation or on a capital increase, at a rate of 1% of the capital amount

Individual Limited Liability Entities pay similar taxes, except that they do not pay Assets Tax or Capital duty Tax.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporate tax is levied on the net aggregate of various sources of business income, including capital gains derived from the transfer of capital assets (generally land and shares). Certain items of investment income derived by resident corporate taxpayers from foreign sources are also subject to Dominican tax, including:

- dividends;
- interest on loans and bank savings; and
- income from banking or financial operations, bonds, shares in capital companies, bills of exchange, and other movable capital or securities on the capital markets.

To determine the net taxable income, the necessary expenses incurred to obtain, maintain and conserve the gross income will be subtracted from the same, as provided for by the Tax Code. In the event of a loss, the net taxable income can be used against the profits generated in the following five years. The following are considered among the deductible expenses of income from business activities:

- interest;
- taxes and fees;
- insurance premiums;

- extraordinary damages;
- depreciation;
- depletion;
- amortisation of intangible assets;
- uncollectible accounts;
- donations to institutions of public welfare; R&D;
- losses; and
- contributions to pension and retirement plans.

The following are not deductible:

- personal expenses;
- withdrawals or paying shareholders' salaries from profit accounts;
- losses from illicit operations;
- income tax;
- surcharges;
- fines and interest on any tax debt; and
- inheritance and gift taxes.

Particular rules apply to carryover losses and interest deductions, among other things.

2.2 Special Incentives for Technology Investments

There are no incentives geared specifically towards technological investments. However, there are tax provisions and regimes that may apply to and incentivise such investments, as follows.

- Investment in R&D can be deducted from gross income in the assessment of taxable income.
- The free zone regime (Law 8-90) provides a custom-sterile environment whereby manufacturing and services could take place for export purposes. Entities located within free zone parks, authorised to operate as such, are generally exempted from income taxes, VAT, and import duties related to machinery and inputs required for its operations, among other exemptions and benefits.
- The border integral development zone regime (Law 12-21) provides incentives to companies based in an especially designated area comprising Dominican provinces located at the Haiti border. This law provides for similar incentives as those provided for by the free zone regime (Law 8-90). However, they are for a limited period of time and include 100% exemption from withholding taxes applicable to technology innovation services required for projects during construction and business set-up only – as well as 100% exemption from taxes applicable to the transfer of corporate shares to other commercial corporations domiciled within the special border development zone.

2.3 Other Special Incentives

Aside from the incentives described in **2.2 Special Incentives for Technology Investments**, the Dominican Republic has granted certain incentives to various sectors, ranging from investment credits to tax exemptions. Among the most important tax incentives are:

- incentives for the promotion of cinematographic activity, including international financial investment in the film industry in the Dominican Republic;
- incentives for books and libraries;
- incentives in textile chain sectors;
- incentives and special regimes for renewable energies;
- special incentives for pensioners and rentiers from foreign sources;
- incentives for competitiveness and industrial innovation;
- incentives for the promotion of tourism development; and
- foreign investment incentives.

2.4 Basic Rules on Loss Relief

Net operating losses may be carried forward for five years, but only up to 20% of the annual total net losses carried forward may be deducted. For the fourth year, the 20% deduction may not exceed an amount equal to 80% of taxable income. For the fifth year, the 20% deduction may not exceed 70% of taxable income. For newly formed entities, losses from the first year of operations should be fully deducted in the second year. The carryback of losses is not permitted.

Other rules may apply.

2.5 Imposed Limits on Deduction of Interest

Thin capitalisation rules limit the deduction of interest. The deductible amount may not be higher than the result of multiplying the total amount of interest accrued in the fiscal period by three times the annual average balance of equity divided by the annual average balance of all of the taxpayer's interest-bearing debt. After applying the annual permitted interest deduction, excess interest may be carried forward for deduction in the following three fiscal years (subject to the same limitation). Interest paid to resident individuals and entities is not subject to the interest deduction limitation

2.6 Basic Rules on Consolidated Tax Grouping

In accordance with the Dominican Tax Code, when the transfer of interest/shares is part of a reorganisation of entities in the same economic group, the results that may arise as a consequence of the reorganisation will not be taxed – provided the previous authorisation for tax neutrality from the tax authority is obtained.

There are also rules on the transfer of tax attributes from one entity to another, which is possible in the context of a merger or spin-off as approved by the tax authority.

Also, the Dominican tax regulations recognise the existence of economic groups when a person or company (or group of people) – whether or not they are domiciled in the Dominican Republic – carry out their activity through companies or organisations and the operations of both entities are related and are controlled or financed by them. In this case, the tax administration may attribute, allocate or assign gross income, deductions and credits among such organisations or companies if it determines that such distribution, allocation or allocation is necessary to prevent tax evasion or to clearly reflect the income of any of the aforementioned organisations or companies.

2.7 Capital Gains Taxation

Capital gains derived from the sale of assets, immovable property, or shares are included in gross income and are subject to the standard corporate income tax rate of 27%. The capital gain is calculated by deducting the acquisition cost (adjusted for inflation) from the sales price and adding the accumulated earnings/losses. (Other adjustments also may apply, depending on the case.)

2.8 Other Taxes Payable by an Incorporated Business

There are other taxes that might be payable by incorporated businesses, as follows.

- Capital duty – capital duty is levied on the formation of a corporation or on a capital increase, at a rate of 1% of the capital amount.

- Payroll tax – in addition to the normal income tax withheld from the salary of an employee, the employer must pay a monthly tax equal to 1% of the regular payroll to finance *"INFOTEP"*, a special training fund. The fringe benefits tax is levied at the corporate income tax rate and is payable by the employer on a monthly basis.
- Real property tax – this is basically an assets tax for corporations, payable under certain conditions.
- Social security – both the employer and the employee must contribute to the social security system. Contributions are calculated based on the employee's earnings (ie, the basic salary plus additional payments in cash or in kind, although certain deductions apply). The upper limits for calculating the contributions are based on multiples of the minimum salary.
- Stamp duty – stamp duty is levied on most written contracts, the registration and renewal of trade marks, and documents evidencing loans, debts, shares and guarantees, as well as all documents prepared or registered by notaries and registrars. The rates vary depending on the taxable event.
- Transfer tax – the transfer of real property located in the Dominican Republic is subject to a transfer tax of 3% of the price of the property or 3% of the fiscal value of the same (whichever is higher).

2.9 Incorporated Businesses and Notable Taxes

VAT or ITBIS (*impuesto sobre transferencias de bienes industrializados y servicios*) is applicable to the transfer of industrialised goods and services at a regular rate of 18%. Exceptions and exemptions apply. On imported goods, VAT is liquidated along with customs duties at customs. VAT charged for goods sold or services rendered must be declared and paid to the tax authority within the first 20 days of the month following the month in which the obligation to pay VAT arose.

Selective excise tax (*impuesto selectivo al consumo*, or ISC) is charged on the import or *"first sale"* of certain products. It might be set as a fixed amount or ad valorem.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses usually operate in a corporate form – mostly as a limited liability entity or an individual limited liability entity. More sophisticated structures are sometimes used, including trusts.

3.2 Individual Rates and Corporate Rates

Individual rates are lower than corporate rates. They are established by income brackets, with 25% being the higher rate (corporate income tax rate is 27%).

There are also more rules and restrictions with regard to, for example, deductions to gross income to determine an individual's taxable income. Employees whose sole source of income results from payments from their employer (salary, commissions, bonus, etc) do not file tax returns and the applicable taxes are deducted by the employer (to be further conveyed to the tax authority) from the amounts paid to the employee, based on the employee's tax bracket (as determined by such employee's annual income). The rules for applying such withholdings are provided for in the regulations.

3.3 Accumulating Earnings for Investment Purposes

There are no rules on accumulated earnings, except that the entity should document investment and have concrete evidence of the same.

3.4 Sales of Shares by Individuals in Closely Held Corporations

There is no difference in taxation on dividend distribution or capital gains for legal entities in general.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The general rule is that income from transactions carried out in the securities market are subject to the ordinary taxation regime established in the Tax Code, save for the exceptions explicitly established in the law, which do not apply to dividends from or gain on the sale in publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding taxes are applicable as follows.

- Dividends – the withholding tax on dividends paid to a resident or a non-resident is 10%. The same withholding tax applies to dividends or benefit remittances by free trade zone entities.
- Interest – the withholding tax on interest paid to a resident individual or a non-resident (individual or entity) is 10%. No tax is withheld on interest paid to a resident legal entity.
- Royalties – the withholding tax on royalties paid to a non-resident is 27% (ie, based on the corporate income tax rate).
- Branch remittance tax – a permanent establishment of a foreign company must withhold 10% on cash dividends paid to its head office.

The tax system incorporates measures that establish an ample web of withholding agents, including financial institutions. It has also established tools for mandatory electronic monthly reporting of purchases, sales or payments (among other things), which includes compliance with withholding obligations, so that the tax authority may promptly cross-check to detect breach of withholding obligations by any withholding agent or failure to properly report transactions subject to withholding taxes.

4.2 Primary Tax Treaty Countries

As mentioned in **1.3 Determining Residence of Incorporated Businesses**, the Dominican Republic is signatory of only two DTTs. The treaty with Canada (1976) only covers income taxes, whereas the treaty with Spain (2011) deals with income taxes and capital gains tax. Generally, neither treaty nor country are particularly used for local investment in local corporate stock or debt. Such usage depends on the focus of investment (mining, banking, hospitality, etc).

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Historically, there was no challenge to the use of treaty entities by residents of non-treaty countries, to the extent permitted by the applicable treaty. However, in 2022, the tax authority issued a norm to govern procedures for the granting of benefits contained in international agreements to avoid double taxation. The norm was subsequently revoked owing to complaints of overreach but it signalled that the tax authority is aiming to exert a more exacting control and apply more rigourous criteria as to the enforceability of the treaties, including the use of treaty country entities by residents of non-treaty countries.

4.4 Transfer Pricing Issues

The main drawback in the application of transfer pricing is that it can result in an excessive administrative burden for taxpayers and the tax administration when assessing a large number and variety of transactions across borders. This is due to historically limited resources to make such assessments accurately.

The tax administration and taxpayers have difficulties in obtaining adequate information to apply the arm's length principle, as this often requires the assessment of uncontrolled and complex transactions and the activities of associated companies – subject to the later evaluation of the tax authority, which still struggles to apply the relevant criteria consistently. However, improvements have been made in adjusting the regulations and enforcing them more consistently.

4.5 Related-Party Limited Risk Distribution Arrangements

Local regulations foresee the possibility of related-party *"costs"* distribution arrangements, which contain several elements that require clarity in the disclosure of the criteria to:

- quantify participation quotas in the expected benefits corresponding to each participant;
- apply accounting principles in a homogeneous manner to all participants for the determination of expenses and the value of contributions;
- reasonably attribute the responsibilities and obligations associated with the activity;
- regulate accession or withdrawal procedures; and
- make compensatory payments or payments that allow the terms of the agreement to be adjusted to reflect changes in economic circumstances.

Reasonability of cost distribution must prevail, as the tax authority could challenge expenses if the activities that are being jointly financed by the related parties do not produce any effective benefit to the resident participants, representing recurring decreases in taxable income beyond a period of up to three years (which can be extended to five, depending on the case).

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

As of 2011, transfer pricing regulations are being modelled based on OECD guidelines and enforcement standards, within limitations. The growing incidence of the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) recommendations in local regulations is obvious. The Dominican Republic have also been part of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes since 2013. The tax authority's institutional strategic plan for 2014-17 was aimed at bringing the tax authority closer to the OECD's best practice guidelines, prioritising the improvement of the service and the quality of information provided to taxpayers.

4.7 International Transfer Pricing Disputes

There has been a notorious shift towards a more exacting enforcement of transfer pricing provisions, including reviewing past transactions and compliance with standards (for up to three years back). There is no reliable information as to the incidence of tax treaties and mutual agreement procedures in transfer pricing disputes, as usually the transactions remain confidential. However, the tax authority issued Norm 10-22 establishing a mutual agreement procedure for resolving disputes regarding double taxation and tax evasion. The impact of this norm is yet to be determined but, given the increasing number of inquiries and disputes, it is likely to become a significant tool.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments may be made after transfer pricing claims are settled, taking into account certain general guidelines – for example, income tax adjustments might be compensated with income tax credits during the same period, whereas VAT adjustments might be compensated with VAT-relevant credits or an added value tax credit might be created where appropriate. Additionally, compensating adjustments may require rectification of the relevant tax return if the disputed settlement occurs during a different tax period to the period subject to dispute.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Generally, there is no difference in taxation for local branches of non-local corporations and local subsidiaries of non-local corporations. However, local branches of non-local corporations might be more closely monitored with regard to remittances to their parent entity or to other related entities.

5.3 Capital Gains of Non-Residents

Pursuant to the terms of Article 289 of the Tax Code, transfer of assets (including stocks) is in principle subject to capital gains tax-related provisions. Furthermore, pursuant to such provisions, for the purpose of capital gains tax, it must be reported that assets and rights located or used in the Dominican Republic have been transferred, pursuant to the transfer of shares in the company that holds such assets when such company has been incorporated abroad.

The foregoing means that if a foreign individual or entity holds assets or rights located or used in the Dominican Republic, upon the transfer by its shareholders of its shares in said entity, capital gains taxes might be levied pursuant to such transfer. Such capital gains are calculated based on a transfer value that takes into account the *"transaction price"* for the shares of the company holding the assets or rights and the proportional value of such assets or rights, vis-à-vis the company's entire patrimony.

Note that, in principle, for capital gains tax to apply it does not matter if the transfer is of an onerous nature or *"free of charge"* or if such transfer occurs directly in the local branch or subsidiary or indirectly through a change of control (change of the ultimate beneficial owner).

5.4 Change of Control Provisions

Capital gains tax may apply upon the occurrence of change of control in local branch of a foreign entity or local subsidiary.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There is no use of *"formulas"* to determine income of foreign-owned local affiliates selling goods or providing services. Rather, there are guidelines to follow with regard to transfer pricing regulations, the obligation to differentiate the foreign-owned local affiliate's accounting from that of its parent company or related entities, rules regarding economic groups and the option for the tax authority to allocate, income tax, deductions, credits, etc, when it deems this necessary to prevent tax evasion.

5.6 Deductions for Payments by Local Affiliates

The general rule is that deductible expenses are those incurred that are necessary to obtain, maintain and preserve taxable income, in the manner provided by the regulations. Such expenses should be duly supported by fiscal invoices/receipts. If the expense does not comply with such basic rules, it may not be deducted.

5.7 Constraints on Related-Party Borrowing

There are no constraints imposed on related-party borrowing except those resulting from transfer pricing regulations (contracted on an arm's length basis) and profit-shifting reduction rules establishing that interest expenses will be deductible in the Dominican Republic to the extent and proportion arising from applying to the expense the quotient between:

- the potential rate resulting from the withholdings to be applied to the payment of interest, plus the taxation for the payment of such interest abroad; and
- the rate applicable to companies in the Dominican Republic, which currently amounts to 27%.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The general rule is that any individual or legal entity resident or domiciled in the Dominican Republic, as well as undivided estates of deceased persons domiciled in the country, must pay tax on their income from Dominican sources and on their income from sources outside the Dominican Republic made from investments and financial gains. The foregoing entails local entities (and local branches of foreign entities) paying taxes on foreign income (not deemed to be Dominican-sourced) resulting from their investments or financial gains only.

6.2 Non-Deductible Local Expenses

Owing to the general rules for deductible expenses, in principle, no expenses can be deducted if they are not incurred in order to obtain or maintain taxable income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received from foreign subsidiaries paid to local corporations might be deemed as foreign income derived from investments of such local corporations and thus part of the latter's taxable income as per the general rule explained in **6.1 Foreign Income of Local Corporations**.

6.4 Use of Intangibles by Non-Local Subsidiaries

Individuals, legal entities or entities that are not residents or not domiciled in the Dominican Republic will be subject to tax on their income from Dominican sources. Dominican-sourced income is generally described as, among other things, income from capital, goods or rights located, placed or used economically in the Dominican Republic. To the extent the use by a non-local subsidiary of intangibles developed by a local corporation does not generate Dominican-sourced income, it should not be taxed.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

There are no provisions that would allow taxes to be levied on the income of local corporations' non-local subsidiaries as earned under controlled foreign corporation (CFC)-type rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no specific applicable rules related to substance of non-local affiliates. However, there are guidelines to determine control or related-party status mainly with regard to transfer pricing regulations and the determination of the existence of an economic group.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Proceeds received by local corporations from the sale of shares in a non-local affiliate might be deemed as foreign income derived from investments of such local corporations and thus part of the latter's taxable income as per the general rule explained in **6.1 Foreign Income of Local Corporations**.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

In the Dominican Republic, since the approval of the Tax Code through Law 11-92, certain anti-abuse or anti-avoidance clauses were included whereby juridical forms are not binding on the tax authority. Pursuant to Article 2 of the Tax Code and consistent with the directives of BEPS Action 5, the tax administration may ignore the legal form used by the taxpayer when the taxable event was defined in accordance with reality. In this way, when the taxation depends on the forms and they are manifestly inappropriate to the reality of the taxable events and this results in a reduction in the amount of the obligations, the tax authority may recharacterise the transaction to make it consistent with reality and impose the appropriate taxes. The application of the criterion of qualification and/or determination of any abuse of forms is made by the tax authority within the framework of its powers of inspection and determination of the tax obligation.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no routine audit cycle in the Dominican Republic – although for certain sectors encompassed within the *"major contributors"* category of taxpayers, periodical audits might be agreed with the tax administration or are usual for such sector. Typically, audits are made at random or triggered by consistent failure to abide by monthly reporting withholding or payment obligations. The tax authority may undertake direct assessments made solely on the information or reports available from the taxpayer and request information or adjustments or even preliminarily assert breach of tax obligations and impose applicable penalties. These procedures give the taxpayer the opportunity to contest or accept such assessments, which may or may not trigger formal audits.

9. BEPS

9.1 Recommended Changes

The BEPS recommended changes already implemented – albeit not fully – have most notably to do with transfer pricing (Actions 8–10). There have been efforts with regard to the taxation of digital services (Action 1) but the most recent overture towards the same was withdrawn for congressional consideration, as the tax overhaul proposed by the government (including such provision) was rejected by most economic sectors and the general public. Limits to interest deductions consistent with BEPS Action 4 were also introduced, albeit subject to further adjustments. There are also reporting obligations imposed that are consistent with BEPS Action 13 – most notably, the ones most recently introduced regarding the master file and country-by-country (CbC) reporting, which may lay the groundwork (information) for identifying multinational enterprise (MNE) groups within the scope of the OECD's Pillar Two, also known as the Global Anti-Base Erosion Rules (the *"GloBE Rules"*).

9.2 Government Attitudes

The Dominican Republic entered the OECD/G20 Inclusive Framework for the Implementation of BEPS in 2018. In this regard, it assumed a series of minimum standard obligations – four of which are the main ones that the DR is currently implementing with regard to documentation and information regulations as related to transfer pricing and MNEs' activities (either directly when headquartered locally or through related entities). As indicated in **9.1 Recommended Changes**, the recent introduction of reporting obligations (including the master file and CbC reporting) are deemed as the groundwork (information) for identifying MNE groups within the scope of the OECD's GloBE Rules – although Pillar One and Pillar Two actions are yet to be implemented, as they require passing a law adjusting in the Tax Code in the context of a currently unpopular tax overhaul.

9.3 Profile of International Tax

As indicated in **9.2 Government Attitudes**, the Dominican Republic committed to the implementation of BEPS recommendations in 2018 and – although it does not necessarily have a high public profile – it has taken steps towards their implementation in the pace and manner permitted, given the current economic environment. Most of the BEPS actions require the passing of laws and/or a shift of the status quo and, in some cases, have encountered resistance – given that the Dominican Republic's policies as of 1996 were geared towards the attraction of foreign investment and put in place incentives laws and special tax regimes that will need to be adjusted and/or discarded.

9.4 Competitive Tax Policy Objective

As the Dominican Republic has committed to the implementation of BEPS actions (at least at a minimum level), it will have to revise its competitive tax policies, which mostly consist of tax incentives laws and regimes that in certain cases (and circumstances) provide for 100% general tax exemptions and other benefits. This is apparently no longer sustainable and thus such incentives laws and regimes should be overhauled accordingly, as – far from incentivising investment – such policies may adversely affect the international corporations currently operating (through local branches or subsidiaries) in the country.

9.5 Features of the Competitive Tax System

Most special tax regimes that have been set up to incentivise investments (eg, free zones, tourism development incentives) – which provide for general tax exemptions, among other things – are the most vulnerable, as they will require substantial overhaul and some may have to disappear altogether. This is currently an ongoing discussion among policymakers and representatives of the affected sector and, in the short-to-medium term, it is expected that measures will be taken in order to at least adjust such regimes.

9.6 Proposals for Dealing With Hybrid Instruments

In the Dominican Republic, there are no specific regulations regarding taxation related to hybrid instrument. Their impact might not be substantial, as the local regulations and tax system does not recognise transparent entities, and thus the usefulness of such hybrid instruments in tax avoidance schemes is unlikely to be significant.

9.7 Territorial Tax Regime

The Dominican Republic has a territorial tax regime. Individuals and corporations are taxed on their Dominican-sourced income and some foreign-sourced income (as derived from investments and financial gains). Non-local individuals or corporations are only taxed on Dominican-sourced income (via withholdings). Given such facts, interest deductibility restrictions are mostly tailored to that regime.

9.8 Controlled Foreign Corporation Proposals

In principle, CFC rules seem to generate taxable events locally, as they may prevent accumulation of profits locally payable to foreign shareholders or deferral of payment for goods and services to the foreign related party (among other things). However, CFC rules also contrast with or affect foreign investment incentives regimes and this also affects the country's competitive tax policies, given that – although local profits might be tax exempted – as a CFC the controller entity may nonetheless pay taxes on such profits (albeit not distributed).

Nonetheless, as already explained in **9.1 Recommended Changes**, the recent introduction of reporting obligations (including master file and CbC reporting) is deemed as the groundwork (information) for identifying MNE groups within the scope of the OECD's GloBE Rules, which foresee the possibility of a minimum global tax.

9.9 Anti-Avoidance Rules

In the Dominican Republic, there are no double tax convention (DTC)-specific limitations on benefits nor anti-avoidance rules that may have an impact on investors.

9.10 Transfer Pricing Changes

As transfer pricing regulations have steadily been introduced, adjusted and implemented since 2012, they currently do not have a radical impact on the tax regime in the Dominican Republic – although changes in enforcement efforts (which vary from time to time) do create momentary disturbances. On the other hand, the IP issue is a cause for controversy, as local transfer pricing regulations still do not foresee a definition of intangible assets and instead there are approximations within regulations with regard to to VAT. Thus, there is a vacuum when it comes to IP-related taxation and the implementation of BEPS actions in this regard.

9.11 Transparency and Country-by-Country Reporting

The Dominican Republic has already taken steps towards transparency and CbC reporting as part of its commitment under the OECD/G20 Inclusive Framework for the Implementation of BEPS. The current gist of the matter is the manner in which such information shall be utilised. There is concern about the type of information to be provided, whether it should be public, mechanisms to protect it, and what impact it may have on the position of MNEs in the country. Although the possibility of public information may improve transparency, owing to increased scrutiny in the media and civil society, technical information disclosed without the appropriate context may damage the position of an MNE in the Dominican Republic and consequently might further limit investment in the same.

9.12 Taxation of Digital Economy Businesses

Regulations related to the taxation of digital services have not yet materialised in the Dominican Republic, unlike in other jurisdictions. Initiatives in this regard have been considered and were even included as a potential source of tax revenue in a recently proposed tax bill foreseen by a significant overhaul of the tax regulations. However, the bill was not well received by civil society or certain economic sectors and hence was dropped.

In the Dominican Republic, a tax overhaul seems to be overdue, aside from the fact that most BEPs related regulatory commitments needs to be passed by the Dominican congresses. Thus, it is expected that any bill in this regard will include provisions concerning the taxation of digital economy businesses.

9.13 Digital Taxation

The Dominican Republic is aiming towards digital taxation and has made efforts in this regard. However, the country is yet to pass the regulations that would allow for the same.

What has been discussed is a new tax along the same lines as the one that has already been successfully implemented in other jurisdictions, such as Colombia and Peru – although it would represent a great challenge for the Dominican Republic, due to the insufficiency of regulations that would allow its immediate application. In other words, it is necessary to adapt domestic legislation to the development of digital trade, to the extent that it allows the Dominican Republic to apply the tax to companies that do not necessarily have a presence in the country nor require it in order to carry out their activities.

In principle, the tax would likely be comparable to those applied to telecommunications services (VAT or ISC) and be withheld by the intermediary of the payment of the services (ie, processors of electronic transfers/payments). However, there is still no definition of the type of tax or processes related to the collection or payment of the same.

9.14 Taxation of Offshore IP

There are no specific regulations dealing with the taxation of offshore IP that is deployed within the Dominican Republic. General rules on income tax, source of income, withholding, etc, still apply.

ECUADOR

Law and Practice

Contributed by:
Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Rafaela Molina Polo
Almeida Guzmán & Asociados

Contents

Contributed by: Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Rafaela Molina Polo, **Almeida Guzmán & Asociados**

Almeida Guzmán & Asociados is a firm of attorneys and consultants that was established in 1981, specialising in juridical-corporate advice and consulting. The firm's professional practice spans the following areas: tax; corporate, commercial and business; labour; immigration; competition/antitrust; consumer protection; environmental; real estate, construction and infrastructure; public procurement; national and international arbitration; tourism; mining; financial, banking and stock exchange; energy (hydrocarbons, electricity and alternative energy); telecommunications and e-commerce; and human health. Consultants are also employed in the fields of economic sciences and accounting. The firm provides services in legal, tax and economic consulting; consulting on project finance, investment projects, mergers, spin-offs and takeovers of companies; and business restructuring.

Authors

Diego Almeida-Guzmán is the senior and technical partner of Almeida Guzmán Asociados, with experience in legal-corporate counselling, as well as in corporate mergers, acquisitions, spin-offs, takeovers, privatisation projects and business restructuring. He provides advice on trusts, fiduciary funds, tax, foreign investment and transfer of technology legislation. He is an acting legal expert for international arbitration cases, an arbitrator at the Center of Mediation and Arbitration of the Ecuadorian–American Chamber of Commerce, and a member of the Quito Bar Society, the Ecuadorian Institute of Tax Law, the International Bar Association and the Inter-American Bar Association.

Andrés Álvarez-Toapanta is an expert in international taxation, international accounting and financial standards (IFRS and IAS), tax counselling and corporate advisory at Almeida Guzmán Asociados. He previously worked as chief tax officer in a well-known transnational corporation in the consumer goods industry. He has a Master's in International Taxation from Universidad de la Rioja (Spain).

Cesar Molina-Delgado is an attorney at Almeida Guzmán Asociados with experience in corporate and tax law, including expertise in international taxation, accounting and working with financial statements. He has vast knowledge and experience in technology, digital platforms, cryptocurrencies, smart contracts and data-oriented applications.

Contributed by: Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Rafaela Molina Polo, **Almeida Guzmán & Asociados**

Rafaela Molina Polo is an attorney at Almeida Guzmán Asociados. She has broad knowledge of tax and corporate law, including expertise in international taxation and tax planning. Rafaela has vast experience representing clients in administrative and judicial tax proceedings. Currently, she is pursuing a Tax LLM with a specialisation in Tax Planning and International Taxation at Universidad Andina Simón Bolívar.

Almeida Guzmán Asociados

Whymper N27-70 y Orellana
Edificio Sassari
Piso 8
Quito D.M.
Ecuador

Tel: +59 32 292 8115
Email: law@almeidaguzman.com
Web: www.almeidaguzman.com

Contributed by: Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Rafaela Molina Polo, **Almeida Guzmán & Asociados**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses commonly adopt a corporate form. The most common structures are corporations and limited liability companies (partnerships), which can adopt the following forms:

- *Compañía anónima* (corporation) – the transfer of issued shares is not subject to limitations. For incorporation, at least two shareholders are required and there is a minimum share capital of USD800.
- *Compañía de responsabilidad limitada* (corporation/partnership) – the transfer of issued shares requires unanimous approval by the partners. For incorporation, at least two partners are required and there is a minimum share capital of USD400.
- *Sociedad por acciones simplificada* (simplified joint-stock corporation) – issued shares may be freely transferred but cannot be traded on an Ecuadorian stock market. For incorporation, only one shareholder is required. There is no minimum capital requirement. This type of company requires relatively fewer formalities for its incorporation and operation.

Corporate structures are taxed as independent entities. Shareholder and partner liability is limited to the amount of their equity in the company.

Consortiums and joint ventures are corporate entities that are not widely used in Ecuador. They are used primarily when undertaking public works contracts, as well as specific projects with a limited duration. For tax purposes, consortiums and joint ventures are regarded as independent entities and taxed accordingly. Nevertheless, their members' liability is not limited to their equity.

1.2 Transparent Entities

All corporate entities are considered to be independent taxpayers. Dividends paid by corporate entities are subject to an income tax withholding, unless the beneficiary is a local corporation. Individual beneficiaries of the dividends may be subject to an income tax withholding pursuant of the applicable tax bracket in relation to the relevant dividend received. Dividends paid to foreign investors are subject to a 10% income tax withholding. Exemptions may apply under double taxation treaties.

Stakeholders in sectors such as banking, insurance, the stock exchange and securities are obliged to use corporations to carry out their business.

The Ecuadorian stock exchange law provides for trusts, investment funds, commercial funds and hedge funds. Under Ecuadorian law, these legal entities are considered to be independent for both commercial and tax purposes. In some cases, trusts and funds are obliged to act as tax withholding agents.

Stakeholders in the construction sector (both for private and public projects) normally perform their activities using trusts, consortiums and joint ventures.

1.3 Determining Residence of Incorporated Businesses

As a general principle, whenever an entity is domiciled and/or incorporated within Ecuadorian territory, it is regarded as a tax resident in the country.

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Under Ecuadorian law, tax residency is determined as follows.

- Primary criteria:
  - (a) the entity's residence; and
  - (b) the entity's incorporation under Ecuadorian law, as well as its main place of business being within Ecuadorian territory.
- Secondary criteria (if the primary criteria cannot be determined):
  - (a) the location where the entity's economic activities are performed; and
  - (b) the location where the taxable event occurred.

Ecuador has entered double taxation treaties with the following countries: Argentina (limited to air transportation), the Andean Community (Bolivia, Peru and Colombia), Belarus, Belgium, Brazil, Canada, Chile, China, Germany, France, Italy, Japan, Mexico, Qatar, Romania, Singapore, South Korea, Spain, Russia, Switzerland, United Kingdom and Northern Ireland, the United Arab Emirates and Uruguay. Ecuadorian double taxation treaties generally follow the OECD model, except for the Andean Community Treaty, certain elements of which follow the United Nations' Model Double Taxation Convention.

Pursuant to most double taxation treaties, construction projects executed during a specific period, a factory, industrial or assembly plant, industrial or assembly workshop, may be regarded as a permanent establishment and therefore a tax resident where the relevant activities are executed.

Under most of the double taxation treaties, Ecuadorian-source income is taxed locally except for corporate profits (for treaties that follow the OECD model). However, certain income sources – such as royalties and interests, and technical service fees – are subject to tax at lower rates (10% and 15% compared to the general 25% rate).

1.4 Tax Rates

Entities are subject to a 25% income tax levied on their net taxable profit. However, a 28% income tax rate applies whenever:

- one or more shareholders are residents of a tax haven territory, and the beneficial owner is a tax resident in Ecuador; and
- the entity does not report to the tax authority its chain of ownership up to the beneficial owner.

Ecuadorian law provides for 15% employee profit-sharing, meaning that the entity is obliged to distribute 15% of its accounting profits among its employees. This expense is tax deductible when determining the taxable base.

Income tax is paid in a single instalment during the first quarter of the fiscal year following the fiscal year that the profit corresponds to.

Since 2022, micro businesses are subject to up to 2% income tax levied on their net income.

Regarding transparent entities, see **1.1 Corporate Structures and Tax Treatment** and **1.2 Transparent Entities**.

Individuals are taxed at progressive rates. The payable income tax bands and rates for 2025 are as follows:

- up to USD12,081 – exempt;
- over USD12,081 and up to USD15,387 – 5% on the balance in excess of USD12,081;

- over USD15,387 and up to USD19,978 – USD165, plus 10% on the balance in excess of USD15,387;
- over USD19,978 and up to USD26,422 – USD624, plus 12% on the balance in excess of USD26,422;
- over USD26,422 and up to USD34,770 – USD1,398, plus 15% on the balance in excess of USD34,770;
- over USD34,770 and up to USD46,089 – USD2,650, plus 20% on the balance in excess of USD46,089;
- over USD46,089 and up to USD61,359 – USD4,914, plus 25% on the balance in excess of USD61,359;
- over USD61,359 and up to USD81,817 – USD8,731, plus 30% on the balance in excess of USD81,817;
- over USD81,817 and up to USD108,810 – USD14,869, plus 35% on the balance in excess of USD108,810; and
- over USD108,810 – USD24,316, plus 37% on the balance in excess of USD108,810.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Ecuadorian commercial entities are obliged to keep their accounting records according to International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS). However, accounting profit is subject to adjustment for tax purposes.

The main adjustments (accounting profit versus taxable profit) are as follows.

- Accounting expenses not deductible for tax purposes:
  (a) depreciation and amortisation in the amount that exceeds the limits provided for by tax law (real estate, ships and planes – 5%; machinery and equipment – 10%; vehicles and transportation equipment – 20%; hardware and software – 33%; and intangible assets – 20%);
  (b) provisions and reserves not allowed by Ecuadorian law;
  (c) interests in the amount that exceeds the maximum rates authorised by the Ecuadorian Monetary Authority;
  (d) interest paid to related parties exceeding 20% of the entity's EBITDA, in the given fiscal year;
  (e) interest paid on foreign loans not registered before the Ecuadorian Central Bank, when required; and
  (f) overall, any other expense not directly related to taxable income.
- Expenses not supported by valid invoices.
- Tax-exempt income, among others:
  (a) dividends paid by Ecuadorian entities to other Ecuadorian corporations;
  (b) occasional capital gains arising from real estate, whenever certain requirements are met, and the sale is made by an individual;
  (c) financial returns generated by investments at terms greater than 180 days; and
  (d) foreign-source income according to double taxation treaties.

The adjustments are made in the applicable tax return, based on accounting records.

2.2 Special Incentives for Technology Investments

In 2023, an income tax rate reduction was introduced for technology-related initiatives, with taxpayers investing their profits in certified projects related to technological development eligible to benefit from an 8%-10% reduction in their income tax rate pursuant to conditions provided by the Ecuadorian tax regime. The incentive was applicable starting from fiscal year 2024.

Nevertheless, new investments may apply for a general incentive; see **2.3 Other Special Incentives**.

2.3 Other Special Incentives

As of 2022, Ecuadorian tax law provides for a three percentage-point reduction in the income tax rate for new corporations and investments. The latter will be applicable for up to 15 years. The accumulated exemption may not exceed the amount invested.

Entities that concluded new investment contracts with the Ecuadorian government after November 2021 will benefit from a five percentage-point reduction in the income tax rate. The accumulated exemption may not exceed the invested amount. The exemption will apply during the contract's term, which may not exceed 15 years, unless the contract provides for a longer term. Nevertheless, the contract may be renewed by the same time period or less. The entities may also benefit from an exemption on specific foreign trade taxes and the capital remittance tax (*impuesto a la salida de divisas*,or ISD), regarding the import of capital goods and raw materials related to the investment (whenever certain conditions are met).

Operators of free trade zones will benefit from a 0% income tax rate starting from the first year in which the competent authority qualified the latter as such. Henceforth a 15% rate will be applicable for such operators.

Public-Private Partnership (APP) is a regime wherein an entity of the government delegates the execution of a specific activity to a private corporation or enterprise. Said regime is applicable, for example, to the execution of a specific public work or the management of a public asset. The APP regime is applicable to projects that meet specific requirements that include the investment of funds by the private entities.

Legal stability is guaranteed for specific regulatory aspects, provided these are regarded as essential by the competent authorities. The term of an APP contract may be up to 30 years. Such term may be extended for an additional 10-year term. In no case may an APP Contract have a duration exceeding 40 years.

In no case may an APP Contract have a term of less than five years.

The income derived from bonds or other securities issued to finance public projects developed through an APP partnership as well as the profit earned in trading such securities are income tax exempted. The benefit does not apply to transactions concluded between related parties.

2.4 Basic Rules on Loss Relief

Losses registered in a fiscal year can be amortised (carried forward) for up to five years. Taxpayers may offset only up to 25% of the taxable income. Ecuadorian law does not provide for loss carry-back, nor for offsetting income losses against capital gains or vice versa. Losses incurred in transactions with related parties are not tax deductible.

2.5 Imposed Limits on Deduction of Interest

Interest is deductible whenever the related loan is needed for the debtor to undertake its commercial activity. For tax purposes, interest is deductible provided the rate does not exceed the maximum rate set by the Ecuadorian Monetary Authority. The amount that exceeds such rate is not deductible.

This also applies to foreign loans, which, in certain cases, are subject to registration before the Ecuadorian Central Bank. For registration purposes, the capital of the loan must be deposited in an Ecuadorian bank. Interest paid exceeding the maximum rate applicable to this kind of transaction is subject to income tax withholding.

Interest paid to related parties that exceeds 20% of the entity's EBITDA will not be deductible.

2.6 Basic Rules on Consolidated Tax Grouping

The consolidation of financial statements for tax purposes is not allowed under Ecuadorian law. As such, groups of companies are not allowed to record losses reported by entities other than those incurring the loss.

However, for reporting purposes before the Superintendence of Companies, IFRS rules on consolidating financial statements apply.

2.7 Capital Gains Taxation

Overall, Ecuadorian law does not provide for a particular tax treatment on capital gains, which are taxed as general income.

However, there are exceptions to the general rule, which are listed below:

- occasional capital gains obtained in the sale of real estate are tax exempt provided certain requirements are met and the seller is an individual; and
- capital gains on the sale of shares and other equity rights are taxed at a 10% rate. This treatment also applies to the indirect sale of the equity of an Ecuadorian entity, provided certain requirements are met. An indirect sale occurs when shares owned by any shareholder within the chain of ownership of an Ecuadorian entity are disposed of, including shares held outside Ecuadorian territory. Indeed, any transfer of shares of any entity that directly or indirectly owns an Ecuadorian corporation's shares is regarded as an indirect sale.

The taxable base applicable to the disposal of shares is determined as the difference between the sale price and:

- the face value of the shares;
- the original cost of the shares; or
- the proportional value of equity.

Whenever the seller is a foreign entity, the Ecuadorian company whose shares are being transferred is obliged to act as a substitute taxpayer and pay the tax on behalf of the shareholder.

The sale of shares listed on an Ecuadorian stock exchange may benefit from the following exemptions and reductions:

- whenever the entity's equity sold does not exceed 25%, a deduction of up to USD604,050 (in 2025) applies; or
- whenever the entity's equity sold exceeds 25%, a deduction of up to USD604,050 (in 2025) applies, and a 5% tax rate on the excess.

2.8 Other Taxes Payable by an Incorporated Business

The following taxes are commonly applicable:

- Value added tax – VAT of 15% is levied on the sale or provision of goods and services. The tax is collected by the business that sells the goods or provides the services. VAT is paid on a monthly basis. Businesses are allowed to deduct (tax credit) the VAT paid when acquiring goods and using services in the ordinary course of business.
- The VAT rate levied on the provision of tourism services may be reduced to 8%, whenever the services are rendered during certain national holidays or specific weekends defined by the president through and executive decree.
- ICE (excise tax) – excise tax is levied on specific imported or domestic goods (generally luxury or demerit goods). For example, alcoholic beverages, cigarettes and vehicles are subject to the aforementioned tax. ICE is collected by the seller of the goods and paid on a monthly basis.
- ISD (capital remittance tax) – capital remittance tax is levied on funds sent abroad by any Ecuadorian entity. It also applies to payment for imports. Up to 31 December 2024, a tax credit was granted whenever the imported merchandise was a raw material used to produce local goods. Nevertheless, ISD paid for the execution of the taxpayer's economic activity may still be used as an income tax deductible expense. Exporters that have not deposited into an Ecuadorian account the funds received for their exports must also pay the capital remittance tax whenever such funds are used by the entity. When certain requirements are met, the payment of dividends and interest may be exempt from ISD.

The Ecuadorian tax system has implemented a 5% ISD tariff applicable throughout 2025. As a consequence of the country's energy crisis, the tax rate is set at zero for January, February and March 2025 for the importation of energy-related and other products, as provided by the regulators. Starting in April 2025, the 0% rate will remain applicable to the import of certain products related to the pharmaceuticals sector. All other payments abroad levied with ISD will continue to be taxed at 5%.

2.9 Incorporated Businesses and Notable Taxes

Tax on Overseas Financial Assets

This tax applies at a rate of 0.1% to 0.35% and is levied on the monthly average of funds held abroad. This tax applies to funds held abroad by the following entities:

- banks and other entities that perform financing activities;
- entities that manage funds and trusts;
- securities companies;
- insurance and reinsurance companies; and
- portfolio managers.

Special Temporary Equity Contribution

Tax on profit generated on the sale of real estate

Profit generated on the sale of real estate is subject to this tax at a rate of 10% and payable to the municipality in which the asset is located.

A deduction of 5% of the net profit for each year of ownership is permitted when determining the taxable base. Once the elapsed time from the date of acquisition by the seller is 20 years, the transfer is tax exempt.

Alcabala tax (impuesto a las alcabala)

The *"Alcabala"* tax is levied on the transfer of real estate property. Transactions such as donations or transfer of property through inheritance, as well as transfer by the trustee to the trust's beneficiaries are levied with this municipal tax. The *"Alcabala"* tax rate is 1%.

Municipal patent tax

Businesses, whether individual or corporate structures, are also subject to a municipal tax called *"Patente Municipal"*, which is payable on an annual basis. The rate of the tax is determined by the municipality based on the entity's equity, and in no case will the tax be lower than USD10 or higher than USD25,000.

"1.5 per thousand tax" on assets

Businesses are obliged to make an annual tax payment to the municipality of their domicile equivalent to 1.5 per thousand (or 0.15%) of their total accounting assets.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate using a corporate form. Commonly, the preferred corporate form is a corporation or a limited liability company. New businesses are expected to be incorporated as a simplified joint-stock corporation, as it is significantly cheaper to incorporate this type of entity.

3.2 Individual Rates and Corporate Rates

Even though corporate rates are lower than individual rates, there are no rules to prevent individual professionals from earning income at corporate rates, because dividends paid by companies to individuals are taxed at individual rates and subject to income tax withholding rates ranging from 0 to 25%. The income tax withheld by the entity distributing the dividends may be recorded as a tax credit by the individual, who then deducts such credit from their final tax.

3.3 Accumulating Earnings for Investment Purposes

There are no legal provisions that prevent closely held corporations from accumulating earnings for investment purposes. However, Ecuadorian law considers loans granted by business to shareholders or partners as taxable dividends.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends paid by Ecuadorian corporations to individuals domiciled abroad are subject to a 10% income tax withholding, whereas Ecuadorian tax residents (individuals) are subject to an income tax withholding rate ranging from 0% to 25%. Dividends received by the latter become part of their taxable income, and, as such, are subject to individual tax rates.

Regarding capital gains on the transfer of shares, see **2.7 Capital Gains Taxation**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends paid by publicly traded corporations are subject to the same treatment applicable to dividends in general.

As for capital gains on the sale of shares of publicly traded corporations in Ecuadorian stock exchanges, some exemptions may apply. Regarding the exemptions on the transfer of shares, see **2.7 Capital Gains Taxation**. If a transaction is not made through an Ecuadorian stock exchange, capital gains are subject to a tax rate of 10%.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Where no double taxation treaties are applicable, the following tax withholding rates apply:

- Dividends paid to non-resident corporations and individuals are subject to a 25% withholding tax rate levied on 40% of the dividend (effective rate: 10%).
- Interest paid to foreign financial institutions related to foreign loans duly registered before the Ecuadorian Central Bank, when required and not exceeding the maximum rate established by the Ecuadorian authorities, is not subject to an income tax withholding. Where no registration has taken place and/or the amount exceeds the maximum rate, a 25% income tax withholding applies.
- Royalties and technical service fees paid to a foreign entity are subject to a 25% income tax withholding.
- Where there is no specific rate, payments made to residents in tax havens are withheld at a 37% rate.

The Ecuadorian tax authority is determined to collect taxes in all transactions. Overall, expenses are tax deductible whenever the relevant tax is withheld by the payor (unless a specific exemption applies). The Ecuadorian tax authority has a particular interest in determining whether the benefits provided for by tax treaties are in fact applicable to transactions concluded by Ecuadorian residents with entities domiciled abroad. Indeed, tax treaties provide for exemptions and reductions on withholding rates. Therefore, the Ecuadorian tax authority analyses whether the provisions of the tax treaties are applicable. Another aspect on which the Ecuadorian tax authority focuses is the economic substance of the transaction (see **4.3 Use of Treaty Country Entities by Non-treaty Country Residents**). Nevertheless, the Ecuadorian tax authority faces certain challenges regarding international taxation (see **9.3 Profile of International Tax**).

4.2 Primary Tax Treaty Countries

Despite the fact that Ecuador has entered into 22 double taxation treaties and a general treaty concluded within the Andean Community of Nations (which includes Colombia, Peru and Bolivia), the primary tax jurisdictions foreign investors use to invest in local corporate stock or debt are Spain, Uruguay, Germany, Brazil, Mexico and Canada.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Ecuador does not challenge the use of treaty country entities by non-treaty country residents. Nevertheless, Ecuador has implemented provisions in order to track the entities that benefit from the provisions of tax treaties and other exemptions. Indeed, local taxpayers are required to file a yearly report on their shareholders to their beneficial owners. Likewise, in order to apply lower withholding rates pursuant to tax treaties, taxpayers must hold a certificate of tax residence of the beneficiary of the payments issued by the competent authority.

The Ecuadorian Tax Administration may analyse whether the transactions that benefit from the treaties lack economic substance. In such case, the payments that benefited from the tax treaties will not be considered deductible for income tax purposes for the local corporation.

Benefits provided by certain tax treaties concluded with countries such as Uruguay, South Korea and China are conditional. Namely, a corporation may benefit from the tax treaty whenever a specific percentage of its beneficial owners are residents in such countries, or if the corporation's shares are listed on a stock exchange.

4.4 Transfer Pricing Issues

Even though Ecuador is not a member of the OECD, the country applies the transfer pricing parameters contained in the guidelines issued by the organisation. Indeed, its general provisions have become part of Ecuadorian tax law and its regulations.

The main concern is related to export prices as well as royalties, technical service fees and interest paid to related parties. Regarding these issues, local law allows Ecuadorian entities to file a consultation (request for an advance pricing agreement) with the tax authority to determine the parameters under which the transfer pricing valuation will be performed.

Corporations that make frequent transactions with related parties (whenever certain requirements are met) must file a yearly transfer pricing report with the Ecuadorian Tax Administration. In this report, the corporation must demonstrate that the transactions concluded with its related parties comply with the arm's-length principle.

For tax purposes, and particularly for determining transfer pricing, transactions with entities domiciled in tax havens are regarded as if they were concluded with related parties.

4.5 Related-Party Limited Risk Distribution Arrangements

Local tax authorities have not challenged the use of related-party limited risk distribution arrangements for the sale or provision of goods or services locally. Nonetheless, Ecuadorian tax law states that transactions between related parties should follow the arm's-length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Ecuador is not a member of the OECD. Nevertheless, Ecuadorian transfer pricing principles and the applicable methodologies generally follow OECD guidelines. Accordingly, local transfer pricing rules and/or enforcement in theory do not vary from OECD standards.

4.7 International Transfer Pricing Disputes

In the past few years, the Ecuadorian tax authority has been focusing its audits on the transfer pricing regime applied by multinational corporations. Regarding the possibility of re-opening earlier years to analyse the fulfilment of the transfer pricing regime, the general rules on tax audits apply (see **8.1 Regular Routine Audit Cycle**).

Commonly, transfer pricing disputes are resolved before local tax authorities and/or courts. The authors are not aware of any international transfer pricing disputes being resolved through double taxation treaties. Local law does not provide for a specific procedure to handle mutual agreement procedures (MAPs) to resolve transfer pricing issues between tax authorities and private entities. Local tax authorities have not publicly entered a MAP with foreign tax authorities.

Nevertheless, as of 2022, tax disputes may be solved through mediation, as per a tax reform enacted in November 2021. This represents a substantial modification in the Ecuadorian tax regime, since prior to the tax reform, all disputes had to be settled through administrative claims or judicial actions.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Until now, transfer pricing issues and claims have been resolved through administrative claims and judicial actions filed by private entities against the Ecuadorian tax authority. The authors are not aware of any specific MAP and/or PTC (pass-through company) processes that Ecuador has been a part of.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches of non-local corporations and local subsidiaries of non-local corporations are taxed equally. The Ecuadorian Constitution and law expressly prohibit any discrimination in the treatment applicable to local and foreign individuals and entities. Nevertheless, payments made by local branches or subsidiaries to their parent corporation may be subject to lower taxation pursuant to tax treaties (see **4.1 Withholding Taxes**).

5.3 Capital Gains of Non-Residents

Capital gains of non-residents on the sale of shares in local corporations are taxed in Ecuador. Indeed, the tax applies when the gains relate to shares of a non-local holding company that owns the shares of a local corporation, both directly and indirectly.

The main principle under Ecuadorian tax law is to tax capital gains on the sale of shares issued by local corporations whenever the indirect transfer of equity within the chain of ownership (including one abroad) affects the ownership of an Ecuadorian entity and certain requirements are met.

5.4 Change of Control Provisions

There are no change-of-control provisions that could apply to trigger tax or duty charges. In particular, there are no such provisions that could apply to the disposal of an indirect holding much higher up in the overseas group. All issues related to the direct or indirect transfer of shares are included in previous sections of this chapter.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no formulas used to determine the income of foreign-owned local affiliates selling goods or providing services. However, transfer pricing guidelines and the arm's-length principle apply to them.

5.6 Deductions for Payments by Local Affiliates

Ecuador allows for the deduction of payments made to foreign companies, including foreign affiliates, whenever income tax is withheld and payments do not exceed certain limits. Ecuadorian entities may only deduct 5% of their taxable base on foreign allocated expenses and costs paid to a non-local affiliate. From 2023, royalties, and technical, administrative and consulting services fees paid by local affiliates to their head office and related entities, will be tax deductible up to a limit equivalent to 5% of the taxable income of each fiscal year. However, the limit may increase when certain requirements are met.

5.7 Constraints on Related-Party Borrowing

The general, provisions applicable to interest related to foreign loans are explained in **2.5 Imposed Limits on Deduction of Interest**.

Additionally, the net amount of interest paid on loan transactions with related parties (for tax purposes) should be no greater than 20% of EBITDA of the given fiscal year.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Ecuadorian corporations are taxed on their worldwide business income. As such, foreign income is taxed in Ecuador. However, Ecuadorian law states that the tax paid abroad on foreign income may be used as a tax credit in the local corporation's annual tax return. The tax credit may be applied only to the foreign-source income, and cannot exceed the relevant tax due.

6.2 Non-Deductible Local Expenses

In general, expenses incurred to generate exempted income are non-deductible. This also applies to foreign exempt income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends paid by subsidiaries located abroad are regarded as foreign income (see **6.1 Foreign Income of Local Corporations**) and taxed accordingly.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangible assets developed by local corporations can be used by non-local subsidiaries in their business. However, under transfer pricing principles, the local entity is obliged to charge for such use under the arm's-length principle. All related income is taxable in Ecuador.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

As of 2024, the Ecuadorian tax law provides a Controlled Foreign Corporation (CFC) regime. Pursuant to such regime, the income of foreign companies whose final beneficiaries (individuals) are residents in Ecuador, will be subject to taxation in the country. However, if the relevant income was already taxed under another applicable regime in Ecuador (eg, dividends or payments to non-residents), it will not be subject to the CFC regime. The final beneficiary (individual resident in Ecuador) will be responsible for paying the relevant tax.

A foreign entity and its income will be subject to the CFC regime whenever the following conditions are met.

- The ultimate beneficiary holds an effective ownership stake equal to or exceeding 25%. Such ownership may be defined in terms of capital, voting rights, entitlement to dividends, profits, benefits, or returns, or similar factors.
- The entity is subject to an effective income tax rate lower than 60% of the applicable rate in Ecuador, or a rate that is unknown.

To calculate the taxable base, the net profit earned by the entity at the end of the fiscal year applicable in its jurisdiction will be considered.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no rules related to the substance of non-local affiliates. Nevertheless, to record an expense as deductible, the latter must be related to taxable income, and the transaction must reflect economic substance. Therefore, under Ecuadorian law, transaction simulation is regarded as a felony and is punishable by law. Likewise, practices regarded as tax avoidance are penalised under Ecuadorian criminal law.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Gains obtained by local corporations on the sale of shares held in non-local affiliates are taxed in Ecuador. No specific rule exists on the matter in local law. As such, these gains will be subject to a 25% income tax rate. If the income is taxed abroad, the local corporation could use tax credit in Ecuador, as outlined in **6.1 Foreign Income of Local Corporations**.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Overall, the Ecuadorian tax regime considers any practice that involves simulating a transaction for the sole purpose of evading taxes as a felony, and it is punishable as such. It is important to note that assessments from the tax authorities in recent years tend to overlook tax-relevant transactions and operations that do not reflect economic substance and/or essence.

Additionally, the new CFC regime may be viewed as an anti-avoidance provision. For further details, refer to **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Ecuadorian Internal Revenue Service or IRS (Servicio de Rentas Internas) does not have a regular, routine audit cycle. Nevertheless, audits of a fiscal year are usually conducted within four years of the date of filing the corresponding tax return. Audits can be conducted within six years if the taxpayer fails to file the tax return on time.

Tax audits are normally performed by reviewing all accounting records and their supporting documentation.

The reports issued regarding tax audits can be challenged before the IRS. Any final administrative resolution issued by the IRS can be challenged before the Ecuadorian tax court.

9. BEPS

9.1 Recommended Changes

The Ecuadorian government has already taken certain actions that are partially aligned with Action 1 of the BEPS plan, and specifically the International VAT/GST Guidelines.

Even though Ecuador has not adopted BEPS within its tax regime, the following standards have been implemented.

CFC

For further details, see **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

Beneficial Owners

From 2024, the IRS modified the shareholder's report (chain of ownership) required from Ecuadorian taxpayers. Starting in 2025, a much more thorough report providing specific information up to final beneficiaries must be filed. Taxpayers who fail to report this information will be taxed at a rate of 28%.

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VAT

From 2020, the legal system expressly states that digital services are subject to VAT if the consumer is a resident in Ecuador and the payment is made by the resident. The Ecuadorian tax system provides for the registry of digital service suppliers that are not domiciled in Ecuador, handled by the Ecuadorian IRS.

Whenever the provider of a digital service is not registered with the Ecuadorian IRS, the consumer is obliged to act as tax collector. However, if the payment is made through an intermediary (credit card issuer or bank), the intermediary will be liable for collecting the VAT.

9.2 Government Attitudes

The Ecuadorian government is committed to complying with OECD standards and participating in the organisation's committees. To that end, the Ecuadorian government ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (CAAM).

Nevertheless, there are no indications that the Ecuadorian government will sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

9.3 Profile of International Tax

The authors consider that, to date, international tax does not have a high public profile in Ecuador. However, it is evident that any new development on the matter, particularly regarding BEPS, will, in a relatively short period, be adopted by local authorities, as noted in relation to VAT applicable to digital services, transfer pricing information requirements and reports regarding the beneficial owners.

Regarding Pillar Two of BEPS (substance), as stated in previous sections, the deductibility of expenses is allowed whenever the transaction reflects economic substance. The economic substance in transactions has been an important principle used by the Ecuadorian tax authority in its audits.

Regarding Pillar One of BEPS (coherence), the Ecuadorian tax system lacks a strong technical background on international taxation. The Ecuadorian regime requires a comprehensive reform to comply with Pillar One.

9.4 Competitive Tax Policy Objective

The Ecuadorian tax system is generally fair and balanced as regards competition between foreign and local entities.

Nevertheless, the existence of indiscriminate tax benefits creates a false sense of competitiveness. Over the past decade, Ecuador has implemented several tax benefits that have not incentivised new national and international investment. This has also been to the detriment of good tax practice by going against the principles of generality and equality that should be present in any tax regime.

Considering the particularities of the Ecuadorian tax regime regarding the characteristics of the country's productive sectors, there does not appear to be any pressure for BEPS to be applicable in Ecuador. The country's exposure to the international community is marginal. Therefore, it is unlikely that there will be pressure from the international or local community to implement tax amendments to fully comply with BEPS, notwithstanding that stated in previous sections.

9.5 Features of the Competitive Tax System

The main issue with the tax system in Ecuador is enforceability, as well as generalised mistrust of taxpayers by the tax authority. It is imperative to implement serious initiatives to train the officials of the local tax authority.

Direct state aid in recent years has mostly been in the form of subsidies granted to the general public applied to the prices of hydrocarbons and fuels. However, these subsidies have now been reduced, although the government has decided not to remove them entirely due to concerns over potential civil unrest.

9.6 Proposals for Dealing With Hybrid Instruments

As previously stated, the Ecuadorian tax system lacks a strong technical background on international taxation. As such, the implementation of new mechanisms, such as actions to deal with hybrid instruments, is far from becoming a reality.

Likewise, there do not appear to be any pieces of legislation or proposals for dealing with hybrid instruments in Ecuador.

9.7 Territorial Tax Regime

Overall, the current tax regime applicable to interest does not provide for restrictions tailored to territorial tax regimes (special economic development zones). Ecuador is a country that requires strong inflows of capital, including capital related to foreign loans. In this sense, imposing additional restrictions on the deductibility of interest would be inconvenient.

Nevertheless, as of 2024 the Ecuadorian tax regime provides for free trade zones that benefit from incentives including a ISD tax exemption on loans paid to foreign entities by the operators of such zones (see **2.3 Other Special Incentives**).

9.8 Controlled Foreign Corporation Proposals

See **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

9.9 Anti-Avoidance Rules

The double tax convention limitations should not have any impact on either inbound or outbound investors. It is important to note that Ecuador has complementary rules in place to avoid evasion and abuse of law.

9.10 Transfer Pricing Changes

The application of transfer pricing in Ecuador is still limited, and for now it mainly applies to export activities. In this sense, before the country implements any changes to transfer pricing, Ecuador needs to further develop its current system. The taxation of profits from intellectual property is not a particular source of controversy or difficulty under Ecuador's tax regime. Profits related to intellectual property are generally taxed as royalties.

9.11 Transparency and Country-by-Country Reporting

Should the proposal for transparency and country-by-country reporting be formally implemented, it is unlikely to have any relevance for Ecuadorian taxation purposes. Nevertheless, recent reforms made by the tax authority require ample information of the multinational group of the local reporting taxpayer (Masterfile). In practice, the Ecuadorian tax authority requires a country-by-country report, similar to the one that is filed by the OECD members.

9.12 Taxation of Digital Economy Businesses

As of 2020, Ecuador has implemented certain legal provisions to tax transactions effected by digital businesses operating largely outside Ecuadorian territory. Specifically, the Ecuadorian tax system has implemented a registry for foreign digital service providers. Likewise, credit card issuers and banks are responsible for collecting the VAT charged on digital services provided by entities that are not registered with the Ecuadorian IRS.

Likewise, the income generated by digital platforms for sports predictions is being targeted in recent reforms by the Ecuadorian tax regime.

9.13 Digital Taxation

Ecuador has taken a few steps in relation to digital taxation; specifically, regarding Action 1 under the International VAT/GST Guidelines of BEPS. In this regard, Ecuador has issued legal provisions to collect the VAT charged on digital services provided by foreign entities (see **9.1 Recommended Changes** and **9.12 Taxation of Digital Economy Businesses**).

As of July 2024, the income perceived by operators of sports-predictions digital platforms is subject to a special income tax. The latter is also applicable to tax residents in Ecuador that engaged in sports prediction operations and perceived profits. The income tax rate is set at 15% of the taxable base.

Non-resident operators must comply with various formal tax obligations. This involves registering before the Ecuadorian tax authority and appointing a representative in the country, as well as fulfilling formal obligations such as filing returns. In case the foreign operator does not comply with such formal obligations, corrective measures may be applied, such as blocking the relevant IP address. Additionally, from 2025, operators must pay a yearly contribution to legally operate digital platforms for Ecuadorian users.

9.14 Taxation of Offshore IP

Ecuador has not introduced any other provisions dealing with the taxation of offshore intellectual property deployed within the country. However, regarding the deductibility of royalties and technical service fees, see **4.1 Withholding Taxes**. Nevertheless, IP licensing agreements must be registered before the Ecuadorian IP authority, otherwise the relevant royalties will not be income tax deductible.

Trends and Developments

Contributed by:
Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Ignacio Jijón-Chiriboga
Almeida Guzmán & Asociados

Almeida Guzmán & Asociados is a firm of attorneys and consultants that was established in 1981, specialising in juridical-corporate advice and consulting. The firm's professional practice spans the following areas: tax; corporate, commercial and business; labour; immigration; competition/antitrust; consumer protection; environmental; real estate, construction and infrastructure; public procurement; national and international arbitration; tourism; mining; financial, banking and stock exchange; energy (hydrocarbons, electricity and alternative energy); telecommunications and e-commerce; and human health. Consultants are also employed in the fields of economic sciences and accounting. The firm provides services in legal, tax and economic consulting; consulting on project finance, investment projects, mergers, spin-offs and takeovers of companies; and business restructuring.

Authors

Diego Almeida-Guzmán is the senior and technical partner of Almeida Guzmán Asociados, with experience in legal-corporate counselling, as well as in corporate mergers, acquisitions, spin-offs, takeovers, privatisation projects and business restructuring. He provides advice on trusts, fiduciary funds, tax, foreign investment and transfer of technology legislation. He is an acting legal expert for international arbitration cases, an arbitrator at the Center of Mediation and Arbitration of the Ecuadorian–American Chamber of Commerce, and a member of the Quito Bar Society, the Ecuadorian Institute of Tax Law, the International Bar Association and the Inter-American Bar Association.

Andrés Álvarez-Toapanta is an expert in international taxation, international accounting and financial standards (IFRS and IAS), tax counselling and corporate advisory at Almeida Guzmán Asociados. He previously worked as chief tax officer in a well-known transnational corporation in the consumer goods industry. He has a Master's in International Taxation from Universidad de la Rioja (Spain).

Cesar Molina-Delgado is an attorney at Almeida Guzmán & Asociados with experience in corporate and tax law, including expertise in international taxation, accounting and working with financial statements. He has vast knowledge and experience in technology, digital platforms, cryptocurrencies, smart contracts and data-oriented applications.

Ignacio Jijón-Chiriboga is an attorney at Almeida Guzmán & Asociados with experience in corporate and tax law, including expertise in international taxation, accounting and working with financial statements. He has significant knowledge and experience in double taxation, international fiscal matters, as well as experience in judicial proceedings before the Ecuadorian tax courts. Currently he is pursuing a Tax LLM at Universidad Andina Simón Bolívar.

Almeida Guzmán Asociados

Whymper N27-70 y Orellana
Edificio Sassari
Piso 8
Quito D.M.
Ecuador

Tel: +59 32 292 8115
Email: law@almeidaguzman.com
Web: www.almeidaguzman.com

Contributed by: Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Ignacio Jijón-Chiriboga, **Almeida Guzmán & Asociados**

Tax Incentives for Investment Contracts

Investment contracts are a legal tool for inbound investments in the Ecuadorian territory, which are concluded with the Ecuadorian government through a public deed. The instrument stipulates the investment's terms and conditions, the amount to be invested and the applicable tax benefits. Such benefits apply through the contract´s term, although they may not exceed the total amount invested.

The investment may be carried out in any economic sector (previously, investment contracts were limited to industries determined by the Ecuadorian government).

To conclude an investment contract, corporations must follow a formal procedure before the competent Ecuadorian authority. Investors must develop a viable project and submit it before the authorities for approval.

The duration of an investment contract may not exceed 15 years, except when the investment is related to public works or industries such as the oil and mining sectors, where the concession or license can have a longer term. Contracts may be renewed for the originally stipulated length, but renewals are not automatic. Therefore, companies must follow a dedicated procedure for that purpose.

Companies that concluded investment contracts with the Ecuadorian government will benefit from:

- a five percentage-point reduction in the income tax rate (25%), applicable during the contract's term provided the incentive does not exceed the amount invested; and
- an exemption from specific custom duties and the Capital Remittance Tax (ISD) levied on payments remitted abroad for importing raw materials and capital goods required by the investment (whenever it is expressly provided for in the investment contract).

The annual tax expenditure ceiling for 2025 is established at USD147.8 million for tax incentives granted under the applicable legal framework. This ceiling applies to investment contracts and their addenda, as approved by the Strategic Committee for the Promotion and Attraction of Investments (CEPAI). Unused balances will not be carried over to subsequent fiscal years.

Additionally, an extra annual tax expenditure of USD60 million has been established for 2025 for tax incentives related to investment contracts and addenda concerning the renewable energy sector under the framework of the Electricity Master Plan.

Tax Incentives for Other Investments

New or existing companies that have not concluded an investment contract may benefit from a three percentage-point reduction in the income tax rate whenever new investments are made in Ecuador (since 2022). The incentive applies exclusively to income directly attributable to the new investment and remains in effect for up to 15 years, provided the total incentive does not exceed the amount invested.

Other Relevant Tax Incentives

Operators of free trade zones benefit from a 0% income tax rate for a period of 15 years, starting from the first year in which the competent authority grants their qualification as free trade zone operators. After this 15-year term, a 15% income tax rate will apply to their earnings.

A Public-Private Partnership (APP) is a regime through which a government entity delegates the execution of a specific activity to a private corporation or enterprise. The regime applies to the management of the public asset, the provision of a public service, or the execution of a public work. The APP regime applies only to projects that meet certain requirements, including a minimum level of private investment.

Pursuant to the APP regime, legal stability is guaranteed for specific regulatory aspects, which may include essential tax-related provisions approved by the competent authorities. An APP contract may be of up to 30 years, with the possibility of an additionally ten-year extension.

Additionally, any income derived from bonds or other securities issued to finance APP projects – as well as profits earned from trading such securities – are exempt from income tax, provided that certain requirements are fulfilled.

Controlled Foreign Corporation

Ecuadorian tax law establishes a Controlled Foreign Corporation (CFC) regime. Pursuant to such regime, the income of foreign companies whose final beneficiaries (individuals) are residents in Ecuador (whether nationals or foreigners) will be subject to taxation in the country. However, if the relevant income was already taxed under another applicable Ecuadorian regime (eg, dividends or payments to non-residents), or was recognised by a permanent establishment of the foreign entity in the country, it will be exempt from the CFC regime.

The entities subject to this regime are regarded as CFC companies. The law provides that a CFC is a company incorporated or domiciled in a foreign jurisdiction. Profits registered by CFCs are subject to taxation in Ecuador when the following conditions are met.

- The ultimate beneficiary holds an effective ownership stake of at least 25%. Such ownership can be defined in terms of capital, voting rights, entitlement to dividends, profits, benefits, or returns, or similar factors.
- The entity is subject to an effective income tax rate lower than 60% in comparison to the applicable rate in Ecuador, or when this rate is otherwise unknown.

The effective income tax rate (or a similar tax) for a foreign company is calculated by dividing the total income tax owed by the company by its total taxable income, based on the previous fiscal year's tax return. The term *"income tax caused"* refers to multiplying the taxable base by the applicable tax rate.

The percentage of effective participation will be understood as the annual average of the participations recorded at the end of each month during which there was participation, corresponding to the fiscal year applicable to the respective CFC.

The final beneficiary (individual resident in Ecuador) is responsible for paying any tax associated with income earned by the CFC. Such income includes the following.

- Capital gains, real estate property exploitation, dividends, financial returns, royalties, or any other type of passive income, regardless of the source of the income.
- Commissions, intermediation margins, or technical, administrative, or consulting services originating in Ecuador.

The relevant income will be included in the individual's annual tax return. The income will be added to the individual's worldwide income in proportion to its effective ownership in the CFC.

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The amount reported corresponds to the net profit registered by the CFC at the end of its fiscal year, multiplied by the individual's ownership percentage.

If a CFC incurs losses in a given fiscal year, these may be offset against the positive taxable base declared by that CFC in the following five fiscal years, provided that the offset does not exceed 25% of the resulting taxable base in any given year. Any remaining balance that is not used within this period cannot be deducted in subsequent years.

The final beneficiary must maintain an account statement for all CFCs in which it has ownership. This record prevents double taxation by demonstrating that certain types of income – such as payments already subject to withholding at source, dividend distributions, or capital gains –were previously taxed and should not be taxed again under the CFC regime.

In any case, income subject to the aforementioned regimes (eg, tax withholding related to payments made abroad for foreigners, dividend distribution and capital gains) will not be considered taxable if the final beneficiary demonstrates that the relevant income was subject to taxation under the CFC regime, through its account statement.

The final beneficiary may use the income tax paid abroad by the CFC as a tax credit. This credit will be applicable in proportion to the ownership of the final beneficiaries. Nevertheless, the final beneficiaries must demonstrate that the CFC did not file a refund claim for such tax or, otherwise, that pursuant to the CFC's tax regime, no refund claim may be filed. This credit cannot exceed the individual's tax liability in Ecuador.

Tax-Withholding Regime for Major Taxpayers

Ecuadorian tax residents qualified as major taxpayers by the authority are required to self-withhold on their taxable income on a monthly basis. The withheld amounts must be reported and remitted to the Ecuadorian tax authority on a monthly basis. Prior to this amendment, the payments made to major taxpayers were subject to tax withholding by their clients, except for specific industries such as oil, mining and communications (which were also required to withhold income earned).

Notwithstanding the above, major taxpayers will not be required to withhold the income arising from the following transactions:

- payments made by the Ecuadorian state to providers of services related to exploration and exploitation of hydrocarbons;
- contracts concluded with entities and agencies of the central government, its decentralised bodies, and its public corporations;
- contracts concluded with entities and agencies of decentralised rural parish, cantonal, metropolitan, and provincial governments, including their decentralised bodies and public corporations;
- contracts concluded with entities of the Ecuadorian social security; and
- income that is subject to special regimes.

Additionally, if the major taxpayer cannot distinguish between taxable and exempt income, it must apply self-withholding to entirety of the income received.

The applicable withholding rates are updated yearly. The Ecuadorian tax authority sets these rates by considering:

- the effective tax rate observed in prior audits for the taxpayer's specific economic sector, segment, or primary economic activity; and
- the taxpayer's tax liability in the previous fiscal year.

Nevertheless, the Tax Authorities may adjust the withholding rates at any moment, considering the economic circumstances of each sector or whenever it is plausible that taxable income of the major taxpayers will significantly decrease.

The self-withholding tax rates established by the Tax Authorities for 2025 are defined as follows (rate adjustments will be communicated by the Tax Authorities throughout the year), by economic sector and range of withholding rate.

- Agriculture, livestock, silviculture, and fishing: 1.25% to 5%.
- Agro-industrial and export manufacturing industry: 1.25% to 2.25%.
- Automotive: 1.25% to 4%.
- Wholesale and retail trade: 1.25% to 10%.
- Construction: 1.25% to 8%.
- Manufacturing industries: 1.25% to 7%.
- Information, technology, and communication: 1.25% to 10%.
- Mobile communication services: 4% to 5%.
- Dairy: 1.25% to 3%.
- Cement industry: 2.25% to 7%.
- Non-renewable mining resources: 7%.
- Non-renewable petroleum downstream: 3% to 8%.
- Non-renewable petroleum fuel sales: 2% to 3%.
- Health: 1.25% to 9%.
- Services: 1.25% to 10%.
- Financial system (banks): 4% to 5%.
- Financial system (minor co-operative institutions): 3% to 4.5%.
- Financial system (insurance): 1.25% to 10%.

Major taxpayers may use ISD credit notes and exemption notes as a means of compensating the tax liability resulting from self-withholding. This can be done without restrictions regarding the fiscal year to which the payment is applied, provided it falls within the validity period of such notes.

A major taxpayer that fails to withhold and pay the relevant tax (totally or partially) will be fined. The fine will be equivalent to 100% of the unwithheld or unpaid tax, plus any accrued interest.

VAT Hike

In January 2024, President Daniel Noboa Azin filed an urgent tax bill to support the country's revenue streams through the increase of value added tax (VAT) from 12% to 15%. However, the bill was not approved by the Ecuadorian national assembly. As a counter measure, the president proposed a moderate VAT rate increase to 13%, with the authority to increase this to 15% with the approval of the Finance Ministry.

The hike was approved on 13 March 2024 via the Organic Law to Address the Internal Armed Conflict, Social and Economic Crisis. Subsequently, through Executive Decree No 198, the VAT rate was increased to 15%, a measure that took effect in April 2024. Later, on 4 December 2024, the president issued another Executive Decree, confirming that the 15% rate would remain throughout 2025. Each increase was approved by the Finance Ministry.

Prior to the reform, Ecuador had one of the lowest VAT rates in Latin America, at just 12% – well below the regional average of 14.27%. However, VAT rates across the continent vary significantly. For example, Cuba imposes no VAT, while Panama applies a modest 7%, representing the lowest rates in the region. In contrast, Uru-

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guay leads, with a VAT rate of 22%, followed by Argentina, at 19%. If Ecuador retains its 15% rate, it will be almost double that of Panama, and will be two percentage points higher than that of El Salvador – both countries that, like Ecuador, use the US dollar as their official currency.

From January to November 2024 a total of USD8.877 million was collected, up 14.4% on the same period in 2023, when collection totalled USD7.757 million.

Capital Remittance Tax Increase

Through the Organic Law to Address the Internal Armed Conflict, Social, and Economic Crisis, the Capital Remittance Tax (ISD) rate increased from 3.50% to 5%. This rate may be modified (reduced) for specific sectors through an Executive Decree.

As a consequence of the country's energy crisis, the tax rate is set at zero for January, February and March 2025 for the import of energy-related and products, as provided by the regulators. Starting in April 2025, the 0% rate will remain applicable to the importation of certain products related to the pharmaceuticals sector. All other payments abroad levied with ISD will continue to be taxed at 5%.

The Ministry of Finance will review the impact on tax collection from the ISD rate reduction every six months. If deemed necessary, it will make adjustments.

Starting form 2025, the ISD paid will no longer represent a tax credit. Previously, the ISD paid on the importation of certain goods for productive processes could be used as an income tax credit. Therefore, the ISD paid up to 31 December 2024 may be applied as a tax credit pursuant to the conditions provided by law.

Notwithstanding the above, taxpayers may still register the ISD paid for the execution of economic activity as a deduction (a tax-deductible expense) in their annual income tax liability.

Sports-Betting Operators

Since July 2024, Ecuadorian law taxes income generated by operators of sports-prediction digital platforms. The tax is also levied on earnings received by the users of such platforms.

The income tax rate for both operators and users is 15%.

The taxable base for operators is the net result of subtracting from all accrued wagers (revenues) the amounts paid to users for all correctly placed bets. The taxable base is assessed by the operators every month and paid to the Ecuadorian IRS. If the base is negative, the negative amounts cannot be carried forward, nor will they be considered a deductible expense.

The costs and expenses incurred in the operation of sports-betting activities cannot be used to assess the tax liability from other economic activities or income sources. When operators cannot distinguish which expenses pertain exclusively to sports betting, they must apply a proportionality factor.

Sports-betting operators are also required to submit a yearly income tax return, consolidating the amounts reported and paid monthly.

In addition, operators must withhold and collect revenue generated by users of the platforms on a monthly basis. Whenever the amounts generated by a user on its correctly placed bets are greater than accrued wagers, the net difference is taxed through withholding.

Contributed by: Diego Almeida-Guzmán, Andrés Álvarez-Toapanta, Cesar Molina-Delgado and Ignacio Jijón-Chiriboga, **Almeida Guzmán & Asociados**

Furthermore, operators will issue a single consolidated monthly receipt registering all of their revenue (accrued wagers). Likewise, operators will issue receipts to users for their deposits used in bets (accrued wagers).

Also, to legally operate sports-betting activities via digital platforms, operators must obtain a Sports Betting Operation License (LOPD), which is valid for five years.

To obtain, maintain, or renew the LOPD, operators must pay the relevant regulatory authority an annual fee equivalent to approximately USD308.000. This fee is due within the first 20 days of the corresponding fiscal year or upon obtaining or renewing the LOPD.

Finally, non-resident operators must comply with various formal tax obligations. This includes registering as an operator before the Ecuadorian tax authority, filing specific information according to applicable regulations, and appointing a representative in the country. If the foreign operator does not comply with the required obligations, corrective measures may be applied, such as blocking the relevant IP address.

EL SALVADOR

Law and Practice

Contributed by:
Manuel Telles Suvillaga and Rolando Suria
Mayora & Mayora, SC

Contents

Contributed by: Manuel Telles Suvillaga and Rolando Suria, **Mayora & Mayora, SC**

Mayora & Mayora, SC is a leading law firm in Central America established more than 55 years ago, with offices in Guatemala, El Salvador and Honduras (Tegucigalpa, San Pedro Sula and Roatán). The firm has a team of over 35 legal specialists who are ready to assist clients in a wide range of legal matters. Renowned for its excellence and ethical approach, the firm offers legal assistance in multiple practice areas. It has been the exclusive member for Guatemala of the largest network of private law firms in the world, Lex Mundi, since its inception in the early 1980s. The firm and its attorneys have been recommended by the most reputable and renowned legal ranking agencies.

Authors

Manuel Telles Suvillaga of Mayora & Mayora provides legal advice to national and foreign banks and financial institutions, as well as to various companies, on their capital raising structuring such as individual and/or syndicated loans, securitisations, international issue 144A/Reg S bond issuances, investment funds, leasing and project financing. He has participated in multiple M&As, as well as in the creation, incorporation and operation of companies in El Salvador. He specialises in providing financial, banking fiduciary, and corporate advice, serving recognised clients such as Banco General, SA, Banco Internacional de Costa Rica (BICSA), Credit Suisse, JPMorgan Chase & Co, Mobile Cash/ Millicom, NEOEN, Grupo Terra, Laboratorios Vijosa, Crowley and OTIS.

Rolando Suria is part of the litigation department at Mayora & Mayora in the El Salvador office. To expand his domain in the procedural field, he has carried out various studies and specialisations in the procedural aspects of commercial, administrative, tax and labour matters, among others. His experience includes providing judicial and extrajudicial advice and representation to national and international companies in these matters, for mediation, obligations, recovery, municipal taxes and contracts with the state.

Mayora & Mayora, SC

Avenida Los Espliegos No 30
Colonia San Francisco
San Salvador
El Salvador

Tel: +503 2212 0100
Fax: +503 2212 0120
Email: info@mayora-mayora.com
Web: www.mayora-mayora.com/en

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in El Salvador generally adopt a corporate form. Regardless of the corporate form adopted by the business, each entity is taxed as a separate legal entity from its members, partners or shareholders. The Salvadoran Commercial Code regulates five basic types of corporate entity:

- general partnership (*Sociedad Colectiva*);
- limited liability company or LLC (*Sociedad de Responsabilidad Limitada*);
- limited partnership (*Sociedad en Comandita Simple*);
- stock corporation (*Sociedad Anónima*); and
- limited partnership with share capital (*Sociedad Comandita por Acciones*).

Foreign corporations may organise branches.

The most commonly used corporate form is the stock corporation (*Sociedad Anónima* or SA). American corporations often adopt the corporate form of a limited liability company (*Sociedad de Responsabilidad Limitada* or SRL) for their subsidiaries in order to achieve look-through tax treatment.

As mentioned above, the corporate entity is taxed separately and must obtain a separate taxpayer number.

Since 16 February 2024, a new *"simplified corporation by stocks"* has been available, with minimum capital requirements and no formalities (in comparison to the traditional corporate forms). It can be organised as *"one-person company"*.

1.2 Transparent Entities

Under local law, there are no transparent entities for tax purposes. However, the Salvadoran LLC is commonly used by US corporations in order to achieve transparency before the US tax authorities.

1.3 Determining Residence of Incorporated Businesses

El Salvador has a double taxation treaty (DTT) with Spain (which is currently in force). Under this treaty, the general rule is that residence is determined on the basis of the criteria under the law of each state (indicated below) that make a person liable to pay taxes there. If under those criteria any person may be considered *"resident"* of both states, then the following criteria will be used to determine the tax liability:

- the state they have a permanent home available to them in;
- if they have a permanent home available to them in both states, the state where their centre of vital interest is;
- if the centre of vital interest cannot be determined, the state in which they have a habitual abode; or
- if they have a habitual abode in both states or in a third one, the competent authorities of the contracting states will settle the question by mutual agreement.

In addition to this DTT, the Salvadoran Tax Law sets out certain standards regarding residence. A corporation is considered *"resident"* for tax purposes if:

- it has been organised under Salvadoran law;
- the corporation is managed in/from El Salvador;
- the corporation has a tax or corporate seat in El Salvador;

- the corporation's centre of economic interests is located in El Salvador; and
- the corporation has a permanent establishment in El Salvador which is subject to taxation in El Salvador (not the foreign corporation).

1.4 Tax Rates

The Salvadoran income tax system differentiates between certain kinds of income. However, corporate and individually owned businesses are taxed at the same rate of:

- 25% on net income up to USD150,000 annual income; or
- 30% on net income above USD150,000 (the first USD150,000 will be taxed at 25%).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

As a rule, profits are taxed based on the accounting profits subject to some adjustments. The most common tax adjustments are certain limits to deductible expenses. Profits are taxed on an accrual basis.

2.2 Special Incentives for Technology Investments

Computer programming, software development, cybersecurity, and generative AI, among others qualify as technology investments by the Ministry of the Economy and are eligible for:

- income tax exemption for 15 years;
- import duties on the equipment and hardware required for the development of the eligible activities; and
- VAT on purchases and sales.

2.3 Other Special Incentives

There are currently tax incentives in the following industries:

- renewable energy-based power generation projects: eligible for an exemption from income tax for a period of five to ten years depending on the project's output measured in megawatts, and a total exemption from import duties on machinery, equipment, raw materials, and supplies for the construction of the power plant for the first ten years;
- manufacturing for exportation to foreign markets within free trade zones, as qualified by the Ministry of the Economy: eligible for an exemption from income tax for a period of ten to 15 years, from municipal taxes for a period of ten to 15 years, from real estate transfer tax on properties used for the eligible activity, and from VAT on purchases of local and/or foreign goods required for the eligible activity;
- provision of telecommunications services (including call centres and BPO): eligible for an exemption from income tax for a period of 15 years, from municipal taxes for ten years, from real estate transfer tax on properties used for the eligible activity, and from VAT on purchases of local and/or foreign goods required for the eligible activity;
- a National Tourism Industry Interest Project, as qualified by the Salvadoran Tourism Institute, requiring an investment equal to or greater than USD25,000: eligible for an exemption from income tax for ten years, from import duties, and from real estate transfer tax on the acquisition of properties intended for the project;
- issuers of digital assets, digital asset service providers, certifiers, and acquirers: exempt from all types of taxes, levies, duties, fees, or contributions on the nominal value and returns of digital assets, as well as on capital

gains or ordinary income derived from any type of digital asset transfer, as established in the Digital Assets Issuance Law;
- transactions related to digital assets: exempt from VAT and from withholding of any type of tax under the Digital Assets Issuance Law; and
- shareholders of companies engaged in digital assets: eligible for tax exemptions on the distribution of profits or dividends derived from digital asset-related activities, in line with the Digital Assets Issuance Law.

2.4 Basic Rules on Loss Relief

Losses incurred during a fiscal year can only be offset against profits for the same period. No carry forward or carry back is therefore allowed. However, in the case of capital losses, a five-year carry forward is allowed.

2.5 Imposed Limits on Deduction of Interest

Interest is deductible if paid in order to generate taxable income. Interest can only be deducted up to the rate determined by the Central Reserve Bank.

2.6 Basic Rules on Consolidated Tax Grouping

Group consolidation is not permitted for tax purposes. Each entity is considered a separate taxpayer.

2.7 Capital Gains Taxation

The taxable gain is determined by the difference between the book value or purchase value (as applicable) and the selling price. The capital gain will be the income minus the cost and improvements and will be taxed at 10%.

2.8 Other Taxes Payable by an Incorporated Business

Transactions are subject to VAT depending on their nature. In general, goods, services and merchandise transacted on commercial markets are subject to VAT at a rate of 13%.

Real estate transactions are subject to a real estate transfer tax of 3% on the transaction price if this is higher than approximately USD29,000.

Securities transactions are generally exempt from VAT.

2.9 Incorporated Businesses and Notable Taxes

There are no other notable taxes.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a corporate form.

3.2 Individual Rates and Corporate Rates

Corporate rates are lower than individual professional tax rates from an annual net income of approximately USD23,000 up to approximately USD150,000. If the annual net income is higher than this, the rates are the same.

There are no rules preventing individual professionals from earning income at corporate rates.

3.3 Accumulating Earnings for Investment Purposes

There are no rules preventing closely held corporations from accumulating earnings for investment purposes. It is mandatory to create a 5%

reserve on net earnings every year, but when this surpasses one-sixth of the corporation's capital, it can be capitalised. Thereafter, the obligation to make a 5% reserve on earnings continues.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends are taxed at a final 5% withholding tax, independent of where the beneficiary resides, unless the beneficiary resides in a tax haven or low-tax jurisdiction. In this case the withholding tax rate will be 25%. Gains on the sale of shares are taxed at 10%. The taxable gain is determined by the difference between the book value or purchase value (as applicable) and the price at which the shares are sold.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no differences between closely or publicly held corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding taxes applicable to non-residents without a permanent establishment are as follows:

- dividends and profit distributions: 5%;
- interest: 10% (foreign fully licensed banking and financial institutions are exempt); and
- royalties: 15%.

It is important to note that the notions of *"interest"* and *"royalties"* under the law are wider than usually understood.

No reliefs are available.

4.2 Primary Tax Treaty Countries

El Salvador only has one bilateral tax treaty with Spain.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

El Salvador has no other in force tax treaties.

4.4 Transfer Pricing Issues

Transfer pricing rules have been in force in El Salvador since 2009. There are no particular issues specifically affecting inbound investors.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited-risk distribution arrangements have not yet surfaced as a focus for the tax administration. However, any related-party arrangement that does not comply with transfer pricing rules could be challenged by the tax authorities.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Transfer pricing in El Salvador generally follows the methods established by the OECD.

4.7 International Transfer Pricing Disputes

There do not appear to be any precedents where the DTT between El Salvador and Spain has been used for mutual agreement procedures (MAPs) to resolve international transfer pricing disputes.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Within the proceedings leading to a transfer pricing-related claim, the tax administration and the taxpayer can voluntarily review the matter and settle the disagreement. Where the settlement calls for compensating adjustments, tax administration officials have reported that the taxpayer proceeds with the compensating adjustments.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches of non-local corporations and local subsidiaries of non-local corporations are taxed in the same way.

5.3 Capital Gains of Non-Residents

The Income Tax Act does not tax indirect disposals of Salvadoran companies. However, their direct disposal is subject to capital gains tax.

5.4 Change of Control Provisions

There are no change of control provisions that trigger any tax or duty.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No formulas are used to determine the income of foreign-owned local affiliates.

5.6 Deductions for Payments by Local Affiliates

Local affiliates are allowed a deduction for payments for management and administrative expenses by a non-local affiliate on condition that:

- the payment is duly supported;
- the expense is necessary to generate taxable income;
- where applicable, the withholding tax has been charged to the non-local affiliate; and
- the applicable international financial reporting standards allow the expense to be recognised as such by the taxpayer.

5.7 Constraints on Related-Party Borrowing

Besides transfer pricing rules and a 10% withholding tax, interest paid to a non-local affiliate is not deductible, unless the beneficiary is a fully licensed financial institution. It is necessary that the agreed-upon interest is within the limits established by the Central Reserve Bank.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations is exempt from corporate tax. The Salvadoran system is fundamentally one of domestic-sourced income.

6.2 Non-Deductible Local Expenses

Intangibles developed by local corporations can be used by non-local subsidiaries in their business at prices complying with transfer pricing rules. The price paid to the local corporation will be taxed at 20%.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are not taxed.

6.4 Use of Intangibles by Non-Local Subsidiaries

Under transfer pricing regulations, intangibles developed by a local company (as its main source of business) cannot be used by non-resident related parties without incurring local corporate tax.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Local corporations are not taxed on the income of their non-local subsidiaries or non-local branches under CFC-type rules. There are no CFC-type rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no substance-related rules applicable to non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Provided the sale takes place in a jurisdiction other than El Salvador, the capital gain on the sale of shares in non-local affiliates will not be taxed.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

El Salvador does not have general anti-avoidance rules, other than those related to the tax adjustments for determining the taxable base.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

El Salvador does not have a regular routine audit cycle.

9. BEPS

9.1 Recommended Changes

El Salvador is not a member of the OECD. It has therefore not yet strictly implemented BEPS. However, the Income Tax Act (issued in 2012) includes some provisions that partly reflect BEPS guidelines, such as transfer pricing regulations which have been heavily influenced by Action 13.

9.2 Government Attitudes

The government seeks to comply with most OECD guidelines, including BEPS. However, there is no strict policy for this purpose.

9.3 Profile of International Tax

Since the Salvadoran taxation system follows the territorial principle, international taxation does not have a high public profile in the jurisdiction.

9.4 Competitive Tax Policy Objective

El Salvador's tax policy is not highly influenced by BEPS.

9.5 Features of the Competitive Tax System

The most important features of the Salvadoran tax system are its basis on the territorial principle and its simplicity. These features do not conflict with BEPS.

9.6 Proposals for Dealing With Hybrid Instruments
Since El Salvador has not yet implemented BEPS, the proposals for dealing with hybrid instruments are not likely to be a pertinent issue in the near future.

9.7 Territorial Tax Regime
El Salvador has a territorial tax regime. Interest is deductible regardless of whether or not the beneficiary is a resident, but only up to the interest rates published by the Central Reserve Bank. The only condition is that the interest is connected to the generation of taxable income. It is unlikely that interest deductibility proposals will affect people investing in and from El Salvador.

9.8 Controlled Foreign Corporation Proposals
El Salvador follows a strict territorial tax principle and therefore, foreign-sourced income is not relevant to the local authorities. Since El Salvador does not have CFC rules, the general drift of CFC proposals should not affect current practice greatly.

9.9 Anti-Avoidance Rules
Salvadoran tax law does not grant any DTC limitation to outbound investors. However, if other jurisdictions were to create limitations on any DTC allowed to inbound investors, this would likely have some impact on direct foreign investments into El Salvador.

9.10 Transfer Pricing Changes
Transfer pricing changes introduced by BEPS after the transfer pricing rules came into force in El Salvador in 2009 are not having a radical effect on the Salvadoran regime. The taxation of profits from intellectual property is not a particular source of controversy in El Salvador.

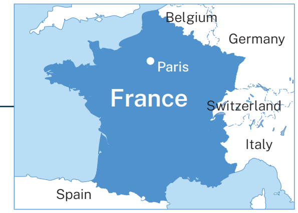
9.11 Transparency and Country-by-Country Reporting
Salvadoran law includes some rules related to transparency. However, country-by-country reporting is not yet in force in El Salvador.

9.12 Taxation of Digital Economy Businesses
There are no specific proposals in this jurisdiction in relation to the taxation of transactions effected or profits generated by digital economy businesses operating from outside El Salvador at the present time.

9.13 Digital Taxation
El Salvador has not taken a position in relation to digital taxation and no proposals have so far been brought forward.

9.14 Taxation of Offshore IP
Payments to non-residents for intellectual property deployed in El Salvador are taxed at 20% withholding tax if the non-resident is not in a tax haven and at 25% if the non-resident is in a tax haven.

FRANCE



Law and Practice

Contributed by:
Vincent Lazimi, Jacques-Henry de Bourmont and François-Xavier Simeoni
Jeantet

Contents

Jeantet was founded in 1924 and is the second-oldest independent French business law firm still active on the French market. Its reputation extends far beyond national borders, with operations in over 150 jurisdictions worldwide. For decades, the firm has been at the forefront of the legal scene, built around a dynamic and ambitious management team. Jeantet attracts talent, as evidenced by the increase in the number of partners to 41 over the past five years, and in the number of associates and support teams to over 200 experts today. Jeantet's internationally recognised tax team advises companies, family shareholdings, investment funds and private banking establishments. It regularly works in the industry, food, real estate development, ultra-high net worth individual (UHNWI), entertainment, capital investment, luxury goods and champagne, merchant banking and private banking sectors.

Authors

Vincent Lazimi specialises in tax law at Jeantet. For over 20 years, with six in London, he has advised clients on their tax audits. He mainly supports companies in the new technologies and fashion sectors on day-to-day (management fee agreements, tax consolidation, VAT) and exceptional operations (taxation of reorganisations, acquisitions, transfer of losses). He also assists US and UK major private equity firms with their internal organisation (setting up in France, partner remuneration policies, taxation of carried interest) and acquisitions (tax audits and tax structuring of acquisition operations). Vincent also assists family offices, UHNWIs, French and US entrepreneurs and French and UK investors in structuring their private and business assets.

Jacques-Henry de Bourmont represents French and international clients, companies and investment funds for Jeantet their tax issues (tax and criminal advice and litigation, transfer pricing, management of intangible assets, asset optimisation, structuring of management packages, executive compensation and real estate taxation). Admitted to the Paris and Frankfurt Bars, Jacques-Henry has significant experience in the Franco-German sphere. He taught real estate taxation at ESSEC and was a French foreign trade advisor. He began his career at Rhône-Poulenc (Sanofi Aventis) and was head of the French desk at Ernst & Young Sociétés d'Avocats in Frankfurt until 2005. He later became managing director of Marcus Partners and head of corporate tax and the Franco-German department of Lefèvre Pelletier.

François-Xavier Simeoni specialises in corporate taxation at Jeantet, and is particularly involved in mergers and acquisitions (tax audits, structuring, day-to-day tax management). He has also developed expertise in tax audits and litigation and assists French and foreign tax residents in fulfilling their tax obligations and transferring their tax residence in France or abroad.

Jeantet AARPI

11 rue Galilée
76116 Paris
France

Tel: +33 01 45 05 80 08
Email: communication@jeantet.fr
Web: www.jeantet.fr

Contributed by: Vincent Lazimi, Jacques-Henry de Bourmont and François-Xavier Simeoni, **Jeantet**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

There are two main groups of companies in France:

- Limited companies (ie, simplified limited liability companies (*sociétés par actions simplifiées* SAS), private limited liability companies (*sociétés à responsabilité limitée* SARL), public limited companies (*sociétés anonymes* SA); and
- Partnerships (*sociétés en nom collectif, sociétés civiles* and *sociétés en commandite simple*).

Limited companies are subject to corporate income tax (CIT) as separate legal entities, while partnerships are pass-through entities (the tax is calculated at the level of the company, but is effectively paid by the shareholders). Please note that specific structures, such as sole proprietorship (*entreprise individuelle*), may exist for taxpayers with limited activity.

1.2 Transparent Entities

Sociétés civiles and *sociétés en nom collectif* are commonly used for property investments. However, depending on the type of rentals, *sociétés civiles* may be subject to CIT. Such companies may also be incorporated as an alternative to the French tax consolidation regime (*régime de l'intégration fiscale*) provided for by Article 223 A of the French Tax Code.

The entities commonly adopted for private equity or venture capital firms are *fonds professionnels de capital investissement* (FPCIs), *fonds commun de placement à risque* (FCPRs), *sociétés de capital-risque* (SCRs) and *sociétés de libre partenariat* (SLPs), which are not subject to CIT per se.

1.3 Determining Residence of Incorporated Businesses

Usually, the effective place of management and/or the place where the company is liable to tax determine its tax residency. There are no special rules in France governing the tax residency of transparent entities; their tax residency depends on the place where they are effectively managed.

1.4 Tax Rates

French-resident companies are subject to CIT at a rate of 25%. However, for companies that can qualify as small to medium-sized enterprises, a reduced corporate tax rate of 15% will apply up to the first EUR42,500 of profits. French companies with turnover exceeding EUR7.63 million are also subject to a social surcharge of 3.3% calculated on the amount of CIT that they owe, reduced by an allowance of EUR763,000.

Shareholders of transparent entities are personally liable to tax on their share of profits – either to personal income tax (individual or company) or to CIT.

When the shareholder is an individual, the profits will be subject to progressive income tax (at a maximum rate of 45% plus social contributions).

The rules applicable for determining the amount of taxable profit will depend on individual's activity.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable basis corresponds to accounting profits adjusted by tax rules (ie, the non-deductibility of CIT, limitation of deductibility of financial charges as the case may be, partial exemption of taxation of dividends/capital gains subject to certain conditions, etc). In principle, only justified expenses incurred during the relevant tax year and incurred in the direct interests of the company deducted for tax purposes.

The profits of a corporate entity are taxed on an accruals basis.

2.2 Special Incentives for Technology Investments

French companies may benefit from research tax credits, innovative tax credits and tax credits for expenses invoiced by research and knowledge dissemination organisations.

France has also implemented an optional intellectual property (IP) box regime (patent box), which is a preferential tax regime on income from the exploitation of IP assets. Subject to certain conditions, net income from licenses and sales of patents, software and similar intangible assets is subject to a preferential CIT rate of 10% instead of the standard rate of 25%.

2.3 Other Special Incentives

There are special incentives for real estate investment entities (*sociétés d'investissements immobiliers cotées* (SIICs) or *sociétés à prépondérance immobilière à capital variable* (SPPICAVs)), venture capital investment companies (*sociétés de capital-risque* SCRs) and young innovative enterprises (*jeunes entreprises innovantes*), which can be exempted from CIT (fully or partially).

2.4 Basic Rules on Loss Relief

Carried-forward losses incurred during a financial year may be deducted from the profits of subsequent financial years without any time limit. There is no need to ask for the deduction of carry-forward losses: they must be automatically offset against the taxable result of the year.

There is a ceiling on the amount of the loss that can be carried forward to the following year. It is limited to EUR1 million per year plus 50% of the fraction of the profit in excess of this ceiling.

Carry-back losses is an alternative to the standard carry-forward loss regime. Companies subject to corporation tax can choose to carry back a loss recorded at the end of a financial year and offset it against the profit of the previous financial year for up to EUR1 million.

When the short-term or long-term regimes apply to the sale of the company's assets, income losses or long-term capital losses could be offset against short-term capital gains/long-term capital gains subject to specific limitations.

2.5 Imposed Limits on Deduction of Interest

In France, complex rules limiting the deductibility of interest payments made by a French borrower to its shareholder or any related party apply.

Interest paid by a company to its direct shareholder is limited to the rate set forth under Article 39-1-3° of the French Tax Code. For FY24, this rate was 5.75 %.

For loans granted by related parties, the foregoing rate applies, or a higher rate that the debtor could have obtained from independent financial establishments under similar conditions (in this case, the maximum allowed interest rate corresponds to the arm's length interest rate).

Moreover, companies subject to CIT that do not belong to a French tax consolidation group may deduct their net financial expenses on only up to 30% of their earnings before interest, taxes, depreciation and amortisation (tax-adjusted EBITDA) or EUR3 million per fiscal year if higher. When the company belongs to a consolidated group, from an accounting perspective, it may benefit – under certain conditions – from an additional deduction (ie, a safeguard clause).

Finally, except in some specific cases, the amount of deductible interest is capped at 10% of prorated tax-adjusted EBITDA (in order to exclude debts to non-affiliated companies from the calculation) or EUR1 million prorated, whichever is higher if the company is thin-capitalised (where the average amount of related-party debt exceeds one and a half times the amount of its net equity). Safeguard clauses may also be applicable to circumvent this limitation.

Equivalent provisions exist for companies that are members of a French tax-consolidated group.

Specific limitations also apply to companies that are members of a tax-consolidated group (*"Charasse limitation"*). Non-deductible interest may be carried forward indefinitely.

2.6 Basic Rules on Consolidated Tax Grouping

French tax law provides for the possibility of setting up a vertical or horizontal tax consolidation group. A tax consolidation group must be set up between companies subject to French CIT that open and close their financial years on the same dates and the years must have a 12-month duration. The parent company has to hold, directly or indirectly, 95% of the share capital of the subsidiary, and the parent company must not be at least 95% held, directly or indirectly, by another company subject to French CIT. Elections must be held within specific deadlines.

When no tax consolidation group has been set up, only shareholders of partnerships that have generated losses can offset the share of losses corresponding to their interest in the partnership against their own taxable result subject to CIT (subject to restrictions).

2.7 Capital Gains Taxation

Favourable tax treatments exist for capital gains arising on the disposal of substantial investments.

Sales of qualifying investments (as defined by French law) are exempt from capital gains tax, but a lump sum of 12% corresponding to costs and expenses must be recaptured and taxed at a CIT rate of 25%, corresponding to an effective tax rate of 3%.

Specific provisions apply to capital gains resulting from the disposal of shares of listed real estate companies that have been held for more than two years (taxation at a rate of 19%).

Some exemptions also apply to the sale of venture capital investment entities complying with specific requirements and held for at least five years, and the disposal of certain intellectual rights can be taxed at a reduced rate of 10%.

2.8 Other Taxes Payable by an Incorporated Business

Incorporated businesses can also be subject to stamp duties on transactions. Stamp duties are due on the transfer of shares and are payable by the buyer. Depending on the kind of shares sold, the applicable rate may vary from 0.1% to 5% (for real estate companies).

VAT (at a rate of 20%) could also be applicable depending on the type of assets sold.

2.9 Incorporated Businesses and Notable Taxes

An additional social security surtax of 3.3%, calculated based on the amount of CIT, may be due by companies with a turnover exceeding EUR7.63 million.

French companies may also be subject to the territorial economic contribution (which includes the business premises contribution (*cotisation foncière des entreprises*) and the business value-added contribution (*contribution sur la valeur ajoutée des entreprises*)) property tax and local taxes.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

At the time of writing, in the first quarter of 2025, over the last four months, the rate of incorporation of closely held local businesses operating in non-corporate form has been higher than the rate of incorporation of businesses operating in corporate form (the non-corporate form accounts for 65.2% of the incorporations in the last four months). See Enterprise births – December 2024, INSEE Statistics.

3.2 Individual Rates and Corporate Rates

The taxation of dividend distributions by a company (at a global rate of 30%), in addition to taxation of the company's income (at a rate of 25%), could prevent individual professionals from earning income at corporate rates.

The effective tax rate in case of distribution of all the company's income would be 47.5%.

3.3 Accumulating Earnings for Investment Purposes

There is no rule that prevents closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are taxed on dividends at a flat rate of 30% (12.8% of income tax plus 17.2% of social contributions), or at the progressive income tax rate (maximum of 45%) with the application of a tax allowance of 40% – ie, 60% of the dividend may be taxed (plus a potential surtax of 3% or 4%).

Individuals who sell shares in a company are taxed at the flat rate of 30%, plus a potential surtax of 3% or 4%. However, in some cases – eg, for shares acquired before 2018 – individuals can opt for taxation at the progressive income tax rate. In this case, an allowance based on the length of time for which the shares have been held may apply.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest

Under French tax law, any interest payment made by a French company to a foreign entity is exempt from withholding tax unless the lender is established in a non-cooperative state and territory (NCST) regarding the exchange of tax information. In such a case, a 75% withholding tax may apply subject to exceptions.

Dividends

Dividends distributed by French companies to non-resident shareholders are, in principle, subject to a withholding tax in France at a rate of 25% for companies and 12.8% for individuals.

The tax treaties concluded by France may reduce such rates.

Moreover, under the Parent-Subsidiary Directive, dividends distributed to an EU parent company may be exempt from French withholding tax if the recipient is subject to CIT and holds or commits to hold at least 10% of the subsidiary's share capital for at least two years. The French parent subsidiary regime may be dismissed if it is used abusively (under anti-abuse provisions).

The withholding tax rate is increased to 75% for dividends paid to an entity established in an NCST.

Royalties

Under French tax law, a withholding tax of 25% may apply on outbound royalty payments. Tax treaties concluded by France may reduce this rate.

A 75% withholding tax may apply in case of payment of royalties to a company established in an NCST.

4.2 Primary Tax Treaty Countries

Luxembourg is often used by foreign investors to make investments in local corporate stock of debt.

Indeed, no substantial participation clause is provided in the tax treaty between France and Luxembourg regarding the disposal of shares held by Luxembourg companies. Moreover, Luxembourg thin capitalisation rules are softer.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

French tax authorities closely scrutinise the use of treaty country entities by non-treaty country residents, especially when they suspect these entities are being used to avoid French taxation. French authorities typically challenge structures where a non-treaty country resident routes income or profits through an entity in a treaty country, claiming treaty benefits like reduced withholding taxes or exemptions.

The main concern is whether the treaty country entity has substantial activities or is merely a conduit with little to no economic substance. If the French authorities determine that the entity lacks genuine business operations and exists primarily to take advantage of the tax treaty, they may deny treaty benefits and apply domestic tax rules, leading to higher tax liabilities for the non-treaty resident.

Authorities often investigate whether the entity has a sufficient operational presence, such as employees, decision-making capabilities and risk-taking functions, in the treaty country. If these elements are missing, the French tax office may disregard the treaty entity and tax the income as if it were earned directly by the non-treaty resident.

To mitigate risks, companies need to demonstrate that their treaty-based structures are compliant with both local rules and international anti-abuse provisions, such as the OECD's principal purpose test (PPT).

4.4 Transfer Pricing Issues

The biggest transfer pricing issues for inbound investors operating through a local corporation typically include the following.

- The determination of transfer pricing comparables, which consists of identifying appropriate comparables for setting arm's length prices, is often difficult, particularly in industries with few local comparables or in markets that differ significantly from global norms. This can lead to disputes over the appropriate profit levels for the local entity.
- The French tax authorities closely scrutinise the allocation of profits between a local corporation and its foreign affiliates. Ensuring that the local entity receives an appropriate share of profits, based on its functions, risks and assets (functional analysis), is a key challenge. Authorities may question whether too much profit is being shifted to low-tax jurisdictions.
- There are transfer pricing documentation requirements that must be fulfilled, especially for companies whose turnover or total gross assets exceeds EUR150 million. For companies with turnover or total gross assets equal to or greater than EUR50 million, other limited documentation requirements are to be fulfilled. This documentation burden can be significant, and failure to meet local requirements may result in penalties or adjustments for companies.
- There are tax audits where authorities review intercompany transactions and may impose retroactive adjustments. This can lead to higher tax liabilities and disputes that may be costly to resolve.

Careful planning and alignment with local and international guidelines, such as OECD standards, are crucial to mitigate these risks.

4.5 Related-Party Limited Risk Distribution Arrangements

French local tax authorities challenge the use of related-party limited risk distribution (LRD) arrangements, particularly when they suspect that these arrangements are being used to shift profits out of France to lower-tax jurisdictions. The French tax authorities scrutinise whether the local distributor, operating under a limited-risk framework, is receiving an appropriate return given its role, functions and risks (functional analysis).

LRD structures, where a French entity acts as a low-risk distributor for a foreign parent company, are often questioned when the profits attributed to the French entity are perceived as too low relative to its operational activities. The authorities analyse whether the limited-risk distributor is genuinely assuming limited risks and functions, and whether its profit margins align with market comparables. Permanent establishment issues may also arise for the principal. To mitigate challenges, companies must maintain robust documentation, demonstrating that the terms of the LRD arrangement meet the arm's length principle and comply with both French and international standards.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

In France, local transfer pricing rules largely align with OECD standards, but there are a few significant variations in enforcement and application. In this respect, French regulations mandate robust transfer pricing documentation, going beyond OECD guidelines. France has specific requirements for maintaining both master files and local files, which provide detailed information about the global group and the local entity's activities. Non-compliance can result in substantial penalties, including a percentage of the adjusted taxable income. In addition, in the context of tax disputes, the French tax authorities often place a high burden of proof on the taxpayer to demonstrate that their transfer pricing complies with the arm's length principle (Article 57 or 238 A of the Federal Trade Commission (FTC) Act). The penalties for non-compliance are more severe compared to OECD recommendations.

It should be noted that French authorities place particular emphasis on transactions involving intangible assets and those perceived as shifting profits to lower-tax jurisdictions. They scrutinise whether French entities receive an appropriate share of profits related to intangibles, often challenging structures that shift intangible-related profits offshore.

While France's rules adhere closely to OECD guidelines, the enforcement is strict, with a strong focus on ensuring compliance and preventing tax avoidance.

4.7 International Transfer Pricing Disputes

In France, tax authorities have become increasingly aggressive in enforcing transfer pricing rules, particularly in recent years. They are proactive in auditing multinational companies, often using new information – such as data from automatic exchanges, whistle-blowers or new tax filings – to reopen earlier years for review. This retrospective approach allows authorities to adjust past assessments, leading to higher tax liabilities and penalties.

International transfer pricing disputes are frequently resolved through double tax treaties (DTTs) and the mutual agreement procedure (MAP), or under the arbitrary convention. French authorities generally accept the MAP process, as it helps resolve disputes related to double taxation. However, the process can be time-consuming, and France tends to be cautious, particularly if the dispute involves aggressive tax planning or profit-shifting schemes. MAP cases are becoming more common as the number of transfer pricing audits and disputes rise.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

In France, compensating adjustments are allowed when a transfer pricing claim is settled. These adjustments help align the tax treatment of the concerned parties based on the final settlement to ensure consistency with arm's length principles. There are often issues with the tax authorities involved in the transaction, and statute of limitation problems may arise.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Taxation is very similar between local branches and subsidiaries of non-local corporations. It should be noted that a local branch (which is part of a foreign entity) is typically taxed only on the income sourced from France and is considered as a permanent establishment benefiting from a DTT. Depending on the localisation of the parent company, a branch tax may be due on the distribution made to the parent company.

A local subsidiary is considered as a separate legal entity and is subject to taxation on its worldwide passive income provided France has the right to tax such income under relevant tax treaties (with the benefit of tax credits). Regarding its trading activity, a French subsidiary is subject to French corporate tax only on the profits attached to the activity performed in France.

5.3 Capital Gains of Non-Residents

Capital gains realised by non-residents on the sale of shares of a French company can be taxed in France if the seller (company or individual), together with their spouse and ascendants and descendants, directly or indirectly holds more than 25% of the rights to the company's profits at any time during the five years preceding the sale. Capital gains resulting from the sale of a predominantly French real estate entity pursuant to French tax law are also taxable in France.

These rules can be dismissed depending on the applicable DTT and the provisions on capital gains.

5.4 Change of Control Provisions

Tax (capital gain tax or stamp duties) could be due in France in case of transfer of shares of a foreign company directly or indirectly holding French property.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The margin realised by a foreign-owned local affiliate depends on the risks assumed. As an example, an affiliate acting as a distributor could realise a margin between 2% and 4%.

5.6 Deductions for Payments by Local Affiliates

The service rendered by a non-local affiliate must be real and justified, and the management and administrative expenses must not be excessive in relation to the service rendered. Usually, a cost-plus method is applied. The cost-plus rate depends on the added value of the service rendered.

In some situations, the remuneration paid for services rendered by a company established in a low tax jurisdiction is not deductible from the taxable result of the local company.

5.7 Constraints on Related-Party Borrowing

Some constraints regarding the deductibility of interest exist for related parties, and anti-hybrid rules, also exist. Moreover, net financial expenses can only be deducted for up to 30% of tax-adjusted EBITDA per year, or EUR3 million if higher (for non-thin-capitalised companies). The rules applicable in this regard to thin-capitalised companies are more stringent.

No withholding tax is levied on interest paid from France unless this interest is excessive and a portion of it is recaptured on the occasion of a tax audit.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

In France, pursuant to the territoriality principle, only profits realised by enterprises conducting business in the country are liable to CIT.

6.2 Non-Deductible Local Expenses

All expenses that are not in the interests of the local corporation will be non-deductible. Moreover, expenses that are linked to a permanent establishment of the French company outside France will not be taxable at the level of the French company.

6.3 Taxation on Dividends From Foreign Subsidiaries

A participation exemption regime (*régime mère-fille*) applies to dividends distributed by subsidiaries where at least 5% of their share capital is held by the parent company. Both the parent company and its subsidiary must be subject to CIT at the standard rate, and the parent company must keep the shares of the distributing company for at least two years (or commit to do so).

In this case, dividends are exempt from CIT but a lump-sum amount of 5% of the dividends distributed (including foreign tax credits), or 1% in certain specific cases, must be recaptured and is subject to the standard CIT rate of 25%. The effective CIT rate is therefore 1.25% (or 0.25% in certain cases).

Otherwise, dividends will be taxable at the standard CIT rate of 25% (for FY24).

6.4 Use of Intangibles by Non-Local Subsidiaries

If intangibles developed by local corporations are used by non-local subsidiaries, a license agreement must be concluded between the two entities.

The license agreement must provide fair remuneration for the use of the intangible. The remuneration will be taxed in France at a rate of 25% or 10% (if, with regard to the intangibles used, the optional IP box regime can be applied).

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

The French Tax Code provides for controlled foreign company (CFC) legislation aimed at dissuading French companies from storing their profits in foreign subsidiaries benefitting from a privileged tax regime. Foreign entities that are tax exempt abroad, or that benefit from an effective corporate tax rate 40% lower than the effective French tax rate, are deemed to benefit from a privileged tax regime.

Subject to conditions and the application of French CFC rules, the profits of a foreign entity are subject to French CIT even though they are not distributed.

A safe-harbour provision applies to entities established in the EU; in this case, the French tax authorities must prove that the foreign entity is an artificial scheme with a tax avoidance purpose.

When the entity is established outside the EU and benefits from a privileged tax regime, CFC rules will not apply if the French company is able to prove that the main purpose and effect of the establishment of the foreign entity is not to localise profits in a jurisdiction benefiting from a privileged tax regime.

The French parent company is deemed to receive fully taxable dividends from foreign subsidiaries in proportion to its participation in the latter or to direct profits from a foreign branch or establishment.

Safe-harbour provisions exist in specific cases.

6.6 Rules Related to the Substance of Non-Local Affiliates

There is no specific rule with respect to the substance of non-local affiliates, but the French tax authorities may try to challenge any abusive schemes based on the abuse of law principle.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Subject to the provisions of tax treaties, local corporations will be taxed on the sale of shares in non-local affiliates.

If the shares correspond to substantial participation, the disposal will be exempt from capital gains tax but a lump sum of 12% corresponding to costs and expenses has to be recaptured and taxed at a CIT rate of 25%, corresponding to an effective tax rate of 3%.

Otherwise, the capital gains linked to the sale will be taxed at a rate of 25%.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

France continuously implements measures against tax avoidance, often through EU-driven reforms.

As an example, Article 57 of the French Tax Code provides that profits indirectly transferred abroad to controlled companies must be incorporated into the French company's results.

Transfer pricing rules, based on the arm's length principle and following the OECD guidelines, also apply in France.

Moreover, France has introduced anti-hybrid measures derived from the OECD's EU Anti-Tax Avoidance Directive (ATAD 2). These rules neutralise the asymmetrical tax effects (deduction/non-inclusion, double deduction) caused by certain so-called hybrid arrangements resulting from differences between French law and the law of other states in relation to the qualification of certain financial instruments and/or entities, or to the attribution of payments.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no regular routine audit cycle in France. In practice, French companies are audited every three or four years (more regularly with respect to large groups).

9. BEPS

9.1 Recommended Changes

Most base erosion and profit shifting (BEPS) recommended changes have been implemented in the French law system.

VAT on customer digital services (Action 1) has already been implemented in domestic law. Action 2 (regarding hybrids) has been implemented through domestic and European directives. The objectives of Action 3 in relation to the CFC are already met by existing CFC rules. ATAD I has been transposed in France to meet the objectives of Action 4 concerning interest deductions.

Concerning Action 5 against harmful tax practices, the OECD considers no harmful regime to exist. Also, in compliance with Action 5, France already exchanges information on tax rulings. The prevention of treaty abuse clause (Action 6) is implemented through a multilateral instrument (MLI). Permanent establishment status (Action 7) is implemented as part of the MLI. The objectives of Actions 8, 9, 10 and 13 concerning transfer pricing have been met. The objectives of Action 12 have also been met now that the DAC 6 directive has been transposed. Regarding the effective dispute resolution mechanism (Action 14), stage 2 thereof is being reviewed, and recommendations are being made. Finally, the BEPS MLI (Action 15) is in force.

9.2 Government Attitudes

The general stance of the French government is to comply with the BEPS project.

France actively supports Pillar One. Pilar Two has been transposed and is in force.

9.3 Profile of International Tax

France is very vigilant with regard to international taxation (tax evasion) and very attentive to the BEPS recommendations with respect to avoiding tax evasion.

9.4 Competitive Tax Policy Objective

France is pushing for the harmonisation of the corporate tax rate to 25%. It does not favour an aggressive approach, but prefers to remain in line with other European countries such as Germany, Luxembourg and the UK. Generally, France does not intend to implement a highly competitive tax policy, unless to attract newcomers moving to France or to favour certain regions or industries.

For France, it is important that BEPS rules apply. France has agreed on a 15% minimum CIT rate.

9.5 Features of the Competitive Tax System

Provisions regarding research tax credit might be more vulnerable than other areas of the French tax regime insofar as it is highly supervised, and many conditions have to be met.

Research tax credit is often subject to a tax audit. There are no incentive rules in France that derogate from EU rules.

9.6 Proposals for Dealing With Hybrid Instruments

The anti-hybrid provisions (ATAD 2) apply to financial years beginning on or after 1 January 2020. From now on, tax deduction in France of the payments, charges and losses of companies will be refused in the presence of a hybrid arrangement.

9.7 Territorial Tax Regime

France has a territorial tax regime with tailored interest deductibility restrictions.

9.8 Controlled Foreign Corporation Proposals

The French CFC rules, which are an exception to the territoriality principle, are not considered potentially defective.

9.9 Anti-Avoidance Rules

As a general rule, Article L64 of the French Tax Procedural Code (FTPC) provides for the abuse of law theory, which allows the French tax authorities to disregard fictitious acts and acts seeking the literal application of texts or decisions for the purpose of avoiding or reducing the amount of taxes that the taxpayer would have normally paid. In this respect, where *"abuse of law"* applies, a tax penalty ranging from 40% to 80% of the avoided taxes may apply.

This anti-avoidance rule is frequently used by the French tax authorities in the case of foreign holding companies in order to disregard them from a tax point of view, where the Finance Law of 2019 introduced a new anti-abuse mechanism equivalent to the common abuse of law procedure (Article L 64 A du LPF). According to this new mechanism, the French tax authorities would be entitled to deny, as not opposable, arrangements mainly motivated by tax considerations (and not exclusively as provided by Article L64 of the FTPC). At this stage, it cannot be entirely ruled out that the French tax authorities will try to make extensive use of this new anti-avoidance rule in the future.

9.10 Transfer Pricing Changes

Insofar as French transfer pricing rules already referred to the OECD guidelines, some actions of BEPS have already been implemented into French tax law (Actions 8 to 10 and 13 regarding transfer pricing documentation).

Taxation of profits from IP at the preferential corporate tax rate of 10% requires French companies to be very rigorous and to prepare specific documentation.

9.11 Transparency and Country-by-Country Reporting

The principle of tax transparency is the cornerstone of a degree of tax equality between countries and helps to avoid tax dumping to the detriment of countries such as France. For reasons such as this, it can be seen as a positive thing. However, tax arrangements put in place to encourage greater tax transparency (such as country-by-country reporting (CBCR), for example – a direct application) can result in an excessive administrative burden on companies, and implementation costs can also be high.

9.12 Taxation of Digital Economy Businesses

In France, a tax on digital services has been introduced. The tax on digital services is a contribution payable by digital companies carrying out three types of activities in France: targeted online advertising, the sale of personal data for advertising purposes and intermediation platform activities.

This tax is levied at a rate of 3% on the sales relating to these activities.

9.13 Digital Taxation

A tax on digital services has already been introduced in France.

9.14 Taxation of Offshore IP

France has provisions for taxing offshore IP used within the country. Under Article 155 A of the General Tax Code, these take the form of direct assessments on the IP owner rather than withholding taxes. France distinguishes between IP owners in tax havens and those in countries with DTTs, often applying stricter rules and higher tax rates to IP owners based in tax havens.

GERMANY

Law and Practice

Contributed by:
Michael Best, Gerald Herrmann and Jannis Lührs
POELLATH

Contents

POELLATH is an internationally operating firm, with more than 180 lawyers and tax advisers providing high-end advice in Berlin, Frankfurt and Munich. More than half of its professionals specialise in the tax implications of the firm's primary areas of expertise: transactions, asset management and private equity. POELLATH is particularly renowned for its close combination of tax and legal advice regarding all its main practice areas, such as M&A, private equity, real estate transactions and family businesses. Corporate tax services include the structuring of national and international M&A and subsequent reorganisations, corporate tax planning and the structuring of national and international groups of companies, and the application and interpretation of double taxation treaties.

Authors

Michael Best is a partner at POELLATH and head of the tax department. He has extensive experience in domestic and international tax law, the tax structuring of cross-border acquisitions and real estate transactions, and the structural and ongoing tax aspects of private equity funds, including tax matters for investors and carried-interest holders. He is a member of the German Association of Tax Advisers and has widely published on corporate tax-related aspects, as well as regularly blogging on *"DER BETRIEB Steuerboard"*. Michael is a sought-after speaker on German corporate tax aspects at national and international conferences, such as SuperReturn and Mupet (Munich Private Equity Training).

Gerald Herrmann is an associated partner at POELLATH and specialises in domestic and international tax law, general tax planning and tax structuring, with a focus on private equity. He is a member of the renowned German Steuerkreis Regensburg eV, the association for the promotion of tax education and training at the University of Regensburg, and is fluent in English and French as well as his native German. Gerald has widely published on tax-related aspects, as well as regularly blogging on current tax issues and topics on *"DER BETRIEB Steuerboard"*.

Jannis Lührs joined POELLATH in 2022 as an associate and is active in domestic and international tax law, focusing on the tax structuring of private equity and M&A transactions and the structural tax aspects of private equity funds. He previously worked for several years in the international tax department of EY and PwC. Jannis studied business administration with a focus on tax law at Mannheim Business School and the University of Magdeburg, and was admitted as a German certified tax adviser in 2022. He has published on tax-related aspects, as well as regularly blogging on current tax issues and topics on *"DER BETRIEB Steuerboard"*.

POELLATH

Hofstatt 1
80331 Munich
Germany

Tel: +49 89 24240 0
Fax: +49 89 24240 999
Email: muc@pplaw.com
Web: www.pplaw.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Germany generally adopt the form of a limited liability company (GmbH) or a joint-stock company (AG). These corporations are taxed as separate legal entities. The key differences between the two relate to the treatment each receives under commercial law.

Under a GmbH, the shareholders are authorised to give instructions to a managing director, there is a low degree of fungibility of shares and there is a wide range of possibilities for the design of the articles of association.

Under an AG, a supervisory board and a management board are mandatory, with both operating independently from the shareholders regarding the business decisions. There is personal liability for the management and supervisory board, and there is a high degree of fungibility of shares.

1.2 Transparent Entities

The type of partnership most commonly used for transparent entities is the *Kommanditgesellschaft* (KG), which is most commonly adopted for investment purposes due to its limitation of liability. Only one shareholder (*Komplementär*) is unlimitedly liable as the general partner (GP), while the liability of the other shareholders (*Kommanditist*) is limited to their compulsory contribution. It is also possible to choose a GmbH as the GP; this means that no individual is subject to unlimited liability. This kind of partnership is referred to as a GmbH & Co. KG, and is usually chosen for private equity structures.

1.3 Determining Residence of Incorporated Businesses

According to German tax law, the residence of incorporated businesses depends on where the following are situated:

- the place of management; and
- the statutory/registered seat.

Usually, double taxation treaties (DTTs) regulate that the place of effective management is decisive in the case of a double residence of a corporation (the *"tie-breaker rule"*).

Due to the special circumstances caused by the COVID-19 pandemic, there is a possibility that the place of actual business management may be affected. According to an OECD guideline published on 21 January 2021, when deciding where the place of effective management is located, the place where it is usually located (notwithstanding the COVID-19 pandemic) should be taken into account.

1.4 Tax Rates

Taxation of Corporations in Germany

Corporations with a registered seat or place of management in Germany are subject to unlimited tax liability in Germany, while non-resident corporations are only taxed on their German-sourced income. The income of a corporation is qualified as business income that is subject to corporate tax and municipal trade tax at an approximate total rate of 30%.

The corporate tax rate (including a solidarity surcharge) stands at 15.825%. A special tax rate applies for shares held in other corporations. Dividends received (as of 1 March 2013, only where the shareholding exceeds 10%) and capital gains recognised from the disposal of shares are tax exempt, although 5% of the proceeds are deemed non-deductible expenses, resulting in an effective corporate tax burden of approximately 0.7%.

Municipal trade tax rates mainly range from 13% to 17%, depending on the municipality in which the business operates. For trade tax purposes, capital gains from the sale of shares are generally tax exempt, whereas dividends received from a corporation are only tax exempt if the shareholding amounts to at least 15%. However, 5% of the proceeds are deemed non-deductible expenses, resulting in an effective trade tax burden of approximately 0.7%.

Partnerships

Partnerships such as a KG are transparent for income/corporate tax purposes so that profits and losses are taxed at the partners' level. The assets, liabilities and income of the partnership are generally allocated to the partners in proportion to their partnership interests. Municipal trade tax, however, is levied at the level of the partnership (if it conducts a trade or commercial activity).

For fiscal years beginning after 31 December 2021, partnerships can apply to be treated like a corporation for corporate income tax and trade tax purposes (*"check the box"* system). This, however, does not apply for civil law, real estate transfer tax (RETT), inheritance tax or gift tax purposes, so it must be carefully assessed if such option is considered.

The exercise of such option is considered a deemed change of form (*Formwechsel*) from a partnership to a corporation for German income and trade tax purposes, so might result in a taxable event.

Individuals

The taxation of the income of individuals (who own a business or are a partner in a transparent partnership carrying out a business), generated by themselves or through the partnership, generally depends upon their personal tax rate; tax rates range up to 47.5%, including a solidarity surcharge of 5.5%, and possibly a church tax. However, dividend payments and capital gains from the sale of shares that are realised in the context of a business are subject to so-called partial-income procedures, so that only 60% of the income deriving from dividends or capital gains will be taxed.

In 2025, the exemption limit on which no solidarity surcharge applies was increased for individuals. However, the solidarity surcharge continues to be levied on the corporate income tax of corporations (particularly GmbHs and AGs), as before.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

As corporations are legally obliged to keep records, they have to determine their income through the comparison of business assets based on annual financial statements. Generally, tax accounts depend on the financial accounts according to the principle of *"decisiveness"* (*Maßgeblichkeitsgrundsatz*). However, there are some deviations of tax accounts from financial accounts, such as the restriction of the application of current value tax depreciation to cases of permanent depreciation and the prohibition of provisions for onerous contracts.

In the case of taxpayers who are required to prepare balance sheets (eg, corporations), profits are taxed on an accrual basis (the *"realisation principle"*).

2.2 Special Incentives for Technology Investments

On 1 January 2020, a law was passed that is intended to promote R&D with tax benefits (*Forschungszulagengesetz*). Essentially, all companies are entitled to subsidies, but projects shall benefit only if they fall into the categories of basic research, applied research or experimental development within the meaning of this act. The subsidy consists primarily of a proportionate reimbursement of the wage costs for the employees of the respective beneficiary. The maximum grant is EUR2.5 million, or EUR3.5 million for SMEs.

In order to further stimulate the economy and promote digitalisation, the Federal Ministry of Finance (BMF) has published a circular under which a normal useful life of one year can be taken as a basis for depreciation for certain digital assets, such as computer hardware (including associated peripheral devices), and for the operating and user software required for data input and processing. This allows the full deduction of corresponding acquisition or production costs in the year of acquisition or production. The shortened useful life applies for fiscal years ending after 31 December 2020.

2.3 Other Special Incentives

Germany provides special investment incentives to small and medium-sized companies by way of an additional capital allowance of up to 40% of the original costs and investment, and a deduction of up to 50% of the prospective original costs.

2.4 Basic Rules on Loss Relief

Regarding income and corporate tax, loss relief is granted through the application of the following instruments.

Firstly, the positive and negative income of one year is netted.

Secondly, taxpayers may choose to carry back the losses to the previous year, or they may choose to carry forward the losses indefinitely. In the case of carry back, any losses may be offset against the profits of the preceding year, up to EUR1 million.

Due to the COVID-19 pandemic, the loss carry back for 2020 and 2021 was EUR10 million, and returned to EUR1 million from 2022 onwards. An offset by way of carry forward is possible up to EUR1 million annually without restriction. Regarding negative income that exceeds the EUR1 million threshold, in each subsequent year only 60% (until 2023 and from 2028 onwards) or 70% (2024 until 2027) of additional income can be offset against such losses carried forward. The transfer of a share percentage over 50% may result in a total forfeiture of carry forward not yet offset. These rules do not apply to the extent there are hidden reserves that are taxable in Germany. Furthermore, these regulations do not apply in the case of intra-group acquisitions of shareholdings (ie, group relief). However, the requirements for this are very strict and hard to meet.

There is another possibility to prevent the forfeiture of the loss carry forward not yet offset if more than 50% of the shares are transferred. This requires that strict conditions are cumulatively met (time-limited application in the tax declaration, continuation of the same business, etc). Furthermore, no so-called harmful event must have taken place (discontinuance of the business, an additional business area is added, etc). When these strict conditions are met, the loss carry forward not yet offset is determined separately as so-called accumulated loss carried forward (*fortführungsgebundener Verlustvortag*) and can be offset against the profits. This accumulated loss carried forward is determined annually. As soon as one of the strict conditions is no longer met, the accumulated loss carry forward is fully lost, unless it is covered by hidden reserves subject to domestic tax.

A case is pending before the Federal Constitutional Court in which it is to be clarified whether the 50% limit is unconstitutional. It is likely that this regulation will also be declared unconstitutional.

In the case of trade tax, trade earnings may be reduced by loss carry forward; carry back is not provided for. An offset is possible without restriction against losses of up to EUR1 million; regarding losses exceeding EUR1 million annually, only 60% of losses may be offset against subsequent trade earnings. The rules regarding the forfeiture of carry forward are the same as for corporate tax.

2.5 Imposed Limits on Deduction of Interest

German tax law provides interest barrier regulations. Interest expenses may be deducted without restriction up to the amount of interest income obtained in the same business year; amounts in excess are only deductible up to the amount of 30% of taxable EBITDA. This restriction does not apply in the following circumstances:

- if net interest income does not exceed EUR3 million each business year;
- if the company is only partially part of a group of companies (the *"standalone clause"*) or
- if an equity comparison shows an equity equal to or higher than the equity of the group of companies (the *"escape clause"*).

The standalone clause does not apply to corporations in the case of harmful debt financing (interest payable to the shareholder exceeding 10% of such interest payable that exceeds interest income) by shareholders/persons related to shareholders/third parties with considerable influence on shareholders holding more than 25% of shares in the corporation. The escape clause is not applicable in the case of harmful debt financing within the whole group of companies. Interest exceeding the 30% threshold may be carried forward indefinitely (*"interest carry forward"*), except in the sale of more than 50% of the shares within five years.

From 2024 onwards, all three exemptions (exemption limit of EUR3 million, standalone clause and escape clause) do not apply to the extent interest expenses were increased due to an interest carry forward. In addition, from 2024 onwards, the definition of interest will be extended to include economically equivalent expenses and other expenses in connection with the raising of debt (eg, agency fees or arrangement fees).

As of 2024, interest expenses resulting from an intra-group cross-border financing relationship are not deductible if:

- the taxpayer is not able to credibly demonstrate that the capital service could have been provided for the entire term from the beginning and that the financing is economically needed and used for the business purpose; or

- the interest rate to be paid exceeds the interest rate at which the company could finance itself on the basis of the group rating, whereby it is possible to provide evidence of the contrary on the basis of an individual rating derived from the group rating.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping (*Organschaft*) enables groups of companies to offset the losses and profits within a group of subsidiaries against the profits of their parent company (and profits transferred to the parent company from other subsidiaries). It requires that:

- the parent company holds the majority of voting rights in the subsidiary;
- the shareholding in the subsidiary is allocated to a domestic permanent establishment of the parent company; and
- a profit and loss transfer agreement (PLTA) has been concluded and executed for at least five years.

However, it should be noted that, under the PLTA, the parent company is also liable for the losses of its subsidiaries.

2.7 Capital Gains Taxation

In effect, 95% of capital gains deriving from the sale of shares in other corporations are tax exempt, resulting in an effective tax rate of 1.5%. However, from time to time it is discussed that the tax exemption for capital gains will only apply for shareholdings of at least 10% in future.

2.8 Other Taxes Payable by an Incorporated Business

If immovable property is transferred, RETT becomes due. The applicable tax rate depends on where the immovable property is situated in Germany, and varies between 3.5% and 6.5%.

If at least 90% of the shares in a corporation or, similarly, at least 90% of the partnership interest in a partnership owning real estate situated in Germany is directly or indirectly transferred to one purchaser or a group of related parties, then the transaction could trigger RETT. Furthermore, the (direct or indirect) transfer of (i) a partnership interest in a partnership owning real estate situated in Germany or (ii) shares in a real estate-owning corporation of at least 90% within a ten-year period to new shareholders could be deemed a taxable event. However, this does not apply for stock exchange transactions in shares of listed companies within the EU/EEA.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are generally subject to VAT; however, they are usually able to claim input VAT as well. The general VAT rate is 19%, but a reduction to 7% and even to 0% is available for some products and services.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses are mostly structured as limited liability companies (GmbH) or as limited partnerships with a limited company as general partner (GmbH & Co. KG).

3.2 Individual Rates and Corporate Rates

If an individual professional intends not to retain the profits of the corporation but instead to pay them out by way of salary or dividends, they face an overall tax burden of up to 48% (plus church tax if applicable). In the case of dividends, this is split into two levels:

- corporate/trade tax at the level of the corporation (at approximately 30%); and
- an individual tax at a flat rate (26.375% on the remaining 70%).

Therefore, there is no benefit besides a tax deferral.

3.3 Accumulating Earnings for Investment Purposes

There are no measures in place to prevent closely held corporations from accumulating earnings for investment purposes. The retained earnings of corporations are taxed at the standard tax rates (approximately 30%).

3.4 Sales of Shares by Individuals in Closely Held Corporations

There are no special taxation rules for closely held corporations; the general rules apply (see **3.5 Sales of Shares by Individuals in Publicly Traded Corporations**).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Where shares are part of the private assets of an individual, dividends are taxed at a flat tax rate of 25% with an additional 5.5% solidarity surcharge, resulting in a final valid tax rate of 26.375% (plus church tax if applicable). Capital gains on the sale of shares are also taxed at this flat tax rate if the individual's stake is below 1%. For the determination of the total taxable income from dividends/sale of shares, a lump sum of EUR1,000 is deducted generally.

The *"partial-income procedure"* (taxation of only 60% of proceeds at the progressive tax rate) is applicable if the stake equals or exceeds 1%, resulting in a maximum tax rate of approximately 28.5% (plus church tax if applicable).

If the stake is below 1%, there are several restrictions regarding the offset of losses from capital gains – for example, only gains of the same kind of income may be offset. If the stake equals or exceeds 1%, there is no restriction regarding the offset of 60% of the losses from the sales of shares with other type of normal income (and for investment income under certain circumstances).

If the shares are part of the individual's business assets, the flat tax rate of 26.375% (plus church tax if applicable) is replaced by the personal tax rate for both dividends and capital gains. However, only 60% of dividends for capital gains are taxed and only 60% of operating costs are deductible, resulting in a tax burden of approximately 28.5% (plus church tax if applicable).

The same rules apply for shareholdings in not publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The withholding tax (WHT) is principally levied on dividends at a rate of 26.375% (including a solidarity surcharge, plus church tax if applicable). Corporations with limited tax liability may request a reimbursement of 40% of withheld tax so that the tax burden effectively amounts to 15.825% (including a solidarity surcharge) and is therefore equal to the tax burden for German corporations.

EU corporations that are subject to a limited tax liability benefit from the Parent-Subsidiary Directive, under which they may obtain a 100% tax exemption for dividends, provided that the parent company has held a direct stake of at least 10% in the subsidiary for a continuous period of 12 months or more. Certain activity requirements need to be met. WHT might also be reduced by DTTs.

The European Court of Justice (ECJ) ruled on 26 February 2019 in the context of the so-called Danish Cases that no WHT exemption applies in the case of abusive structures, even if the criteria are met. Whether a structure is classified as abusive depends on certain criteria (eg, conduit only).

Under the recently renewed German anti-treaty shopping rule, a foreign recipient of German dividends will only be entitled to obtain a relief from German WHT to the extent that one of the following conditions is met:

- its shareholders would have been entitled to the same relief if they had received the payment directly;
- the source of the income has a significant connection to an own business activity carried on by the foreign recipient that explicitly does not apply in the case of a conduit situation (Danish Cases); or
- the foreign recipient is a publicly traded company listed on a recognised stock exchange.

If none of these conditions is met, the foreign recipient may prove that none of the main purposes of its involvement is to obtain a tax advantage.

Further limitations are expected under the Unshell Directive (see **9.2 Government Attitudes**).

Only specific interest income is subject to WHT; this includes profit-related interest and exceptions such as interest resulting from *"over-the-counter transactions"* and interest attributed to other types of income.

In certain other cases (eg, interest collateralised by real estate in Germany), there is no German WHT, but the foreign recipient of the interest income has to file a German tax return (limited tax liability).

Interest paid from an EU corporation to another EU corporation may be tax exempt if the Interest and Royalties Directive is applicable. Royalty payments are subject to limited tax liability and WHT at 15.825%, which is levied on the gross income.

4.2 Primary Tax Treaty Countries

Due to the favourable taxation measures granted to EU corporations, most foreign investors invest via EU member states. The most common tax treaty countries are the Netherlands and Luxembourg.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

German tax law has several anti-treaty shopping clauses to prevent the abuse of DTTs. German tax authorities therefore check whether an entity claiming tax relief with reference to a tax treaty generates its income through its own activities and whether there are considerable reasons to act via the tax-privileged entity in question.

Furthermore, there are subject-to-tax clauses that prevent certain income from being taxed in either of two treaty countries.

Regarding the Unshell Directive, see **9.2 Government Attitudes.**

4.4 Transfer Pricing Issues

The main issue in tax audits regarding transfer pricing is ensuring compliance with the arm's length principle. Other issues are:

- the examination of the transfer pricing methodologies chosen;
- the assessment of the attribution of beneficial ownership in the companies' assets as declared; and
- ensuring the fulfilment of formal requirements when issuing the obligatory reports.

4.5 Related-Party Limited Risk Distribution Arrangements

All transactions within a group of companies must meet the requirements of the arm's length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Germany makes explicit reference to the OECD standards in the circulars issued by the Federal Ministry of Justice and case law; furthermore, legal provisions such as Section 1 of the Foreign Tax Act are based on the OECD standards.

4.7 International Transfer Pricing Disputes

Germany has concluded DTTs with 96 countries, most of which follow the internationally used OECD Model Convention, which contains provisions on mutual agreement procedures (MAPs). More recent DTTs often contain provisions requiring arbitration to resolve a conflict following an unsuccessful MAP. About half of the MAPs are transfer pricing disputes, and about 72% of those disputes are resolved by MAPs between the two states. MAPs are quite commonly used by the German tax authorities.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally, German tax authorities scrutinise compensating adjustments critically and will only recognise them subject to strict conditions. Consequently, compensating adjustments must be based on a previously agreed pricing method that is applied in predefined scenarios of uncertainty and must lead to an *"arm's length"* result.

The underlying Principles of Administrative Procedure have recently been updated. There are no reports on any particular difficulties in operating MAPs. On the contrary, based on MAP statistics from December 2022, only 1.5% of completed procedures involving Germany could not be settled, so the overall operation of MAPs is deemed to be satisfactory.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Generally, there are no differences between local branches of non-local corporations and local subsidiaries of non-local corporations; however, in practice, there are usually problems, or at least discussions, regarding the allocation of income/expenses and assets.

5.3 Capital Gains of Non-Residents

Capital gains of non-residents on a sale of stock in local corporations are taxed if the shareholding is at least 1%. However, the DTTs usually eliminate such taxation.

5.4 Change of Control Provisions

A change of control might result in the forfeiture of tax losses carried forward in the case of a change of at least 50% of the shareholding (see **2.4 Basic Rules on Loss Relief**).

Furthermore, RETT could be triggered by certain transactions with corporations/partnerships owning real estate (see **2.8 Other Taxes Payable by an Incorporated Business**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No specific formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services, but it must be ensured that the determination follows the arm's length principle.

5.6 Deductions for Payments by Local Affiliates

There are no specific rules regarding deductions for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. However, in general, the arm's length principle and the transfer pricing rules must be taken into consideration.

5.7 Constraints on Related-Party Borrowing

Any borrowing between related parties must comply with the arm's length principle. The granting of an interest-free loan or of one with an interest rate below market standards by a local affiliate to a parent entity may result in a hidden profit distribution. In comparison, a loan granted with an interest rate that is above market standards to a parent entity may result in income adjustments in cross-border cases.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

In principle, the worldwide income of local corporations is taxed in Germany. The part of the income of a local corporation that originates from foreign sources that are taxed in the state of source with a tax comparable to German corporate tax is taxed in Germany, taking into account the tax paid abroad. If a DTT applies, the regulations laid down therein have priority. A 95% tax exemption applies for dividends and capital gains from foreign sources if the shareholding is at least 10% (for corporate income tax) or 15% (for trade tax).

For controlled foreign corporation (CFC) taxation, see **6.6 Rules Related to the Substance of Non-Local Affiliates**.

6.2 Non-Deductible Local Expenses

If foreign income is tax exempt in Germany, the corresponding expenses that are economically directly connected to such income are not deductible in Germany. Expenses related to dividends and capital gains are tax deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Under German tax law, for income to qualify as dividend income, the same rules apply regardless of whether the dividends originate from foreign or local sources. Thus, under income tax aspects, 95% of dividend income is tax exempt, unless it is dividend income deriving from a free float below 10%.

For trade tax, the tax exemption for proceeds resulting from foreign subsidiaries is granted if the local corporation holds at least 15% of the subsidiary.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles may be transferred or let (royalties) under arm's length conditions, resulting in taxable income (transfer price or royalties) at regular rates.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Under the German CFC rules, certain low-taxed passive income of a foreign corporation could be subject to German CFC taxation. Such passive income is referred to as low-taxed if the tax burden is lower than 15% (25% for passive income of fiscal years ending before 1 January 2024).

German CFC rules have been fundamentally changed with effect from 1 January 2022 in the course of implementing the Second Anti-Tax Avoidance Directive (ATAD II). One of the fundamental changes has been the introduction of a new *"control concept"*. Based on the new wording, low-taxed passive income is only subject to German CFC taxation if a (single) taxpayer controls the respective CFC. A (single) taxpayer controls a CFC if such taxpayer (alone or together with *"related person"*) is entitled to more than half of the shares, voting rights, capital or profit entitlement. A related person is a person who acts through concerted behaviour with such taxpayer (in relation to partners in a partnership, this is deemed to mean that even one German tax resident minority partner in a partnership implies control over the whole partnership but can generally be disproved if a shareholding of 5% in the partnership is not exceeded and there are no special circumstances). For each foreign corporation realising low-taxed passive income, the (indirect) German shareholders have to file a CFC/PFIC tax return.

This new control concept does not apply with regard to certain passive income referred to as passive investment income (*Einkünfte mit Kapitalanlagecharakter* – PFIC) – ie, CFC taxation applies even below 50%.

Under the revised CFC rules, dividend payments will be determined as passive (investment) income if:

- the dividend payment is tax deductible at the level of the payor; or
- the foreign corporate recipient of the dividend does not own at least 10% of the shares in the payor.

Before the aforementioned changes in the CFC rules, capital gains might have been determined as passive income. Under the (applicable) revised CFC rules, capital gains are generally determined as active income.

In December 2024, the German tax authorities published a proposal to delete the relevant section of the CFC law under which these rules apply for German minority shareholdings – ie, outside of a control situation – retroactively from 2022 onwards. This would reduce the application of the CFC law substantially; however, it is not yet known whether such proposal will be adopted and if so to what extent.

6.6 Rules Related to the Substance of Non-Local Affiliates

German CFC rules do not generally relate to the substance of non-local affiliates. However, the carve-out from CFC rules that is provided for EU/EEA corporations requires – alongside other conditions – that the German shareholder proves that the specific income is derived from a substantial economic activity performed in the state of residence of the CFC (the so-called motive test; regarding ATAD III, please see **9.2 Government Attitudes**).

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

The gains made by local corporations on the sale of shares in non-local affiliates enjoy the same 95% tax exemption as granted for the sale of shares in local subsidiaries.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Section 42 of the General Tax Code provides for a general anti-avoidance rule that applies in the case of abusive tax structures. At the level of the EU, the Anti-Tax Avoidance Directive (ATAD) establishes a common minimum level of anti-avoidance rules with which every member state must comply.

Germany has implemented a mandatory disclosure regime for cross-border arrangements if one or more specified characteristics (hallmarks) are met and if the arrangements concern more than one EU country or an EU country and a non-EU country (DAC 6). These hallmarks are aimed at aggressive tax avoidance structures but are drafted much more broadly, so non-tax-motivated transactions may also be caught. If one or more hallmarks are met, the person or company who markets, designs or organises a cross-border tax arrangement or makes these arrangements available for use by third parties (an intermediary) has several reporting obligations. The reporting deadline is 30 days after the day on which:

- the structure is made available for implementation;
- the structure is ready for implementation; or
- the first step of implementation of the structure is started.

Failure to comply with these rulings could lead to significant sanctions under local law.

The new German government intends to extend the scope of such reporting obligation to national tax arrangements for companies with a turnover of more than EUR10 million.

The Defence Against Tax Haven Act (*Steueroasen-Abwehrgesetz*) contains several mechanisms to make it more difficult to avoid paying taxes in Germany through a business relationship with a state or territory that is on the EU list of non-co-operative tax jurisdictions (the so-called blacklist), which is amended from time to time. The measures include:

- denial of deducting business expenses;
- tighter CFC rules;
- tighter withholding tax measures; and
- measures relating to profit distributions and sales of shares.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no audit cycle prescribed by law, but audits tend to take place once every three to four years.

9. BEPS

9.1 Recommended Changes

The BEPS 1 Implementation Act passed the German legislation process at the end of 2016, and was the first step towards implementing the recommendations of the BEPS process into domestic law.

BEPS Action 13

The BEPS 1 Implementation Act led to an extension of co-operation obligations in cross-border situations, based on BEPS Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting). As a result, the transfer pricing documentation now consists of:

- a master file;
- a country-specific and company-related local file; and
- a country-specific country-by-country report.

The information exchange standards and reporting obligations arising from the amendments to the EU Mutual Administrative Cooperation Directive have also been implemented into German law. The amended transfer pricing documentation rules are applicable for fiscal years starting after 31 December 2016.

BEPS Action 5

As of 1 January 2017, tax rulings (ie, advance cross-border rulings and advance pricing arrangements) issued, reached, amended or renewed after 31 December 2014 must automatically be exchanged amongst EU member states. These amendments take the recommendations made in BEPS Action 5 (Measures to Counter Harmful Tax Practices) into account.

Furthermore, Germany has introduced a provision to limit the tax deductibility of licence fees or royalty payments to foreign-related parties that benefit from preferential tax regimes (such as intellectual property, licences or patent boxes) that are incompatible with the OECD nexus approach of BEPS Action 5 (Measures to Counter Harmful Tax Practices).

In addition, the BEPS 1 Implementation Act introduced a new regulation into domestic law to prevent the double taxation of business expenses (ie, double deduction) for partnerships, effective from 1 January 2017.

OECD Multilateral Instrument

Germany signed the OECD Multilateral Instrument (MLI) in June 2017. As a first step, Germany would like to amend more than 30 of its 96 DTTs, provided that the other countries agree. In November 2020, the MLI was introduced as part of a national legislative procedure; however, the implementation law only covers 14 DTTs. In compliance with the recommendation of BEPS Action 12 and the EU Directive on Administrative Cooperation in the field of taxation, the German government managed to implement an obligation to notify cross-border tax arrangements into national law within the set deadline of 31 December 2019 (see **7.1 Overarching Anti-Avoidance Provisions**).

EU Anti-Tax Avoidance Directive

The Federal Ministry of Finance started working on the implementation of the EU Anti-Tax Avoidance Directive at the end of 2019, with the federal government passing a draft law on 24 March 2021. The law passed the German legislation process on 30 June 2021.

9.2 Government Attitudes

The German government has fully supported the BEPS project at all times, and Germany played a prominent role in the project, both politically and professionally.

As Germany already has comparably strict tax laws, the particular intention of the German government with regard to BEPS is to enforce stricter international taxation standards in the EU and other countries, in order to achieve fair tax competition between countries.

On 14 December 2022, the EU Commission presented a directive to ensure a minimum level of taxation of 15% of multinational enterprise groups within the EU (published on 22 December 2022). Such directive was implemented into German tax law in 2023 and the minimum taxation applies as of 2024 for multinational enterprises that have generated revenue of EUR750 million or more in at least two of the last four financial years.

Furthermore, the EU Commission intends to work swiftly on regulations to implement the allocation of taxing rights under Pillar One of the OECD plans.

The Unshell Directive

On 22 December 2021, the EU Commission presented a proposal for a directive in the fight against shell entities (*Briefkastenfirmen*) within the EU (the *"Unshell Directive"*). This proposal (also referred to as ATAD III) intends to establish new transparency standards around the use of shell entities by using a number of indicators related to income, staff and premises to detect entities that exist merely on paper. The implementation at the level of the member states was planned for 2023 so that the national regulations can apply from 2024, but the proposed directive has not yet been implemented due to the concerns of some member states. It is therefore unclear whether this directive will be completed/ implemented at all.

On 11 May 2022, the EU Commission presented another proposal for the alignment of the tax treatment of equity and debt under the so-called Debt Equity Bias Reduction Allowance (DEBRA) Initiative. The objective is to reduce tax incentives for debt financed investments and to incentive equity investments by implementing a notional interest deduction on equity and a limited deductibility of interest expenses (deductibility is limited to 85% of interest expenses). Negotiations are currently temporarily suspended and may result in a limited reporting obligation only.

9.3 Profile of International Tax

There is public concern over whether the current applicable international tax law is able to keep up with the challenges of globalisation or if it enables tax avoidance and allows base erosion and profit shifting advantages. The discussion was sparked in 2012 by media reports of Starbucks avoiding taxes on a large scale in the UK, and was extended to global IT firms and swept over other EU countries.

Developments such as *"the Luxembourg Leaks"* and *"the Panama Papers"* particularly influenced public and political discussions on aggressive tax structures (such as intellectual property boxes) and underlying tax rulings, which led to tax rates of less than 5%. As a result, not only the German business and political press but also the tabloids frequently reported on such developments. However, neither the BEPS project nor the implementation of its recommendations receives significant media attention.

9.4 Competitive Tax Policy Objective

As a strong export country, Germany does not pursue a competitive tax policy objective. In fact, Germany has already introduced anti-abuse and CFC rules to limit base erosion and profit shifting. As a result, Germany seeks to achieve international standards for fair and realistic tax competition.

9.5 Features of the Competitive Tax System

Germany does not have a competitive tax system, state aid or other similar constraints that might be particularly affected by anti-BEPS measures.

9.6 Proposals for Dealing With Hybrid Instruments

Hybrid instruments have mainly been used in Germany for cross-border financing. Germany has implemented a domestic anti-abuse rule (the *"correspondence principle"*) for interest income and dividend payments from hybrid instruments of foreign corporations, which is applicable as of the 2014 assessment year. Furthermore, the very same correspondence principle has been considered in the EU Parent-Subsidiary Directive.

In line with the BEPS 1 Implementation Act, a separate regulation to prevent the double deduction of business expenses for partnerships has been introduced into German domestic law, effective from 1 January 2017. The recommendations of BEPS Action 2 have largely been incorporated into ATAD II.

In the course of the implementation of the ATAD II regulations, in 2020 Germany enacted a law limiting the tax deductibility of business expenses in the case of hybrid arrangements. The limitation applies, inter alia, if:

- expenses are recorded twice in two countries; or
- an expense is deducted at the level of a German entity but the related income is not subject to taxation in the foreign country due to a hybrid arrangement (or a hybrid legal entity).

9.7 Territorial Tax Regime

The German tax regime is residence-based rather than territorial. Germany generally taxes worldwide income, subject to DTTs that usually exempt interest income of foreign shareholders from taxation.

9.8 Controlled Foreign Corporation Proposals

With respect to EU law, conflicts may be looming with the general drift of the CFC proposals, particularly with regard to the freedom of establishment. The ECJ has decided in the case of Cadbury Schweppes that CFC rules unjustifiably restrict the freedom of establishment, unless the specific objective of a CFC rule is to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out in national territory. Thus, the case law of the ECJ has limited the application of CFC rules. It is questionable whether the BEPS proposals consider this fact.

Apart from that, German tax law already provides for strict CFC rules for offshore subsidiaries whose passive income is taxed at *"low rate"* of less than 15% (25% for passive income of fiscal years ending before 1 January 2024). These CFC rules have recently been renewed and hence no further amendments are expected in the near future; see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

9.9 Anti-Avoidance Rules

To address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios, Germany implemented domestic *"anti-treaty shopping rules"* several years ago (see **4.1 Withholding Taxes**). According to these regulations, benefits will not be granted if a company's main purpose is to gain access to advantageous conditions derived from a DTT and/or EU directives (eg, the EU Parent-Subsidiary Directive).

Furthermore, domestic subject-to-tax clauses to prevent under-taxation and non-taxation due to DTT or EU directive benefits and CFC rules are in place. Thus, German tax law already provides adequate regulations to address the abuse of benefits and tax avoidance in general.

9.10 Transfer Pricing Changes

Transfer pricing matters for intellectual property are a crucial issue for companies and advisers in Germany, as the evaluation, benchmarking and documentation of intellectual property are always challenged in German tax audits.

As a result of the transfer pricing documentation concept with the implemented country-by-country reporting, as well as the master file and the local file, intellectual property must be documented more extensively. Therefore, comments must be made regarding the creation, beneficial ownership, chances and risks, etc, of intellectual property. The concept does not radically change things; however, intellectual property will be more transparent for tax authorities in Germany and other countries. Consequently, there are some concerns that this could lead to more challenging tax field audit procedures, including income corrections in Germany and other countries.

9.11 Transparency and Country-by-Country Reporting

Due to German transfer pricing reporting and documentation requirements, a certain transparency with regard to intercompany cross-border transactions already existed prior to the BEPS project. Furthermore, there are disclosure obligations if a German tax resident (an individual or a legal entity) establishes permanent enterprises or partnerships abroad or acquires shares in foreign corporations.

Concerns are being raised in connection with the country-by-country reporting that has been implemented by the BEPS 1 Implementation Act, as companies will face further significant administrative barriers in the future. Finally, increased bureaucracy is to be expected due to the new disclosure obligations for cross-border tax arrangements based on BEPS Action 12 (see **9.1 Recommended Changes**).

9.12 Taxation of Digital Economy Businesses

Prompted by BEPS Action 1, the EU Commission adopted two legislative proposals in March 2018 relating to the taxation of digital activities in the EU. One of the two draft directives seeks to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. However, the EU draft directive relating to the taxation of digital economy businesses has not yet been adopted, and no German draft legislation has yet been published to this effect.

9.13 Digital Taxation

The second legislative proposal relating to the taxation of digital activities that was adopted by the EU Commission in March 2018 (see **9.12 Taxation of Digital Economy Businesses**) sought to impose an interim digital tax but was rejected at the EU finance ministers' meeting in March 2019. As one of the opposing EU members, Germany had rejected the proposed European digital tax in order not to pre-empt an international solution at G20 level. With the publication of the EU directive to ensure a minimum level of taxation of multinational enterprise groups (see **9.2 Government Attitudes**), which is intended to target digital economy businesses in particular, national digital taxes are no longer expected.

9.14 Taxation of Offshore IP

Germany has restricted the tax deductibility of licence fees or royalty payments to foreign-related parties that benefit from preferential tax regimes (ie, licences or patent boxes) since January 2018, in order to discourage harmful tax practices relating to offshore intellectual property. This restriction, however, does not apply if a preferential tax regime is compliant with the nexus approach of BEPS Action 5 and hence requires a sufficient degree of substance and research activity on the part of the licensor. From 2024 onwards, tax deductibility is only restricted if the licence fees are taxed below 15% under the preferential tax regime (below 25% before 31 December 2023).

GIBRALTAR

Law and Practice

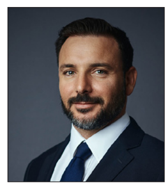
Contributed by:
Stuart Dalmedo, Adrian Pilcher and Louise Anne Turnock
ISOLAS LLP

Contents

ISOLAS LLP is a market-leading full-service Gibraltar law firm providing commercial and pragmatic advice to international corporate and personal clients. It puts clients first, matching their needs to the best person for the job. With the legal expertise and dynamism of a firm at the vanguard of developments in legal solutions designed to tackle an ever-evolving range of issues, ISOLAS stays ahead of the curve and makes sure its clients do the same. The firm provides expert advice across a number of sectors, working with a wide international client base that often requires cross-border solutions. The ISOLAS tax team has assisted in a wide variety of tax planning and structuring scenarios involving private individuals, businesses and charitable organisations to achieve maximum efficiency.

Authors

Stuart Dalmedo is a partner at ISOLAS and has over a decade of experience in tax and private client matters. He has become the *"go-to"* lawyer within the firm for all tax matters and has extensive experience in advising high net worth individuals on the establishment of tax-efficient structures and cross-border planning. Stuart regularly counsels clients on setting up businesses in Gibraltar and on the corporate, tax and regulatory aspects of business, as well as assisting individuals relocating to Gibraltar with their residency and all other aspects of relocation, including Category 2 and High Executive Possessing Specialist Skills applications.



Adrian Pilcher is a partner at ISOLAS and has particular expertise in international corporate and trust structures, tax and estate planning, pensions and financial services. He was involved in drafting the Private Trust Companies Act 2015, the Private Foundation Act 2017, the Financial Services (Pensions) Regulations 2017 and the Proceeds of Crime Act 2015 (Amendment) Regulations 2020. Adrian advises high net worth individuals and families on wealth and succession planning and family governance. He acts as trustee of a number of private family trusts and as director of various family-owned investment-holding corporate entities and was appointed as Chair of the Society of Estates and Practitioners Gibraltar branch in June 2023.

Louise Anne Turnock joined ISOLAS in September 2021 and currently sits in the tax and private client department. Having graduated in 2018 from the University of Keele, she undertook a four-month internship at a law firm in Washington, DC, and has also worked in other areas within the financial sector, including insurance. She completed the Professional Skills Course and Professional Certificate of Competence in Gibraltar Law at the University of Gibraltar, for which she was awarded a distinction, and recently obtained a distinction in the Advanced Certificate in Principles of International Taxation, AML & Compliance course through STEP.

ISOLAS LLP

Portland House
Glacis Road
PO Box 204
Gibraltar

Tel: +350 2000 1892
Fax: +350 2007 8990
Email: info@isolas.gi
Web: www.gibraltarlawyers.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Although businesses in Gibraltar generally adopt a corporate form, they could be set up as a company, a sole trader or a partnership.

Company

Companies in Gibraltar may take various forms:

- companies limited by guarantee (with or without a share capital);
- companies limited by shares;
- protected cell companies; and
- unlimited companies.

Companies limited by shares are by far the most common form of corporate vehicle in use in Gibraltar. These may be set up as a private company (in which case the company's shares or debentures are not allowed to be offered to the general public) or as a public company (in which case the company's shares or debentures are allowed to be offered to the general public).

Every type of company will have separate legal personality and will be taxable as a separate legal entity.

Protected cell company

For the purposes of taxation, the protected cell company and each of its cells shall be considered as if each cell were a separate company.

Sole Trader

Becoming a sole trader is the simplest way to start a business, as it is an individual who owns and runs their own business as an individual on their account. A sole trader business does not have any legal identity separate to its owner.

Sole traders would need to be registered as self-employed persons with the relevant authorities.

Sole traders are taxed as individuals.

Partnership

There are three types of partnerships:

- general partnerships;
- limited partnerships (LPs); and
- limited liability partnerships (LLPs) (see **1.2 Transparent Entities**).

Partnerships are transparent for tax purposes. As a result, every partner (whether a company or individual) would be taxed on their share of the taxable income generated by the partnership.

Other Structures

Gibraltar law also provides a framework for the establishment of trusts and foundations.

Trusts

Trust legislation in Gibraltar is generally based on the UK's trust law. The Trustees Act of Gibraltar is the main governing act, which applies the provisions of the Convention on the Law Applicable to Trusts and on their Recognition, with various additions, such as the establishment of asset protection trusts.

The trustees of a trust resident in Gibraltar shall be charged tax at the prescribed rate in respect of any assessable income.

Foundations

The Private Foundations Act came into force in 2017 and provides a framework for the establishment, registration and operation of a foundation.

A foundation is a legal entity separate from its founder, its councillors and its beneficiaries (if any), and is able to hold assets in its own name as absolute legal and beneficial owner. The foundation's constitution is comprised of a charter and rules setting out the information that governs the management and administration of the foundation, as well as the provisions governing the guardian and beneficiaries (if any).

Beneficiaries of a foundation who are ordinarily resident in Gibraltar shall be charged tax at the prescribed rate in respect of any assessable income.

Unlike a trust, it is the foundation itself that is subject to tax.

1.2 Transparent Entities

General Partnerships

General partnerships are established under the Partnership Act 1895, and are also referred to as *"traditional"* partnerships. In general partnerships, each partner can act on behalf of the partnership in the conduct of its business, with binding effect on the other partners, and all partners have unlimited liability for the debts of the partnership. A general partnership is not a legal person.

Limited Partnerships

The concept of *"limited partnership"* was introduced by the Limited Partnerships Act 1927. It allows a person to be *"limited partner"*, whose liability for the partnership's debts is limited to their capital contribution to the partnership. A limited partnership must consist of at least one general partner, whose liability is unlimited, and one limited partner; limited partners must not be involved in the management of the partnership's business.

The Limited Partnerships Act 2021 (which repealed the Limited Partnerships Act 1927) and the Protected Cell Limited Partnerships Act 2021 came into effect in 2021, modernising and adapting the existing legislation.

The Limited Partnerships Act has been meticulously designed to provide a framework for, inter alia:

- the partnership interests of limited partnerships being represented by shares, bonds, notes, loans or other debt securities or instruments;
- limited partners being able to undertake a more active role in the affairs of the limited partnership without forfeiting their limited liability; and
- the general partners of a limited partnership being able to elect whether or not the limited partnership is to have legal personality.

The act also ensures that the voting rights of each partner will be in proportion to their partnership interest, unless otherwise varied.

The Protected Cell Limited Partnerships Act allows limited partnerships that are set up as funds to create one or more cells to protect and segregate cellular assets from non-cellular assets, and to keep each cell separate and separately identifiable from other cells.

Limited Liability Partnerships

Limited liability partnerships are established under the Limited Liability Partnerships Act 2009 as *"body corporate"* with legal personality separate from its members. This enables each member to limit their liability for the partnership's debts to an amount agreed with the other members of the LLP (usually the capital they have invested in the LLP).

1.3 Determining Residence of Incorporated Businesses

A company is considered *"ordinarily resident"* in Gibraltar when it is:

- managed and controlled from Gibraltar; or
- managed and controlled outside Gibraltar by persons who are ordinarily resident in Gibraltar.

An individual is considered ordinarily resident in Gibraltar when (regardless of whether such individual is domiciled in Gibraltar or not) in any year of assessment they are:

- present in Gibraltar for a period of at least 183 days, or periods together amounting to at least 183 days; or
- present in Gibraltar for more than 300 days in aggregate over three consecutive years of assessment.

There is no statutory definition of *"management and control"* under Gibraltar law. Instead, what constitutes management and control is governed by English case law, which usually refers to the highest level of oversight.

There is no separate concept of *"residence"* as opposed to ordinarily resident.

1.4 Tax Rates

Companies

The standard rate of taxation for a company is 15%. Utility and energy provider companies are liable to a higher rate of 20%.

Generally, companies are taxed on a territorial basis of taxation (see **2.1 Calculation for Taxable Profits**).

Transparent Entities

Due to the fact that partnerships are transparent entities for tax purposes, the profits or gains from the partnership are deemed to be the share to which the partner was entitled.

The rate to which the partner would be subject would depend on the type of partner (ie, a company or individual).

Individuals

Individual taxpayers have the choice of being taxed under either an Allowance Based System (ABS) or a Gross Income Based System (GIBS). Regardless of the system opted for, upon final assessment the Income Tax Office will apply the system that is most beneficial to the taxpayer.

Allowance Based System

This system enables an individual to claim certain allowances against assessable income, including:

- personal;
- spouse;
- child;
- nursery school;
- medical insurance premiums paid;
- life assurance premiums paid;
- pension contributions paid;
- first-time home purchase;
- mortgage interest;
- low income allowance and credit;
- social insurance contributions paid; and
- pensioner.

The tax rates under the ABS are as follows:

- 14% on the first GBP4,000;
- 17% on the next GBP12,000; and
- 39% on the balance.

Gross Income Based System

Under the GIBS, a taxpayer is entitled to very few allowances/reliefs, but the applicable rates are lower. The allowances/reliefs available under the GIBS include:

- first-time home purchase;
- mortgage interest;
- pension contributions paid; and
- medical insurance premiums paid.

The tax rates under the GIBS are as follows.

- Individuals with gross income of up to GBP25,000:
  - (a) 6% on the first GBP10,000;
  - (b) 20% on GBP10,001 to GBP17,000; and
  - (c) 28% on the balance.
- Individuals with gross income of more than GBP25,000:
  - (a) 16% on the first GBP17,000;
  - (b) 19% on the next GBP8,000;
  - (c) 25% on the next GBP15,000;
  - (d) 28% on the next GBP65,000; and
  - (e) 25% on the balance.

Any taxpayer with income of GBP11,450 or less is not liable to income tax in Gibraltar.

Other Rates of Tax, Duties and Contributions

Stamp duty

There is a fixed charge of GBP10 per share or loan transaction. Stamp duty is applicable for companies and transparent entities that purchase residential real estate in Gibraltar, and is payable at the following rates.

- For first and second time buyers, the stamp duty rates are as follows:
  - (a) 0% where the value of the property does not exceed GBP300,000;
  - (b) 5.5% where the value of the property exceeds GBP300,000 but is less than GBP350,000;
  - (c) 3.5% where the value of the property exceeds GBP350,000 but is less than GBP800,000; and
  - (d) 4.5% where the value of the property exceeds GBP800,000.
- For third time or more buyers and companies purchasing properties valued at under GBP200,000, no stamp duty is payable.
- For third time or more buyers and companies purchasing properties valued at between GBP200,000 and GBP350,000:
  - (a) 2% where the value of the property is between GBP0 and GBP250,000; and
  - (a) 5.5% where the value of the property is between GBP250,000 and GBP350,000.
- For third time or more buyers and companies purchasing properties valued at over GBP800,000:
  - (a) 3% where the value of the property is between GBP0 and GBP350,000;
  - (b) 3.5% where the value of the property is between GBP350,000 and GBP800,000; and
  - (c) 4.5% where the value of the property is over GBP 800,000.

Stamp duty is also payable on mortgages or further advances secured in Gibraltar, at the following rates:

- 0.13% for a mortgage of GBP200,000 or less;
- 0.20% for a mortgage of over GBP200,000; and
- 0.03% of the amount borrowed for the release of a mortgage.

Tax on sale of shares of companies

In general, tax is not payable on the sale of shares in a Gibraltar company, unless that company owns real estate in Gibraltar.

Import duty

Goods that are imported into Gibraltar are subject to import duty at varying rates (with some exemptions).

Social insurance

Social insurance contributions are payable by every employee or self-employed person in any week in which they work.

Employee contributions are 10% of gross earnings, subject to a minimum of GBP13.65 per week or GBP59.15 per month and a maximum of GBP38.85 per week or GBP168.35 per month.

Employer contributions are based on 18% of gross earnings, subject to a minimum of GBP30.45 per week or GBP131.95 per month and a maximum of GBP53.55 per week or GBP232.05 per month.

Self-employed contributions are 20% of gross earnings, subject to a minimum of GBP29.00 per week or GBP125.67 per month and a maximum of GBP51.00 per week or GBP221.00 per month.

Individuals aged 60 and over and those whose statutory occupational retirement age is earlier than 60 are exempt from paying the employee's share of social insurance contributions.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Companies are taxed on a territorial basis, meaning that only income accrued in or derived from Gibraltar will be subject to taxation in Gibraltar. *"Accrued in or derived from"* refers to the location of the activities that give rise to the profits of the company.

The income of a business whose income arises from an underlying activity that requires a licence and regulation under any law of Gibraltar (such as a business licence or a licence issued by the Gibraltar Financial Services Commission), or that is licensed in another jurisdiction but enjoys passporting rights into Gibraltar, shall be deemed to accrue in and derive from Gibraltar.

Intercompany loan interest (which exceeds GBP100,000 per annum) and royalty income shall be deemed to accrue in and derive from Gibraltar if it is received by a company that is registered in Gibraltar.

The Income Tax Act 2010 prescribes the rules for ascertaining profits or gains in Gibraltar, which shall be computed in accordance with Gibraltar Generally Accepted Accounting Practice. In addition, UK or international accounting standards may apply.

Profits are taxed on an accruals basis.

Deductions

Generally, any expense incurred wholly and exclusively for the production of income shall be allowable as a tax-deductible expense.

No deduction shall be allowed in respect of:

- expenses not incurred for the production of income;
- domestic or private expenses;
- any expenses of a capital nature (although capital allowances are available – see below);
- any sum recoverable under an insurance contract or contract of indemnity;
- any tax charged in Gibraltar under the Income Tax Act;
- the depreciation of assets (although capital allowances are available – see below);
- contributions paid to non-approved pension schemes;
- interest paid other than on borrowing for the purposes of the trade or business; and
- certain other expenses, under relevant anti-avoidance provisions.

Capital Allowances

The capital allowances for accounting periods ending between 1 July 2021 and 30 June 2023 were based on the higher of the following:

- the first year allowance for plant and machinery of up to GBP30,000 was fully deductible, with the balance going into a pool (see below);
- the first year allowance for computer equipment of up to GBP5000,000 was fully deductible, with the balance going into a pool; or
- a pool allowance of 15% annually on a reducing balance basis.

Incentives

There are also a number of incentives available to companies, which may be taken as deductions. These include deductions for approved expenditure on premises, for improvement in EPC rating, for training costs towards qualifying qualifications and for property investment.

2.2 Special Incentives for Technology Investments

No special incentives exist for technology investments in Gibraltar.

2.3 Other Special Incentives

No special incentives apply to particular industries.

2.4 Basic Rules on Loss Relief

A company is able to carry forward any losses against future profits indefinitely, provided that there is no change in ownership nor any major change in the nature and conduct of the business within a period of three years. There is no provision for the carrying back of losses.

The Gibraltar Parliament has introduced a Bill to amend the Income Tax Act to include a provision to allow for the carrying forward of losses when an intra-group transfer occurs. Please note that this has not yet been commenced.

2.5 Imposed Limits on Deduction of Interest

General Provisions

Any interest incurred for the production of income shall be deductible. Any interest paid or payable to a person not resident in Gibraltar that is charged at more than a reasonable commercial rate shall not be deductible.

A deduction is not allowed for any interest paid or payable on money borrowed other than for the purposes of the trade or profession that generates the income, or for acquiring the capital employed in acquiring the trade or profession that generates the income.

Specific Anti-Avoidance Provisions

Thin capitalisation

Interest paid on a loan by a company to related parties (which are not themselves companies), or on loans where security is provided by related parties, where the ratio of the value of the loan capital to the equity of the company exceeds 5:1 is considered as a dividend payment and is therefore not a deductible expense for tax purposes.

Payments to connected parties

The amount of interest paid to connected persons that is in excess of that payable at *"arm's length"* is deemed a dividend payment and is therefore not a deductible expense for tax purposes.

Interest limitation rule

The interest limitation rule provides that exceeding interest expenses are deductible up to either 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA) or EUR3 million, whichever is higher.

2.6 Basic Rules on Consolidated Tax Grouping

There are no rules in Gibraltar for consolidated tax groupings.

2.7 Capital Gains Taxation

There is no capital gains taxation in Gibraltar.

2.8 Other Taxes Payable by an Incorporated Business

On a transaction involving Gibraltar property, there may be property rates payable as well as any possible charge by a landlord for the consent for an assignment. Stamp duty may also be payable (see **1.4 Tax Rates**).

2.9 Incorporated Businesses and Notable Taxes

Exit Tax applies when:

- a taxpayer transfers assets from its head office to its permanent establishment outside Gibraltar, and Gibraltar, as the head office, no longer has the right to tax the transferred assets due to the transfer;
- an entity transfers assets from its permanent establishment in Gibraltar to its head office or another permanent establishment outside Gibraltar, and Gibraltar no longer has the right to tax the transferred assets due to the transfer;
- a taxpayer transfers its tax residence from Gibraltar to another jurisdiction, except for those assets that remain effectively connected with a permanent establishment in Gibraltar; and
- a taxpayer transfers the business carried on by its permanent establishment from Gibraltar to another jurisdiction, and Gibraltar no longer has the right to tax the transferred assets due to the transfer.

"transfer of business" is defined as when the entity ceases to have a taxable presence in Gibraltar and acquires a taxable presence in another jurisdiction, without becoming tax resident in that other jurisdiction. *"transfer of assets"* is defined as when Gibraltar loses the right to tax the transferred assets, while the assets remain under the ownership of the same taxpayer.

For the purposes of the above, *"taxpayer"* means an ordinarily resident company that has assessable income under the provisions of the Income Tax Act 2010, or a permanent establishment of such company resident outside Gibraltar.

Tax would be applied at the applicable corporate rate on the difference between the market value of the transferred assets at the time of exit of the assets, minus their value for tax purposes.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form through a company. However, a growing number of local businesses are operating as sole traders.

3.2 Individual Rates and Corporate Rates

There are no rules that prevent individual professionals from earning income in a corporate form.

Whilst corporate rates (generally 15%) are lower than individual rates (effective rate of 26%), if the individual then draws any income out of the corporation then this income would be taxable in the hands of the individual at the individual rates (either under the PAYE system, in relation to a salary, or as a dividend payment).

Gibraltar also has specific legislation regarding benefits in kind, which are treated as gains from employment and include:

- expense payments;
- vouchers and credit tokens;
- living accommodation;
- cars, vans and related expenditure;
- loans to employees, directors and shareholders; and
- removal benefits and expenses.

There is also a catch-all provision for other benefits that are not specifically listed above.

The employer may opt to pay the tax on the benefits on behalf of an employee at the following rates:

- 0% where the total annual value is less than GBP250;
- 20% where the value is between GBP250 and GBP15,000; and
- 29% where the value is over GBP15,000.

3.3 Accumulating Earnings for Investment Purposes

There are no rules in place to prevent closely held corporations from accumulating earnings for investment purposes. It is important to note that there are anti-avoidance provisions under Gibraltar tax legislation, which the Commissioner of Income Tax may apply to transactions or arrangements he or she deems to be *"artificial or fictitious"*.

3.4 Sales of Shares by Individuals in Closely Held Corporations

In Gibraltar, there is no specific regulation for the sales of shares by individuals in closely held corporations. Individuals would be taxed in Gibraltar at normal individual rates on the receipt of dividends (minus the tax credit given for any Gibraltar tax incurred by a company) unless:

- the individual is not ordinarily resident in Gibraltar; or
- the dividends are paid out of profits on which no tax has been charged in Gibraltar to the extent that the amount of the dividend represents the distribution of such profits.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends are not taxed in Gibraltar if they are paid by a company whose shares are listed on a recognised stock exchange.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Gibraltar does not apply any withholding tax to interest, dividends and royalties.

4.2 Primary Tax Treaty Countries
Gibraltar and the UK signed a tax treaty (based on the OECD model) in October 2019, which came into force in April 2020.

An international tax agreement between the UK and Spain concerning Gibraltar (with the UK acting in its position as the recognised state responsible for Gibraltar's external relations) was signed in March 2019, and came into force in March 2021.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents
It is too early to comment on whether local tax authorities will challenge the use of treaty country entities by non-treaty country residents, as the two agreements listed in **4.2 Primary Tax Treaty Countries** have only recently come into force.

4.4 Transfer Pricing Issues
The general anti-avoidance rule in the Income Tax Act should be interpreted in the manner that best secures consistency with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and other documents designated as comprising part of the transfer pricing guidelines.

4.5 Related-Party Limited Risk Distribution Arrangements
At present, there is no legislation in Gibraltar that governs the use of related-party limited risk distribution arrangements for the sale of goods or provision of services.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards
See **4.4 Transfer Pricing Issues**.

4.7 International Transfer Pricing Disputes
At this moment in time, it is too early to tell whether any international transfer pricing disputes will be resolved through double tax treaties and mutual agreement procedures, as Gibraltar's tax treaties have only been entered into recently (see **4.2 Primary Tax Treaty Countries**).

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled
Gibraltar has limited application of specific transfer pricing mechanisms, so the compensating adjustments allowed/made when a transfer pricing claim is settled are unclear.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations
Local branches of non-local corporations are not taxed differently to local subsidiaries of non-local corporations – the local branch or subsidiary would be liable to tax in Gibraltar on any assessable income that is accrued in and derived from Gibraltar (see **2.1 Calculation for Taxable Profits**).

5.3 Capital Gains of Non-Residents
Gibraltar does not have any capital gains tax.

5.4 Change of Control Provisions

A change of control of a local entity that owns Gibraltar real estate would trigger stamp duty and property fees (see **2.8 Other Taxes Payable by an Incorporated Business**).

A change in control could result in tax losses not being available for set-off against future profits, provided there is also a major change in the nature and conduct of the business (see **2.4 Basic Rules on Loss Relief**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

This is not applicable in Gibraltar.

5.6 Deductions for Payments by Local Affiliates

The Commissioner of Income Tax does not apply a specific standard in allowing a deduction for payments by local affiliates for management and administrative expenses by a non-local affiliate. However, if the Commissioner regards a company's expenses with a connected party as a means to reduce the company's tax liability, they may apply restrictions on the deduction of said expenses. This restriction may be imposed against 5% of the gross turnover of the company or 75% of the pre-expenses profit, whichever is lower.

There is also a restriction on head office expenses incurred for the common purpose of a branch, at 5% of the branch turnover.

5.7 Constraints on Related-Party Borrowing

There are no specific rules regarding financing operations between related parties, but limits on interest payments could be made (see **2.5 Imposed Limits on Deduction of Interest**).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Subject to the CFC rules (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**), Gibraltar follows the territoriality principle, meaning that only Gibraltar-sourced income is subject to taxation in Gibraltar (see **2.1 Calculation for Taxable Profits**).

6.2 Non-Deductible Local Expenses

Local expenses attributable to exempt foreign income would not be deductible for tax purposes.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by a company from another company are exempt from tax.

6.4 Use of Intangibles by Non-Local Subsidiaries

Generally, intangibles developed by local companies can be used by non-local subsidiaries in their business without incurring corporate tax in Gibraltar. However, if the Gibraltar company is in receipt of income in respect of the non-local subsidiaries' use of such intangibles, it may be deemed royalty income and would be subject to taxation in Gibraltar.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

CFC rules have been introduced, under which the non-distributed income of a company or permanent establishment arising from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage must be included as income of the taxpayer for that tax period.

In order for an entity or permanent establishment to be considered a CFC under the Regulations, two conditions must be satisfied:

- firstly, in the case of an entity, the taxpayer must by itself or together with its associated enterprises hold a direct or indirect participation of more than 50% of the voting rights or capital, or must be entitled to receive more than 50% of the profits of that entity; and
- secondly, the actual tax paid on its profits by that entity or permanent establishment is lower than the difference between the tax that would have been charged on the entity or permanent establishment in accordance with the Income Tax Act and the actual tax paid on its profits.

An arrangement or series of arrangements is regarded as non-genuine under the Regulations to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risk that generates all or part of its income if it were not controlled by a company where the significant people functions that are relevant to those assets and risks are carried out and are instrumental in generating the CFC's income. Where there is such a non-genuine arrangement, the income to be included will be calculated in accordance with the arm's length principle.

In order to ensure that there is no double deduction, the following applies:

- where the entity distributes profits to the taxpayer, and those distributed profits are included in the assessable income of the taxpayer, the amounts of income previously included as income of the taxpayer shall be deducted from the income of the taxpayer when calculating the amount of tax due on the distributed profits;
- where the taxpayer disposes of its participation in the entity of the business carried out by the permanent establishment, and of any part of the proceeds from the disposal previously having been included in the income of the taxpayer, that amount shall be deducted from the income of the taxpayer when calculating the amount of tax due on those proceeds; and
- the Commissioner of Income Tax shall also allow a deduction of the tax paid by the entity or permanent establishment in its state of residence or location from the tax liability of the taxpayer in accordance with Section 37 of the Income Tax Act.

Entities or permanent establishments with accounting profits of no more than EUR750,000 and non-trading income of no more than EUR75,000, or those whose accounting profits amount to no more than 10% of their operating costs for the tax period, will not be considered CFCs under the Regulations.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no rules applicable to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

There is no capital gains taxation in Gibraltar.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The overarching anti-avoidance provision in place in Gibraltar relates to the principle of *"artificial and fictitious"*, as defined in the Income Tax Act, in relation to transactions that are seen as inauthentic and not real. The Income Tax Act also refers to transactions that are not consistent with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Gibraltar does not have a regular routine audit cycle. It is possible for the Income Tax Office to raise queries, but this normally occurs on an informal basis.

9. BEPS

9.1 Recommended Changes

Gibraltar joined the OECD inclusive framework on BEPS as a full member in 2019. As a result, various BEPS recommended changes have already been implemented, including country-by-country reporting and mandatory disclosure regimes.

9.2 Government Attitudes

Gibraltar is committed to transposing further measures against BEPS as they are co-ordinated, as well as further measures against double non-taxation.

On 31 December 2024, legislation was passed implementing the Pillar Two global minimum tax rules in Gibraltar. The legislation confirms a 15% domestic minimum top-up tax, which would apply to multinational enterprise groups and domestic groups meeting the revenue threshold for financial years starting on or after 31 December 2023. The legislation has also introduced an income inclusion rule that would apply for financial years starting on or after 31 December 2024.

9.3 Profile of International Tax

Although Gibraltar is a small country, tax has a high public profile in the jurisdiction. This is a result of certain sectors of Gibraltar's economy having a global reach, such as the gaming sector and the growing fintech and distributed ledger technology framework.

This is likely to influence the implementation of BEPS recommendations, as Gibraltar looks to remain fully compliant with international tax obligations to ensure equivalent standards with the UK and the EU.

9.4 Competitive Tax Policy Objective

The policy of successive Gibraltar governments has been to provide a competitive tax environment that is fully compliant with international best practice. Gibraltar has always been an early complier with OECD and other international initiatives, and that policy is expected to continue.

9.5 Features of the Competitive Tax System

Gibraltar has a competitive tax system in place that includes the following:

- a partial territorial tax system – companies are only taxed on activities located in Gibraltar;
- a low corporate tax rate of 15%;
- no VAT or sales tax;
- no capital gains tax;
- no withholding tax; and

- tax treaties and agreements with only the UK and Spain.

This is likely to continue to be balanced against any implementation of BEPS recommendations.

9.6 Proposals for Dealing With Hybrid Instruments

Gibraltar's implementation of hybrid instruments relating to the BEPS recommendations has focused primarily on the implementation of EU Directives focused on anti-tax avoidance.

Under Gibraltar law, payments under hybrid instruments and payments to associated hybrid entities will be disregarded where the deduction or payment benefits from a tax deduction in the payer's jurisdiction and is not taxed in the jurisdiction where the payment is received.

9.7 Territorial Tax Regime

Gibraltar's tax system is territorial in nature (see **2.1 Calculation for Taxable Profits**), and Gibraltar has interest deductibility restrictions in place (see **2.5 Imposed Limits on Deduction of Interest**).

9.8 Controlled Foreign Corporation Proposals

The OECD's Action Plan in respect of CFCs builds on the existing fundamental principles of residence-based taxation, which would not align with a traditional territorial basis of taxation. However, Gibraltar has transposed the Anti-Tax Avoidance Directive (ATAD), which includes CFC rules (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**). Therefore, while Gibraltar's tax system is largely territorial, it is more hybrid in nature to accommodate domestic goals and international standards. Gibraltar is expected to take a similar approach to any future CFC proposals.

9.9 Anti-Avoidance Rules

It is highly unlikely that any double tax convention limitation of benefit or anti-avoidance rules will have any impact in Gibraltar, at least for the foreseeable future.

9.10 Transfer Pricing Changes

Gibraltar has not yet implemented the transfer pricing changes introduced by BEPS.

In terms of intellectual property taxation, royalties received/receivable by Gibraltar companies are taxed at 15%.

9.11 Transparency and Country-by-Country Reporting

Gibraltar has introduced legislation on country-by-country reporting and the automatic exchange of information, indicating the country's approval of enhancing transparency in combatting BEPS.

9.12 Taxation of Digital Economy Businesses

Gibraltar has not implemented any changes in relation to the taxation of transactions effected or profits generated by digital economy businesses operating largely outside of Gibraltar, nor have any been discussed or proposed.

9.13 Digital Taxation

Gibraltar has not yet stated its position in relation to digital taxation, and no proposals have been put forward.

9.14 Taxation of Offshore IP

Gibraltar does not have any specific provisions dealing with the taxation of offshore intellectual property that is deployed within Gibraltar. As a result, it does not impose any withholding tax or tax by direct assessment on the IP owner. It is important to stress the Commissioner's powers regarding expenses incurred with a connected party (see **5.6 Deductions for Payments by Local Affiliates**).

GREECE

Law and Practice

Contributed by:
Maria Zoupa, Daphne Cozonis and Elina Belouli
Zepos & Yannopoulos

Contents

Zepos & Yannopoulos is a leading Greek law firm known for its long heritage, legal acumen and integrity. It offers comprehensive legal and tax services, with a focus on multinational companies and high-net-worth individuals. The firm's tax and accounting practice is acknowledged as the largest and most specialised of any law firm in Greece, and offers the full range of tax services on both a transactional and ongoing basis. Areas covered include business tax advice and compliance, finance and capital markets taxation, international tax and taxation of M&A, real estate taxation, tax controversy and litigation, transfer pricing, VAT, indirect tax, and customs.

Authors

Maria Zoupa heads Zepos & Yannopoulos' corporate tax advisory and compliance team. She advises multinationals on the full spectrum of corporate and international tax matters relevant to their Greek business. Maria frequently advises clients on tax compliance aspects, assisting them in determining tax risks and remediation measures, in addition to handling corporate and international tax disputes. She is also active in M&A, assisting clients with tax due diligence, negotiations, and structuring of transactions. Maria further specialises in energy taxation and has accumulated extensive experience in tax matters related to the acquisition and operations of businesses active in the energy industry.

Daphne Cozonis is a partner at Zepos & Yannopoulos, where she specialises in corporate and international taxation, with a particular focus on the financial and insurance sector, as well as on finance and capital markets transactions. She has more than 25 years' experience of advising clients on a broad range of tax issues, such as private equity acquisitions, structured finance, funds, corporate restructurings, and complex corporate taxation matters. Daphne has an LLM degree in corporate law from New York University.

Elina Belouli is a senior associate at Zepos & Yannopoulos, where she focuses on transfer pricing, business restructurings and corporate international tax. She frequently advises on compliance matters with regard to transfer pricing requirements and assists clients in addressing transfer pricing issues in Greece. Elina is experienced in the elaboration and implementation of business restructurings involving domestic and international clients alike. Before joining the firm, Elina was employed by the EC Directorate-General for Taxation and Customs Union (DG TAXUD), where she participated in infringement cases concerning direct taxation in Greece, Cyprus, Luxembourg, Portugal and the UK.

Zepos & Yannopoulos

280 Kifissias Ave.
152 32 Halandri
Athens
Greece

Tel: +30 210 6967 000
Email: info@zeya.com
Web: www.zeya.com

ZEPOS & YANNOPOULOS

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Greece most commonly adopt the forms of:

- a *société anonyme* (*Ανώνυμη Εταιρεία*, or AE);
- a limited liability company (*Εταιρεία Περιορισμένης Ευθύνης*, or ΕΠΕ); or
- a private company (*Ιδιωτική Κεφαλαιουχική Εταιρεία*, or ΙΚΕ).

All of these forms of companies are referred to as *"capital companies"* (*κεφαλαιουχικές εταιρείες*). One of the features that distinguishes them from partnerships is that the liability of their shareholders or members is limited. Corporations and partnerships alike are taxed as separate legal entities.

Large companies usually take the form of an AE, which – unlike the ΕΠΕ and ΙΚΕ – is subject to a minimum capital requirement (EUR25,000 as of 1 January 2019). The popularity of the ΙΚΕ form for SMEs has risen in recent years, as it offers a more flexible structure compared to an ΕΠΕ. SMEs engaged in service provision and family businesses often take the form of a general partnership (*Ομόρρυθμη Εταιρεία*, or OE) or limited partnership (*Ετερόρρυθμη Εταιρεία*, or EE).

1.2 Transparent Entities

In general, business entities are not transparent. Exceptions include Greek Venture Capital Mutual Funds (ΑΚΕΣ) and Greek Alternative Investment Funds (ΟΕΕ) (upon a relevant election).

The tax of Greek undertakings for collective investment in transferable securities (ΟΣΕΚΑ) is calculated as a percentage of their net assets, and exhausts the tax liability of the undertaking and its shareholders.

The tax of Greek real estate investment companies (ΑΕΕΑΠ) is calculated as a percentage of the average fair market value of their investments. This tax also exhausts the tax liability of the undertaking and its shareholders.

1.3 Determining Residence of Incorporated Businesses

Subject to the operation of double taxation treaties, incorporated businesses are deemed to be resident in Greece if:

- they are formed in accordance with Greek law;
- their registered seat is in Greece; or
- the place of their effective management is in Greece.

The place of effective management is determined on the basis of facts and circumstances, with particular consideration being given to the places where:

- day-to-day business is undertaken;
- strategic decisions are adopted;
- annual shareholders', board of directors' and other executive meetings are held;
- books and records are kept; and
- the directors' place of residence.

The place of residence of the majority shareholders may potentially be considered. The rules on residence do not apply to certain companies operating under special shipping regimes.

1.4 Tax Rates

The ordinary income tax rate is 22% (down from 24% in 2020), and is applicable to:

- businesses incorporated in the form of an AE, ΕΠΕ or IKE;
- partnerships in the form of an OE or EE; and
- all other legal persons and entities defined in the Income Tax Code, including local permanent establishments (PEs) of non-resident entities.

This does not apply for credit institutions that have opted to apply a scheme to enhance capital adequacy by converting deferred tax assets into deferred tax credits against the Greek state, which are taxed at a rate of 29% for the relevant years.

Business income of individuals who are directly engaged in a business forms part of their taxable basis, including any salary and pension income, and is taxed at a progressive scale ranging from 9% to 44%. Individuals who transfer their tax residence in Greece for such purpose may benefit from reduced tax rates or exemptions for seven years.

Reduced tax rates are available to companies formed as AEs or ΕΠΕs on certain non-taxed profit reserves formed under growth incentive laws if converted into share capital. Prerequisites for this include, in certain cases, restrictions to ensure the continuity of the relevant company and the preservation of capital.

Each year businesses are obliged to prepay a certain percentage of their income tax due in the form of an income tax prepayment. The applicable percentages are 80% for legal persons and entities, 100% for banks and 55% for business income earned by individuals.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable profits of incorporated businesses are based on accounting profits, subject to the special rules and classifications provided for in the income tax legislation. In general, taxable profits equate to the aggregate of revenues after subtracting business deductible expenses, depreciation allowed for tax purposes, and certain provisions for bad debts.

Additionally, in order to be deductible, all business expenses must have:

- been actually incurred;
- been incurred for business; and
- been properly recorded in the books and supported by adequate documentation.

As of 2023 a minimum level of imputed taxable profits, calculated in accordance with a combination of parameters set in the law, is applicable annually in respect of businesses conducted by individuals.

Non-Deductible Expenses

Categories of business expenses that are not deductible are explicitly defined, and include:

- provisions (except specifically allowed bad debt provisions);
- penalties and fines;
- payments for goods or services exceeding EUR500 if not effected through banking transactions;
- unpaid social security contributions;
- payments to persons resident in the jurisdictions deemed non-co-operative or preferential

unless the taxpayer proves that there is no tax avoidance or evasion; and
- certain other types of expenses.

Payments to residents in EU and EEA jurisdictions that are deemed to be preferential are deductible in principle. Specific limitations apply to the deduction of interest.

Taxable Profits

As a general rule, the profits of incorporated businesses are taxed on an accruals basis. Any profits that are distributed or capitalised without having previously been taxed are subject to tax upon such distribution or capitalisation.

2.2 Special Incentives for Technology Investments

R&D Expenses and Patents

Subject to a governmental procedure, a super-deduction of an additional 100% of certain R&D expenses – including any depreciation of machinery and equipment used for R&D purposes – is available at the time such expenses are realised. R&D expenses paid to non-associated, registered startups and certain research and innovation centres and universities specified by law are tax deductible by an additional 150%. If they are incurred by micro, small and medium-sized enterprises, they are tax deductible overall by an additional 200% on condition that they correspond to more than 20% of total expenses incurred in the same year; if, within a fiscal year, they exceed the average of the corresponding expenses for the two prior years, they are tax deductible by an additional 215%.

Profits derived by a business from the sale of assets produced by deploying self-created patents internationally recognised in its name – and from services provided with the use of its own patents – are exempt from full corporate income tax for a period of up to three fiscal years from the year in which the relevant revenues were first accrued and from 10% of the corporate income tax for the ensuing period of seven consecutive years. The relevant profits are taxed when they are distributed or capitalised.

Certain instruments and equipment used for R&D that are decided by the government can be amortised at a 40% rate annually.

Special Regime of Law 89/1967

The cost-plus regime of Law 89/1967, which provides a special framework for the establishment in Greece of shared-services centres rendering certain services specified in the law to associated companies, includes within its scope marketing and consulting services, software development, IT support, data management and storage and computer-based call centres. The regime provides for the full deductibility of business expenses that combine to form the taxable gross revenues for income tax purposes after addition of a profit mark-up, which cannot be less than 5% and which is acknowledged in advance by the tax authorities. Eligibility under the regime presupposes annual expenditures of at least EUR100,000 and employment of at least four persons (one of whom can be part-time).

2.3 Other Special Incentives

The current EU-compliant framework for the establishment of private investment aid schemes for the country's regional and economic development focuses on 13 specific areas of business activities, including green transition and the digital and technological transformation of businesses. The law includes state grants in the form of tax exemptions for eligible investments.

EU-compliant tax incentives for the production of audio–visual content, the provision of ancillary services, and the development of source code for computer game software provide for a 30% deduction of eligible expenses (incurred in Greece) from taxable income.

Incentives for the creation of new jobs are also available and consist of a 50% super-deduction for the relevant social security contributions payable by employers, subject to a maximum limit specified in the law. Specific tax incentives, such as exemption from real estate transfer tax, are available to entities that acquire property and commence activities in special industrial zones and entrepreneur parks.

Green Incentives

Incentives for sustainable development include super-deductions for expenses or increased depreciation related to environmental protection – ie, in relation to zero or low emission vehicles or public transportation season tickets. Explicit deductibility for corporate income tax purposes of expenses related to corporate social responsibility (CSR) activities has also been introduced as an incentive for sustainable development.

Moreover, a super-deduction of an additional 100% of expenses relating to green economy, energy and digitalisation is available in respect of expenses incurred or fixed assets acquired in FY 2023–24 and FY 2024–25 by SMEs (except for those active in primary agricultural production, fishing and aquaculture).

Strategic Investments

During 2019, new legislation was introduced with the aim of streamlining the existing framework for attracting strategic investments in all sectors of the Greek economy through the grant of incentives. The rules define strategic investments as those that are capable of producing material quantitative and qualitative results when it comes to expanding employment, reconstructing production, and improving the country's natural and cultural environment. The legal framework was enhanced in 2021 to include additional categories of investments, such as flagship investments promoting green economy, innovation, technology, and the low-carbon economy and environmental footprint (if implemented until 31 December 2025). These investments are to be financed by the EU Recovery and Resilience Plan for Greece.

Strategic investments would mostly embrace innovation, competitiveness, comprehensive planning, the preservation of natural resources in the context of the circular economy, and high added value – notably in the business sectors of international trade and services. The tax incentives offered are:

- the stabilisation of the tax rate for 12 years;
- income tax deferral;
- accelerated depreciation; and
- beneficial taxation for expatriate executives.

Shipping Tax Regime

A tonnage tax regime applies in respect of ship-owning companies as well as companies chartering bare vessels (bareboat charterers) or companies leasing vessels (ship lessees). The tax is calculated on the basis of the capacity and age of the vessels and exhausts any further income tax obligation of the ship-owning company, bareboat charterer or ship lessee, as well as such entities' shareholders with regard to income arising from the operation and exploitation of the vessels.

As regards vessels under foreign flags, tonnage tax is imposed only in relation to those vessels that are managed in Greece by foreign companies that have established offices in Greece for such management or by companies established in Greece – in both cases, under a specially regulated regime. Under such regime, the income of such management companies is exempt from tax. In addition, vessels flying flags of EU or EEA member states can also be subject to the tonnage tax regime in respect of defined types of vessels, regardless of the place of management.

Greek companies and foreign companies that have established an office in Greece under the aforementioned special regime and engage in activities other than the management of vessels – for example, brokering in chartering, sale and purchase and building in respect of ships under the Greek or a foreign flag with a total tonnage of more than 500 gross registered tonnes – are subject to an annual contribution calculated on the basis of the amount of funds (in euros or other currency) that is required by law to be imported into Greece annually in order to cover their operating expenses.

Family Offices

A recently introduced regime offers tax incentives for the establishment in Greece of family offices managing and administering the wealth, assets and investments of Greek tax-resident individuals and their families. Qualifying family offices should incur annual expenditure of at least EUR1 million and should employ at least five employees. The taxable gross revenues of family offices are determined by adding a 7% profit mark-up on all costs incurred, thereby ensuring the full tax deductibility of the relevant costs. Services provided between the family office and its members fall outside the scope of VAT.

2.4 Basic Rules on Loss Relief

Tax losses incurred by the conduct of a business within a certain financial year can be carried forward to be offset against profits made during the next five consecutive years. Previously untaxed profits that are taxed as a result of their distribution or capitalisation cannot be offset against tax losses incurred in the relevant year. Special rules apply for the amortisation of losses arising from an exchange of bonds under the Greek PSI programme, as well as in respect of banks, financial leasing and factoring companies from specified debt write-offs and disposals of loans and credits.

Tax losses incurred abroad can neither be used to determine taxable profit in the same fiscal year nor carried forward – with the exception of tax losses arising from the conduct of business through permanent establishments in EU/EEA member states, provided that the relevant profits are not exempt from Greek income tax by virtue of a double taxation treaty between Greece and the relevant EU or EEA member state.

2.5 Imposed Limits on Deduction of Interest

According to a rule transposing part of the EU Anti-Tax Avoidance Directive into Greek domestic law, subject to a de minimis threshold of EUR3 million annually, *"exceeding borrowing costs"* are not deductible by local corporations and local PEs of non-resident entities to the extent that they exceed 30% of EBITDA – with a possibility to carry forward the non-deductible portion without any time limitation. *"Exceeding borrowing costs"* is defined as the amount by which the otherwise deductible borrowing costs of a company exceed taxable interest revenue and other economically equivalent taxable revenue.

Companies that are part of consolidated groups as per Greek Generally Accepted Accounting Practice (GAAP) may deduct all of their exceeding borrowing costs if the ratio between their share capital and total assets is equal to (or higher or lower by no more than) 2% of the group ratio, provided that the method of valuation of all assets and liabilities is the same as in the consolidated financial statements. These companies can also deduct exceeding borrowing costs up to the amount arising from application to their EBITDA of the group ratio of exceeding borrowing costs (in respect of lending from third parties) over group EBITDA.

The above-mentioned interest limitation rules do not apply to several types of financial undertakings, such as credit institutions, insurance companies, and specific institutions for occupational retirement. Regarding related-party transactions, this rule is applied after any transfer pricing adjustment.

Another restriction on the deduction of interest is that the portion of interest expenses corresponding to any rate exceeding the interest rate for credit lines to non-financial corporations referred to in the most recent Bulletin of Conjunctural Indicators of the Bank of Greece (as at the time of the loan) is not deductible. This limitation does not apply to interest on bank loans or bond loans, nor to interest paid to related parties.

2.6 Basic Rules on Consolidated Tax Grouping

There is no consolidated tax grouping regime in Greece.

2.7 Capital Gains Taxation

Capital gains from the disposal of assets (including shares in other corporations) are fully included in the taxable basis of corporations for income tax purposes in the financial year in which they are realised.

Greek legal persons and Greek PEs of non-resident EU/EEA legal persons are exempt from tax on capital gains arising from the disposal of shares in EU Parent–Subsidiary Directive-qualifying subsidiaries (see **6.3 Taxation on Dividends From Foreign Subsidiaries**) insofar as they hold at least 10% participation in those subsidiaries for a minimum holding period of 24 months. In addition, as of fiscal year 2025, Greek legal persons disposing of shares in qualifying non-EU subsidiaries (see **6.3 Taxation on Dividends From Foreign Subsidiaries**) and Greek PEs of non-resident, non-EU legal persons disposing of shares in non-Greek subsidiaries are exempt, under the same conditions, from tax on capital gains arising from such disposals.

Under a grandfather clause, losses arising from the transfer of shares are deductible for tax purposes: i) as of 1 January 2020 when they arise on the disposal of shares in qualifying EU subsidiaries; and ii) as of 1 January 2025 when they arise on a disposal of shares in qualifying non-EU subsidiaries, and in both cases they must be incurred up to 31 December 2026. Tax treatment applies to the extent that the losses were reflected in financial-statement valuations performed up to 31 December 2019 for qualifying EU subsidiaries and up to 31 December 2023 for qualifying non-EU subsidiaries, and also on condition, in both cases, that they are recorded in the taxpayers' books or are reflected in the financial statements audited by certified public accountants.

Capital gains derived from certain qualifying corporate reorganisations – for example, mergers, divisions, partial divisions, transfers of assets and exchanges of shares – are exempt from tax at the time of the relevant operation, subject to specific anti-abuse rules.

2.8 Other Taxes Payable by an Incorporated Business

Value Added Tax

Value added tax (VAT) is levied on virtually all transactions relating to goods and services. The standard VAT rate is 24%, although reduced rates are also available in certain cases (eg, for certain agricultural supplies, hotel accommodation, certain social services, etc). VAT is imposed on the total consideration received for the supply of goods or services, excluding the tax itself. VAT is not a burden for companies with the right to fully deduct input VAT.

Stamp Tax and Digital Transaction Duty

As of 1 December 2024, the stamp tax levied on documents issued or executed in Greece in respect of certain transactions that are not subject to VAT has been replaced by a Digital Transaction Duty, which is similar to stamp tax but is not imposed on the basis of territoriality. The most common transactions that are subject to Digital Transaction Duty are certain commercial leases, and loans and transfers of business concerns.

Digital Transaction Duty is applied at different rates, depending on the type of parties to a transaction. Business transactions falling under the scope of Digital Transaction Duty are, in principle, subject to a 2.4% rate applied on their monetary value. The rate for commercial leases is 3.6%.

Real Estate Transfer Tax and VAT Treatment

The transfer of real estate except new buildings is subject to real estate transfer tax, which is imposed on the higher between the so called *"objective value"* (which is an imputed value computed on the basis of a specific formula provided for in the law) and the actual transfer value agreed and which is borne by the purchaser. The tax rate is 3%. An additional 3% municipality tax is applied to the amount of the real estate tax, so that the overall tax burden adds up to 3.09%. Reduced rates of real estate transfer tax apply in certain corporate reorganisations, such as mergers.

Sales of new buildings by businesses are in principle subject to VAT at 24%. Between 2020 and 2025, the sale by businesses of buildings that would normally be subject to 24% VAT are exempt from VAT upon the filing of a relevant application. The exemption covers buildings that have been completed with building permits following 1 January 2006, as well as those that will be built by the end of 2025. Constructors who opt not to apply VAT on a sale waive the right to deduct the VAT on the construction cost. Any non-recoverable VAT can be deducted as an expense for income tax purposes.

Listed Shares Sales Tax

A transfer tax at the rate of 0.1% is levied on sales.

Banking Levy

An annual banking levy, known as the *"Law 128 contribution"*, applies on loans and credits granted by Greek and foreign credit institutions. The applicable rates depend on the type of credit, and range between 0.12% and 0.6%.

2.9 Incorporated Businesses and Notable Taxes

Unified Real Estate Tax

Incorporated businesses owning property rights on real estate located in Greece are subject to a unified real estate tax (*Ενιαίος Φόρος Ιδιοκτησίας Ακινήτων*, commonly referred to as ENFIA), which consists of a main and a supplementary tax. The main tax applies to each property separately and is calculated based on a formula that varies depending on the type and location of the real estate assets and a number of other parameters set in the law. The basis rate for the main tax (which is then multiplied by set coefficients, depending on the particular case) ranges from EUR0.001 to EUR16.20 per square metre, depending on the type of property.

The supplementary standard tax rate is set at 0.55%, although properties that are used by the taxpayer for its business activities are subject to a supplementary tax of 0.1%. Reduced rates or a number of exemptions are available for specific categories of properties and/or taxpayers (eg, real estate investment companies).

Special Real Estate Tax

A Special Real Estate Tax (*Ειδικός Φόρος Ακινήτων*) on real estate owned as of 1 January of each calendar year is imposed for the purposes of tackling the ownership of Greek real estate by non-transparent structures. It is imposed at a rate of 15% of the value of the real estate imputed for tax purposes. It is, in practice, not applicable to a great number of incorporated businesses owning Greek real estate, owing to a number of exemptions. Recent amendments to the Special Real Estate Tax legislation extend explicitly the regulated investment vehicle exemption to EU alternative investment funds that fall under the AIFM Directive.

Capital Accumulation Tax

A special tax is imposed on capital accumulation (*φόρος συγκέντρωσης κεφαλαίων*) at a rate of 0.2% applicable as of 12 December 2023. This applies to capital in cash or in kind contributed to legal entities of any form in the context of a capital increase. Such tax is not imposed on the capital accumulated upon the establishment of an entity. A duty of 0.1% on share capital is additionally imposed on companies taking the form of an AE in favour of the Greek Competition Committee.

Municipal Taxes and Taxes in Favour of Third Parties

Corporations holding or renting real estate may be liable to various municipal taxes/duties, such as cleaning and lighting duties which are collected through electricity utility bills. A property duty is levied by each municipality at a rate ranging from 0.025% to 0.035% on the objective value of immovable property located in the territory of the relevant municipality.

Municipality duties are also imposed for specific types of advertisements and advertising material.

A number of taxes in favour of third parties (such as the Lawyers' Pension Fund, universities, other funds and non-profit organisations) are applicable to incorporated businesses and other taxpayers, as the case may be.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses usually operate in corporate forms, as companies with legal personality. SMEs and family businesses often take the form of a general partnership or limited partnership. Operation as a sole proprietorship, with a minimum level of imputed taxable profits annually, is preferred only for very small-scale businesses.

3.2 Individual Rates and Corporate Rates

An individual professional is taxed at progressive tax rates, which – depending on the level of the income – may or may not lead to an effective rate that is lower than the combined effective rate of corporate taxation and tax imposed on profits distributions (where applicable). See **3.4 Sales of Shares by Individuals in Closely Held Corporations** for further details.

3.3 Accumulating Earnings for Investment Purposes

There are no tax rules that prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Greek tax-resident individuals are subject to 5% income tax on profits and dividends from closely held corporations. Profits of small partnerships (in the form of an OE or EE) keeping single-entry books are taxed only at company level, with no further income taxation on profit distributions at the level of partners. AE, ΕΠΕ and IKE companies cannot keep single-entry books.

Capital Gains

Capital gains of Greek tax-resident individuals derived from the sale of shares in closely held corporations are subject to 15% income tax. Gains on the sale of shares in closely held corporations are, in certain circumstances, calculated on an imputed manner set by the relevant rules on the basis of the level of the corporation's equity.

Capital gains realised by employees and shareholders as a result of transferring shares in non-listed start-up companies purchased through the exercise of stock option rights acquired within a period of five years of the company's establishment are subject to 5% capital gains tax on the condition that there is a minimum period of three years between the stock options grant and the disposal of the relevant shares. In the case of all other companies except start-ups, employees are subject to 15% capital gains tax on the condition that there is a minimum period of two years between the stock options grant and the disposal of the relevant shares. If minimum holding periods are not met, the relevant benefits are classified and taxed as employment income.

Capital Losses

Capital losses from sales of shares and other securities can be carried forward for five years to be set off against future capital gains deriving from similar transactions only.

Exemptions

Under domestic legislation, foreign tax-resident individuals are exempt from tax on capital gains derived from the sale of shares in Greek companies, provided they are resident in a jurisdiction that has a double-taxation treaty with Greece.

Withholding Tax

Foreign tax-resident individuals are subject to withholding tax on distributions of dividends and profits from Greek companies, subject to relief or reduced rates under double-taxation treaties.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The individuals' tax regime provided for dividends from shares in closely held corporations also applies to shareholdings in publicly traded corporations. Greek and foreign tax-resident individuals are exempt from income tax on gains derived from the sale of exchange-listed shares, except where they hold at least 0.5% of the total share capital and the shares have been acquired on or after 1 January 2009, in which case they are taxed at 15%. See **3.4 Sales of Shares by Individuals in Closely Held Corporations** for further details.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Under domestic legislation, entities or individuals that are not resident in Greece will be subject to income tax in Greece only by way of withholding on Greek-source interest, royalties and dividends. Any tax so withheld exhausts their Greek tax liability. This is provided that they do not have a PE in Greece to which the relevant profits would be attributable.

Under domestic law, 5% withholding tax applies to dividends. Dividends distributed to qualifying EU parent companies are exempt from any withholding tax, provided that:

- the parent company participates in the subsidiary with a minimum holding of 10% in the capital or voting rights for at least 24 months;
- the beneficiary company receiving the dividend payment is included in the list of companies referred to in Annex I Part A of the EU Parent–Subsidiary Directive;
- the beneficiary company is tax-resident in an EU member state and, under the terms of an income tax treaty concluded with a third state, is not considered resident for tax purposes outside the EU; and
- the beneficiary company is subject to one of the taxes listed in Annex I, Part B of the Directive (without the possibility of an option or of being exempt) or to any other tax that may be substituted for any of those taxes.

Until completion of the minimum holding period, a bank guarantee for the amount of withholding tax that would otherwise be due can be deployed instead of payment of the withholding tax and a posterior refund claim. A special anti-avoidance rule prohibits the withholding tax exemption on the above-mentioned qualifying dividend payments if the exemption is claimed in the context of artificial arrangements that are not put in place for valid commercial reasons reflecting economic reality but, rather, are aimed mainly at obtaining a tax advantage.

Under domestic law, 20% withholding tax applies on Greek-source royalties and 15% withholding tax applies on Greek-source interest.

Interest and Royalties

Interest and royalties paid to qualifying EU associated companies are exempt from any withholding tax, provided that:

- the beneficiary company receiving the interest or royalties participates in the payor with a minimum holding of 25% in the capital or voting rights for at least 24 months, or the payor participates in the beneficiary company with the same minimum holding, or a third company participates in the payor and the beneficiary with the same minimum holding;
- the beneficiary is included in the list of companies referred to in the Annex to the EU Interest Royalties Directive;
- the beneficiary is tax-resident in an EU member state and is not considered as resident for tax purposes outside the EU under the terms of an income tax treaty signed with a third state; and
- the beneficiary company is subject to one of the taxes listed in the EU Interest Royalties Directive (without the possibility of an option or of being exempt) or to any other tax that may be substituted for any of those taxes.

Until completion of the minimum holding period, a bank guarantee for the amount of withholding tax that would otherwise be due can be deployed instead of payment of the withholding tax and a posterior refund claim.

Further Exemptions

Withholding tax exemptions on the above-mentioned types of payments also apply – under similar conditions to those applicable to payments to EU qualifying companies – in respect of payments to beneficiaries in Switzerland.

Interest payments effected as of 1 January 2020 towards non-resident individuals and legal entities that do not maintain a permanent establishment in Greece are exempt from interest withholding tax insofar as such interest is on corporate bonds listed on trading venues within the EU or on organised markets outside the EU, provided such markets are regulated by an authority accredited by the International Organization of Securities Commissions.

Treaties

Domestic withholding tax rates on interest, dividends and royalties can be reduced or eliminated if payments are made to beneficiaries in income tax treaty jurisdictions.

Greece currently has income tax treaties in force with countries throughout the world. All tax treaties follow the OECD Model in principle, except for those concluded with the USA and the UK.

4.2 Primary Tax Treaty Countries

Based on data from the Bank of Greece, the primary tax treaty countries that foreign investors use to make investments in local corporate stock or debt are Germany, France, Switzerland, Cyprus, Italy, the USA, Luxembourg, the Netherlands, and the UK.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Where appropriate documentation (including a tax residence certificate signed by the competent foreign authorities) is available, in practice, it has been rare up to now for local tax authorities to challenge the use of treaty-country entities by non-treaty country residents. In any event, on 26 January 2021, Greece ratified the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), which came into force on 1 July 2021 and has adopted the principal purpose test in order to prevent arrangements and transactions whose main purpose is to obtain the benefits of the tax treaty.

4.4 Transfer Pricing Issues

Taxable profits are subject to readjustment in the case of transactions between related parties that are not in line with the arm's-length principle. An individual or legal entity participating directly or indirectly in the capital or management of an enterprise is defined as a related party for transfer pricing purposes. A 33% threshold applies with regard to the minimum direct or indirect participation in the capital or the exercise of voting rights, above which entities are defined as related. The exercise of managerial control or decisive influence over an enterprise is also used as a means to define related parties, irrespective of any participation in the controlled enterprise's capital or voting rights.

A Greek taxpayer may request a corresponding adjustment to its profits following a primary transfer pricing adjustment in the context of a tax audit of an associated entity taxable in Greece. A relevant tax refund or set-off is only effected on the condition that the associated entity has paid the tax assessed as a result of the primary adjustment.

Most transfer pricing disputes revolved around the applicability of more lenient penalties for failure to comply with transfer pricing documentation requirements and the burden of proving compliance with the arm's-length principle. This latter issue has evolved over time. Administrative courts have confirmed that – as long as the taxpayer produces the appropriate transfer pricing documentation – the burden lies with the tax authority, which is required to justify any challenge made to the taxpayer's position.

More recently, the role of each related party in the development, enhancement, maintenance, protection and exploitation (DEMPE) functions of intangible assets has become increasingly significant to the scrutiny of related-party transactions between domestic licensees and foreign IP-holding entities. Matters concerning the reliability of comparable data (particularly in cases of financial transactions), the definition of related parties, the use of full or interquartile range, the reasonableness of comparability adjustments and – more recently – the appropriateness of selected transfer pricing methods and allocation keys for expenses have also been coming into the discussion.

As tax authorities focus increasingly on transfer pricing, the discussions surrounding it are expected to increase.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited risk distribution arrangements are extensively applied by multinational enterprises doing business in Greece. Tax authorities are carefully scrutinising these arrangements in the context of transfer pricing audits and primarily focusing on whether the return of the local entity can be considered consistent with the arm's-length principle following in-depth reviews of its functional and risk profile.

The reliability of comparables is also challenged in this context. In some instances, the tax authorities challenge the selection of the transfer pricing method or of the tested party.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The current legal framework fully endorses the arm's-length principle, defined in Article 9 of the OECD Model and interpreted by the OECD Transfer Pricing Guidelines, following the revisions introduced as a result of Actions 8–10.

4.7 International Transfer Pricing Disputes

Greek tax authorities have been focusing increasingly on transfer pricing when auditing Greek taxpayers during the past decade. Considering the lack of extensive case law on transfer pricing issues, aggressive approaches are often witnessed on the Greek tax authorities' part.

As regards using *"new"* information received to re-open earlier years, this was somewhat impossible for the tax authorities until recently – given that earlier years were usually already time-barred (unless exceptional time limitation rules applied with regard to specific financial years). Lately, however, Greek tax authorities tend to focus on auditing more recent years. Combined with the fact that the finding of *"new"* information may lead to an extension of the prescription period to ten years for specific financial years, this could lead to the more frequent re-opening of previous years. In addition, the use of *"new"* information resulting from exchanges of information upon request has also been observed lately.

It should be noted that, in addition to the above-mentioned matters, the Greek tax authorities have focused on providing the procedural framework for MAPs and on aligning the domestic framework with the recommendations received in the context of the MAP Peer Review Reports (Stages 1 & 2). Until recently, however, the application of MAPs was rare and therefore the local tax authorities have yet to develop any consistent practice or view in this respect.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are allowed under Greek legislation. Increased scrutiny from the tax auditors should be anticipated insofar as downward adjustments are concerned.

Taxpayers may perform compensating adjustments upon filing their annual tax returns or upon filing amending tax returns within the standard five-year statute of limitation. Upon initiation of a tax audit, Greek law allows the submission of an amending tax return up to the time of notification of the relevant preliminary tax assessment to the taxpayer.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

In general, local branches of non-local corporations are not taxed differently to local subsidiaries of non-local corporations when it comes to their Greek profits. A tax on remittance of profits to the head office that applied previously has now been repealed. In practice, the deductibility of interest payments to the head office may sometimes be challenged by the tax authorities.

5.3 Capital Gains of Non-Residents

Capital gains of non-resident corporations on the sale of stock in local corporations are not subject to tax, provided that the stock is not held through a PE in Greece. Under a rule whose application has been suspended several times (and is still suspended until 31 December 2026), gains derived from the transfer of real estate property – as well as from the transfer of shares in companies that derive more than 50% of their value, either directly or indirectly, from real estate by individuals who are not engaged in business activities – are subject to capital gains tax at 15%. In view of the consecutive suspensions, it has not been clarified whether such rules may also apply to non-resident companies directly or indirectly transferring stock in local corporations deriving more than 50% of their value from Greek real estate.

5.4 Change of Control Provisions

Tax losses carried forward are forfeited if the direct or indirect participation in the capital or voting rights of a local company changes by more than 33% within a financial year, while at the same time – within the same or the next financial year – the local company changes its business activity in a way that affects more than 50% of its turnover when compared with the turnover prior to the change.

Tax losses are not forfeited if the company is able to prove that the activity change is grounded on reasons that are economically justifiable in the context of the company's business – for example, cost cutting, achieving economies of scale, or intercompany restructuring.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Currently, no formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services. Tax authorities can determine taxable income through indirect techniques – such as analysing the price-to-turnover ratio or cash position – and other techniques set out in the legislation.

Taxable profits are subject to re-adjustment in the case of transactions between related parties that are not in line with the arm's-length principle.

5.6 Deductions for Payments by Local Affiliates

Payments by local affiliates for management and administrative expenses incurred by a non-local affiliate may be disallowed if:

- they are not in accordance with arm's-length standards;
- they are not considered to serve the business purposes of the local affiliate; or
- they are not properly documented and recorded in the books reflecting the transactions of the relevant fiscal period.

Payments to persons residing in states deemed as non-co-operative or preferential are not deductible, unless the taxpayer proves that these expenses are incurred for real transactions and do not result in profit-shifting aimed at tax avoidance or evasion.

If the states in question are EU/EEA member states, payments to persons that are resident in such states are deductible in principle. The regimes that are deemed to be non-co-operative or preferential are set annually by means of governmental decision on the basis of criteria set in the law, including (for preferential regimes) the criterion of taxation of profits or gains at a rate that is equal to or less than 60% of the applicable Greek income tax rate for corporations.

5.7 Constraints on Related-Party Borrowing

There are no constraints relating specifically to related-party borrowing by foreign-owned local affiliates paid to non-local affiliates, apart from that interest must be in line with the arm's-length standard.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Local corporations are taxed on their worldwide income, with the exception of business income attributable to a PE in one of the few jurisdictions that has a double-taxation treaty with Greece that provides an exemption method. Any foreign tax paid can be credited against the Greek income tax payable, provided that the foreign tax does not exceed the Greek tax corresponding to such income.

6.2 Non-Deductible Local Expenses

There are no local expenses that are treated as non-deductible owing to exemptions on foreign income, in particular. Certain limitations on the deductibility of interest on loans used to finance participations that yield tax-exempt dividends and capital gains income apply equally to foreign and domestic income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries are included in the tax basis of local corporations for income tax purposes.

An underlying tax credit in respect of tax paid on the profits from which dividends are derived at the source state is allowed with regard to dividends sourced from countries with which Greece has signed a double-taxation treaty that provides for such a credit mechanism (eg, China, Cyprus and the UK).

Inbound dividends received by Greek companies from qualifying EU subsidiaries are exempt from income tax under the conditions detailed in **4.1 Withholding Taxes**.

Inbound dividends from qualifying non-EU subsidiaries are exempt from income tax as of the fiscal year 2025 under the following conditions:

- the distributing legal person must be a capital company according to the law of its country of establishment;
- the distributing legal person must not be established in a jurisdiction deemed non-cooperative;
- the distributing legal person must be subject to legal persons' income tax or other similar tax without the possibility of an option or of being exempt; and
- the taxpayer receiving the dividends must hold a participation of at least 10%, based on value or number in the share or equity capital or voting rights of the distributing legal person and such participation is maintained for at least 24 months.

Until completion of the minimum holding period, a bank guarantee of an amount equal to the amount of withholding tax that would otherwise be due can be deployed instead of payment of the withholding tax and a posterior refund claim.

The above-mentioned exemption from Greek income tax on dividends received by Greek companies from qualifying EU and non-EU subsidiaries applies to the extent that such profits are not deductible by the subsidiary. This amendment targets hybrid instruments and aims at preventing situations of double non-taxation due to mismatches in the tax treatment of profit distribution between the states in which the subsidiary and the parent company are situated. In addition, a special anti-abuse rule prohibits the tax exemption in case of an arrangement or series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances.

6.4 Use of Intangibles by Non-Local Subsidiaries

Gains or royalties derived from the transfer or licensing of an intangible developed by a local corporation to a non-local subsidiary are included in the taxable basis of the local corporation for income tax purposes. Transfers of intangibles between related parties due to business restructuring – whereby intangible assets or a transfer package consisting of functions, assets, risks and business opportunities are being transferred (whether within or outside Greece) – should be made in exchange for arm's-length remuneration and any gain is taxable.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Under Controlled Foreign Corporation (CFC) rules, which were recently revised to incorporate part of the EU Anti-Tax Avoidance Directive into Greek domestic law (along with the BEPS measures), local corporations can be taxed on the income of their non-local subsidiaries and PEs as earned. In accordance with such rules, profits earned by a CFC are added to the taxable profits of the local corporation, under the following conditions:

- the local corporation by itself – or together with its associated enterprises – holds directly or indirectly a participation of more than 50% in the voting rights, or owns directly or indirectly a percentage of more than 50% of the capital, or is entitled to receive more than 50% of the profits of the relevant CFC (legal person or entity);
- the actual corporate tax paid on the CFC's profits is less than 50% of the corporate tax that would have been charged on such profits in Greece; and
- 30% or more of the income before taxes accruing to the CFC falls within the following categories:
  - (a) interest or any other income generated by financial assets;
  - (b) royalties or any other income generated from IP;
  - (c) dividends and income from the disposal of shares;
  - (d) income from financial leasing and income from insurance, banking and other financial activities; and
  - (e) income from companies that undertake invoicing and realise income from sales and services and income from goods and services purchased from and sold to associated enterprises, adding no or little economic value.

CFC rules do not apply to companies or PEs resident in EEA member states, provided that such entities carry out a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by all relevant facts and circumstances. In such cases, the tax authorities bear the burden to prove the absence of a substantive economic activity.

In the case of distribution by a CFC of profits that are included in the taxable basis of the local corporation, any CFC income taxed in a previous fiscal year is deducted from the relevant taxable basis.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no uniform local rules related to the substance of non-local affiliates. Guidelines can be found on a case-by-case basis with regard to certain specific anti-avoidance provisions. In addition, national legislation transposing EU Directives must be interpreted also on the basis of the CJEU's case law. Factors that can be taken into account are local management, physical presence, full-time employees, active VAT number and taxation. Financial statements and information about the business organisation can also be taken into account, along with the other factors.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Gains on the sale by local corporations of shares in non-local affiliates are fully included in the taxable basis for income tax purposes, with the exception of gains on the disposal of shares in qualifying subsidiaries in respect of which legal persons are exempt under certain conditions (see **2.7 Capital Gains Taxation**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

A general anti-abuse rule exists under Greek legislation as part of the wider measures to combat tax evasion or avoidance. Such rule incorporates part of the EU Anti-tax Avoidance Directive into Greek domestic law.

The rule allows tax authorities – having regard to all relevant facts and circumstances – to ignore an arrangement or a series of arrangements that, having been put in place for the main purpose of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine. An arrangement is not considered genuine if it is not put in place for valid commercial reasons that reflect economic reality. In such cases, the tax liability is determined as the tax liability that would arise in the absence of such an arrangement.

In accordance with the relevant guidelines, the burden of proof is on the tax authorities. Moreover, no avoidance is considered to exist solely by reason of a taxpayer seeking to reduce its tax burden.

The rule has been relied upon at certain times by the tax authorities to assess taxes, and certain decisions in this respect issued by the Dispute Resolution Directorate of the Independent Authority for Public Revenues can be used for interpretation. No substantial relevant jurisprudence by the Supreme Court exists.

A specific anti-abuse rule applies in respect of tax-neutral corporate reorganisations such as mergers, share-for-share exchanges, spin-offs and demergers effected under the framework of the Income Tax Code. According to this rule, tax benefits are withdrawn in whole or in part where the principal objective (or one of the principal objectives) behind the reorganisation is tax evasion or avoidance.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Tax authorities can audit the accuracy of tax returns, as well as the general compliance of taxpayers with their tax obligations, on the basis of procedures provided for in the Tax Procedures Code currently in force. The State's right to assess taxes in addition to those deriving from a taxpayer's tax return is time-barred, in principle, and lapses after a period of five years from the end of the year in which a tax return is due to be filed (ie, effectively six years after the audited year).

There are a number of derogations from this principle, including cases of tax evasion, cases where the relevant taxpayer has not filed a tax return within the five-year period, and cases of emergence for the tax authorities of new data or new information that could not have come to their knowledge within the five-year period. In such cases, the prescription period is ten years in principle. Also, where the Greek tax authorities have requested information from foreign authorities, the right to assess taxes is time-barred to lapse one year after the receipt of the information.

The Greek tax authorities are obliged to publish annually the number of full and partial tax audits prioritised for the following year on the basis of risk-analysis criteria and other available information.

Taxpayers can challenge a tax assessment by filing an out-of-court administrative appeal against such assessment prior to filing a judicial appeal.

9. BEPS

9.1 Recommended Changes

Greece is largely compliant with the principles developed and the measures recommended by the OECD/G20 BEPS action plan. In addition, being an EU member state, Greece was bound to transpose into domestic law the EU Directives that implement OECD/G20 BEPS conclusions at an EU level.

Since the introduction of a new income tax code on 1 January 2014, Greece has implemented various measures in compliance with the BEPS principles (as also implemented by the EU) – for example, CFC rules, interest deduction limitations, rules neutralising the effects of hybrid mismatch arrangements, rules on the mandatory disclosure of potentially aggressive tax-planning arrangements and rules on reporting obligations of digital platform operators. Greece has also transposed into domestic law the EU Directives providing for the automatic exchange of information on cross-border tax rulings and advance pricing agreements between EU member states. In April 2024, Greece transposed the Pillar 2 Directive ((EU) 2022/2523) on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the EU into domestic law.

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9.2 Government Attitudes

In general, the Greek government fully endorsed the BEPS project from the outset and Greece is a member of the Inclusive Framework on Base Erosion and Profit Shifting. The allocation of taxing rights for MNEs to end market and source jurisdictions if Pillar One progresses may have a positive impact on fiscal revenues in Greece going forward.

9.3 Profile of International Tax

International tax has a high public profile in Greece, most notably with regard to transfer pricing and the general objective of transparency. Transfer pricing has become an area of primary focus, both in terms of public opinion and at the level of tax authorities. A fully dedicated team within Greece's Independent Authority for Public Revenue deals with the transfer pricing legislative framework, including the issuance of decisions on APAs and MAPs.

9.4 Competitive Tax Policy Objective

At this time, the primary focus in Greece is on the collection of taxes and the enhancement of attitudes towards tax compliance. Such measures do not appear to be conflicting with the BEPS outcomes. In any event, what should be ensured is that BEPS-related measures and anti-tax avoidance rules are not implemented by the tax authorities in an overly restrictive manner.

9.5 Features of the Competitive Tax System

There are no significant features of Greece's tax system that are particularly vulnerable to measures aiming to achieve the BEPS objectives, in particular. Also, as an EU member state, Greece is obliged to take all required actions in order for state aid to comply with EU rules.

9.6 Proposals for Dealing With Hybrid Instruments

As regards legislation for dealing with hybrid instruments, Greece has transposed into domestic law the amendments made to the EU Parent–Subsidiary Directive, in accordance with which dividends paid by EU-based qualifying subsidiaries are not taxed if such profits are not deductible by the subsidiary and are taxed to the extent that such profits are deductible by the subsidiary.

As mentioned in **9.1 Recommended Changes**, Greece has transposed the provisions of the EU Anti-Tax Avoidance Directive and – with effect from 1 January 2022 – of EU Directive 2017/952 amending the EU Anti-Tax Avoidance Directive as regards hybrid mismatches with third countries. Hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities, with the possible effect of a deduction in both states or a deduction of the income in one state without inclusion in the tax base of the other. The legislation lays down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome.

9.7 Territorial Tax Regime

Greece generally imposes tax on worldwide income, in the sense that it also exercises taxation rights in respect of the foreign-source income earned by Greek tax residents. Foreign tax residents are taxed in Greece under a territorial system – ie, they are only taxed on Greek-source income. It is notable that profits distributed by EU subsidiaries are exempt from corporate income tax in Greece, subject to specific requirements under the rules transposing the Parent–Subsidiary Directive.

Legal persons are exempt under conditions from tax on capital gains arising from the disposal of shares in certain qualifying subsidiaries (see **2.7 Capital Gains Taxation**). In such cases, apart from the generally applicable interest deductibility limitations, interest incurred as a result of financing the relevant participations may in certain circumstances not be deductible. The BEPS-related interest deducibility limitation of up to 30% of EBITDA operates subject to a de minimis threshold of exceeding borrowing costs set at EUR3 million annually, which makes it likely to affect a smaller number of Greek enterprises.

9.8 Controlled Foreign Corporation Proposals

As mentioned in **9.7 Territorial Tax Regime**, Greece does not have a territorial tax regime. Greek CFC rules, amended in line with the EU Anti-Tax Avoidance Directive, only capture profits of CFCs that fall under certain categories. When it comes to subsidiaries established in EEA member states, Greece does not have sweeper CFC rules. Even if such states are low-rate jurisdictions, the relevant subsidiaries and PEs are beyond the scope of the CFC rules if such entities carry on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by all relevant facts and circumstances.

9.9 Anti-Avoidance Rules

In the context of the MLI, Greece has adopted the principal purpose test rule in order to prevent the abuse of benefits derived from its tax treaty network. Greece has explicitly opted out of the Simplified Limitation of Benefits. As detailed in **7.1 Overarching Anti-Avoidance Provisions**, Greece incorporated a general anti-abuse rule into domestic law in 2014.

Both inbound and outbound investors may, therefore, be affected by a combination of the domestic law provisions, the anti-avoidance rules included in the double-taxation treaties, and the EU rules as transposed into domestic law. Consequently, new structures should be carefully reviewed from all of these perspectives.

9.10 Transfer Pricing Changes

As mentioned in **9.1 Recommended Changes**, prior to BEPS, the applicable legal framework for transfer pricing in Greece fully endorsed the arm's-length principle as defined in Article 9 of the OECD Model Tax Convention and interpreted by the OECD Transfer Pricing Guidelines. Currently, it also follows the revisions introduced as a result of Actions 8–10 of the OECD BEPS project. In general, no radical changes have taken place under the BEPS transfer pricing changes. As regards documentation, the required content of the local transfer pricing files is not yet fully aligned with BEPS Action 13 – particularly in relation to value chain analysis.

In the aftermath of BEPS, Greece has also introduced into domestic legislation the automatic exchange of CbC reports between EU member states, as well as among the signatories of the Multilateral Competent Authority Agreement on the Exchange of CbC Reports (concerning MNEs with an annual consolidated turnover exceeding EUR750 million). A relevant bilateral agreement has also been concluded with the USA. The first reporting year was the year commencing 1 January 2016. Surrogate reporting and local notification requirements have also been adopted.

Information on the ownership of intangible assets in the group, as well as related-party transactions for the licensing of rights on intangible assets, forms part of the transfer pricing documentation required under domestic law. As mentioned in **4.4 Transfer Pricing Issues**, the role of each related party in the DEMPE functions of intangible assets is an element of increasing significance in terms of the scrutiny of related-party transactions between domestic licensees and foreign IP-holding entities.

9.11 Transparency and Country-by-Country Reporting

Although transparency, CbC reporting and mandatory disclosure of potentially aggressive tax-planning arrangements are positive measures in terms of combatting tax avoidance, care should be taken that the relevant implementation rules and their interpretation by the tax authorities lead to the minimum possible compliance burden for enterprises. Where applicable, measures should be adopted to ensure that the relevant procedures do not lead to the unnecessary disclosure of commercial information.

9.12 Taxation of Digital Economy Businesses

Greece has not implemented any changes specifically relating to the taxation of transactions effected or profits generated by digital economy businesses operating largely from outside the jurisdiction. At a local direct taxation level, Greece has a legal framework regarding the taxation of short-term rentals in the sharing economy through digital platforms.

Greece has transposed Directive 2021/514/EU amending Directive 2011/16/EU on administrative co-operation in the field of taxation, towards imposing reporting obligations for digital platform operators with the aim of enabling tax administrations to assess and control gross income earned from commercial activities performed with the intermediation of digital platforms.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Greece imposes withholding tax on royalties paid to offshore owners in exchange for the use of IP. Rates can be reduced or eliminated if payments are made to beneficiaries in income tax treaty jurisdictions. Moreover, payments to persons residing in states deemed as non-co-operative or preferential are not deductible, unless the taxpayer proves that these expenses are incurred for real transactions and do not result in profit-shifting aimed at tax avoidance or evasion.

Trends and Developments

Contributed by:
Maria Zoupa, Ioanna Tapeinou and Diana Tsourapa
Zepos & Yannopoulos

Zepos & Yannopoulos is a leading Greek law firm known for its long heritage, legal acumen and integrity. It offers comprehensive legal and tax services, with a focus on multinational companies and high-net-worth individuals. The firm's tax and accounting practice is acknowledged as the largest and most specialised of any law firm in Greece, and offers the full range of tax services on both a transactional and ongoing basis. Areas covered include business tax advice and compliance, finance and capital markets taxation, international tax and taxation of M&A, real estate taxation, tax controversy and litigation, transfer pricing, VAT, indirect tax, and customs.

Authors

Maria Zoupa heads Zepos & Yannopoulos' corporate tax advisory and compliance team. She advises multinationals on the full spectrum of corporate and international tax matters relevant to their Greek business. Maria frequently advises clients on tax compliance aspects, assisting them in determining tax risks and remediation measures, in addition to handling corporate and international tax disputes. She is also active in M&A, assisting clients with tax due diligence, negotiations, and structuring of transactions. Maria further specialises in energy taxation and has accumulated extensive experience in tax matters related to the acquisition and operations of businesses active in the energy industry.

Ioanna Tapeinou is a partner at Zepos & Yannopoulos specialised in corporate and international taxation, with a particular focus on finance and capital markets. She has extensive experience in advising both domestic and foreign banks on matters of taxation. Ioanna has also gained experience in corporate taxation, advising multinational companies on a wide range of matters involving the assessment of tax risks, strategies for mitigating tax exposure and support in the course of tax audits. She has worked across sectors such as financial services (banking, real estate, insurance, investment services), Large Corporates (telecommunications, oil & gas, logistics) and Gaming (casinos, online gaming).

Diana Tsourapa is a partner at Zepos & Yannopoulos and specialises in corporate and international taxation. She covers a variety of tax matters, ranging from structuring investments and financing to negotiating tax clauses in M&A projects and dealing with specialised tax issues for different industry sectors. Diana also focuses on tax litigation, and has extensive experience handling tax audits in various tax matters such as income tax, transfer pricing, VAT, stamp duty and real estate taxes. She works closely with clients to determine the appropriate line of defence and represents them before tax authorities and courts of all instances, including the Supreme Administrative Court. Diana is admitted before the Court of Appeals.

Zepos & Yannopoulos

280 Kifissias Avenue
152 32 Halandri
Athens,
Greece

Tel: +30 210 6967 000
Email: info@zeya.com
Web: zeya.com

ZEPOS & YANNOPOULOS

Contributed by: Maria Zoupa, Ioanna Tapeinou and Diana Tsourapa, **Zepos & Yannopoulos**

Greece further modernised its tax legislation and digitalised procedures in 2024, which was a very productive year.

Key Tax Highlights of 2024

Continuing progress of the past decade in incorporating international tax standards in legislation and modernising tax systems and processes, Greece was very active in undertaking a variety of significant corporate tax legislative amendments in 2024.

Among other measures, Greece implemented two long-awaited changes to the core of its corporate taxation. First, it introduced a new law on tax-neutral transformations (Law 5162/2024) that replaced various incentive laws reinforcing tax certainty and further enhancing tax neutrality. Second, it abolished a very old and outdated set of rules on stamp duty, introducing the *"digital transaction duty"* (Law 5135/2024). It also expanded participation exemption rules to third-party subsidiaries and introduced further incentives for startups and regarding R&D that are critical for several business sectors, particularly technology and energy that have been booming in the past few years.

Greece has not been idle, either, in the area of important Directives, and transposed into Greek law Pillar II (Law 5100/2024) and the CRSD (Law 5164/2024). Guidelines are in the pipeline on all newly issued legislation in order to clarify any ambiguities.

In parallel, the Greek courts continue to shape the tax environment by applying a more thorough, fair and legally consistent approach in the interpretation of tax rules with regard not only to domestic legal science but also to international tax rules and precedents in their decision-making, aiming for alignment with international and EU standards. In this respect, although 2024 was not a year of specific milestone developments in terms of tax litigation, recent case law proves that even lower Administrative Courts are becoming more familiar with technical issues within the scope of accounting and transfer pricing or other corporate tax issues. Considering that Greece does not maintain specialised tax courts, corporate tax matters have always been highly complex for non-specialised judges, and have not been not given due consideration in certain situations. This change therefore represents significant progress in favour of a fairer outcome at lower-court level for taxpayers. That said, Greek tax auditors do have an increased bias towards the application of anti-avoidance rules, so it remains to be seen how the courts will react to this shift.

At the same time, Greece is building further on its ambitious plans to tackle tax evasion, among other ways through the real-time electronic transmission of fiscal documents to the tax administration. Electronic delivery notes have also been launched, and e-invoicing is in the pipeline following the EU Commission's recently issued favourable opinion.

In parallel, reforms are constantly being introduced to make the tax administration's structure more efficient, with the Independent Authority for Public Revenue announcing more measures to facilitate compliance. This has involved the digitalisation of all services, and a very significant reorganisation of tax departments in 2024, which, despite some practical discrepancies, is expected to generate significant benefits in terms of increased public revenue.

All in all, in 2024, Greece took steps to create a more competitive tax environment on par with the tax systems in force in other EU countries.

Contributed by: Maria Zoupa, Ioanna Tapeinou and Diana Tsourapa, **Zepos & Yannopoulos**

Below is a summary of key Greek corporate tax takeaways or changes for 2024.

Reform of Rules on Business Transformations

Greece had long maintained four different tax incentive laws on corporate transformations. For more than three decades, a system of parallel application of different regimes, although offering an opportunity for different tax incentives depending on the type of assets and the desired type of restructuring, had given way to many discrepancies. This was due to multiple overlaps that created confusion as to their applicability, but also intensified as of the major reform of corporate law on mergers that in many aspects diverged from certain of the tax regimes. The new law on transformations, Law 5162/2024, hereinafter *"the Law"* or *"the New Law"*, was thus introduced in 2024, aimed at unifying all regimes in a single set of rules that is now harmonised and in alignment with corporate law.

Law 4935/2022 on transformation incentives for SMEs and the special regime of Law 2515/1997 for credit institutions remain in effect, while transformations of real estate investment companies (REICs) are covered by the New Law.

The scope of the New Law covers domestic and cross-border mergers, divisions, partial divisions, spin-offs and legal form conversions (together referred to as *"corporate transformations"*), as well as share exchanges. Specifically, as regards spin-offs and share exchanges, the ambit is extended, and a foreign non-EU entity may be involved provided it is a tax resident in a country maintaining in force with Greece a Double Tax Treaty or Mutual Administrative Assistance Convention.

The New Law provides for tax neutrality on all above forms of transformations.

The New Law also provides the framework for the contribution of a sole proprietorship or a joint venture to another entity, and sets the tax treatment for Greek shareholders in the event of transformations or share exchanges of foreign tax-transparent companies.

The new regime applies on merger/division and similar plans or corporate resolutions for conversions and acquisitions of shares under a share exchange, which are published or re-published after the effective date of the Law, ie, 5 December 2024. Any transformations published before that date will be governed by the respective repealed regime chosen.

The basic features of the Law are that: i) there is no step-up of assets transferred; ii) it broadens tax neutrality for the contributing and receiving entities; and iii) it also clarifies exemption for the shareholders under a minimum holding period of the received shares. At the same time, for key definitions, it aligns with corporate law on the transformations to which it refers, thus eliminating the relevant discrepancies of the past. The Law, as compared to repealed regimes, does not set any strict restrictions in terms of the legal form, years of operation of the transformed entities or minimum capital. In more detail, the basic features that also constitute the main differences from the previous multiple regimes, are as follows.

- Valuation requirements should be determined under corporate law on mergers and company law.
- For the recipient entity, there is no increase in the taxable value of assets transferred to it, and any capital gains upon transformation are tax exempt.
- For the shareholder, or the contributing entity under a spin-off, shares acquired are recog-

nised at their fair market value. Capital gains are permanently tax-exempt, except for any portion corresponding to cash payment. Shares acquired in a share exchange retain their taxable value prior to the exchange. For tax neutrality to apply, a minimum two-year holding period is introduced for the shares acquired by the shareholder or the contributing entity. Otherwise, for example, in an earlier sale of the shares, their taxable value is equal to the value before the transformation. No such mention is made as regards the share exchanges.

- The permanent tax exemption of capital gains at the level of the shareholders is therefore subject to the minimum holding period.
- An important procedural change is that a no tax return is no longer required if real estate assets are among the assets of the transformed entities.
- An amendment is introduced to the definition of the sector for purposes of the partial division or spin-off. In particular, the Law defines the sector or branch of activity to be the entirety of the assets and liabilities of a division of a company or the designated assets along with the corresponding liabilities, that constitute, from an organisational perspective, an autonomous operation (ie, a unit capable of functioning independently, regardless of whether it generates income from its operations prior to the transformation). This definition is broader than that provided by the EU Tax Merger Directive and corporate law on mergers. However, further clarification is needed through the tax guidelines.
- Exemption from all other taxes applies, while a special anti-avoidance rule is also included in the law.

Expanded Intragroup Dividend and Participation Exemptions

Greece introduced an extended scope of application of the intragroup dividend tax participation exemption and the capital gains participation exemption in order to include the receipt of dividends and capital gains from the transfer of shares/titles in non-EU tax resident subsidiaries. This is on condition that the shareholder: i) is a capital entity; ii) is not located in a non-cooperative jurisdiction; iii) is subject to corporate income tax without the option for exemption; and iv) maintains the minimum participation ratio of the PSD – ie, 10% of the capital or voting rights of the Greek entity. The special anti-abuse rule capturing tax exemption of dividend income is now extended to relevant income stemming from subsidiaries located in third countries.

R&D Expenses Towards Startups, Research Centres and Universities Deductible at Higher Rates

R&D expenses paid towards registered startups and certain research and innovation centres and universities (provided that they are unrelated parties with the recipient of the project or service), are tax deductible increased by 150%, subject to the governmental approval procedure already set in the Greek income tax code.

Tax Exemption for Income Related to Internationally Recognised Patents

Greek income tax code provided that an income-tax exemption for profits of an enterprise arising from the exploitation of internationally recognised patents on its name was available for three consecutive tax years. By virtue of an amendment in 2024, patent incentives are extended and now additionally provide that the relevant enterprise may receive a 10% exemption of the payable tax amount corresponding to the aforementioned profits and for the subsequent seven consecutive years to the extent that the development of the patent can be linked and further substantiated with respective R&D expenses.

Stamp Duty Replacement by the *"Digital Transaction Duty"* (DTD Law 5135/2024)

The DTD Law has replaced a very old legislation on stamp duty. The major changes introduced in comparison to the prior regime are notably the following.

- Digital transaction duty orDTD will apply only on transactions restrictively enumerated under the provisions of the Law.
- The duty is levied on transactions, and not on written agreements – as was the case with stamp duty. Uncertainties arise when the law provides for contracts in some cases or for contracts under conditions where the ambit of the law is not clear ie, whether it intends to tax a contract even if the related transaction is not concluded.
- DTD Law abolishes the *"territoriality principle"* that prevailed under the stamp duty regime, according to which an agreement signed and executed outside Greece remained outside the scope of Greek stamp duty. DTD applies irrespective of the location where the transaction was executed or the contract was concluded, as long as at least one of the transacting parties is a tax resident of Greece or has a permanent establishment in Greece (if the transaction in question relates to the activity of that permanent establishment in Greece).

Further to the above, it is explicitly provided that the DTD will not apply on transactions that fall within the scope of the provisions of the Value Added Tax (VAT) Code, the Inheritance, Donation, and Parental Gift Tax Code, the Real Estate Transfer Tax, the Capital Concentration Tax, and the Special Banking Tax.

As per the general rules and subject to the provisions applicable to each transaction, the taxable person shall be the party who receives the monetary benefit or is the beneficiary of the transaction. When one of the counterparties is the State or a Government Entity which will be exempt from stamp duty, then the other party will be the taxable person. The taxable person is also in principle the person liable for the submission of the return and the attribution of the DTD. However:

- if one party is a foreign tax resident without a permanent establishment in Greece, then the other party becomes liable for the submission of the return and the attribution of the DTD; and
- if one party is an individual and the other party is a legal entity, then the latter shall be liable for the submission of the return and the attribution of the DTD.

The Law also explicitly allows the transacting parties to mutually decide how to allocate this expense without affecting the transaction's value.

DTD will apply on acts, transactions and contracts concluded or executed as of 1 December 2024. Transitional provisions are to be monitored for transactions that may have taken place prior to the entry into force of the DTD Law but have effects or are executed after that.

Conclusion

With regard to the above very active legislative *"production"* of 2024, it remains to be seen whether the much-needed guidelines will be issued on time to allow businesses to adapt to the new rules and to safeguard that tax authorities will implement them in line with the intention of the legislator, which is to facilitate business and promote tax certainty.

GUATEMALA

Law and Practice

Contributed by:
Eduardo Mayora, Juan Carlos Casellas, Juan Carlos Foncea Ferraté and Juan Pablo Gramajo
Mayora & Mayora, SC

Contents

Contributed by: Eduardo Mayora, Juan Carlos Casellas, Juan Carlos Foncea Ferraté and Juan Pablo Gramajo, **Mayora & Mayora, SC**

Mayora & Mayora, SC is a leading law firm in Central America established more than 55 years ago, with offices in Guatemala, El Salvador and Honduras (Tegucigalpa, San Pedro Sula and Roatán). The firm has a team of over 35 legal specialists who are ready to assist clients in a wide range of legal matters. Renowned for its excellence and ethical approach, the firm offers legal assistance in multiple practice areas. It has been the exclusive member for Guatemala of the largest network of private law firms in the world, Lex Mundi, since its inception in the early 1980s. The firm and its attorneys have been recommended by the most reputable and renowned legal ranking agencies.

Authors

Eduardo Mayora is the regional managing partner of Mayora & Mayora and the son of the founder of the firm, Eduardo Mayora Dawe. He has been an attorney and notary since 1980, pursuing various postgraduate studies, including doctorates, in both legal and economic matters. A renowned Guatemalan jurist, his professional practice includes banking, financial, commercial, securities, arbitration, administrative and fiscal matters. He has also excelled in academia and opinion journalism, as a teacher and lecturer at a national and international level and was dean of the faculty of law at Francisco Marroquín University. He has been a board member of banking institutions, trade associations, NGOs and international associations.

Juan Carlos Casellas specialises in tax matters (advisory and litigation) and has achieved successful outcomes in many highly complex cases. He has provided tax advice to clients such as Avianca and Ingenio Palo Gordo. Before joining Mayora & Mayora, he was legal adviser to the Superintendency of Tax Administration (SAT) and consultant to the Constitutional Court of Guatemala, as well as a researcher in tax law at the University of Salamanca. He has been a professor of tax law at several universities, both in undergraduate, master's and doctoral studies. He has also served as president of the Latin American Institute of Tax Law, the only Guatemalan lawyer to have held such a position.

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Juan Carlos Foncea Ferraté has been with Mayora & Mayora since 2008 and has professional and academic expertise in the area of tax law, a discipline in which he obtained a master's degree from the International Tax Centre of the University of Leiden in 2014. His professional practice focuses on providing transactional and tax advice to local and foreign entities, as well as on administrative law and public procurement matters. He also develops foreign investment policies for international clients, with an emphasis on tax structures, energy matters, identification of rights of way, and real estate analysis for project implementation.

Juan Pablo Gramajo has been an attorney and notary since 2009 and joined Mayora & Mayora in 2015. He is the associate in charge of knowledge management and the research specialist at the firm, having the chance to exchange know-how and experience with colleagues across all practice areas. He also handles labour and administrative matters. He holds a master's degree in history and a doctorate in law. Additionally, he has published academic articles on constitutional, philosophical and historical topics.

Mayora & Mayora, SC

15 Calle 1-04 Zone 10
Centrica Plaza
Tower 1
Office 301
Guatemala City
Guatemala

Tel: +502 2223 6868
Fax: +502 2366 2540/1
Email: info@mayora-mayora.com
Web: www.mayora-mayora.com/en

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Guatemala generally adopt a corporate form. Regardless of the corporate form adopted, each entity is taxed as a separate legal entity from its members, partners or shareholders. The Guatemalan Commercial Code regulates five basic types of corporate entity as follows:

- general partnership (*Sociedad Colectiva*);
- limited liability company or LLC (*Sociedad de Responsabilidad Limitada*);
- limited partnership (*Sociedad en Comandita Simple*);
- stock corporation (*Sociedad Anónima*); and
- stock corporation (*Sociedad Comandita por Acciones*).

Foreign corporations may organise branches or agencies.

The most commonly used corporate form is the stock corporation (*Sociedad Anónima* or SA). American corporations often adopt the corporate form of a limited liability company (*Sociedad de Responsabilidad Limitada* or SRL) for their subsidiaries, in order to achieve look-through tax treatment.

As mentioned above, the corporate entity is taxed separately and must obtain a separate taxpayer number.

A simplified and simpler corporate form, called *"for entrepreneurship"*, is now available for some specific corporate purposes, with lower capital requirements and fewer formalities. It can be organised as *"one-person company"*.

1.2 Transparent Entities

Under local law, there are no transparent entities for tax purposes. However, the Guatemalan LLC is commonly used by US corporations in order to achieve transparency before the US tax authorities.

1.3 Determining Residence of Incorporated Businesses

Guatemala has no double taxation treaties currently in force. However, Guatemalan Tax Law sets certain standards regarding residence. A corporation is considered *"resident"* for tax purposes if:

- it has been organised under Guatemalan law;
- the corporation is managed in/from Guatemala;
- the corporation has a tax or corporate seat in Guatemala;
- the corporation has its centre of economic interests located in Guatemala; and
- the corporation has a permanent establishment in Guatemala which would be subject to taxation in Guatemala (not the foreign corporation).

1.4 Tax Rates

The Guatemalan income tax system differentiates between certain kinds of income. However, corporate and individually owned businesses are taxed at the same rate of:

- the general statutory regimen of 25% on net income; or
- (at the election of the taxpayer for each fiscal year) at a flat rate of 7% or 5% on gross income (excluding exemptions).

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Annual income up to approximately USD46,800 is taxed at 5%, with a 7% tax rate being applied on the surplus above that amount.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

As a rule, profits are taxed based on the accounting profits subject to some adjustments. The most common tax adjustments are certain limits to deductible expenses. Profits are taxed on an accrual basis.

2.2 Special Incentives for Technology Investments

There are currently no incentives directly applicable to technology investments.

2.3 Other Special Incentives

There are currently tax incentives for the following industries:

- power generation using clean energy technology;
- manufacturing for exportation to foreign markets;
- BPO services online for foreign clients/users; and
- any other industries operating in a special economic development zone, qualified by the Free Trade Zone Administration (*"ZOLIC"*).

Generally, the tax incentives are:

- income tax exemption for up to ten years;
- exemption from or suspension of (as applicable) customs duties on the importation of machinery and capital goods related to the activity;
- exemption from or suspension of (as applicable) VAT on the importation of machinery and capital goods related to the activity; and
- exemption from VAT on the purchase of locally produced goods (for manufacturers that export to foreign markets).

2.4 Basic Rules on Loss Relief

Losses incurred during a fiscal year can only be offset against profits in the same fiscal year. No carry forward or carry back is therefore allowed. However, in the case of capital losses, these may be offset against capital gains only and carried forward for up to two years.

2.5 Imposed Limits on Deduction of Interest

Interest is deductible if paid in order to generate taxable income. Interest can only be deducted up to an amount equal to the interest rate determined by the Monetary Board, multiplied by the average net assets in any fiscal year, times three.

2.6 Basic Rules on Consolidated Tax Grouping

Group consolidation is not permitted for tax purposes. Each entity is considered a separate taxpayer.

2.7 Capital Gains Taxation

Capital gains are taxed at a rate of 10%. As a general rule, the taxable gain is determined by the difference between the book value or cost of acquisition (as applicable) and the sale price.

The cost of shares or participations is:

- the cost of acquisition; or
- the value of the shares or participations recorded by the issuing company.

The cost of goods and rights granted as a gift is the value attributed in the deed by which they are donated.

There are no exemptions or reliefs relative to capital gains. However, it is possible to deduct up to 15% of the transaction value as transaction costs.

Capital gains as a consequence of mergers and acquisitions are also taxable.

2.8 Other Taxes Payable by an Incorporated Business

Transactions are subject to VAT or to stamp tax depending on their nature. In general, goods, services and merchandise transacted on commercial markets are subject to VAT at a rate of 12%. The assignment of personal rights is generally subject to stamp tax at a rate of 3%.

Real estate sold on secondary markets is subject to stamp tax, but, if sold by a developer, it is subject to VAT. However, real estate assets contributed to business corporations are exempt if they were not previously contributed to a real estate developer company.

Securities transactions are generally exempt from VAT and stamp tax.

2.9 Incorporated Businesses and Notable Taxes

Creditable tax on revenues or assets (*Impuesto de Solidaridad* or ISO) is charged at a rate of 1% on the greater of:

- one-quarter of the annual gross income of the taxpayer; or
- one-quarter of the net assets of the taxpayer.

The amounts paid for this tax can be credited to the income tax of the taxpayer.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

There are two kinds of corporate tax, and the taxpayer may elect which one to apply. The taxpayer may elect to pay on gross income or on net income. If the former, the rates are 5% and 7% (see **1.4 Tax Rates**). If the latter, the rate is 25%.

Corporate tax is therefore not necessarily higher or lower than individual rates, although any corporation paying a marginal rate equal to or higher than 5% (if the gross annual income is less than USD48,000) or 7% (if the gross annual income is more than USD48,000) is expected to elect the flat tax option.

Compared with the rates applicable to individual professionals, the rates and taxable bases are roughly the same as the flat tax option for corporations and, presumably, higher than the net income option for corporations. That said, the administrative costs incurred in this latter case can be relatively higher for an individual professional than for a corporation.

Although not directed at this issue, the Code of Commerce does not allow any profession regulated by a bar association or a professional board to use a corporate structure. Additionally, at the time a taxpayer applies for a taxpayer number, it is required to provide the Tax Administration with a description of its business activity.

As of 8 April 2025, individual or corporate taxpayers deriving annual income of approximately GTQ496,000 (approximately USD65,000) or less are eligible for the special small taxpayer regime. Under this small taxpayer regimen taxpayers are subject to a flat 5% tax on their gross income. Their transactions will not be subject to VAT.

Similarly, as of 8 April 2025 two new regimes will be in effect: the *"Primary Regime"* and the *"Livestock Regime"*. These regimes are applicable to individual or corporate taxpayers in the agricultural and livestock business for supplying primary markets (for supplying local markets) with annual income equal or less than GTQ13 million (approximately USD1.6 million). Taxpayers registered under either of these regimes are subject to 1.5% tax levied on their gross sales and are exempt from VAT and income tax. However, dealers of livestock will be subject to a 10% tax rate on their profits.

These regimes are not applicable to persons selling to end consumers and to exporters. Exporters of goods related to these regimens will be subject to 2% tax on their gross exports.

3.3 Accumulating Earnings for Investment Purposes

There are no rules preventing closely held corporations from accumulating earnings for investment purposes. It is mandatory to create a 5% reserve every year, but when this surpasses 15% of the corporation's capital, it can be capitalised. Thereafter, the obligation to make a 5% reserve on earnings continues.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends are taxed at a final 5% withholding tax rate independently of the beneficiary's residence. Gains on the sale of shares are taxed at 10%. The taxable gain is determined by the difference between the book value or purchase value (as applicable) and the price at which the shares are sold.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no differences between closely or publicly held corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding taxes applicable to non-residents without a permanent establishment are as follows:

- dividends and profit distributions: 5%;
- interest: 10% (foreign fully licensed banking and financial institutions are exempt); and
- royalties: 15%.

It is important to note that the notions of *"interest"* and *"royalties"* under the law are wider than usually understood.

No reliefs are available.

4.2 Primary Tax Treaty Countries

There are currently no tax treaties in force.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

There are currently no tax treaties in force.

4.4 Transfer Pricing Issues

There are no particular issues specifically affecting inbound investors.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited-risk distribution arrangements have not yet surfaced as a focus for the Tax Administration. However, any related-party arrangement that does not comply with transfer pricing rules could be challenged by the tax authorities.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The main differences between local transfer pricing rules and OECD standards concern:

- the value method for imports and exports (sixth method in the local provisions, not considered by the OECD Guidelines). The Tax Administration favours the application of this method before any of the five OECD methods; and
- the adoption of a criterion of *"related party"* based on the parties to the transaction being relatives within certain degrees.

4.7 International Transfer Pricing Disputes

The local tax authorities are more aggressive on transfer pricing than they used to be. However, new information does not appear to have been used to re-open earlier disputes.

Since Guatemala has not ratified any double tax treaties, no mutual agreement procedures have been used to resolve international transfer pricing disputes.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Within the proceedings leading to a transfer pricing-related claim, the Tax Administration and the taxpayer can voluntarily review the matter and settle the disagreement. Some Tax Administration officials have reported cases where a taxpayer has proceeded with the adjustments upon settlement.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches of non-local corporations and local subsidiaries of non-local corporations are not taxed differently.

5.3 Capital Gains of Non-Residents

The capital gains of non-residents on the sale of stock in local corporations are taxed in Guatemala. However, if the transaction is executed in a jurisdiction other than Guatemala, on terms and conditions such that the capital gain is not generated in Guatemala and the party selling the stock is *"acting"* (disposing of the stock) outside Guatemala, the capital gain would not be subject to tax in Guatemala.

5.4 Change of Control Provisions

A change of control that results in one of the parties indirectly disposing of an indirect holding higher up overseas is not taxed. However, this is subject to a substance test in the sense that the structure has not been set up to avoid taxation in Guatemala.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No formulas are used to determine the income of foreign-owned local affiliates.

5.6 Deductions for Payments by Local Affiliates

Local affiliates are allowed a deduction for payments for management and administrative expenses by a non-local affiliate on condition that:

- the payment is duly supported;
- the expense is necessary to generate taxable income;
- where applicable, the withholding tax has been charged to the non-local affiliate; and
- the applicable international financial reporting standards allow for the expense to be recognised as such by the taxpayer.

5.7 Constraints on Related-Party Borrowing

Besides transfer pricing rules and 10% withholding tax, interest paid to a non-local affiliate is not deductible, unless the beneficiary is a fully licensed financial institution.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations is exempt from corporate tax. The Guatemalan system is fundamentally one of domestic-sourced income.

6.2 Non-Deductible Local Expenses

If a company has incurred any costs or expenses to generate foreign income, these would not be deductible, because it is required by law that any costs or expenses must generate *"taxable"* income in order to be deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are not taxed.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by local corporations can be used by non-local subsidiaries in their business at prices complying with transfer pricing rules. The price paid to the local corporation would be taxed at the ordinary corporate income tax rates if the transaction is in the ordinary course of business. Otherwise, it would be taxed as passive income at a 10% rate.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Local corporations are not taxed on the income of their non-local subsidiaries or non-local branches under CFC-type rules. There are no CFC-type rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no substance-related rules applicable to non-local affiliates, although the Tax Administration has investigated the substance of the beneficiary (whether or not related) to allow the deductibility of certain expenses.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates
Provided the sale takes place in a jurisdiction other than Guatemala, the capital gain on the sale of shares in non-local affiliates is not taxed.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions
Guatemala does not have general anti-avoidance rules, other than those related to tax assessments for characterising the taxable base.

8. Audit Cycles

8.1 Regular Routine Audit Cycle
Guatemala does not have a regular routine audit cycle. However, any tax refund, including the VAT tax reimbursement, is subject to a previous tax audit. According to the law, the annual planned tax audit must be placed on the Tax Agency website.

9. BEPS

9.1 Recommended Changes
The Income Tax Act of 2012 includes some provisions that partly reflect BEPS guidelines, such as transfer pricing regulations heavily influenced by Action 13.

9.2 Government Attitudes
The Tax Administration usually implements BEPS guidelines in Guatemala, although many of them require legislative and/or executive action. However, no official policy has been developed in order to adopt and implement BEPS guidelines.

9.3 Profile of International Tax
The Guatemalan domestic-sourced income system does not presently reflect many of the BEPS recommendations. However, the Tax Administration has sought to adopt and implement some of them.

9.4 Competitive Tax Policy Objective
The Guatemalan government does not have a competitive tax policy objective. The private sector lobbies on a casuistic basis in favour of a competitive tax policy, as they see it, but there is no official policy.

9.5 Features of the Competitive Tax System
Although not intended to be a feature of *"competitive"* tax system, the Guatemalan corporate tax law is relatively simple. It is domestic source-based and the rates are competitive with those of other countries in the region.

9.6 Proposals for Dealing With Hybrid Instruments
There is a draft securities law that will regulate hybrid instruments. It might be passed in the near future and includes the taxation of investment vehicles. At this point, this is not a policy issue.

9.7 Territorial Tax Regime
Guatemala has a territorial tax regime and there are some deductibility restrictions. These are as follows:

- interest payments to non-residents are not deductible, except where the beneficiary is a non-resident fully licensed financial institution;
- interest is deductible up to the interest rate published by the Monetary Board; and

- interest is deductible up to the interest rate times the annual average net assets of the taxpayer times three.

It is not likely that interest deductibility proposals will affect people investing in and from this jurisdiction.

9.8 Controlled Foreign Corporation Proposals

Guatemalan law provides for certain limits on the deduction of interest (see **9.7 Territorial Tax Regime**) that do not correspond to CFC rules but have a similar result in practice.

9.9 Anti-Avoidance Rules

Guatemalan tax law does not grant any DTC to outbound investors. If other jurisdictions created limitations on any DTC allowed to inbound investors, this would likely have some impact on direct foreign investments into Guatemala.

9.10 Transfer Pricing Changes

Transfer pricing changes introduced by BEPS after the transfer pricing rules came into force in Guatemala in 2015, are not changing things radically. The taxation of profits from intellectual property is not a particular source of controversy in Guatemala.

9.11 Transparency and Country-by-Country Reporting

The Guatemalan tax regime has included provisions for transparency (Decree 20-2006) and also country-by-country reporting.

9.12 Taxation of Digital Economy Businesses

The Tax Administration has proposed regulating the taxation of transactions effected or profits generated by digital economy businesses operating outside Guatemala. At this point, the general rules apply, but not outside the jurisdiction.

9.13 Digital Taxation

The Tax Administration has proposed taxing transactions and profits generated by businesses in the digital economy.

9.14 Taxation of Offshore IP

Payments to non-residents for intellectual property deployed in Guatemala are taxed at 15% withholding tax and are subject to a deductibility cap of 5% of gross income (of the intellectual property user). No distinction is made between tax havens and other countries.

HONDURAS

Law and Practice

Contributed by:
Odín Guillén and Andrea Pereira
Mayora & Mayora, SC

Contents

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Authors

Odín Guillén specialises in civil, corporate, labour and international law at Mayora & Mayora, as well as dispute resolution. He advises important clients in a wide variety of industries such as energy, food and beverage, and NGOs. He is also an arbitrator and secretary at the Centre for Conciliation and Arbitration of the Chamber of Commerce and Industry in Tegucigalpa. He holds a master's degree and other postgraduate qualifications in international law and international relations. He has appeared as an attorney before the Inter-American Commission on Human Rights and is a university professor and newspaper columnist. He is currently a doctoral candidate in economic law and international commerce.

Andrea Pereira has been part of the Mayora & Mayora team in Honduras since 2018. She started as a paralegal and was promoted to junior associate. She has a bachelor's degree in law from the National Autonomous University of Honduras, where she graduated cum laude, and participated in moot courts competitions in Washington, DC. She has assisted international and regional clients regarding complex legal matters involving tax and competition law. She also assists in corporate, tax, administrative and financial law matters.

Mayora & Mayora, SC

Centro Morazán
Tower 2
Floor 14
Local 14
Tegucigalpa
Honduras

Tel: +504 2221 2095
Email: info@mayora-mayora.com
Web: www.mayora-mayora.com/en

Contributed by: Odín Guillén and Andrea Pereira, **Mayora & Mayora, SC**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form. Regardless of the corporate form adopted by the business, each entity is taxed as a separate legal entity from its members, partners or shareholders. The Honduran Commercial Code regulates six basic types of corporate entity, as follows:

- general partnership (*Sociedad Colectiva*);
- limited liability company or LLC (*Sociedad de Responsabilidad Limitada*);
- limited partnership (*Sociedad en Comandita Simple*);
- stock corporation (*Sociedad Anónima*);
- corporation by stocks (*Sociedad Comandita por Acciones*); and
- co-operative business (*Sociedad cooperativa*).

Foreign corporations may organise branches.

The most used corporate form is the stock corporation (*Sociedad Anónima* or SA). American corporations often adopt the corporate form of a limited liability company (*Sociedad de Responsabilidad Limitada* or SRL) for their subsidiaries, to achieve look-through tax treatment under US law.

As mentioned above, the corporate entity is taxed separately and must obtain a separate taxpayer number.

There is also the option to organise the corporation (by stocks or the limited liability company) through a simplified form that can be signed online or physically at the Commercial Registry. By relying on a special law, corporations of any kind can be organised as *"one-person company"*, according to the characteristics of each corporation.

However, the following companies cannot be organised through this process:

- companies supervised by the National Banking and Insurance Commission (CNBS);
- companies dedicated to mining, forestry or other exploitation of natural resources;
- special purpose companies created for the execution of public-private partnership projects; and
- companies dedicated to providing security services.

1.2 Transparent Entities

Under local law, there are no transparent entities for tax purposes. However, the Honduran LLC is commonly used by US corporations to achieve transparency before the US tax authorities.

1.3 Determining Residence of Incorporated Businesses

There are no double taxation treaties in Honduras.

Honduran tax law sets certain standards regarding residence in corporations. A corporation will be considered *"resident"* for tax purposes if:

- it has been organised under Honduran law; and
- it has been incorporated in Honduras.

A company is regarded as having a permanent establishment if it meets the following.

- Maintains fixed places or centres of economic activity, such as:

(a) any activity management centre;
(b) any branch, agency or office that acts in the name and on behalf of a foreign company;
(c) factories, workshops, real estate or other analogous installations;
(d) mines, mineral deposits, quarries, forests, factories and other exploitation centres for the extraction of natural resources; and
(e) warehouses for merchandise deposits intended for internal trade and not just demonstrations or exhibitions.

- Has an office for:
  (a) the practice of technical, financial, or consulting of any nature to develop projects related to contracts or agreements made inside or outside the country; and
  (b) the provision of services useable by people who work in public entertainment, such as the theatre, film, television, the arts and radio, as well as musicians, athletes, salesmen of air tickets and maritime navigation or transportation, to be used in Honduras or outside of it.

It is also regarded as having a permanent establishment in Honduras if a person or entity acting on behalf of the company, holds or habitually practices some economic activity in the country.

Non-resident natural or legal persons in Honduras who obtain income from Honduran sources are taxed according to the following rates:

- income from movable or immovable property: 25%;
- royalties from mining operations, quarries or other natural resources: 25%;
- payments, salaries, or other monetary compensation for provided services: 25%;
- income or earnings obtained by foreign enterprises through branches, subsidiaries, affiliate offices, agencies, legal representatives and others that operate in Honduras: 10%;
- income, earnings, dividends or other participation in profits or reserves of natural or legal persons: 10%;
- royalties and other monetary compensation provided using patents, designs, and processes, trade secrets, trade marks and copyrights: 25%;
- interests in commercial operations, bonuses, securities or other types of obligations: 10%;
- income from aircraft operations, boats and cars: 10%;
- income from communication enterprises operations, software use, computing solutions, telematics and other forms of telecommunications: 10%;
- insurance and bond premiums or any other type of subscribed policies: 10%;
- income coming from public shows: 25%;
- movies and videotapes for cinemas, television, video clubs and rights for cable television: 25%; and
- any other income not mentioned above: 10%.

Those who make payments are responsible for withholding and paying the corresponding tax.

1.4 Tax Rates

Legal entities will pay a rate of 25% on their total net taxable income.

Honduras has a progressive income tax rate for resident or domiciled natural persons of 15%, 20% or 25% depending on the amount of the individual's taxable income. Sole traders pay taxes according to natural person's rates. From the progressive tax table for 2025 the amount of HNL217,493.16 is exempt from tax. Therefore, the tax to be calculated must be considered from that starting point.

Natural or legal persons with a gross income greater than HNL1 billion in the previous fiscal period must pay 1.0% of their gross income if the 25% rate on their net taxable income is less than 1.0% of their declared gross income. This rate will be reduced to 0.5% for certain sectors.

In the case of air, land and maritime transport companies established abroad and operating in the country, a taxable net income equivalent to 10% of the total annual gross income from Honduran sources will be taken for tax calculation purposes. The income tax rate applicable to this amount will be 25%. The agents or agencies established in the country will be considered representatives of these companies.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

As a rule, profits are taxed based on the accounting profits subject to some adjustments. The most common tax adjustments are certain limits to deductible expenses. Profits are taxed on an accrual basis.

2.2 Special Incentives for Technology Investments

In Honduras there is the Promotion and Development of Science, Technology, and Innovation Act, which establishes tax incentives to support investments in these areas. However, there are currently no incentives directly applicable to technology investments in Honduras.

There is a draft Amendment Law that has been put before the Honduran National Congress for discussion. This includes various tax incentives.

2.3 Other Special Incentives

There are currently tax incentives for the following industries:

- power generation using clean energy technology (renewable energy);
- industrial processing areas for exports (*"ZIP"*) as qualified by the Secretary of Economic Development;
- BPO and/or call centre services online for local and/or foreign clients/users;
- free trade zone (*"ZOLI"*), qualified by the Secretary of Economic Development;
- tourism industry, qualified by the Honduran Tourism Institute;
- tourism industry in the Bay Islands as qualified by the *"ZOLITUR"*;
- medium and small businesses (*"MYPIME"*), as qualified by the Secretary of Economic Development;
- a temporary import regime (*"RIT"*), as qualified by the Secretary of Economic Development;
- agricultural export zones (*"ZADE"*) and
- thermal energy generation.

The tax incentives may generally include all or some of the following benefits:

- income tax, solidarity tax and net assets exemption for five, ten or 20 years depending on the type of incentive;
- exemption from or suspension of (as applicable) customs duties on the importation of machinery and capital goods related to the activity;
- exemption from or suspension of (as applicable) VAT (*Impuesto Sobre Ventas*) on the

importation of machinery and capital goods related to the activity;
- domestic VAT on machinery, capital goods and/or services related to the activity; and
- exemption from payment of taxes and municipal contributions.

2.4 Basic Rules on Loss Relief

As a rule, there is no relief for losses within the same fiscal year. However, taxpayers in the agriculture business, agribusiness, manufacturing, mining and tourism can apply to the Tax Administration for a carry forward of past losses of any fiscal year for up to three fiscal years. Loss relief is limited to a maximum of 50% of the net taxable income for the corresponding fiscal year.

In the case of taxpayers who carry out specific activities, any loss relief can only be compensated against profits in the same activity.

In terms of capital gains tax, if the set of operations yields a loss, this cannot under any circumstances be deducted from the gross income of the taxpayer.

2.5 Imposed Limits on Deduction of Interest

Interest is deductible if incurred to generate taxable income, without any limit.

2.6 Basic Rules on Consolidated Tax Grouping

Group consolidation is not permitted for tax purposes. Each entity is considered a separate taxpayer.

2.7 Capital Gains Taxation

Capital gains of residents are taxed at a rate of 10%. As a rule, the taxable gain is the difference between the book value or cost of acquisition (as applicable) and the sale price.

Capital gains of non-residents are initially subject to a 4% withholding tax on the total value of the transaction. The taxpayer must proceed to a settlement before the Tax Administration thereafter and pay and/or claim any difference between the tax withheld and the 10% on the difference between the book value or cost of acquisition (as applicable) and the sale price.

Capital gains because of mergers, acquisitions or spin-offs among related entities are exempt.

2.8 Other Taxes Payable by an Incorporated Business

Transactions are subject to VAT depending on their nature. In general, goods, services and merchandise transacted on commercial markets are subject to VAT at a rate of 15%.

Real estate transactions are subject to a real estate transfer tax of 1.5% on the transaction price.

Banking transactions are subject to *"security tax"* at a rate of HNL2.00 per thousand or any additional fraction.

Securities transactions are generally exempt from VAT.

2.9 Incorporated Businesses and Notable Taxes

Solidarity Tax

This is an additional 5% charge on the taxpayer's net income if the taxpayer's net income is greater than approximately HNL1 million and is not otherwise exempt.

Net Assets Tax

This is a 1% charge on the taxpayer's net assets as of December 31 of the previous fiscal year if the taxpayer is not otherwise exempt.

Interest Tax

Interest charged on securities, sight deposits, saving deposits and term deposits, accrued by individuals or corporations, is taxed at a rate of 10%. The tax will be retained, at the time of carrying out any of these operations, by banks or other financial intermediaries. Interest from savings accounts that have an annual average not exceeding HNL50,000 are not taxed.

Municipal Gross Income Tax

Each municipality charges a tax on gross income generated within its jurisdiction at a rate approved by each municipal government every year.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Honduran law does not include a formal concept equivalent to closely held corporations.

3.2 Individual Rates and Corporate Rates

Honduras has a progressive income tax rate for resident or domiciled natural persons of 15%, 20% or 25% depending on the amount of the individual's taxable income. Sole traders pay taxes according to natural person's rates. From the progressive tax table for 2025 the amount of HNL217,493.16 is exempt from tax. The tax to be calculated must therefore be considered from that starting point. The rates applicable to individuals on a lower annual income are lower.

The deductible expenses available to individuals are less than those available to corporations.

Although not specifically related to this issue, fees charged by individual professionals are not subject to VAT. Professionals are not subject to solidarity tax or to net assets tax and they therefore generally prefer not to adopt a corporate structure.

3.3 Accumulating Earnings for Investment Purposes

There are no rules preventing closely held corporations from accumulating earnings for investment purposes. It is mandatory to create a 5% reserve every year, but when it surpasses one-fifth of the corporation's capital it can be capitalised. Thereafter, the obligation to make a 5% reserve on earnings continues.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends are taxed at a final 10% withholding tax rate, independently of the beneficiary's residence. Gains on the sale of shares are taxed at 10%. If the seller is a non-resident, the buyer must withhold 4% on the total value of the transaction, subject to a final settlement before the Tax Administration. The taxable gain is determined by the difference between the book value or acquisition value (as applicable) and the price at which the shares are sold.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no differences between closely or publicly held corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding taxes applicable to non-residents are as follows:

- dividends and profit distributions: 10%;

- interest: 10%; and
- royalties: 25%.

No reliefs are available.

4.2 Primary Tax Treaty Countries
Honduras has no tax treaties in force.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents
There are currently no tax treaties in force.

4.4 Transfer Pricing Issues
Transfer pricing rules in Honduras have been in force since 2014. There are no transfer pricing rules issues specifically affecting inbound investors. At a general level, the biggest issue concerns financial and commercial transactions between related entities.

On 19 March 2024, the Tax Administration Service (SAR) announced Agreement SAR-653-2023 regarding the Country-by-Country Report, effective from the 2025 fiscal year. This is a new obligation that entities must consider.

4.5 Related-Party Limited Risk Distribution Arrangements
Limited risk distribution arrangements have not yet surfaced as a focus of the Tax Administration. However, any related-party arrangement that does not comply with transfer pricing rules could be challenged by the tax authorities.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards
The main differences between local transfer pricing rules and OECD standards concern:

- the adoption of a criterion of *"related party"* based on the parties to the transaction being relatives within certain degrees;
- the additional alternative methodology for valuing commercial and financial transactions, to address complexities; and
- the fact that double taxation is commendable but incomplete, especially regarding transparency standards and tax intelligence exchange with foreign jurisdictions.

4.7 International Transfer Pricing Disputes
Since Honduras has not ratified any double tax treaties, no mutual agreement procedures have been used to resolve international transfer pricing disputes.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled
Where the settlement calls for compensating adjustments, Tax Administration officials have reported that the taxpayer proceeds with the compensating adjustments.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations
Local branches of non-local corporations and local subsidiaries of non-local corporations are not taxed differently.

5.3 Capital Gains of Non-Residents
Non-residents' sale of stock in local corporations is taxable under capital gains tax. The capital gains of non-residents are initially subject to a 4% withholding tax on the total value of the transaction. The taxpayer must proceed to

a settlement before the Tax Administration and pay and/or claim any difference between the tax withheld and the 10% on the difference between the book value or cost of acquisition (as applicable) and the sale price.

Honduras has not subscribed to any tax treaties.

5.4 Change of Control Provisions

The indirect sale of local corporations, including those involving upper holding companies, are taxable under capital gains tax. The economic reality principle establishes that if holding companies do not have any economic substance, the final sale will affect the local company and must be taxed under non-residents' capital gains tax.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

At a general level, there are no formulas for determining the income of foreign-owned local affiliates. The tax applied to land, maritime and air transportation services of local affiliates is calculated as 10% of the gross income at a 25% rate.

5.6 Deductions for Payments by Local Affiliates

Local affiliates are allowed a deduction for payments for management and administrative expenses by a non-local affiliate on condition that:

- the payment is duly supported;
- the expense is necessary to generate taxable income;
- where applicable, the withholding tax has been charged to the non-local affiliate; and
- the applicable international financial reporting standards allow for the expense to be recognised as such by the taxpayer.

5.7 Constraints on Related-Party Borrowing

Besides transfer pricing rules and 10% withholding tax, interest paid to a non-local affiliate is deductible, if incurred to generate taxable income.

Advance dividends are accounts receivable from partners or related companies that do not arise from a commercial transaction and have a term greater than 100 calendar days. Dividend tax rates should therefore be applicable to them.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations is exempt from corporate tax. The Honduran system is based on domestic-sourced income.

6.2 Non-Deductible Local Expenses

If the company has incurred any costs or expenses to generate foreign income, these will not be deductible because by law any costs or expenses need to generate *"taxable"* income to be deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are not taxed.

6.4 Use of Intangibles by Non-Local Subsidiaries

Under transfer pricing regulations, intangibles developed by a local company (as its main source of business) cannot be used by non-resident related parties without incurring local corporate tax.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Local corporations are not taxed on the income of their non-local subsidiaries or non-local branches under CFC-type rules. There are no CFC-type rules in Honduras.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no substance-related rules applicable to non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Provided the sale takes place in a jurisdiction other than Honduras, capital gains on the sale of shares in non-local affiliates will not be taxed.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Honduras has the Income Tax Anti-Avoidance Measure Act, whereby businesses with operational losses over two consecutive or alternating years avoid income tax payment.

In addition, the Honduran Criminal Code specifies tax evasion is a criminal offence.

Honduras also has legislation related to tax assessments to characterise the taxable base.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Honduras does not have a regular routine audit cycle. However, it is specified in Honduran legislation that the Tax Authority may audit when necessary.

9. BEPS

9.1 Recommended Changes

Honduras joined the Inclusive Framework on BEPS on 11 December 2019. The Transfer Pricing Act and its regulations include a provision that may be considered to have been influenced by BEPS Actions 8 to 10. In addition, a Tax Justice Bill is being discussed at the Honduran National Congress that will incorporate BEPS Actions 3 and 5.

Country-by-country reporting has been required since the 2025 fiscal period.

9.2 Government Attitudes

The Tax Administration usually tries to implement BEPS Actions in Honduras, even though many of these require legislative and/or executive action. Although no official policy is being followed to adopt and implement BEPS, if the Tax Justice Bill is approved, some BEPS Actions will be implemented.

9.3 Profile of International Tax

The Honduran domestic-sourced income system does not presently reflect many of the BEPS Actions. However, if the Tax Justice Bill is approved, some BEPS Actions will be implemented.

9.4 Competitive Tax Policy Objective

The government is seeking to create a competitive tax policy with the Tax Justice Bill. However, the private sector does not share this conclusion and continues to lobby in favour of a competitive tax policy, as they see it.

9.5 Features of the Competitive Tax System

Although not intended to be a feature of *"competitive"* tax system, the Honduran corporate tax law is relatively simple and it is domestic source-based.

9.6 Proposals for Dealing With Hybrid Instruments

Although Honduras recently joined the Inclusive Framework on BEPS, it has not yet implemented the BEPS Action for hybrid instruments.

9.7 Territorial Tax Regime

Honduras has a territorial tax regime. Interest is deductible regardless of whether the beneficiary is a resident or not. The only condition is that the interest must be connected to the generation of taxable income. It is not likely that the interest deductibility proposals will affect people investing in or from Honduras.

9.8 Controlled Foreign Corporation Proposals

Honduras follows a strict territorial tax system and foreign-sourced income is not relevant to the local authorities. No CFC provisions have yet been implemented in the country therefore. This might change if the Tax Justice Bill is approved.

9.9 Anti-Avoidance Rules

Honduran tax law does not grant any DTC to outbound investors. However, if other jurisdictions create limitations on any DTC allowed to inbound investors, this is likely to have some impact on direct foreign investments into Honduras.

9.10 Transfer Pricing Changes

Transfer pricing rules have been in force since 2014 and have led to greater control between related companies by the Tax Administration. Nevertheless, the taxation of profits from intellectual property is not a particular source of controversy in Honduras.

9.11 Transparency and Country-by-Country Reporting

A major tax bill is presently being discussed, which incorporates transparency measures. Honduras has recently included a country-by-country report requirement from the 2025 fiscal period.

9.12 Taxation of Digital Economy Businesses

The Honduran Tax Authority seeks to regulate digital economy businesses. However, no formal proposal has been approved as of yet. However, if the Tax Justice Bill is passed it is expected that some of its regulations will apply to digital economy businesses.

9.13 Digital Taxation

Honduras has not presented any proposals regarding digital taxation. However, the government has on several occasions expressed the importance of incorporating e-commerce into the tax system.

9.14 Taxation of Offshore IP

Payments to non-residents for intellectual property deployed in Honduras are taxed by 25% withholding tax. No distinction is made between tax havens and other countries.

INDIA

Law and Practice

Contributed by:
S. Vasudevan, Karanjot Singh Khurana, Sonali Bansal and Loveena Manaktala
Lakshmikumaran & Sridharan

Contents

Contributed by: S. Vasudevan, Karanjot Singh Khurana, Sonali Bansal and Loveena Manaktala, **Lakshmikumaran & Sridharan**

Lakshmikumaran & Sridharan is a leading full-service Indian law firm specialising in the areas of corporate and commercial law, dispute resolution, taxation and intellectual property. Founded by V. Lakshmikumaran and V. Sridharan in 1985, the firm keeps a finger on the pulse of litigation and commercial law matters throughout the country from its offices in 14 locations in India, and serves its clients through its more than 425 professionals (including over 70 partners). The firm has handled thousands of litigation cases before various forums in India and abroad, including hundreds of cases before the Supreme Court of India. Over the last four decades, the firm has worked with over 15,500 clients, including start-ups, small and medium enterprises, large corporates, banks and financial institutions, and MNCs. Lakshmikumaran & Sridharan is well known for its high ethical standards, quality work and transparency in all its business dealings.

Authors

S. Vasudevan is the executive partner of Lakshmikumaran & Sridharan, and an advocate. He is the national head of the firm's direct tax practice. He has worked in multiple tax verticals during his 18 years of association with the firm. He assists clients on all aspects of tax and allied laws, ensuring that solutions are sound from both a legal and accounting perspective. He has expertise in handling complex tax investigations and litigations involving multinational companies and big domestic companies. His wealth of experience pertaining to sectors such as fast-moving consumer goods (FMCG), telecommunications, finance, energy, information technology and e-commerce enables him to provide tax-efficient practical and holistic solutions. He is also a chartered accountant and cost accountant by qualification.

Karanjot Singh Khurana is a partner of direct tax practice at Lakshmikumaran & Sridharan. He advises on various issues in domestic tax, international tax and transfer pricing. He has advised clients in a variety of sectors including banking and finance, oil and gas, IT and ITeS, telecommunications, iron and steel, and electric automobiles. He has conducted various due diligence assignments and handled complex matters involving PE exposure. He has also handled litigation matters before various courts, tribunals and other appellate forums. He has been an active speaker at various seminars and conferences organised on direct taxation. He has also authored many articles in reputed national and international journals.

Sonali Bansal is a principal associate at the Delhi office of Lakshmikumaran & Sridharan. She is a chartered accountant by qualification, and has been actively involved in providing advisory-related assistance in corporate and international taxation. She has also assisted clients on a litigation front before various forums.

Loveena Manaktala is a senior associate with the direct tax team of Lakshmikumaran & Sridharan. She is a chartered accountant by qualification and has been actively involved in providing advisory-related assistance in corporate and international taxation. With experience in restructuring, transfer pricing and intricate tax matters, she navigates complexities and offers strategic solutions to clients.

Lakshmikumaran & Sridharan

5 Link Road
Jangpura Extension
opposite Jangpura Metro Station
New Delhi
110 014
India

Tel: +91 11 4129 9800
Fax: +91 11 2619 7578
Email: Lsdel@lakshmisri.com
Web: www.lakshmisri.com

Contributed by: S. Vasudevan, Karanjot Singh Khurana, Sonali Bansal and Loveena Manaktala, **Lakshmikumaran & Sridharan**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Forms of Business Entities

In India, modern businesses prefer a corporate structure, given the convenience of setting up, management, expansion and exit. The various types of structures for running a business are as follows.

Company

A company is a separate legal entity, incorporated under the Companies Act, 2013.

Companies can typically be classified into the following types.

- A one-person company – all the shares are owned by one member.
- Private companies – these are closely held companies, requiring a minimum of two members, with an upper limit of 200 members. There is a restriction on the transfer of shares.
- Public companies – these companies require a minimum of seven members, with no maximum cap. The shares of these companies can be traded publicly on a stock exchange. A business set-up or a private company can, after evolving into a reasonable size, transform itself into a public company, if the members so choose.

One-person and private companies can further be divided into three sub-types.

- A company limited by shares – suitable for a new business set-up, a business managed by a foreign holding company, a family, or a business managed by a small group of people. This structure is the widely used form of setting up a presence in India by foreign investors.
- A company limited by guarantee.
- An unlimited company.

A company limited by guarantee and unlimited companies are not practically suitable for business operations, given the unlimited liability of investors/shareholders attached therewith.

Partnership

A partnership is a common name by which two or more persons carry on their business; although, under common law, a partnership is not seen as a person distinct from its partners. However, under the Indian tax laws, a partnership is considered to be a person separate from the partners. Partners can be natural persons or a juridical person (such as a company).

There are, broadly, two types of partnerships:

- a general/unlimited liability partnership – all partners have unlimited liability; and
- a limited-liability partnership (LLP) – all partners have limited liability.

Many traditional businesses and family-managed businesses are carried on as partnerships in India. The unlimited liability attached to the partners has at times discouraged businesses from adopting a partnership as a form of business. Sometimes, partnerships are formed to execute specific projects as a joint venture. However, with the recent legislative introduction of LLPs with limited liability on partners, few small and medium-sized businesses have adopted the LLP set-up for carrying on business.

While foreign direct investment (FDI) in a general partnership firm is allowed only subject to prior approval of the Reserve Bank of India (RBI), FDI in an LLP is allowed freely under an automatic approval route, subject to other conditions.

Sole proprietorship

A sole proprietorship is owned and managed by a single person.

Unincorporated business associations

An association of persons (AOP) or a body of individuals (BOI), whether incorporated or not, is treated as a separate person for taxation in India.

Taxation of Business Entities

A company is taxed separately on its profits, and its shareholders are taxed only on the dividend income received by them from the company.

For tax purposes, partnerships (including LLPs) are each considered as a separate legal entity. Accordingly, a partnership is taxed on its profits. The partners are taxed on their salary and interest income from the partnership; whereas their share in profits is exempt from tax. Thus, partnerships are treated as tax-opaque entities in India. Likewise, an AOP/BOI is considered as a tax-opaque entity and is taxed as a separate legal entity.

Sole proprietorships are taxed as individuals.

1.2 Transparent Entities

India generally does not recognise any business entity as fiscally transparent. However, in recent times, investment vehicles and investment trusts have been permitted to be set up as transparent entities/pass-through entities. Such a set-up helps in removing the cascading tax effect on the return on investment. Final tax is levied on the investor alone and the investment trust is exempt from taxation. Pass-through entities are more common in sectors where collective investments are essential, such as real estate, infrastructure sectors, etc.

1.3 Determining Residence of Incorporated Businesses

In India, the determination of residence is on a year-to-year basis.

Subject to a double-taxation avoidance agreement (a tax treaty), a company is said to be resident in India, if:

- it is an Indian company (incorporated under Indian law); or
- its place of effective management (where key management and commercial decisions are in substance made) is in India.

For a partnership firm/AOP/BOI, unless the control and management of its affairs is located wholly outside India, it would be resident in India.

The basic rule for determination of residential status of an individual is if their physical presence in India is 182 days or more, in a year. A few other rules must also be applied, on a case-by-case basis, for determining the residential status of individuals.

1.4 Tax Rates

Tax rates applicable to companies vary, according to their residential status.

Domestic Companies

A domestic company whose total turnover or gross receipt during the financial year 2021–22 (updated to financial year 2022–23 vide Finance Bill, 2025, yet to be enacted (*"FB 2025"*)) does not exceed INR4,000 million is taxed at the rate of 25%. For any other domestic company, the rate of tax is 30%.

The amount of tax in both cases is to be increased by a surcharge and cess. The rate of surcharge and cess is notified annually, and ranges between 11.28% to 16.48% of the aforementioned basic tax, depending on the taxable income of the company.

Minimum alternative tax (MAT) on domestic companies

Where the normal tax liability of a company is less than 15% of its profits shown in the books of accounts (book profits), India levies a MAT at 15% of book profit (plus surcharge and cess, as applicable) instead of normal tax liability. An excess of MAT over normal tax liability so paid is available as credit against normal tax liability in subsequent years, subject to certain restrictions.

Concessional tax regime for domestic companies

In order to stimulate economic activities and investments, the following domestic companies may opt for concessional rates of taxation, subject to the condition that they do not claim certain stipulated deduction or incentives which are usually available to such companies:

- new manufacturing companies (which are set up after 1 October 2019 and which have commenced manufacturing before 31 March 2024) – 15% (plus applicable surcharge and cess); and
- other domestic companies – 22% (plus applicable surcharge and cess).

A domestic company which has opted for a concessional tax regime is exempted from applicability of MAT provisions.

Non-Resident Companies (Foreign Companies)

A foreign company is taxed at a flat rate of 35% on the business income received or accruing in India.

However, income in the nature of dividends, interest, royalties and fees for technical services (FTS) (collectively referred to as *"special incomes"*) are taxed at special rates on a gross basis (without providing for any deduction for expenditure):

- dividend – 20%;
- interest – 5% to 20%, depending on the source of income; and
- royalties and FTS – 20%.

The basic tax rates previously mentioned are subject to surcharge and cess, which ranges between 6.08% to 9.2% of the basic tax, depending on the taxable income of the foreign company.

MAT on foreign companies

MAT is not applicable to foreign companies that do not have a permanent establishment (PE) in India.

Further, capital gains income from the transfer of securities and special income earned by a PE of a foreign company in India will not be chargeable to MAT, if the tax payable on such income is less than 15% (exclusive of surcharge and cess, as applicable).

Partnerships

The business income of a partnership firm (whether resident or non-resident) is taxable at the rate of 30%. The amount of tax will be increased by a surcharge and cess, which ranges between 4% to 16.48% of the basic tax, depending on the taxable income of the partnership.

Alternative minimum tax (AMT) on partnerships

Where the normal tax liability of the partnership is less than 18.5% of the adjusted total income, the partnership shall be liable to pay AMT at 18.5% of the adjusted total income (plus surcharge and cess, as applicable) instead of discharging normal tax liability. An excess of AMT over normal tax liability so paid is available as a credit against normal tax liability in subsequent years, subject to certain restrictions.

Adjusted total income means total income under normal provisions as increased by certain deductions claimed by a taxpayer. Thus, AMT shall apply only if the partnership has claimed certain deductions provided under the domestic income tax law.

Sole Proprietorships

In India, a sole proprietorship business is not taxed as a different legal entity. Rather, the business owner, a resident or a non-resident of India is taxed on their total income, including the income from sole proprietorship business. The tax liability is determined on the basis of the slab rates applicable to their taxable income, which varies from 5% to 30%. The rate of tax would be increased by applicable surcharge and cess, which varies from 14.4% to 42.48% of the basic tax, depending on the taxable income earned by the individual.

AOP/BOI

The taxability of an AOP is usually dependent on factors such as whether its members' share is determinate or not and the rate at which members' income is taxed. Accordingly, the rate at which an AOP is taxed varies as per the facts involved in each case, and the effective rate of tax ranges from 5.2% to 42.74%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are largely calculated based on accounting profits, after making certain adjustments for specific deductions/restrictions provided under the taxation laws. Substantial adjustments to accounting profits include the following.

- Depreciation – the rate at which depreciation is computed for taxation purpose is separately provided.
- Deductions of expenses – for instance, capital expenses may be allowed as a deduction in certain cases when calculating taxable profits. Weighted or accelerated deductions of expenses may also be allowed.
- Denial of certain deductions – for instance, expenses on which withholding tax is not applied, expenses incurred in cash over INR20,000, Corporate Social Responsibility expenses and penal expenses are not allowed as a tax deduction.
- Deferment of expenses – pre-incorporation expenses and expenses for raising capital to expand a business are allowed as a deduction over five years.
- Denial of excessive expenditure to associated enterprises (AEs) – expenditure in excess of an arm's length price (ALP), where payment is made to an AE, is denied as deduction.
- Notional income – where any income accrues from an AE and is less than an ALP, the difference is deemed as income of the enterprise carrying on business in India.

The profits are taxed on the basis of the method of accounting consistently followed by a company, which could either be on a receipt basis or on an accrual basis.

2.2 Special Incentives for Technology Investments

Indian income tax law provides for a concessional taxation regime for income from patents. Any income by way of royalties in respect of a patent developed and registered in India earned by an eligible taxpayer is subject to tax at the rate of 10% (plus surcharge and cess) on a gross basis, with no allowance of expenditure incurred on royalty income.

Further, Indian tax law provides for special tax deductions, including weighted deductions, on certain other technology investments:

- capital expenditure on scientific research pertaining to the business;
- a contribution made to an approved research association, university, college or other institution, to be used for scientific research;
- a contribution made to an approved company registered in India, to be used for scientific research;
- a payment made to a national laboratory or university, or to an Indian institute of technology or a specified person, for scientific research;
- capital expenditure incurred by a company on scientific research, in approved in-house scientific research and development facilities;
- additional or accelerated depreciation on investments in plant and machinery used in manufacturing or generation/transmission/distribution of power; and
- 100% profit linked deductions for a period of three years for the eligible start-ups engaged in business which involves innovation, development, deployment or commercialisation of new products, processes or services driven by technology or intellectual property (eligible start-ups should be set up between April 2016 and March 2025 (the FB 2025 has proposed extending the timeline of incorporation for eligible start-ups to 31 March 2030).

2.3 Other Special Incentives

India provides a number of tax incentives to various industries, transactions and businesses, such as the following.

Offshore Banking Units and International Financial Services Centres (IFSCs)

A deduction of 100% of the income is available to an offshore banking unit located in a Special Economic Zone (SEZ) for an initial five consecutive years. Further, for a subsequent five years, the deduction is allowed at the rate of 50% of income for financial year(s) up to 31 March 2022, and at the rate of 100% for the financial year 2022–23 and onwards.

A unit set up in an IFSC is eligible for deduction of 100% of its income for ten consecutive years out of 15 years, among other incentives.

Start-Up Companies

A deduction of 100% of the profits and gains is available for three consecutive years out of ten years, beginning from the year of incorporation, subject to certain conditions. Start-ups are exempt from angel tax provisions in India, which seeks to tax excess of consideration received upon issuance of shares at premium, in excess of the fair market value of those shares, subject to the fulfilment of certain conditions. Angel tax provisions are not applicable in India with effect from 1 April 2025.

Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs)

REITs and InvITs are real estate and infrastructure investment vehicles, respectively, which undertake investments either directly in real estate/ infrastructure projects or through special purpose vehicles (SPVs).

Pass-through benefits have been given to the following incomes received by REITs and InvITs:

- interest received from SPVs;
- dividends received from SPVs; and
- rental income received from assets directly held by REITs.

The aforementioned incomes are directly taxable in the hands of the unit holders/investors upon distribution by REITs and InvITs. However, the dividend income is exempt in the hands of unit holders/investors in certain circumstances.

Weighted Deduction for Employment Generation

A taxpayer can claim additional deduction of up to 90% of the total employee cost incurred by it on new employees employed by it. The deduction is allowed equally over a period of three consecutive years starting from the year in which employment was provided, subject to fulfilment of certain conditions.

2.4 Basic Rules on Loss Relief

Offset of Losses

Business loss

Loss from business can be offset against any other income, except salary and profits from speculative business. Losses from a speculation business can be offset against the profits of the speculation business only.

Speculation business means involving purchase and sale of any commodity, including stocks and shares which are periodically or ultimately settled without actual delivery of commodities/ scrips.

Loss from transfer of capital asset ("Capital Loss")

Capital Loss can be offset against gains from transfer of other capital assets only. The regulations, however, vary, depending on the period for which the asset is held (short-term or long-term) and the nature of the asset. For instance, set-off rules may vary for listed or unlisted shares and securities of an Indian company, and for units of a mutual fund, in comparison to other assets.

Carry-Forward of Losses

Business loss

A loss from speculation business can be carried forward for up to the next four assessment years from the assessment year in which the loss was incurred, and can be adjusted against income from speculation business only.

Other business loss can be carried forward for up to the next eight assessment years from the assessment year in which the loss was incurred. The carried-forward loss can be adjusted only against business income. The carry-forward and offset of business loss in a private company is allowed only if the beneficial shareholders holding shares carrying 51% of voting rights remain the same on the dates on which loss was incurred, and on the date on which it is being claimed.

Loss from the transfer of a capital asset

Capital loss can be carried forward for up to the next eight assessment years from the assessment year in which the loss was incurred.

Offset and Carry-Forward of Unabsorbed Depreciation

Any depreciation which cannot be offset against business income during a particular year is allowed to be carried forward indefinitely as unabsorbed depreciation and offset against any income of any future year.

2.5 Imposed Limits on Deduction of Interest

Interest paid on capital borrowed for the purposes of business is a tax-deductible expenditure.

However, if the capital is borrowed for acquiring a capital asset, interest liability pertaining to the period until the time the asset is put to use is added to the cost of that asset and is not allowed as a tax-deductible expense.

Transfer-Pricing Rules

Indian transfer-pricing rules apply to interest that is paid by an Indian corporation to its foreign-related parties, where the interest that is in excess of an arm's length interest is disallowed.

Thin-Capitalisation Rule

India recently introduced a thin-capitalisation rule as a specific anti-tax avoidance mechanism to cap interest deductions claimed by an Indian company or Indian PE of a foreign company on account of interest paid to non-resident AEs on debts issued by the latter. The restriction would be over and above the ALP rule followed in relation to all expenditure, where payment is to be made to an AE.

The rule seeks to disallow any interest expense which exceeds 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA) of the borrower. The rule applies only to those whose total interest expense exceeds INR10 million in the year.

Further, where the loan is advanced by a non-AE, but an AE provides a guarantee to that lender, the loan is deemed to have been issued by an AE. Accordingly, the thin capitalisation rule becomes applicable in such a case.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping is not permitted under Indian income tax law. Instead, each individual company of a group files and pays corporation tax on a standalone basis.

2.7 Capital Gains Taxation

India distinguishes between business income and capital gains for tax purposes. For companies, capital gains and losses arising from the transfer of capital assets are calculated separately, with net chargeable gains taxed at prescribed rates. The tax rate depends on the nature of the capital asset, the period of holding (long-term/short-term) and the residential status of the transferor.

Generally, an indexation benefit is available on the cost of acquisition and the cost of improvement for assets classified as long-term, while computing capital gains.

Further, certain transactions are not regarded as transfers and are thus exempt from taxation – for example:

- transfer of a capital asset by a demerged company to the resulting Indian company during the course of a demerger;
- transfer of capital assets in a scheme of amalgamation; and
- transfer of capital assets between a holding and a wholly owned subsidiary are not regarded as a transfer for capital gains tax

purposes, subject to fulfilment of certain conditions.

2.8 Other Taxes Payable by an Incorporated Business

An incorporated business may have to pay the following taxes on a transaction:

- goods and services tax (GST), which has subsumed the various indirect taxes that were levied previously (such as excise duty, service tax and value-added tax (VAT)/central sales tax (CST));
- the importation of goods/services will attract integrated GST and may attract customs duty, among others;
- the exportation of goods/services is zero-rated under GST – exporters can claim a refund of input tax credit of inputs/input services used in the exportation of goods/services, subject to the fulfilment of prescribed conditions;
- stamp duty is payable on all legal property transactions;
- property tax; and
- securities' transaction tax (STT), which is applicable to transactions that involve the purchase/sale of equity shares through a recognised stock exchange.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are generally subject to GST.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses of a large or medium scale usually operate in corporate form. Partnerships and sole proprietorships are usually preferred for small businesses.

3.2 Individual Rates and Corporate Rates

India follows progressive tax rates for individuals. While individuals earning a minimal income experience lower taxes (0%, 5% or 10%, based on the income), individuals earning a substantially higher income are generally liable to tax at rates higher than corporate rates.

Individual professionals are, however, barred from carrying on a profession as a corporate, under the laws by which they are permitted to practise as professionals. For example, the Advocates Act, 1961, the Indian Medical Council Act, 1956 and the Chartered Accountants Act, 1949 prohibit a professional from carrying out their profession in corporate form. Such professionals carry out their practice as sole proprietors, unlimited partnerships or LLPs.

3.3 Accumulating Earnings for Investment Purposes

Currently, there are no specific rules preventing closely held corporations from accumulating earnings for investment purposes, although such rules have existed in the past.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividend Income

From the financial year 2020–21, an individual shareholder is liable to pay tax on dividend income from shares held in a company. If the shares are held as a trader, the dividend income therefrom is taxable as business income; whereas if shares are held as an investment, income arising in the nature of a dividend shall be taxable as income from other sources. While dividend income of resident individuals is taxed as per applicable slab rates, dividend income of non-resident individuals is taxed at 20% plus surcharge and cess.

Capital Gains

Capital gains arising from the sale of equity shares held by individuals in closely held corporations are taxed as follows:

- long-term capital gain for residents – 12.5% (plus the applicable surcharge and cess) without the benefit of indexation;
- long-term capital gain for non-residents – 12.5% (plus the applicable surcharge and cess) without the benefit of indexation; and
- short-term capital gain – as per the slab rates applicable to the individual.

Shares of closely held corporations held for more than two years are considered to be long-term assets.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividend Income

From the financial year 2020–21, an individual shareholder is liable to pay tax on dividends from shares in publicly traded corporations – ie, listed on a recognised stock exchange. There is no distinction in the taxation of dividend income from a closely held company and from a publicly traded company.

Capital Gains

Capital gains arising from the sale of equity shares held by individuals in publicly traded corporations are taxed as follows:

- long-term capital gain (listed if STT is paid) – 12.5% (plus the applicable surcharge and cess) without benefit of indexation, if that gain exceeds INR125,000 in a year;
- long-term capital gain (listed, if STT is not paid) – 12.5% (plus the applicable surcharge and cess) without benefit of indexation; and
- short-term capital gain – 20% (plus the applicable surcharge and cess).

Equity shares of publicly traded corporations held for more than one year are considered long-term assets.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding taxes on interest, dividends and royalties are applied as final tax on the gross income earned by a non-resident. The withholding tax rates would be increased by surcharge and cess, depending on the income earned by the non-resident.

- Interest – usually, a withholding tax rate of 20% is applicable on the interest on a foreign currency loan paid by an Indian resident to a non-resident. A concessional rate of 5% is applicable in certain cases.
- Dividends – a withholding tax rate of 20% is applicable on the payment of dividends to a non-resident.
- Royalties/FTS – a withholding tax rate of 20% is applicable on the payments in the nature of a royalty and FTS made to a non-resident.

4.2 Primary Tax Treaty Countries

India has signed tax treaties with around 100 countries.

Earlier, tax treaties entered into with Mauritius, Singapore and Cyprus were beneficial to the taxpayer, as capital gains on the sale of shares of Indian companies were exempt from taxation in India, and the domestic law of these countries did not tax capital gains. Accordingly, India received a significant quantum of investments from these countries. These treaties have, however, been amended, with effect from the financial year 2017–18, to provide for source-based taxation on gains from the sale of shares.

Some tax treaties, such as those with the Netherlands and Sweden, still provide exemptions for gains derived from the sale of shares of an Indian company in certain situations.

Despite the amendments to the tax treaties, foreign investors continue to invest in India from Mauritius and Singapore.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Indian tax authorities challenge the use of an entity that is a resident of a tax-treaty country, if that entity is effectively owned or controlled by a person who is a resident of a different country. Legal basis for denial of benefits includes the following:

- the limitation of benefits clause or the *"beneficial owner"* clause in the applicable treaty;
- the *"principal-purpose test"* under the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting (MLI), as incorporated in the applicable treaty; and
- general anti-avoidance rules, as in domestic tax law.

4.4 Transfer Pricing Issues

The main issue in disputes regarding transfer pricing is the adequacy of documents maintained for establishing the nature of the transaction entered into with the AE. Tax authorities have raised many transfer-pricing disputes in the past relating to the following:

- intragroup services;
- cost-contribution arrangements;
- corporate guarantees;
- advertisements;
- marketing and brand promotion (AMP) expenses;
- royalties/fees for technology/know-how; and
- secondary adjustments, etc.

Other transfer pricing issues include the following:

- the examination of the transfer-pricing methodologies chosen;
- the comparable companies adopted; and
- ensuring the fulfilment of various reporting requirements.

4.5 Related-Party Limited Risk Distribution Arrangements

The use of a related-party limited risk distribution arrangement is not challenged in principle by the tax authorities. However, based on the nature of functions actually carried out and the risks assumed by the distributor, tax authorities may seek to re-characterise the distributor as bearing medium or full risk, and, accordingly, may enhance the ALP margin of the distributor.

Contributed by: S. Vasudevan, Karanjot Singh Khurana, Sonali Bansal and Loveena Manaktala,
Lakshmikumaran & Sridharan

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

By and large, Indian transfer-pricing rules follow the OECD Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

Transfer pricing issues have always been susceptible to scrutiny from the tax department. Domestic tax law permits officers to re-open cases from earlier years; however, the limitation to opening such cases is usually three years from the end of the relevant assessment year, which can be extended to ten years in high-income cases.

The tax treaties entered into by India provide for resolution of any taxation that is not in accordance with the treaty, through the Mutual Agreement Procedure (MAP).

In line with the BEPS final report on *"Making Dispute Resolution More Effective"*, India substituted the rule which dealt with the same issue of implementation of the MAP. India has also issued MAP guidance for the benefit of the taxpayers, tax practitioners, tax authorities and chartered accountants (CAs) of India and of treaty countries.

While in the past, the MAP has not led to much success, in view of recent changes it is now expected that the taxman would look favourably upon the resolution of disputes via the MAP rather than litigation.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Although compensating adjustments are allowed to settle a transfer-pricing dispute or claim, this is not very popular among taxpayers in India.

Globally, India lags behind in the settlement of disputes when referred under the MAP. Disputes have been pending for a long period of time in certain cases.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

An Indian subsidiary of a foreign corporation is liable to the same taxing rules/rates as an Indian corporation. However, an Indian branch of a foreign corporation is liable to the higher rate of tax that is applicable to foreign corporations.

For local branches, the taxable entities remain the foreign corporations only, who will be required to obtain tax registrations in India. For ensuring computation of profits at an ALP, the branch office is hypothetically considered a separate legal entity from the foreign corporation. The deduction allowable to the branch on payments made towards certain head office expenses is restricted to 5% of the income of the branch.

5.3 Capital Gains of Non-Residents

India taxes the capital gains arising for a non-resident on the direct sale of shares of an Indian company.

India also levies tax in the case of indirect transfers – ie, where the gain is on the transfer of shares of a foreign holding company that derives substantial value from Indian assets, including shares of an Indian corporation.

Almost all the tax treaties entered into by India allow India to tax the direct transfer of shares of an Indian company.

Many of these treaties, such as those with Mauritius, Singapore, the Netherlands, Japan and South Korea, eliminate the capital gains tax in India applicable to the indirect transfer of shares of an Indian company.

Some of the treaties, such as those with the USA, UK, Canada, Israel and South Africa, allow India to tax both direct and indirect transfers of shares of an Indian company.

5.4 Change of Control Provisions

India levies tax on indirect transfers as well, subject to treaty benefits. That is, the gains arising from the transfer of any share or interest in a non-resident company are taxed in India, if that share or interest derives its value substantially from the assets located in India.

Changes in ownership amounting to a change in control can also disentitle an Indian company from carrying forward and offsetting accumulated losses, as stated in **2.4 Basic Rules on Loss Relief**.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no specific formulas used to determine the income of foreign-owned local affiliates selling goods or providing services. The income would, however, have to comply with the arm's length principle.

5.6 Deductions for Payments by Local Affiliates

All expenditure allowed for the carrying on of business is allowed as a deduction, irrespective of the nature of the corporation. The expenditure deduction would, however, have to comply with the arm's length principle.

5.7 Constraints on Related-Party Borrowing

There are no restrictions in tax laws on the amounts that can be borrowed from a related party. However, the allowability of a deduction on any such borrowings from related parties will be subject to the arm's length principle in transfer pricing and under the thin capitalisation rule.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Indian companies are tax residents of India; hence, their global income is liable to tax in India. Foreign income of Indian companies is liable to tax on the same basis as profits from activities in India, subject to the benefit of foreign tax credits to avoid double taxation.

6.2 Non-Deductible Local Expenses

Generally, foreign income of an Indian company is also liable to tax in India. However, if some foreign income is tax-exempt in India, any expenses incurred to earn such income will not be tax-deductible in India.

6.3 Taxation on Dividends From Foreign Subsidiaries

A dividend received from a foreign company is taxed as business income (where shares are held as stock in trade) or as other-sources income (if shares are held as investments). Such dividend income is taxed at applicable corporate tax rates. Any expense incurred to earn dividend income can be claimed as deduction while computing business income, but deduction allowance is restricted to certain expenses while computing dividend income under the head of other sources.

Further, any tax paid outside India by a local corporation can be claimed as credit against tax liability in India.

6.4 Use of Intangibles by Non-Local Subsidiaries

Where the intangibles developed and owned by an Indian corporation are used by a non-Indian subsidiary, the Indian corporation is entitled to receive royalties. Such royalties would be subject to the arm's length principle under transfer-pricing regulations. Even if the non-Indian subsidiary does not pay a royalty, for the purpose of the transfer-pricing rules, the Indian corporation would be deemed to receive an arm's length royalty from the non-Indian subsidiary and would be taxed accordingly.

If intangibles developed by an Indian corporation are assigned or transferred outright to a non-resident subsidiary, the arm's length sale consideration for that intangible may be subject to tax as business income or capital gains.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

There are no provisions relating to CFC-type rules in Indian income tax law.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no rules relating to the substance of non-local affiliates in Indian income tax law.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Indian companies are tax residents of India; hence, their global income is liable to tax in India. Any gains arising from the sale of shares in a non-Indian affiliate of an Indian company are taxed as capital gains in India, subject to treaty and foreign tax-credit benefits. There are no special rules prescribed for these.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

India has enacted the General Anti-Avoidance Rules (GAAR) with effect from 1 April 2016. The provisions are based on the doctrine of *"substance over form"*, and are applicable to arrangements regarded as *"impermissible avoidance agreements"* that are primarily structured to achieve tax benefit. The taxman has been empowered to recharacterise any such arrangement and even to deny tax and/or treaty benefits in order to curb the tax avoidance intended through such arrangement. An *"impermissible avoidance agreement"* is a defined term under the domestic tax law. Presently, the monetary threshold for applicability of the GAAR is INR3 crores.

Apart from the GAAR, specific anti-avoidance regulations also form part of domestic law in specific instances – eg, where certain assets are transferred at a price less than their fair market value, anti-avoidance regulation deems the fair market value as the consideration received on the transfer.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Income tax returns are filed on a self-assessment basis by the taxpayers. India does not have a regular routine audit cycle.

India has moved to a hybrid system for selecting tax returns for audit. A computer-aided scrutiny selection (CASS) system has been designed to identify high-risk tax returns for audit. Tax returns are also picked up for audit based on historic audit findings, the nature of business, etc.

9. BEPS

9.1 Recommended Changes

India is an active supporter of the OECD BEPS project and has implemented many of its recommendations/actions, as follows:

- BEPS Action 1 (Equalisation Levy and Significant Economic Presence (SEP));
- BEPS Action 4 (Thin-Capitalisation Rule);
- a patent box regime (BEPS Action 5);
- BEPS Actions 6 and 15 (MLI);
- country-by-country reporting (BEPS Action 13); and
- Guidelines on MAP (Action Plan 14).

Indian law is already in line with Action Plans 8–10 (Intangibles).

9.2 Government Attitudes

India has been actively involved in the implementation of the OECD recommendations in relation to the BEPS.

OECD Pillars One and Two are likely to be revolutionary reforms in the international tax landscape. India is among those countries that have joined the OECD statement. India is likely to introduce necessary changes into domestic tax laws to give effect to Pillar One and Pillar Two.

Moreover, India's taxation regime operates on a source basis. In view of that, Pillar Two's *"Subject to Tax Rule (STTR)"* would help India to curb base erosion and profit-shifting. The STTR is based on the rationale that a source jurisdiction that has ceded taxing rights in a tax treaty should be able to apply a top-up tax, where the income is taxed below the minimum rate by the resident country. Accordingly, on implementation, India would be able to tax those multinational enterprise (MNE) groups which are otherwise not being taxed by their resident jurisdictions.

9.3 Profile of International Tax

International tax is seen as a high-profile portfolio in India. Experienced Revenue Officers are specifically trained for handling cross-border taxation, including transfer pricing. The introduction of an equalisation levy and SEP Rules have increased their importance. The presence of a separate team of highly skilled personnel will help India in implementing BEPS recommendations at a faster pace.

9.4 Competitive Tax Policy Objective

Traditionally, India has not pursued a competitive tax policy. In fact, the corporate tax rates in India are already above the global minimum corporate tax rates of 15% prescribed under Pillar Two. India was either already compliant with, or had already implemented, a significant number of BEPS recommendations. As a result, India seeks to achieve international standards for fair and realistic tax competition.

9.5 Features of the Competitive Tax System

India does not have a competitive tax system that might be particularly affected by anti-BEPS measures.

9.6 Proposals for Dealing With Hybrid Instruments

Indian businesses are looking at hybrid instruments as an alternative mechanism for raising funds at a competitive price. However, the lack of clarity on its taxation has stalled the process of augmenting capital. Recently, representations have been made to frame rules for taxing such instruments, but the diversity of the characters of those instruments is delaying a policy decision.

9.7 Territorial Tax Regime

India generally taxes the worldwide income of its residents and does not follow a territorial tax regime. Non-residents, including the PE of non-Indian residents, are generally taxed only on the income derived from Indian sources.

The thin capitalisation rule will have a significant impact on investments.

9.8 Controlled Foreign Corporation Proposals

India does not have a territorial tax regime for resident companies.

9.9 Anti-Avoidance Rules

The limitation of benefit (LoB) rule and other anti-avoidance rules, such as the principal purpose test (PPT), introduced into tax treaties entered into by India (either directly or through a multilateral instrument (MLI)) are likely to have a significant impact on both inbound and outbound investors.

Even without these provisions, Indian tax authorities have, time and again, challenged benefits claimed under various tax treaties by applying the substance-over-form test and judicially recognised GAAR principles. Express inclusion of such provisions in the tax treaties, as well as legislative GAAR provisions, will further encourage the tax authorities to question and challenge treaty benefits claimed by investors.

The PPT introduced by the MLI is vague and subjective, and will likely expose investors to increased litigation in jurisdictions such as India.

9.10 Transfer Pricing Changes

Transfer-pricing matters involving intellectual property are a crucial issue for companies and advisers in India, as the evaluation, benchmarking and documentation of intellectual property are always challenged in Indian tax audits.

In light of the transfer-pricing documentation/reporting requirement covering country-by-country reporting, as well as the master file and the local file, intellectual property must be documented more extensively. Therefore, comments must be made regarding the creation, beneficial ownership, chances and risks, etc, of intellectual property.

This does not radically change things. However, information regarding intellectual property will be available to tax authorities in India and other countries with a greater level of transparency. Consequently, there are concerns that this could lead to more challenging tax-audit procedures.

9.11 Transparency and Country-by-Country Reporting

In response to BEPS Action 13, *"Guidance on Transfer Pricing Documentation and Country-by-Country Reporting"*, India has already incorporated transfer-pricing provisions to adopt the three-tiered documentation approach consisting of a country-by-country report, a master file and a local file.

Owing to these comprehensive reporting and documentation requirements, there is concern regarding the administrative barriers that companies may have to face.

9.12 Taxation of Digital Economy Businesses

India has introduced an *"Equalisation Levy"* and the concept of *"significant economic presence"* for the taxation of digital economy businesses.

An Equalisation Levy of 2% is levied on the amount of consideration received or receivable by an e-commerce operator from an e-commerce supply or services made, facilitated or provided by the operator. This levy has been withdrawn with effect from 1 August 2024.

Further, Equalisation Levy of 6% which is levied on online advertisements services provided by non-residents has been withdrawn with effect from 1 April 2025.

A new nexus rule in the form of an SEP has been introduced into Indian tax law. Generally, any income of a non-resident arising from a business connection in India is subject to tax in India. Any such business connection will include an SEP of a non-resident taxpayer in India.

A non-resident is said to have an SEP in India in the following cases (the FB 2025 proposes to expressly clarify that activities of mere purchase of goods in India for exports shall not constitute SEP of a non-resident):

- for transactions in any goods, services or property carried out by a non-resident in India, whereby aggregate payments exceed INR20 million in a year; and
- where the non-resident systematically and continuously solicits business or interacts with 300,000 or more users in India.

9.13 Digital Taxation

India is one of the first countries to introduce digital taxation by way of an Equalisation Levy and SEP provisions. However, India has withdrawn Equalisation Levy 2.0 on digital transactions with effect from 1 August 2024.

Further, Equalisation Levy of 6% on online advertisements has been withdrawn vide Finance Act 2025, with effect from 1 April 2025.

9.14 Taxation of Offshore IP

Any income by way of a royalty or FTS received by a non-resident from offshore intellectual property deployed in India is generally taxable in India at the rate of 20% plus the applicable surcharge and cess.

Taxation of such income usually takes the form of a tax-withholding by the payer in India. However, when no tax has been withheld by the payer as applicable, the taxpayer is directly required to discharge tax liability on such royalty/FTS income.

Indian tax law does not distinguish between non-resident owners of intellectual property in tax havens or in other countries. Non-residents located in countries that have favourable tax-treaty provisions with India may be eligible to avail of the applicable benefit under the treaties.

Trends and Developments

Contributed by:
S. Vasudevan, Karanjot Singh Khurana, Sonali Bansal and Loveena Manaktala
Lakshmikumaran & Sridharan

Lakshmikumaran & Sridharan is a leading full-service Indian law firm specialising in the areas of corporate and commercial law, dispute resolution, taxation and intellectual property. Founded by V. Lakshmikumaran and V. Sridharan in 1985, the firm keeps a finger on the pulse of litigation and commercial law matters throughout the country from its offices in 14 locations in India, and serves its clients through its more than 425 professionals (including over 70 partners). The firm has handled thousands of litigation cases before various forums in India and abroad, including hundreds of cases before the Supreme Court of India. Over the last four decades, the firm has worked with over 15,500 clients, including start-ups, small and medium enterprises, large corporates, banks and financial institutions, and MNCs. Lakshmikumaran & Sridharan is well known for its high ethical standards, quality work and transparency in all its business dealings.

Authors

S. Vasudevan is the executive partner of Lakshmikumaran & Sridharan, and an advocate. He is the national head of the firm's direct tax practice. He has worked in multiple tax verticals during his 18 years of association with the firm. He assists clients on all aspects of tax and allied laws, ensuring that solutions are sound from both a legal and accounting perspective. He has expertise in handling complex tax investigations and litigations involving multinational companies and big domestic companies. His wealth of experience pertaining to sectors such as fast-moving consumer goods (FMCG), telecommunications, finance, energy, information technology and e-commerce enables him to provide tax-efficient practical and holistic solutions. He is also a chartered accountant and cost accountant by qualification.

Karanjot Singh Khurana is a partner of direct tax practice at Lakshmikumaran & Sridharan. He advises on various issues in domestic tax, international tax and transfer pricing. He has advised clients in a variety of sectors including banking and finance, oil and gas, IT and ITeS, telecommunications, iron and steel, and electric automobiles. He has conducted various due diligence assignments and handled complex matters involving PE exposure. He has also handled litigation matters before various courts, tribunals and other appellate forums. He has been an active speaker at various seminars and conferences organised on direct taxation. He has also authored many articles in reputed national and international journals.

Contributed by: S. Vasudevan, Karanjot Singh Khurana, Sonali Bansal and Loveena Manaktala,
Lakshmikumaran & Sridharan

Sonali Bansal is a principal associate at the Delhi office of Lakshmikumaran & Sridharan. She is a chartered accountant by qualification, and has been actively involved in providing advisory-related assistance in corporate and international taxation. She has also assisted clients on a litigation front before various forums.

Loveena Manaktala is a senior associate with the direct tax team of Lakshmikumaran & Sridharan. She is a chartered accountant by qualification and has been actively involved in providing advisory-related assistance in corporate and international taxation. With experience in restructuring, transfer pricing and intricate tax matters, she navigates complexities and offers strategic solutions to clients.

Lakshmikumaran & Sridharan

5 Link Road
Jangpura Extension
opposite Jangpura Metro Station
New Delhi
110 014
India

Tel: +91 11 4129 9800
Fax: +91 11 2619 7578
Email: Lsdel@lakshmisri.com
Web: www.lakshmisri.com

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Lakshmikumaran & Sridharan

Recent trends and developments in the Indian corporate tax domain can be broadly classified under the following key headings:

- angel tax abolished;
- reliefs with respect to transfer pricing provisions;
- presumptive taxation scheme for non-residents providing services for electronics manufacturing facilities;
- clarification regarding the scope of significant economic presence (SEP);
- extension of timeline for tax benefits to start-ups;
- buyback of shares to be treated as *"deemed dividend"* in the hands of the shareholder;
- Equalisation Levy abolished;
- application of the principal purpose test (PPT) in the India-Mauritius tax treaty;
- Apex Court stays the applicability of the Delhi High Court judgment in *Tiger Global International*
- Apex Court rules that reduction of share capital amounts to *"transfer"*, subject to capital gains tax;
- no obligation on non-residents to obtain a permanent account number (PAN) for filing Form 10F, to avail of treaty benefits; and
- new Income Tax Bill, 2025.

Angel Tax Abolished

To curb generation and use of unaccounted money, closely held companies in India were earlier subject to tax on excess of issue price over the fair market value of shares where the shares are issued to a resident investor. This tax was known as angel tax. With effect from 1 April 2025, the angel tax provisions have been abolished to bolster the Indian start-up ecosystem and to promote investments in start-ups.

Relief With Respect to Transfer Pricing Provisions

Introduction of block assessment for transfer pricing cases

Earlier, determination of arm's length price (ALP) was an exercise required to be undertaken for each financial year (FY). However, in many cases it was observed that circumstances/facts relating to the concerned international transactions or specified transactions were similar over the years. Similarities may be due to the entities being involved in such transactions, proportionate quantum of transactions, location of associated enterprises, etc. Repeating the assessments for such transactions for each year increased the compliance burden for taxpayers, and created an administrative burden for the revenue authorities.

In order to tackle these issues, the Finance Bill, 2025(*"FB 2025"*) has proposed carrying out the transfer pricing assessments in block. Accordingly, the FB 2025 provides that the ALP determined for an international transaction or specified international transaction shall apply for a block period of three FYs. The taxpayer can choose to exercise this option in the time and manner prescribed in the domestic act. The amendment will be effective from 1 April 2026 – ie, FY 2025–26, and subsequent years.

Expanding the scope of safe harbour rules

In India, if a taxpayer meets the criteria prescribed in the safe harbour rules, the transaction price of certain international transactions declared by the taxpayer shall be accepted by the income tax authorities. Currently, the scope of these rules is confined to 11 types of international transactions. These rules aim at reducing transfer pricing litigation and providing certainty to taxpayers. Expanding the scope of safe harbour rules has been proposed. Further, specific

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safe harbour rules have also been proposed for non-residents who store components for supply to specified electronics manufacturing units. The rules are yet to be notified.

Presumptive Taxation Scheme for Non-Residents Providing Services for Electronics Manufacturing Facilities

The Indian government wants to encourage development of semiconductors and the display manufacturing ecosystem in the Indian electronics industry. The Ministry of Electronics and Information Technology (MeitY) has notified schemes for setting up such facilities in India. It is envisioned that non-residents will be involved in providing support services, including technology, to these manufacturing facilities.

To provide tax certainty and to promote ease of doing business, introduction has been proposed of a new presumptive taxation regime for non-residents engaged in providing services or technology in India for setting up electronics manufacturing facilities or for manufacturing electronic products in India. The salient features of the scheme are as follows.

- Non-residents should be engaged in the business of providing *"services"* or *"technology"* in India, for the purpose of setting up an electronics manufacturing facility or in connection with manufacturing or producing electronic goods, articles or things in India.
- The service recipient should be a resident company engaged in establishing or operating said electronics manufacturing facility or a connected facility under a scheme notified by the central government. The resident should also satisfy the prescribed conditions.
- Under this scheme, 25% of the aggregate amounts received/receivable by non-residents (or any person on their behalf) shall be deemed to be the profits liable to tax as business income of the non-resident.
- Set-off of unabsorbed depreciation and brought-forward business losses will not be allowed.

Clarification Regarding the Scope of SEP

Section 9 of the Indian Income Tax Act, 1961 (the *"Act"*) provides for criteria for a source rule of taxation in domestic taxation law. Income accruing or arising, directly or indirectly, from any *"business connection"* in India is generally taxable in India. Various exceptions are carved out regarding the scope of *"business connection"*, with one such exception being income of non-residents whose operations are confined to purchase of goods in India for the purpose of exportation.

With effect from 1 April 2022, SEP of a non-resident in India was deemed to constitute a business connection in India. SEP means, inter alia, transactions in respect of any goods carried out by a non-resident with any person in India, if the aggregate value of such transactions during a year exceeds INR20 million (approximately USD230,000). This created a possible anomaly. A non-resident merely purchasing goods in India for exportation could be said to have SEP in India (and hence a business connection), if the transactions exceeded prescribed monetary thresholds, despite an otherwise express exclusion from the scope of *"business connection"*.

To remove this anomaly and to provide clarity, with effect from 1 April 2026, the FB 2025 proposes to expressly clarify that activities of mere purchase of goods in India for exportation shall not constitute SEP of a non-resident.

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Lakshmikumaran & Sridharan

Extension of Timeline for Tax Benefits to Start-Ups

The existing provision of the Act provides for a deduction of 100% profits and gains derived from an eligible business by an eligible start-up for three consecutive assessment years out of ten, beginning from the year of incorporation at the option of the taxpayer, subject to fulfilment of certain conditions. One of the conditions was that the eligible start-up has to be incorporated between 1 April 2016 and 31 March 2025. Recently, the FB 2025 proposed extending the timeline of incorporation for eligible start-ups to 31 March 2030. The amendment would take effect from 1 April 2025.

Buyback of Shares to Be Treated as *"Deemed Dividend"* in the Hands of the Shareholder

Earlier, a company had to pay additional corporate tax in the form of buyback tax (BBT) on the amount of income distributed to shareholders during buyback of shares. Consequently, income received by shareholders upon such buyback was exempt in the hands of the shareholders.

Recently, the provisions have been amended to shift the taxation of buyback transactions to the shareholders instead of the company. With effect from 1 October 2024, proceeds from buyback of shares would be treated as dividend taxable in the hands of the shareholders at the applicable rates. Further, no expense would be allowed as deduction to the shareholder with respect to such dividend income.

At the same time, the shareholders would be provided relief by allowing capital loss to the shareholder on such buyback transaction to the extent of cost of acquisition of shares. This capital loss is allowed to be carried forward and set off against capital gain earned by the taxpayer in future.

Equalisation Levy abolished

With effect from 1 April 2016, Indian had imposed Equalisation Levy of 6% on non-resident providers of online advertising.

From 1 April 2020, such levy was expanded and an equalisation levy of 2% was introduced on income generated by non-resident e-commerce operators from the e-commerce supply of goods or services to India. An *"e-commerce operator"* was defined in a wide manner to cover any non-resident who owns, operates or manages digital or electronic facilities or platforms for online sale of goods or online provision of services, or both. This was a unilateral measure adopted by India to tax income generated from digital transactions pursuant to recommendations made by BEPS Action Plan 1. Concerns were raised by non-resident taxpayers regarding the ambiguous scope and compliance burden of this levy. Also, countries such as the USA had threatened retaliatory tariffs on goods and services exported from India in response to this unilateral measure, which was considered as disregarding the existing tax treaty provisions.

Subsequently, India agreed with the USA to withdraw the equalisation levy, in anticipation of implementation of the Pillar 1 and 2 multilateral solutions proposed by the OECD. As such, with effect from 1 August 2024, the equalisation levy of 2% was abolished.

Equalisation Levy of 6% has also been withdrawn vide Finance Act 2025, with effect from 1 April 2025.

Application of PPT in the India-Mauritius Tax Treaty

On 7 March 2024, India and Mauritius signed a protocol for amending the India-Mauritius tax treaty. This protocol proposes replacing the pre-

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amble to encompass the intention of eliminating double taxation without creating the opportunities for non-taxation or reduced taxation though tax evasion or avoidance.

It also proposes introducing Article 27B to include the PPT. In this regard, India and Mauritius are required to notify each other regarding the completion of the procedures required by law for bringing this protocol into force. Pending requisite notifications, this protocol is yet to enter into force.

Apex Court Stays the Applicability of the Delhi High Court Judgment in Tiger Global International

Recently, the Hon'ble Delhi High Court held that the capital gains arising for a Mauritius-based investor from the sale of shares in a Singaporean company (which in turn was holding shares in an Indian company) were not taxable in India. The ruling also relied on the grandfathering benefit provided under Article 13(3A) of the India-Mauritius Double Tax Avoidance Agreement, with respect to capital gains on shares acquired before 1 April 2017.

The Court also observed that, once it is established that the transaction has economic substance and the conditions prescribed in the LoB clause are met, a treaty benefit is required to be extended based on a valid tax residency certificate (TRC). The onus lies on the tax department to bring forth convincing evidence proving lack of economic substance, in order to deny treaty benefit. Importantly, the Court noted that the role played by the holding company in the decision-making of the subsidiary company is not sufficient to allege lack of substance in the subsidiary. This judgment was of vital importance for all the investment holding companies investing in India directly or through step-down subsidiaries.

The Hon'ble Supreme Court has admitted the Revenue's appeal and has stayed the Delhi High Court ruling. The final word on this issue from the Supreme Court is still pending.

Apex Court Rules That Reduction of Share Capital Amounts to *"Transfer"*, Subject to Capital Gains Tax

In this judgment, the taxpayer received certain consideration upon cancellation of its shares in an Indian company. A capital loss was claimed by the taxpayer against the cancellation of shares. The taxpayer continued to hold 99.99% before and after the cancellation of shares by the Indian company. The Indian revenue authorities challenged the set-off of such capital loss. Under the Act, capital gain/loss is computed on account of *"transfer"* as defined in the Act. The definition of transfer includes, inter alia, extinguishment of rights in capital assets.

The Apex Court ruled in favour of the taxpayer by holding that the cancellation of shares amounts to extinguishment of rights attached to the reduced shares (capital asset). The fact that the taxpayer received a monetary consideration for extinguishing of rights reinforced the conclusion that the reduction in shareholding resulted in *"transfer"*. The Court observed that, despite the ownership of shares in percentage terms remaining constant, the reduction in the number of shares and rights attached therein would make the transaction a transfer.

No Obligation on Non-Residents to Obtain a PAN for Filing Form 10F, to Avail of Treaty Benefits

In order to claim treaty benefits under the Act, non-residents have to furnish certain documents such as a TRC. In this regard, the rules prescribe that Form10F be furnished with requisite details – such as status, nationality, tax identification

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Lakshmikumaran & Sridharan

number – when these details are not part of the TRC. Form 10F was mandated to be submitted electronically on the income tax portal. This necessitated that non-residents obtain a PAN for submitting this form.

Recently, an option has been made available on the income tax portal allowing non-residents to submit Form 10F without obtaining a PAN. The portal now requires non-residents to submit details such as date of incorporation/birth, tax identification number, country of residence, etc. Further, these details are subject to verification with a one-time password.

New Income Tax Bill, 2025

A new Income Tax Bill, 2025 was tabled before parliament on 13 February 2025. The Bill seeks to replace the existing Income Tax Act, 1961. Once enacted, the new Bill will come into force from 1 April 2026. The objective behind introduction of the new Bill is to simplify and structurally rationalise legislation. The Bill is not intended to make any policy changes but to reduce the overall volume of existing income tax law.

IRAQ

Law and Practice

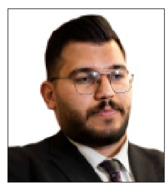
Contributed by:
Ahmed Hankawi and Anas Duraid
Hinka Tax Solutions

Contents

Hinka Tax Solutions was established in 2017 with four lawyers and is one of the first specialised tax firms in Iraq and the UAE. Now boasting over 25 tax experts, the firm serves clients across the Kurdistan Region of Iraq. With decades of collective experience, Hinka offers tailored tax services, supporting international corporations, local businesses and SMEs through complex tax compliance and planning. The team of 30 lawyers in Baghdad works alongside the team at the Dubai office. Hinka excels in addressing intricate tax challenges, providing strategic insights to optimise clients' tax positions. Committed to client satisfaction, the firm streamlines processes, identifies tax-saving opportunities and aligns with clients' financial goals while ensuring regulatory compliance. Driven by innovation and efficiency, Hinka remains focused on delivering value through cost-saving strategies and personalised solutions, cementing its reputation as a trusted partner in tax advisory and planning.

Authors

Ahmed Hankawi is the chair at Hinka Tax Solutions, a firm based in Iraq that has its registered office in Dubai, UAE. Specialising in taxes and legal matters, he plays a key role in delivering top-tier tax services in Iraq. With deep expertise in Iraqi law, Ahmed has successfully represented multinational corporations, local businesses and contractors in complex commercial matters. His strategic approach ensures optimal client outcomes. Ahmed holds a Master's in Law, specialising in expunging trade marks for violations of registration procedures, with a strong focus on Iraqi trade mark law and procedural compliance. His expertise extends to tax matters, ensuring regulatory compliance and efficiency.



Anas Duraid is a lawyer specialised in tax consulting and settlements for individuals, corporations and real estate transactions. He excels in issuing tax clearance certificates and ensuring full legal compliance. With expertise in auditing and financial statement preparation, Anas integrates legal and financial aspects of taxation, particularly concerning foreign workers and related procedural requirements. He also has in-depth knowledge of labour law, social security regulations and foreign worker compliance. Additionally, he is experienced in trade mark registration, intellectual property protection and real estate law. His strong communication skills and ability to liaise with government bodies ensure smooth legal procedures.

Contributed by: Ahmed Hankawi and Anas Duraid, **Hinka Tax Solutions**

Hinka Tax Solutions

Baghdad
Baghdad Governorate
10015
Iraq

Tel: +964 781 500 1400
Email: info@hinkaiq.com
Web: www.hinkaiq.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Corporate structures in Iraq include the following.

- The limited liability company (LLC) structure requires at least two shareholders. Liability is limited to their contributions, excluding banking/insurance activities. The LLC structure is ideal for SMEs and investors seeking liability protection.
- The joint stock company (JSC) structure is designed for larger businesses that can issue shares, and can be public or private. JSCs are common in sectors like energy and telecommunications. They require more capital compared to LLCs.
- Foreign branches allow foreign companies to operate in Iraq as an extension of their parent company, and are suitable for multinational companies.
- In general partnerships, shareholders share profits, losses and liabilities equally. General partnerships are commonly used for small businesses and professional services, and are taxed at the individual level.
- The sole proprietorship is owned by one individual with unlimited liability; this structure is best for small businesses and self-employed individuals. Income is taxed as personal income.

LLCs and JSCs are taxed separately at 15%, with higher rates for companies in the oil and gas sector, while partnerships and sole proprietorships pass income through to owners, who are taxed individually. Foreign branches are taxed on Iraqi income, with potential withholding taxes (WHTs).

1.2 Transparent Entities

Transparent entities in Iraq allow income or losses to pass through to owners, who are taxed individually. These entities are simpler than formal structures, making them attractive for specific sectors and investment groups.

- General partnerships share profits, losses and liabilities among partners. They are simple to form and common in small, family, legal, accounting and consultancy businesses. Partners are fully liable.

- Limited partnerships encompass general partners (with unlimited liability) and limited partners (with liability limited to their investment). They are attractive for investment groups – especially in the context of real estate, private equity, hedge funds, energy and infrastructure – allowing easy profit distribution, providing liability protection and flexible management and helping share risks and resources in large projects, such as in the oil and gas sector.
- Joint ventures (JVs) are temporary partnerships for specific projects, with income and liabilities distributed based on agreement. JVs are often used in large infrastructure, construction and oil and gas projects, helping share risks and resources for large projects in, for example, the oil and gas sector.
- Unincorporated investment vehicles are informal structures used for pooling funds, with income taxed at the investor level. They are common in private equity and niche investments.

1.3 Determining Residence of Incorporated Businesses

Concerning determination of the residence of incorporated businesses and transparent entities, the following applies.

- Incorporated businesses:
  - (a) place of incorporation – businesses incorporated under Iraqi law are considered tax residents of Iraq;
  - (b) place of management and control – if management and control is conducted in Iraq, the business is considered a tax resident;
  - (c) place of effective management – refers to where key management decisions are made, which is important for dual residence situations;
  - (d) economic connection – a company with significant operations or assets in Iraq may be considered a resident; and
  - (e) permanent establishment (PE) – a foreign company with a PE in Iraq (eg, an office or construction site) is taxed on income earned in Iraq.
- Transparent entities (eg, partnerships, joint ventures):
  - (a) residence of shareholders – the tax residence of shareholders determines the entity's residence;
  - (b) location of activities – if the entity operates in Iraq, its residence is tied to the location of its activities; and
  - (c) PE – transparent entities operating through a PE in Iraq are taxed on Iraq-sourced income, with shareholders reporting income individually.
- Double taxation treaties (DTTs):
  - (a) tie-breaker rules – when an entity is a resident of both Iraq and another country, DTTs use criteria like management location, incorporation and economic activities to determine residency; and
  - (b) PE provisions – DTTs specify what constitutes a PE and determine Iraq's rights to tax its income. Income is typically taxed in the source country (eg, Iraq for income sourced from Iraq), with relief provided by the country of residence.

1.4 Tax Rates

Concerning the tax rates paid by incorporated businesses and businesses owned by individuals, the following applies.

- Incorporated businesses:
  - (a) corporate income tax (CIT) – the standard rate is 15%, but businesses in the oil and gas sector may face a rate of up to 35% due to special agreements;

  (b) WHT – 15% on payments to non-resident entities unless reduced by a tax treaty; and
  (c) capital gains – taxed at the standard 15% CIT rate.
- Businesses owned by individuals:
  (a) individual income tax – income up to IQD250,000/month and income over IQD250,000/month is taxed at 15%;
  (b) partnerships and JVs – income is passed through to individual owners and taxed at personal income tax rates; and
  (c) sole proprietorships – taxed on net profits as personal income.
- Sector-specific considerations:
  (a) incorporated businesses in the oil and gas sector are taxed at up to 35%;
  (b) construction and infrastructure – LLCs and JSCs are taxed at 15%, with potential WHT for non-residents; and
  (c) small businesses and professional services are typically taxed at individual rates for sole proprietorships or partnerships.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Basis of Taxation

Concerning the basis of taxation, the following applies:

- accounting profits – accounting profits in financial statements are adjusted to meet Iraqi tax laws;
- accruals basis – taxable income is based on earned income and incurred expenses, not when cash is received or paid; and
- receipts basis – small businesses may use the receipts basis for simplicity.

Taxable Income Adjustments

Concerning taxable income adjustments, the following applies:

- non-taxable income excludes income, such as dividends, from Iraqi-resident companies and government-exempt income;
- non-deductible expenses – expenses like fines, excessive entertainment and unrelated costs are not deductible;
- depreciation – accounting depreciation is adjusted, and tax depreciation follows fixed rates;
- provisions and reserves are not deductible unless realised or specifically allowed;
- loss carry forward – losses can offset future profits for up to five years, and there is no loss carry back; and
- transfer pricing – profits may be adjusted if related-party transactions do not follow arm's-length pricing.

Allowable deductions include operating expenses, interest, repairs and maintenance, research and development (R&D) and taxes paid.

Capital gains are taxed as ordinary income at 15%, foreign income classified as *"worldwide income"* is subject to tax that may be relieved under tax treaties and the WHT rate is 15% on payments to non-residents, unless reduced by a treaty.

2.2 Special Incentives for Technology Investments

The following applies regarding special incentives for technology investments.

- Tax and investment incentives:
  (a) R&D deductions – businesses can deduct expenses related to R&D activities, such as product development and process

improvement, and some costs may require capitalisation and amortisation with proper documentation;
  (b) investment law benefits – the Investment Law (No 13 of 2006) provides incentives for technology-focused projects; and
  (c) depreciation of technology assets – technology investments may qualify for accelerated depreciation, reducing taxable income more rapidly.
- Priority sectors for technology investment:
  (a) IT and telecommunications – focusing on modernising infrastructure, with regulatory support and partnership opportunities; and
  (b) renewable energy and green technology – extended tax exemptions and grants are available for clean energy projects (eg, solar, wind).
- Limitations:
  (a) Iraq does not have a patent box system or advanced R&D tax credits, although businesses can benefit from general tax incentives; and
  (b) international businesses may receive tax relief on intellectual property (IP) income through DTTs.

2.3 Other Special Incentives

Iraq provides a range of tax incentives to promote investment and economic development across various industries. These incentives are designed to support key sectors and encourage business growth.

Concerning specific industries, oil and gas businesses receive customs duty exemptions on equipment, while renewable energy projects, especially solar and wind, can benefit from up to ten years of tax exemptions and machinery import relief. Manufacturing businesses, particularly export-focused ones, also receive favourable tax treatment.

Transaction incentives include reduced WHTs for infrastructure financing and tax holidays for public-private partnerships in sectors like transportation and healthcare. Real estate developers in affordable housing projects can access duty exemptions on materials and partial tax relief.

SMEs benefit from simplified tax filing and grants, while technology businesses can deduct research expenses. Agriculture also receives support through tax exemptions on farming income and machinery.

Regional incentives offer extended tax holidays and customs exemptions, with even more favourable terms in the Kurdistan Region of Iraq, such as ten-year corporate tax exemptions and reduced regulations to encourage investment.

2.4 Basic Rules on Loss Relief

The basic rules on loss relief are as follows:

- loss carry forward – losses incurred in a tax year can be carried forward and offset against taxable profits in future years (limited to five years);
- loss carry back – Iraq does not allow businesses to carry losses back to offset profits from previous tax years;
- offset of losses – business losses can generally be offset against business income in future years, but cannot typically be offset against capital gains as these are treated separately; and
- restrictions – loss relief may be disallowed if there is a significant change in ownership or business activity based on specific circumstances.

2.5 Imposed Limits on Deduction of Interest

Concerning limits imposed generally on the deduction of interest by local corporations, the following applies:

- business purpose requirement – interest is only deductible if a loan was taken for business purposes and directly relates to generating taxable income;
- documentation – proper documentation, including loan agreements and payment proofs, is required to support the deduction;
- thin capitalisation rules – while there are no strict thin capitalisation rules, interest payments to related parties may be audited to ensure alignment with transfer pricing principles; and
- capitalisation of interest on loans used for acquiring or constructing capital assets must be capitalised as part of the asset's cost, rather than deducted immediately.

2.6 Basic Rules on Consolidated Tax Grouping

Iraq does not allow consolidated tax grouping, meaning each company in a group is taxed separately. Losses from one company cannot offset the profits of another within the same group. Instead, companies must handle losses and profits independently, using loss carry forward rules to offset future income. The following applies in Iraq:

- loss carry forward – losses can be carried forward for up to five years and used to offset future taxable profits of the same company;
- intra-group transactions – transactions between group companies must comply with the arm's length principle and be reported independently; and
- strategic structuring – companies can strategically allocate income-generating and loss-incurring activities to minimise tax liabilities.

2.7 Capital Gains Taxation

Corporate taxation on capital gains depends on the nature of the assets sold and the company's activities:

- depreciable assets – gains from the sale of depreciable assets are taxed at the standard CIT rate of 15%;
- shares and bonds – for non-trading activities, gains from the sale of shares and bonds not part of regular trading may be exempt from tax, whereas for trading activities, if the sale is part of regular trading, gains are taxed at the standard CIT rate of 15%; and
- oil and gas sector – companies in the oil and gas industry are taxed at a higher CIT rate of 35%, including on capital gains.

2.8 Other Taxes Payable by an Incorporated Business

Incorporated businesses in Iraq may face various additional taxes and levies depending on the nature of the transactions and the business sector, as follows:

- WHT – payments to non-residents for services in Iraq are subject to WHT, ranging from 3% to 15%, with a standard rate of 7% for oil and gas contracts;
- stamp duty – imposed at 0.2% of the transaction value on certain legal documents and contracts;
- real estate transfer – 3% tax applies to real estate transactions when businesses buy or sell property;
- customs duties – customs duties on imported goods vary, typically ranging between 0%

and 30% depending on the classification of the goods;
- sales tax – Iraq does not have VAT, but some goods and services, like telecommunications and hotel accommodations, are subject to a 5% sales tax;
- municipality taxes – renting or leasing property may incur municipal taxes, such as 10% on hotel accommodations;
- social security contributions – employers must contribute 12% of employees' salaries to social security for payroll or employment contracts; and
- sector-specific levies – higher taxes and levies apply in the oil and gas sector (35% CIT), and specific transaction taxes or fees may apply in the banking and insurance sectors.

2.9 Incorporated Businesses and Notable Taxes
Incorporated businesses in Iraq face several key taxes and obligations:

- CIT – 15% on most businesses, 35% for those in the oil and gas sector;
- payroll taxes – personal income tax withheld from employee salaries, ranging from 3% to 15%;
- social security – employers contribute 12%, and employees 5%;
- customs duties – vary from 0% to 30% for imported goods;
- sales tax – 5% on certain goods and services (eg, telecommunications, hospitality);
- stamp duty – 0.2% on legal documents;
- real estate taxes – 3% transfer tax on property sales, plus annual property taxes;
- WHT: 3% to 15% on payments to non-resident entities;
- sector-specific taxes – additional taxes in the oil and gas and telecom sectors;
- municipal taxes – taxes on property leases, advertising and permits; and
- licensing fees – fees for operational licences and compliance.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses
Most small businesses in Iraq operate in non-corporate forms, although some opt for corporate structures depending on their size, industry and growth goals.

Non-corporate forms include:

- sole proprietorship – a simple form for small, family-run businesses, where the owner is fully liable for debts and obligations;
- general partnership – two or more individuals share resources but are personally liable for the business's obligations; and
- limited liability partnership (LLP) – provides limited liability for some partners and is often used by professional services and family-run businesses.

Corporate forms include:

- LLC – a form used by medium-sized businesses for limited liability protection, requiring at least two shareholders; and
- JSC – a common form for larger, more capital-intensive businesses in sectors like oil and gas; JSCs are complex to manage due to stricter regulations.

3.2 Individual Rates and Corporate Rates
There are no specific rules preventing professionals (eg, architects, engineers, consultants)

from incorporating to benefit from lower corporate tax rates. However, certain general principles may apply:

- substance over form – tax authorities may challenge arrangements designed solely to reduce tax liability without a legitimate business purpose;
- corporate tax filing – incorporated businesses must comply with corporate filing requirements, maintain proper accounts and pay 15% CIT on profits;
- WHT – payments to incorporated professionals may be subject to WHT, especially for contract-based services; and
- personal income tax – salaries or dividends drawn by a professional from the company are taxed at individual rates (3–15%).

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules preventing closely held corporations from accumulating earnings for investment purposes, but certain considerations apply.

- CIT: Closely held corporations are taxed on profits, whether earnings are retained or distributed.
- Dividends and profit distribution: Shareholders are taxed on dividends at individual income tax rates. Retaining earnings may avoid immediate dividend taxes, but could raise audits if it seems the purpose is to avoid personal income tax.
- Justification for retained earnings: Retained earnings should be for legitimate business purposes, like growth or debt repayment. Excessive accumulation without a clear reason could be questioned.
- Investment income taxation: Income from retained earnings invested in assets (eg, interest, rents, capital gains) is still subject to CIT.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are taxed on dividends and gains from the sale of shares in closely held corporations as follows.

- Dividends: Gains from selling shares are usually exempt unless part of regular trading or business activities.
- Gains on the sale of shares:
  - (a) exempt from tax – gains from selling shares are usually exempt unless part of regular trading or business activities; and
  - (b) taxable – if the individual is regularly trading shares as a business, the gains are subject to individual income tax at progressive rates (3% to 15%).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are taxed on dividends and gains from publicly traded corporations as follows:

- dividends – generally, dividends received by individuals from publicly traded corporations are exempt from tax; and
- gains on the sale of shares – gains from the sale of shares in publicly traded corporations are typically tax-exempt for individuals.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

WHTs in Iraq apply to payments made to non-residents for interest, dividends and revenues as follows:

- WHTs:
  - (a) interest – generally 15%, unless reduced by an income tax treaty;
  - (b) dividends – there is no WHT on dividend payments, even for non-residents; and
  - (c) revenues – 15% WHT on payments to non-residents.
- Reliefs available:
  - (a) income tax treaties – reduced WHT rates or exemptions may apply if a treaty exists; and
  - (b) exemptions for local transactions – certain local transactions may not attract WHT.
- Focus areas for enforcement:
  - (a) oil and gas – strict enforcement, especially for international contracts; and
  - (b) large construction and service contracts – payments to foreign contractors are audited for WHT compliance.

Concerning WHT collection, the following applies:

- strict audits – tax authorities audit payments to ensure proper WHT deduction;
- payment withholding – payments to non-residents may require proof of WHT deduction before processing; and
- fines and penalties – non-compliance can lead to penalties, fines and delays in transactions.

4.2 Primary Tax Treaty Countries

Iraq has a limited number of tax treaties, and foreign investors often use bilateral agreements to optimise tax treatment when investing in Iraq. Key treaty countries include:

- United Kingdom – reduces WHTs on interest, revenues and other income;
- France – offers tax relief on cross-border transactions and investments;
- Turkey – popular for regional investors due to economic ties;
- Jordan and Egypt – frequently used by Middle Eastern investors due to strong trade relationships; and
- United Arab Emirates – encourages investment in Iraq's corporate and debt markets.

Benefits of tax treaties include:

- reduced – or exemption from – WHTs on interest, dividends and revenues; and
- avoidance of double taxation, ensuring income is not taxed in both Iraq and the investor's home country.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Local tax authorities may challenge the use of treaty country entities by non-treaty country residents if they suspect such use is solely for tax benefits. Iraq lacks anti-avoidance laws, and authorities rely on the following general principles.

- The substance over form principle: authorities may investigate whether the treaty country entity has a legitimate business purpose and real economic substance or is just a shell for tax benefits.
- Beneficial ownership: authorities may challenge treaty benefits if the entity receiving income is not the beneficial owner, but rather just a conduit for a non-treaty resident.
- Focus areas: payments such as dividends, interest and revenues are audited to ensure proper treaty benefits. The oil and gas sector is a key focus for tax rule enforcement, including treaty abuse prevention.

- Consequences of challenges: If misuse is detected, the entity may lose treaty benefits, and WHT could be charged at full domestic rates.

4.4 Transfer Pricing Issues

Transfer pricing regulations in Iraq are underdeveloped compared to global standards, which may create challenges for inbound investors. Transfer pricing issues include the following.

- Lack of formal transfer pricing rules: Iraq does not have transfer pricing regulations aligned with global frameworks, creating uncertainty regarding how related-party transactions are assessed.
- Key issues:
  - (a) related-party transactions – payments for goods, services or revenues between local corporations and foreign affiliates may be audited;
  - (b) management fees and revenues – authorities may challenge excessive charges for management or IP; and
  - (c) intercompany financing – interest rates on loans from parent companies must be justifiable, or deductions may be disallowed.
- Enforcement risks: Enforcement is inconsistent but tax authorities may audit intercompany pricing, especially in sectors like oil and gas and large-scale infrastructure, and adjust taxable income.
- Documentation challenges: There are no formal requirements for transfer pricing documentation.

4.5 Related-Party Limited Risk Distribution Arrangements

Iraq's tax authorities do not have detailed transfer pricing rules to specifically challenge related-party limited risk distribution (LRD) arrangements, but general principles could lead to audits:

- key concerns – profit shifting, arm's-length principle, tax base erosion;
- areas of auditing – management fees and revenues, pricing of goods/services;
- enforcement practices – inconsistent approach, focus on high-value industries; and
- risk mitigation – making sure the local entity's role and risk match its profits, keeping contracts and documents showing fair pricing and following global guidelines, like OECD rules.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Iraq's transfer pricing rules differ from global standards, like the OECD standards, due to the lack of formal regulations:

- no detailed rules – Iraq lacks specific laws or guidelines for transfer pricing;
- arm's-length principle – this is not strictly applied, and tax authorities may challenge related-party transactions based on fairness;
- enforcement – typically triggered by audits, especially in sectors like oil and gas, with no set methods applied;
- no documentation requirements – Iraq does not require detailed records, unlike the OECD, but companies should still keep internal documentation to defend their pricing if challenged; and
- focus on profit allocation – tax authorities may review whether profits are reasonable based on the company's activities, without following detailed OECD analysis methods.

4.7 International Transfer Pricing Disputes

Iraq's tax authorities are not very aggressive with respect to transfer pricing due to a lack of detailed rules, though audits are increasing in some sectors. However, tax authorities can use new information found during audits to re-assess past years, especially if profit shifting is suspected.

Mutual agreement procedures (MAPs) are infrequently used in Iraq because there are few tax treaties and a lack of transfer pricing frameworks. While Iraq may sometimes participate in MAPs, it prefers handling disputes locally and is not proactive in initiating MAPs.

Due to limited enforcement and tax treaties, MAPs are rare in Iraq. However, if transfer pricing enforcement increases and cross-border transactions grow, MAPs could become more relevant.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

In Iraq, compensating adjustments for related-party pricing discrepancies are not explicitly addressed in tax laws:

- lack of specific rules – there are no formal transfer pricing regulations in Iraq that require or allow compensating adjustments;
- practical approach – any adjustments are made on a case-by-case basis during audits or disputes;
- double tax risk – without compensating adjustments, there is a risk of double taxation if another jurisdiction does not recognise Iraq's adjustments; and
- MAP – if a tax treaty exists, the taxpayer may attempt to resolve double taxation via a MAP, though such cases are rare in Iraq.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

In Iraq, local branches and local subsidiaries of non-local corporations are taxed differently:

- local branches of non-local corporations – Iraq-sourced income is taxed at 15% (standard rate) or 35% (in the oil and gas sector), and there may be additional WHT when profits are transferred to the foreign parent; and
- local subsidiaries of non-local corporations – taxed on global income sourced in Iraq (15% standard rate, 35% in the oil and gas sector), and there may be WHT on dividends to the foreign parent.

Regarding key differences, branches are taxed on Iraqi income, while subsidiaries are taxed on global income. Branches transferring profits directly to the parent may be subjected to local tax, as well as subsidiaries distributing profits as dividends.

5.3 Capital Gains of Non-Residents

Non-residents are taxed on capital gains from the sale of stock in local corporations, and gains are taxed at the 15% CIT rate for non-residents.

Concerning indirect capital gains, Iraq does not specifically tax capital gains from the sale of shares in a non-local holding company that owns stock in a local corporation; tax authorities may challenge such structures if they believe they are designed to avoid local tax.

Tax treaties with Iraq may offer exemptions or reduced rates on capital gains from local stock, depending on the treaty's terms. Most treaties do not cover indirect capital gains, so these may not benefit from treaty provisions.

5.4 Change of Control Provisions

Changes in ownership of a company may trigger tax or duty charges.

Direct Change of Control

A direct sale of shares in a local corporation may trigger a 15% capital gains tax for the seller (if taxable in Iraq). Legal documents related to the transfer may incur a stamp duty (eg, 0.2% of the transaction value).

Indirect Change of Control

Iraq may not tax the indirect transfer of ownership through a sale of shares in an overseas holding company. However, authorities may investigate if such structures are used to avoid local taxes, though enforcement is limited.

Key Focus Areas

Transactions in the oil and gas sector may face additional auditing to ensure local tax obligations are met. Authorities may challenge indirect transfers if structured solely for the purpose of tax avoidance.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Iraq does not use fixed formulas to determine the income of foreign-owned local affiliates, but may estimate income if records are insufficient.

Simplified Methods

If documentation is lacking, tax authorities may estimate taxable income using practical or negotiated methods.

Arm's-length principle

Although transfer pricing rules are not in place, Iraq expects related-party transactions to reflect market-based pricing.

Case-specific adjustments

During audits, authorities may use rough calculations or local data to assess income, particularly if profits seem artificially low. Proper documentation is important to avoid disputes.

5.6 Deductions for Payments by Local Affiliates

Deductions for management and administrative expenses paid by local affiliates to non-local affiliates are allowed under certain conditions.

- Reasonableness standard: Expenses must be reasonable and reflect the actual benefit to local affiliates. Excessive charges may be disallowed.
- Documentation: For deductions, local affiliates must provide proof, such as invoices, agreements and payment evidence. Without documentation, deductions are likely to be denied.
- Arm's-length principle: Payments should be made at market rates for similar services, even though Iraq lacks formal transfer pricing rules.
- Auditing: Tax authorities may audit payments to confirm they are being used to shift profits out of Iraq.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing by foreign-owned local affiliates from non-local affiliates is generally allowed in Iraq considering the following:

- arm's-length principle – interest rates must be reasonable and reflect market rates;

- deductibility of interest – interest payments are deductible for tax purposes if directly related to business and properly documented with loan agreements and payment records;
- no thin capitalisation rules – Iraq does not have formal thin capitalisation rules, so there is no strict debt-to-equity ratio limit for related-party borrowing; and
- potential auditing – tax authorities may review loans for profit shifting.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Foreign income of local corporations is not exempt from corporate tax.

- Tax on global income: Local corporations are taxed on their worldwide income, including foreign income.
- Tax rate: The standard rate of 15% applies to foreign income. For oil and gas companies, the rate is 35%.
- Relief for double taxation: If foreign income is also taxed in another country, Iraq may allow a tax credit or deduction to avoid double taxation, depending on the circumstances.

6.2 Non-Deductible Local Expenses

Foreign income is taxable in Iraq, meaning there are no special rules for non-deductible expenses attributed to foreign income. Local expenses related to foreign income are generally deductible if they are directly related to generating taxable income and properly documented.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are treated as taxable income. Income received by a local corporation from its foreign subsidiaries is included in the corporation's worldwide taxable income. The tax rate is 15%, except for oil and gas companies, where it is 35%.

If dividends were taxed in the foreign subsidiary's country, Iraq may allow a tax credit or deduction to avoid double taxation, up to the amount of tax payable in Iraq on the same income.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by local corporations have potential tax implications if used by non-local subsidiaries.

- Any revenue from licensing an intangible to a non-local subsidiary is taxed at 15%.
- If an intangible is sold or transferred, the local corporation is taxed on capital gains at 15%. The gain is the difference between the sale price and the intangible's book value.
- If the intangible is shared without payment or commercial benefit, there may be immediate tax, but tax authorities could investigate potential profit shifting.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Iraq does not have controlled foreign corporation (CFC) rules. Local corporations may be taxed on the income of their non-local subsidiaries when earned.

Income from non-local branches is included in the local corporation's global income and taxed in Iraq at the standard tax rate of 15% (35% for oil and gas companies). There is no deferral; income is taxed as it is earned.

6.6 Rules Related to the Substance of Non-Local Affiliates

Iraq does not have specific rules requiring non-local affiliates to maintain a certain level of substance. However, under general principles, tax authorities may challenge transactions with non-local affiliates if they believe any such affiliate lacks economic substance and is being used for tax avoidance.

Key focus areas include payments to non-local affiliates, such as management fees or interest, which may be audited if the affiliate lacks real operations. There are no transfer pricing rules, but related-party transactions must be reasonable and commercially justifiable.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Local corporations in Iraq are taxed on gains from the sale of shares in non-local affiliates as follows.

- Taxable as income: Gain is included in the corporation's worldwide taxable income, calculated as the sale price minus the cost basis of shares.
- Tax rate: Gain is taxed at the standard tax rate of 15%. For oil and gas corporations, the rate is 35%.
- Relief for double taxation: If gain is taxed in the country where the affiliate is located, Iraq may allow a tax credit or deduction to avoid double taxation, subject to limits.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Iraq does not have formal anti-avoidance provisions, but certain general principles apply:

- tax authorities may disregard arrangements that lack economic substance or are structured solely for tax avoidance purposes, focusing on the true economic intent of transactions;
- there are no transfer pricing rules, but related-party transactions must reflect reasonable market terms; and
- deliberate misrepresentation or hiding of income can lead to penalties or criminal charges under general tax laws.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Iraq does not have a fixed routine audit cycle; tax authorities audit based on triggers or priorities.

- Audit triggers: Industries like oil and gas and construction are more likely to be audited. Large deductions, related-party transactions or tax return irregularities may trigger audits. Some audits may be conducted randomly.
- Audit process: Tax authorities issue a notice requesting records and explanations. Authorities examine financial statements, contracts and other documents. If discrepancies are found, adjustments and additional taxes or penalties may apply.
- Frequency: Audits occur periodically based on the company's profile and risk factors.

9. BEPS

9.1 Recommended Changes

Iraq's tax system is still developing, and while it has not fully implemented BEPS recommendations, some of its practices align with BEPS principles:

- transfer pricing – Iraq expects related-party transactions to reflect market-based pricing;
- tax treaty use – Iraq's tax treaties may include measures to prevent treaty abuse;
- profit allocation – authorities may review profit allocation, especially in key sectors; and
- ongoing improvements – Iraq has not yet adopted some key BEPS measures, such as country-by-country (CbC) reporting and interest deduction limitations.

9.2 Government Attitudes

Concerning the government's approach to base erosion and profit shifting (BEPS), Iraq has not fully implemented BEPS recommendations yet, as its tax system is still evolving. The government is focused on ensuring compliance and enforcement.

Iraq is unlikely to adopt Pillar One soon, as it requires advanced systems to allocate taxing rights for multinational corporations. Regarding Pillar Two, Iraq may consider implementing a global minimum tax if international pressure increases.

The adoption of Pillar One or Two in Iraq is likely to occur several years after global implementation, as the country updates its laws and systems. Changes could impact the oil and gas sector by increasing taxes on multinational companies, which may raise revenue but could also affect foreign investment.

The Iraqi government aims to prevent tax evasion and profit shifting, especially in critical sectors. It plans to gradually align with international tax standards to improve co-operation and transparency.

9.3 Profile of International Tax

International tax attracts limited attention in Iraq, so the implementation of BEPS is unlikely to be driven by public demand. The government's focus will likely remain on revenue collection from key industries rather than aligning fully with BEPS reforms.

International tax issues, including BEPS, have a low public profile in Iraq; the focus is on domestic tax collection and compliance. There is limited pressure for quick BEPS adoption as international tax is not a significant public concern. The government's priorities, such as taxing multinational corporations, may influence the pace of BEPS implementation more than public opinion.

9.4 Competitive Tax Policy Objective

Iraq's tax policy will likely slow full BEPS adoption as it focuses on attracting investment. Iraq wants to attract foreign investment by keeping corporate tax rates low, and will focus on tax policies that are friendly to investors while slowly adopting BEPS measures. Iraq will gradually implement BEPS changes, balancing the need for tax revenue with the desire to remain attractive to foreign investors.

9.5 Features of the Competitive Tax System

Iraq's tax system has some vulnerabilities, especially in terms of sector-specific incentives and weak transfer pricing enforcement. While there are no formal state aid rules, tax incentives could be questioned internationally as Iraq moves towards global tax standards.

- Vulnerable features:
  - (a) Iraq offers tax breaks in specific sectors, but these could be questioned if seen as too preferential;
  - (b) the lack of formal rules makes it easier for companies to shift profits and erode the tax base; and
  - (c) inconsistent enforcement of tax rules could allow multinational companies to exploit loopholes.
- State aid: Iraq does not have state aid rules, but its tax incentives could be criticised if they unfairly favour specific investors.
- Experience with rules: Tax rules mainly support foreign investment in oil and gas. There have been few challenges to Iraq's tax policies so far, as the system is still evolving.

9.6 Proposals for Dealing With Hybrid Instruments

Iraq currently does not regulate hybrid instruments, and implementing related BEPS recommendations is not a priority for the country. If adopted, these rules would likely first target specific high-priority sectors. Iraq has no specific laws for hybrid instruments, which are treated differently in various jurisdictions.

BEPS Actions recommend eliminating the tax advantages of hybrid instruments by ensuring consistent treatment. Iraq has not yet adopted this approach. If Iraq adopts BEPS changes, they will likely focus on sectors like oil and gas. The adoption will be gradual and may take years. Iraq lacks detailed frameworks for international tax issues, making it difficult to implement BEPS rules on hybrid instruments. Enforcement may also be inconsistent due to limited resources.

9.7 Territorial Tax Regime

Iraq does not have a territorial tax system or specific rules on interest deductibility. If BEPS recommendations on interest deductibility are adopted, they could affect debt-financed investments. Iraq operates a worldwide tax system, taxing both domestic and foreign income for local corporations.

Iraq lacks specific restrictions on interest deductibility, such as thin capitalisation or EBITDA-based limits. For inbound investors, new interest deduction restrictions could make debt financing less attractive, whereas outbound investors – ie, Iraqi companies investing abroad, may face stricter audits on cross-border interest payments if other countries adopt BEPS recommendations.

9.8 Controlled Foreign Corporation Proposals

Iraq does not have a territorial tax system, so CFC rules are not currently applicable. However, adopting CFC rules could help prevent tax avoidance. Concerning potential benefits, CFC rules could prevent profit shifting by taxing the undistributed foreign income of local corporations' subsidiaries, helping protect the local tax base. As potential issues, Iraq lacks the infrastructure to implement and enforce CFC rules effectively. Overly complex rules could discourage foreign investment if they are seen as burdensome or unclear.

9.9 Anti-Avoidance Rules

Iraq has a limited number of DTTs with countries like the UK, France and Turkey. These treaties have minimal limitation on benefits (LOB) or anti-avoidance rules, but these may apply in certain cases. The impact on inbound investors is minimal as LOB clauses in Iraqi treaties are not strict. Investors can usually access treaty benefits without issues. For Iraqi outbound investors, LOB or anti-avoidance rules in the treaties of other countries could limit access to reduced tax rates or exemptions.

9.10 Transfer Pricing Changes

BEPS changes have had minimal impact in Iraq due to the lack of formal transfer pricing rules. While the arm's-length principle is informally expected, enforcement is inconsistent.

Iraq does not have specific rules for taxing IP. This creates challenges in regulating IP-related transactions.

9.11 Transparency and Country-by-Country Reporting

Iraq has not yet implemented CbC reporting or detailed transparency measures – the focus remains on basic tax enforcement. CbC reporting could improve tax oversight by identifying profit shifting and ensuring multinationals pay taxes where profits are generated.

Iraq faces administrative capacity challenges, lacking the infrastructure and expertise for large-scale reporting systems. A more gradual approach could involve focusing on sector-specific audits and strengthening local tax enforcement in high-risk industries.

9.12 Taxation of Digital Economy Businesses

Iraq does not have specific tax rules for digital economy businesses. The tax system still focuses on businesses with a physical presence, like PEs, making it challenging to tax digital businesses without a local base.

There has been minimal discussion regarding taxing digital economy businesses, although Iraq may consider adopting international guidelines (such as BEPS Pillar One) in the future. Iraq's tax authorities lack the infrastructure to monitor or tax foreign digital businesses.

9.13 Digital Taxation

Iraq has not yet addressed digital taxation, focusing instead on traditional businesses that require a physical presence. There have been no proposals or discussions regarding digital taxation.

Iraq lacks the capacity to monitor or tax digital transactions effectively, although it may adopt global standards in the future, like BEPS Pillar One.

9.14 Taxation of Offshore IP

Iraq applies a 15% WHT on revenue payments for the use of offshore IP. There are no special rules for taxing offshore IP or IP owners. WHT is applied at the point of payment, and the IP owner is taxed directly if they have a PE in Iraq. Double tax treaties may reduce or eliminate the WHT on revenues payments, depending on the treaty terms.

Trends and Developments

Contributed by:
Ahmed Hankawi, Farah Mahmood and Shayma Aziz
Etihad Law Firm

Etihad Law Firm is a licensed, registered firm in Iraq headquartered in Baghdad. As a member of the IBBC ranked by legal directories including Chambers and Partners, the firm provides comprehensive legal services to individuals and corporations. Etihad Law Firm's primary commitment is to advise clients on their legal rights and responsibilities, representing them in criminal and civil cases, business transactions and various legal matters. The firm provides legal services to a diverse range of clients including multinational and national corporations that operate across various industries, contractors working with the Iraqi government on significant infrastructure and development projects and prestigious international law firms seeking local expertise and collaboration.

Authors

Ahmed Hankawi is managing partner at Etihad Law Firm, a leading legal practice based in Iraq with a registered office in the UAE. Specialising in commercial law, corporate law and litigation, Ahmed provides expert legal counsel to multinational corporations, local enterprises and individuals navigating complex regulatory frameworks. His knowledge of Iraqi law enables him to deliver strategic solutions that ensure compliance and operational efficiency. With a strong foundation in IP law, corporate legal compliance and business regulations, Ahmed is recognised as a market leader, guiding companies through complex legal landscapes. His expertise spans contract negotiation, regulatory compliance, risk management, corporate governance and ensuring businesses operate within legal frameworks while achieving strategic growth.

Farah Mahmood is head of commercial operations at Etihad Law Firm with a legal career spanning more than ten years. She has gained experience in various roles across international organisations, and in private practice, encompassing legal programming, emergency response and supporting vulnerable populations, focusing on displaced communities, civil documentation, housing and property rights. Farah is recognised for her strong leadership and management capabilities, including remote team management, programme and budget oversight and capacity-building efforts. With deep knowledge of both national and international legal systems, she excels in research, analysis and reporting. Farah is also skilled in facilitating training and fostering collaborative environments, ensuring protection of the confidentiality of sensitive materials.

Shayma Aziz joined Etihad in 2024 and has more than a decade of experience in management, marketing and development. As an office manager, she excels at tailoring her approach to individuals' strengths, creating a productive work environment. Skilled in crafting reports, negotiating and strategic planning, Shayma ensures successful project execution. With a background in Iraqi corporate law, taxes and governance, she provides valuable legal guidance, reviews contracts and offers accurate legal translations. Shayma plays a key role in shaping the firm's strategy, maintaining strong client relationships and driving efficiency while fostering long-term growth and sustainability in a dynamic market.

Etihad Law Firm

Baghdad
Baghdad Governorate
10015
Iraq

Tel: +964 781 500 1100
Email: s.aziz@etihad-law.com
Web: www.etihad-law.com

Contributed by: Ahmed Hankawi, Farah Mahmood and Shayma Aziz, **Etihad Law Firm**

Introduction

This guide provides a comprehensive overview of Iraq's taxation system, outlining various tax categories such as payroll taxes, social security contributions, indirect and direct taxes and taxes on trading and natural resources. It also highlights key tax exemptions, allowances and the challenges facing Iraq's tax system, including tax evasion, low awareness and delays in collections. Recent tax reforms and the adoption of the International Financial Reporting Standards (IFRS) are discussed as steps towards modernising the tax framework and improving transparency. Additionally, the chapter examines the tax implications for foreign corporations and the opportunities and challenges related to trading and investing in Iraq's natural resources sector.

Payment to Relevant Parties

Payroll tax

Payroll taxes operate on a pay-as-you-earn (PAYE) basis, where employers deduct tax from employees' salaries. Progressive rates apply, with a maximum rate of 15% in mainland Iraq. Employers must remit these deductions to the tax authorities monthly. Late filings or payments incur penalties and interest.

Social security contributions

Employers contribute 12% of salaries to the social security fund, while employees contribute 5%. Certain industries, like oil and gas, may face a higher employer contribution rate of 25%. Non-Iraqi employees may be exempt if covered by their home country's social security system. Late payments incur a 2% monthly penalty.

Withholding tax

Payments to non-residents for services, royalties or interest are subject to a withholding tax of 15%. Dividends are generally exempt if profits have already been taxed. Payments under oil and gas contracts may have rates of 3.3% or 7%. Withholding tax must be remitted promptly to avoid penalties.

Indirect Tax

Sales tax

Iraq does not have a general VAT system but imposes specific sales taxes. Alcohol and tobacco products are subject to a 300% sales tax, while cars, travel tickets and mobile recharge cards face rates of 15% to 20%. Deluxe restaurants and first-class hotels are taxed at 10%. Businesses handling these goods and services must comply with the sales tax requirements.

Customs duties

Customs duties in Iraq range from 0% to 30% depending on the product, as outlined in th e Customs Tariff Law. Specific exemptions apply to goods used in government projects or for humanitarian purposes. Importers must ensure proper documentation to clear goods without delays. Non-compliance with customs regulations may result in fines or confiscation.

Direct Tax

Corporate income tax

Iraq imposes a corporate income tax at a flat rate of 15% on taxable profits for most companies. However, companies in the oil and gas sector are subject to a higher rate of 35%. The General Commission for Taxes (GCT) applies either a 15% rate of taxable profit or a deemed tax rate on total revenue, selecting the higher of the two. All income derived from Iraq is taxable regardless of the recipient's residence. Accurate record-keeping and compliance are critical to avoid penalties.

Foreign oil company income tax

Foreign oil companies operating in Iraq are taxed at a flat rate of 35% on income earned from contracts related to oil and gas production. This rate applies to branches, offices and subcontractors working in the sector. Compliance includes registering with tax authorities and adhering to filing requirements. Non-compliance may lead to significant penalties and restrictions.

Corporate – corporate residence

A corporation is deemed resident in Iraq if it is incorporated or managed and controlled within Iraq. The distinction between *"trading in"* and *"trading with"* is important. Companies trading in Iraq must register with the GCT and are subject to corporate income tax. Non-compliance with registration requirements can lead to penalties and limitations on operations.

Permanent establishment

Iraq does not explicitly define a permanent establishment in its tax laws. However, activities such as contracts concluded in Iraq, payments into Iraqi bank accounts and services rendered physically in Iraq can create tax obligations. Companies performing such activities must register, file tax returns and comply with local regulations to avoid penalties.

Capital gains

Capital gains are taxed as ordinary income at the corporate tax rate of 15%. Gains from depreciable assets are always taxable, while gains from shares and bonds may be exempt if not part of trading activity. Proper documentation is essential to ensure compliance and determine exemptions.

Additional profit tax

Additional profit tax is levied on profits earned by companies exceeding a specified threshold. In some cases, it applies to entities involved in high-profit industries, like oil and gas. This tax is designed to ensure equitable distribution of wealth and prevent excessive profiteering.

Other Taxes

State taxes

State taxes in Iraq are levied at the federal level and apply to companies conducting business within the country. These taxes can include customs duties, excise taxes or specific levies tied to particular sectors or activities.

Municipal tax

Municipal taxes are imposed at the local government level to fund regional services and infrastructure. Common examples include taxes on property, commercial licences and operational permits for businesses. Rates vary depending on the location and type of business operation.

Transfer pricing

Iraq lacks comprehensive transfer pricing regulations. However, the tax authority may adjust taxable income if transactions between related parties do not reflect arm's-length conditions. Multinational companies should maintain proper documentation to justify their pricing mechanisms.

Transaction tax

Stamp duties apply to contracts and legal documents at rates ranging from 0.1% to 3% of the transaction value. Payment is required at the time of execution or registration. Non-compliance may invalidate contracts or lead to penalties. Certain government-related transactions may be exempt.

Taxation of Non-Local Corporations

Key features of taxation of non-local corporations include the following:

- source-based taxation – tax applies to income generated within the country;
- permanent establishment – taxation is triggered by a physical or significant economic presence in the country;
- withholding taxes – levied on payments like dividends, interest and royalties to nonlocal corporations;
- tax treaties – double taxation agreements (DTAs) may reduce or eliminate tax liabilities;
- branch profits tax – some countries impose additional taxes on the profits of nonlocal branches;
- transfer pricing rules – regulations ensure fair pricing for transactions between related entities to prevent profit shifting;
- tax filing requirements – nonlocal corporations must file tax returns or disclosures for local activities;
- exemptions and incentives – some sectors or activities may qualify for reduced tax rates or exemptions;
- economic substance rules – corporations must demonstrate substantial activity in the country to qualify for favourable treatment; and
- anti-avoidance measures – there are regulations to prevent tax evasion, such as thin capitalisation rules and beneficial ownership tests.

Tax Audit Cycle

The tax audit cycle involves procedures designed to ensure compliance with the country's tax laws and regulations. This cycle is conducted by the GCT under the Ministry of Finance and includes the following key stages.

- Taxpayer registration: Businesses and individuals engaging in taxable activities must register with the tax authorities. Taxpayer information, including income, assets and activities, is documented and maintained in official records.
- Tax filing and payment: Taxpayers are required to file annual tax returns and disclose their income, deductions and other relevant financial information. Taxes owed are calculated and paid based on the filed returns, with specific deadlines for submission.
- Documentation review: Tax auditors examine financial records, including income statements, balance sheets, and supporting documents.
- Audit findings: Upon completing the review, auditors prepare a report detailing their findings, including any discrepancies or violations. The taxpayer is informed of the results and of any additional taxes, penalties or adjustments.
- Taxpayer response: Taxpayers have the opportunity to respond to the findings, provide clarifications or dispute the results. Supporting evidence can be submitted to address issues raised during the audit.
- Final assessment: The tax authority issues a final assessment based on the audit findings and taxpayer responses. Any outstanding taxes, interest or penalties must be paid within a specified period.
- Appeals process: Taxpayers have the right to appeal the final assessment if they disagree with the findings. Appeals are handled through administrative or judicial processes.
- Compliance monitoring: After the audit, tax authorities may monitor the taxpayer's activities to ensure future compliance. Repeat audits or follow-ups may be conducted for high-risk taxpayers.

Tax Exemptions and Allowances

Iraq offers various tax exemptions and allowances to promote investment and support economic growth. Under Investment Law No 13 of 2006 (the *"Investment Law"*), domestic and foreign investors can benefit from corporate tax exemptions for up to ten years, and from customs duty waivers on equipment and materials. Specific sectors, such as agriculture and businesses in free trade zones, also enjoy exemptions to encourage development.

Personal income tax allowances include deductions for dependents and social security contributions. Businesses can claim allowances for operational expenses, depreciation and loss carry-forwards. These measures aim to stimulate economic activity while reducing the tax burden on individuals and corporations.

Brief Overview of Tax Challenges and Reforms

Iraq's tax system faces challenges such as complex legislation, widespread tax evasion, low tax awareness, delays in collections, weak oversight and conflicts in laws. These issues hinder efficient tax administration and compliance.

To address these problems, the government introduced tax reforms in 2024, focusing on expanding the tax base, modernising property tax calculations, taxing new sectors like media and e-commerce and automating tax systems. Key measures include streamlined tax collection, incentives for compliance and enhanced governance through electronic systems. These reforms aim to improve revenue generation, transparency and fairness in Iraq's tax system.

Complexities of tax legislation

Iraq's tax system suffers from unclear and outdated tax laws, making compliance challenging for taxpayers. The complexity of the regulations leads to frequent misinterpretations and administrative inefficiencies. These issues create confusion among businesses and individuals, discouraging proper tax filing. Simplification of tax laws is necessary to promote compliance and reduce administrative burdens. Reforms are ongoing to align tax legislation with international standards.

Tax evasion

Tax evasion is a significant issue in Iraq, with many individuals and businesses underreporting income or concealing earnings. Weak enforcement mechanisms and limited audits contribute to this issue. Tax evasion reduces government revenue and undermines the fairness of the tax system. Addressing this requires stricter penalties, better monitoring and automated systems to track income. Expanding the tax base to capture unregistered taxpayers is also critical.

Poverty of tax awareness

Low awareness among Iraqis leads to unintentional non-compliance and errors in tax filing. Many taxpayers are unfamiliar with their obligations and available exemptions. Educational campaigns and accessible resources are needed to improve understanding of the tax system. Increased awareness can help reduce violations and improve voluntary compliance. Government initiatives should focus on simplifying tax guidelines and educating the public.

Delays in collections

The tax collection process is often delayed due to bureaucratic hurdles and inefficient systems. These delays impact the government's ability to maintain fixed revenue streams. Streamlining administrative processes and adopting digital payment systems can improve efficiency. Timely tax collection is essential for funding public services and economic stability. Enhanced co-ordination between agencies is needed to address bottlenecks.

Supervision and control

Weak oversight mechanisms in Iraq's tax system allow fraud and manipulation of tax data. Insufficient resources and outdated technology limit the ability to verify taxpayer information. Strengthening supervision and adopting modern tools like electronic filing can enhance accuracy. Transparent audits and penalties for non-compliance are critical to restoring trust. Improved monitoring will ensure fair taxation and reduce revenue losses.

Conflict of laws and legislation

Such conflict creates confusion and loopholes that taxpayers can exploit. These inconsistencies arise from differences between various government directorates and outdated frameworks. Harmonising tax laws across jurisdictions is essential to ensure consistency and clarity. Legal reforms should focus on closing gaps and providing clear guidelines. Co-ordination between agencies can prevent discrepancies and improve enforcement.

Tax reforms initiated in 2024

The Iraqi government launched reforms in 2024 to address tax challenges, forming a higher committee to oversee implementation. Key measures include expanding the tax base by incorporating unregistered sectors like healthcare and e-commerce. Automation of systems aims to reduce corruption and delays in tax processes. Property taxes are redrafted to reflect market values, with exemptions for timely payments. These reforms aim to enhance transparency, efficiency and revenue generation.

Adoption of the IFRS

Iraq has been gradually moving towards adopting the IFRS to enhance transparency, improve financial reporting and attract foreign investment. The adoption of the IFRS aligns Iraq with global accounting practices, which helps modernise its financial system. While Iraq's full adoption of the IFRS is still in progress, it represents a critical step in enhancing financial governance, increasing investor trust and aligning the country's financial reporting with global practices.

Key points concerning Iraq's adoption of the IFRS include the following.

- Improved financial transparency: Adoption of the IFRS aims to provide a standardised and transparent framework for financial reporting, enabling stakeholders to make informed decisions. This is particularly beneficial for foreign investors seeking clarity in Iraq's financial markets.
- Alignment with global standards: Shifting to the IFRS aligns Iraq's accounting practices with international norms, fostering better integration with global financial markets. This alignment is essential for multinational companies operating in Iraq.
- Challenges in implementation: Iraq faces challenges in fully adopting the IFRS, including limited expertise, outdated systems and a lack of training for accountants. Transitioning from local accounting standards requires significant capacity-building efforts.
- Sector-specific focus: The adoption of the IFRS is prioritised in key sectors like banking and oil, which are vital to Iraq's economy. Compliance with the IFRS in these industries ensures accurate financial reporting and boosts investor confidence.
- Support from professional bodies: Professional organisations, such as the Iraqi Accountants and Auditors Syndicate, play a critical role in training and supporting accountants to adopt the IFRS. Government initiatives are also underway to facilitate the transition.

Contributed by: Ahmed Hankawi, Farah Mahmood and Shayma Aziz, **Etihad Law Firm**

Taxation on Trading in Iraq

Taxation on trading is governed by laws and regulations that aim to generate revenue while fostering economic growth. These include taxes on imports, exports and transactions involving goods and services. Key aspects of tax trading in Iraq are as follows.

- Customs duties: Imported goods are subject to customs duties based on their classification, value and origin. Iraq has specific rates outlined in its Customs Tariff Law, with exemptions for certain goods such as essential commodities and investment-related imports.
- Value added tax (VAT): While Iraq has discussed introducing VAT, it currently relies on sales taxes for some products, with future plans to broaden the tax base through VAT implementation.
- Corporate income tax: Trading companies operating in Iraq are subject to corporate income tax, generally at a rate of 15%, though higher rates may apply to specific sectors like oil and gas.
- Withholding taxes: Payments to foreign traders or contractors may be subject to withholding taxes, particularly on services, dividends or royalties.
- Local trading regulations: Traders in Iraq must comply with the licensing and registration requirements of the GCT, ensuring proper tax filing and payments.

Taxation on Trading With Iraq (International Trade)

Foreign entities engaging in trade with Iraq are subject to the country's import/export tax framework. Key considerations include the following.

- Import taxes: Goods imported into Iraq are taxed under its Customs Tariff Law. Rates vary based on product category, with essential items often benefitting from reduced or zero rates.
- Export taxes: While exports from Iraq are generally exempt from taxes, specific goods may be subject to licensing or regulatory fees, especially in the oil and gas sector.
- DTAs: Iraq has signed agreements with several countries to avoid double taxation, providing tax relief for international traders and investors.
- Tax compliance requirements: Foreign traders must comply with Iraqi tax laws, including proper documentation of transactions and adherence to customs regulations. Non-compliance may result in penalties or delays.

Challenges and Opportunities

Trading in and with Iraq presents opportunities due to the country's resource wealth and market growth. However, challenges such as bureaucratic inefficiencies, inconsistent enforcement of tax laws and a lack of digital systems complicate compliance. Continued reforms and modernisation efforts aim to streamline tax trading processes and attract international trade partners.

Taxes on Natural Resources

Iraq's tax system for the energy sector, including oil and gas activities and renewable energy, is structured to maximise revenue while promoting sectoral development. Each subsector is subject to specific tax treatments, as outlined below.

Taxes on oil and gas activity

Taxes on oil and gas activity include:

- corporate income tax – oil and gas companies operating in Iraq are typically taxed at rates ranging from 15% to 35%, depending on the specific contract terms and activity type;

- production sharing contracts – foreign oil companies pay taxes on their share of production profits, often alongside royalty payments to the government;
- withholding taxes – payments to subcontractors, including foreign companies, are subject to withholding taxes on services, often set at 7–10%;
- customs duties and VAT – equipment and materials imported for oil and gas operations may be exempt from customs duties or VAT under investment laws, provided they are directly tied to production or exploration activities; and
- environmental fees – some activities in the oil and gas sector may incur environmental levies aimed at mitigating the environmental impact of operations.

Taxes on general energy activities

Taxes and exemptions on oil and gas activity include:

- corporate taxation – energy companies, including electricity generation and distribution corporates, are subject to the standard corporate income tax rate of 15%;
- subsidies and tax incentives – the government provides tax relief for energy projects that address critical infrastructure needs or enhance energy supply, particularly in rural or underserved areas; and
- customs exemptions – import duties may be waived on equipment and materials for energy infrastructure development.

Taxes on renewable energy

Taxes and exemptions on renewable energy include:

- tax incentives for renewable energy – Iraq encourages investment in renewable energy projects by offering tax exemptions and reductions. For example, solar, wind and hydropower projects may enjoy exemptions from corporate income taxes for a specified period under the Investment Law;
- customs duty waivers – renewable energy equipment, such as solar panels and wind turbines, often qualifies for duty-free import to promote clean energy development;
- carbon credits and tax benefits – projects contributing to emission reductions may qualify for tax credits under emerging environmental policies aligned with global climate agreements; and
- VAT and local taxes – renewable energy projects may be exempt from VAT or local taxes during the construction and initial operational phases, reducing costs for investors.

Key challenges and opportunities

Regarding oil and gas, while taxes thereon generate significant revenue, regulatory inconsistencies and environmental concerns indicate challenges.

Regarding the energy sector, modernising tax policies for energy infrastructure is critical to attract private investment and meet growing electricity demand.

Regarding renewable energy, tax incentives for renewables are promising, but challenges such as bureaucratic inefficiencies and a lack of clear policy frameworks need to be addressed to fully realise the sector's potential.

Conclusion

Iraq's tax system is undergoing significant transformation to address challenges such as complex legislation, tax evasion and inefficiencies in collection and enforcement. While reforms have been introduced to modernise the system, including the adoption of IFRS and the expansion of the tax base, there are still hurdles to overcome, such as bureaucratic inefficiencies and a lack of clear policies in certain sectors. The country offers attractive incentives for sectors like renewable energy and oil, yet regulatory inconsistencies remain a concern. As Iraq continues to streamline its tax processes and enhance compliance, the opportunities for both local and foreign investors are expected to grow, contributing to the nation's economic development.

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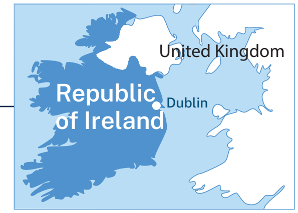


Law and Practice

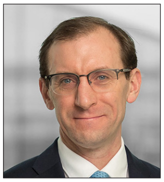
Contributed by:
Andrew Quinn, William Fogarty and David Burke
Maples Group

Contents

Maples Group advises global financial, institutional, business and private clients on the laws of the British Virgin Islands, the Cayman Islands, Ireland, Jersey, Luxembourg and the Marshall Islands through its leading international law firm, Maples and Calder. With offices in key jurisdictions around the world, the Maples Group has specific strengths in the areas of corporate tax, commercial, finance, investment funds, litigation and trusts. Maintaining relationships with leading legal counsel, the Group leverages this local expertise to deliver an integrated service offering for global business initiatives.

Authors

Andrew Quinn is global head of tax at Maples Group, and is an acknowledged leader in Irish, EU and international tax. He advises companies, investment funds, banks and family offices on Irish, EU and international tax. Andrew is the joint author of the book *"Taxing Financial Transactions"* (Irish Taxation Institute). He is a co-founder, member of the executive committee and former chair of the Irish Debt Securities Association, the trade association representing Ireland's EUR1 trillion-plus securitisation industry, and a member and former chair of the Law Society of Ireland Tax Committee. Andrew also serves on the Irish Government Tax Advisers Liaison Committee on OECD/BEPS and the Irish Department of Finance Business Tax Stakeholder Forum.



William Fogarty is a partner in Maples and Calder's tax group in the Maples Group's Dublin office. He advises international financial institutions on Irish investment, financing and property transactions, with a focus on real estate and debt structuring. He also advises private equity firms on executive remuneration, carried interest structuring and VAT planning. He has been ranked in Chambers Europe since 2014.

David Burke is a highly experienced tax specialist and advises on international transactions structured in – and through – Ireland. He works with companies, banks and investment funds and their advisers to structure and implement capital markets, structured finance, asset finance and funds transactions.

Contributed by: Andrew Quinn, William Fogarty and David Burke, **Maples Group**

Maples Group

75 St. Stephen's Green
Dublin 2
D02 PR50
Ireland

Tel: +353 1 619 2000
Fax: +353 1 619 2001
Email: andrew.quinn@maples.com
Web: www.maples.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

The Companies Act 2014 provides for the following forms of incorporated entity:

- private company limited by shares (LTD);
- designated activity company (DAC);
- public limited company (PLC);
- company limited by guarantee (CLG);
- unlimited company; and
- investment company.

Most often, businesses gravitate towards the LTD model due to its familiarity and simplicity. However, DACs and Irish Collective Asset Management Vehicles (ICAVs) are utilised by companies involved in the issuance of listed debt securities and investment funds respectively.

Entities with separate legal form are taxed separately.

1.2 Transparent Entities

In Ireland, partnerships and limited partnerships are treated as transparent for tax purposes. Partnerships are generally used for investment purposes and also by certain professional services firms (eg, accountants and solicitors). In addition, pension funds may make use of a particular form of tax-transparent investment fund called a common contractual fund (CCF).

1.3 Determining Residence of Incorporated Businesses

A company that has its central management and control in Ireland is considered resident in Ireland, regardless of where it is incorporated. A company that is incorporated in Ireland is considered resident in Ireland, except where the company is regarded as not being resident in Ireland under a double taxation treaty between Ireland and another country.

The term *"central management and control"* is, in broad terms, directed at the highest level of control of the company. The Irish Revenue Commissioners (*"Irish Revenue"*) and the Irish courts emphasise the location of the meetings of the board of directors.

1.4 Tax Rates

Ireland currently has three rates of corporation tax:

- A 12.5% rate applies to the trading income of a company that carries on a trade in Ireland (including certain qualifying foreign dividends paid out of trading profits). There is no precise definition of what constitutes trade for this purpose but, broadly, a company should be considered to be trading for tax purposes if it is carrying on an active business in Ireland on a regular or habitual basis and with a view to realising a profit.
- A 25% rate applies in respect of passive or investment income, profits arising from a possession outside of Ireland (ie, foreign trade carried on wholly outside of Ireland) and profits of certain trades, such as dealing in or developing land and mineral exploration activities.
- A new 15% rate was introduced in the Finance Act (No 2) 2023 pursuant to the implementation of the OECD Pillar Two rules in Ireland and applies by way of a top-up tax on Irish companies that are part of a multinational group with an annual turnover exceeding EUR750 million.

Separately, a 33% rate applies to capital gains. The same capital gains rates also apply to gains earned by individuals directly or through transparent entities.

Personal income is subject to tax at rates of up to 55%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporation tax is imposed on the profits of a company (including both income and chargeable gains), wherever they arise, for the fiscal year or *"accounting period"* of the company. The accounting period cannot exceed 12 months.

The starting point for determining taxable profits is the profit of the company according to its statutory accounts, subject to any adjustments required by law. The more important items that are not deductible when calculating the tax-adjusted profits include:

- any capital expenses;
- any expenses not wholly or exclusively incurred for the purposes of the trade or profession;
- general provisions for bad debts (specific bad debts and specific bad debt provisions are deductible);
- dividends or other distributions paid or payable by the company; and
- certain specific expenses, including business entertainment costs, interest on late payment of taxes, general provisions for repairs and certain motor leasing expenses.

A tax deduction is not available for accounting depreciation. However, capital allowances are available in relation to qualifying capital expenditure on land and buildings, plant and machinery and certain intellectual property.

Chargeable gains that do not form part of the trading profits are calculated in accordance with capital gains tax rules.

2.2 Special Incentives for Technology Investments

R&D Tax Credit

A 30% tax credit for qualifying research and development (R&D) expenditure exists for companies engaged in qualifying in-house R&D undertaken within the European Economic Area (EEA). This credit may be set against a company's corporation tax liability, and is available on a group basis in the case of group companies. The first portion of a claim on R&D expenditure has also been increased to EUR75,000 from 1 January 2025, which is payable in full in cash.

Qualifying R&D activities must satisfy certain conditions and, in particular, must seek to achieve scientific or technological advancement and involve the resolution of scientific or technological uncertainty. Where a company has insufficient corporation tax against which to claim the R&D tax credit in a given accounting period, the tax credit may be credited against corporation tax for the preceding period, may be carried forward indefinitely or, if the company is a member of a group, may be allocated to other group members.

For accounting periods ending on or after 1 January 2023, the R&D tax credit may now be paid out to all claimants, regardless of the corporation tax position, in three instalments over three years. Companies with R&D tax credit claims of more than EUR50,000 will receive the three refunds over three years in a 50%/30%/20% split.

Knowledge Development Box

Ireland has an OECD-compliant *"knowledge development box"* for the taxation of certain intellectual property. The amount of expenditure incurred by a company in developing, creating or improving qualifying patents or computer programs (*"qualifying expenditure"*) is divided by the overall expenditure on such assets before being multiplied by the profits arising from such assets (eg, from royalties and net sales). The result is effectively taxed at 10%. A potential 30% uplift in the qualifying expenditure is available, capped at the total amount of acquisition costs and group outsourcing costs.

Capital Allowances on Provision or Acquisition of Intangible Assets

Capital allowances (tax depreciation) are available for companies incurring capital expenditure on the provision of intangible assets for the purposes of a trade. The relief applies to a broad range of intangible assets (eg, patents, copyright, trade marks, know-how) that are recognised as such under generally accepted accounting practice, and are listed as *"specified intangible assets"* in the Irish tax legislation. The relief is granted as a capital allowance for set-off against profits arising from the use of the intangible assets. The write-off is available in line with the depreciation or amortisation charge in the accounts or, alternatively, a company can elect to take the write-off against its taxable income over a 15-year period.

Where the intangible asset was acquired prior to 14 October 2020 and is held for more than five years, there is no claw-back of the allowances on a disposal to an unconnected buyer. If an intangible asset is acquired on or after 14 October 2020, a claw-back or *"balancing charge"* will arise on the disposal of that asset if the sales proceeds are in excess of the *"tax written down value"* of the asset. The allowance can be surrendered by way of group relief or carried forward if unused.

Digital Gaming Tax Credit

In 2022, Ireland introduced a new tax credit for the digital gaming sector, which operates as a refundable corporation tax credit for qualifying expenditure incurred in the design and development of digital games. The tax credit is available at a rate of 32% of qualifying expenditure, with a maximum limit of EUR25 million per project. A per project minimum spend requirement of EUR100,000 applies.

2.3 Other Special Incentives

Certain reliefs and incentives may apply for companies involved in shipping, financial services, property development, forestry, farming, film production and mining businesses.

2.4 Basic Rules on Loss Relief

Ireland distinguishes between losses arising from trading income and losses arising from non-trading income. Trading losses are calculated in the same manner as trading profits. Trading losses may be offset against non-trading profits, but are adjusted on *"value basis"* so that they do not reduce the non-trading income more than they would have reduced the trading income.

Broadly, the following actions apply to trading losses, in the following order:

- trading losses can be set off against other profits of the company (before charges) in the same accounting period;
- trading losses can be set off against profits (before charges) of the previous accounting period of corresponding length, if the company carried on the trade in that period;
- trading losses of one Irish company (or of an Irish branch of an EU company) can be set off against the profits of an Irish-resident company or Irish branch of an EU company in the same corporate group as the company that has excess trading losses; and
- trading losses can be carried forward on an indefinite basis and set off against future profits derived from the same trade.

2.5 Imposed Limits on Deduction of Interest

In general, trading companies can only take a deduction for interest incurred wholly and exclusively for the purposes of the trade. Interest expenses incurred on funds borrowed to purchase, repair or improve rented premises are allowed as a deduction against the related rental income. Interest incurred by a company on funds borrowed to acquire shares in, or loan money to, certain other companies can be allowable in full against the total profits of the company (as a charge on income), providing specific conditions are met.

While there are no *"thin capitalisation"* rules that apply in Ireland, it is nonetheless possible in certain limited cases for the interest to be reclassified as a distribution, preventing such interest from being tax-deductible.

The EU Anti-Tax Avoidance Directive (EU ATAD) contains a fixed ratio interest limitation rule (ILR), and applies to accounting periods commencing on or after 1 January 2022. The ability to claim a tax deduction for the excess interest is restricted to 30% of EBITDA (earnings before tax and before deductions for net interest expense, depreciation and amortisation). The Irish ILR legislation incorporates a number of important exemptions and exclusions in line with EU ATAD, including an exemption for *"standalone entities"* and entities whose net interest expense is less than EUR3 million per annum.

Companies can elect to operate the ILR on a single entity or on a local Irish group basis. Moreover, where the taxpayer is part of a consolidated worldwide group for accounting purposes, the indebtedness of the overall group at a worldwide level may be considered for the purposes of providing additional relief under one of two grouping rules.

2.6 Basic Rules on Consolidated Tax Grouping

The concept of consolidated tax grouping for corporation tax purposes does not exist in Ireland. Trading losses may be offset on a current-year basis against the taxable profits of another group company.

Both the claimant company and the surrendering company must be within the charge to Irish corporation tax. To form a group for corporation tax purposes, both the claimant company and the surrendering company must be resident in an EU country or an EEA country with which Ireland has a double tax treaty. In addition, one company must be at least a 75% subsidiary of the other company, or both companies must be at least 75% subsidiaries of a third company. The 75% group relationship can be traced through companies resident in *"relevant territory"* ie, an EU member state, an EEA treaty country, or another country with which Ireland has a double tax treaty.

2.7 Capital Gains Taxation

Capital gains other than gains from development land are included in a company's profits for corporation tax purposes and are charged to tax under a formula, with the effect that tax is paid at the prevailing capital gains tax (CGT) rate, which is currently 33%.

Substantial Shareholder's Relief

Disposals by a company of a substantial shareholding in a subsidiary company that is resident in an EU member state or a country with which Ireland has concluded a double tax treaty are exempt from CGT if, at the time of the disposal:

- the subsidiary company carries on a trade, or the activities of the disposing company and all of its 5% subsidiaries taken together amount to trading activities; and/or
- the disposing company holds or has held at least 5% of the ordinary share capital and economic interest in the subsidiary company for 12 months, beginning not more than two years before the disposal.

Intra-Group Relief

Relief from CGT is available where both the company disposing of the asset and the company acquiring the asset are within a CGT group. A CGT group consists of a principal company and all its effective 75% subsidiaries. In addition, the shares must be within the charge to corporation tax on capital gains both before and after the transfer.

The effect of the relief is that both the company disposing of and the company acquiring the asset are treated as if the shares were acquired for such consideration as would secure that neither a gain nor a loss would accrue to the disposing company (that is, the acquiring company takes the shares at the same base cost as applied to the disposing company).

Paper-for-Paper Reconstructions

Where shares are transferred as part of a bona fide scheme of reconstruction or amalgamation and certain additional conditions are met, no CGT arises for the disposing shareholders, and the acquiring shareholders are deemed to have received the shares on the same date and at the same cost as the old shares. The relief will only apply where the company acquiring the shares has – or as a result of the transaction will have – control of the target company, or where the share-for-share exchange results from a general offer made to the members of the target company.

2.8 Other Taxes Payable by an Incorporated Business

Stamp duty and VAT may be payable by companies on particular transactions.

Stamp Duty

Stamp duty is a tax on certain instruments (primarily written documents). Generally, unless exempted, stamp duty is chargeable on a document if the document is both:

- of a type set out in Schedule 1 to the Stamp Duties Consolidation Act 1999 (this lists the different categories of document to which stamp duty applies, including conveyances or transfers on sale of stocks or marketable securities and property); and
- executed in Ireland or, if executed outside Ireland, relates to something done or to be done in Ireland.

Generally, the purchaser or transferee is liable to pay stamp duty arising on a written instrument, and a return must be filed and stamp duty paid within 44 days of the execution of the instrument.

Stamp duty is charged on either the consideration paid for or the market value of the relevant asset, whichever is higher. The main categories of instrument to which stamp duty applies and the applicable rates of the duty are as follows:

- transfers of shares or marketable securities: 1%;
- transfers of commercial property: 7.5%; and
- transfers of residential property:
  - (a) 1% on the consideration up to EUR1 million;
  - (b) 2% on the consideration between EUR1 million and EUR1.5 million;
  - (c) 6% on the consideration in excess of EUR1.5 million; and
  - (d) 15% on the consideration of ten or more houses over a 12-month period.

Stamp duty may also be chargeable in connection with certain leases and rent payments.

There are a number of reliefs and exemptions, including:

- associated companies relief on transfers between companies where the transferor and transferee are at least 90% associates at the time of execution and for two years afterwards; and
- exemptions for transfers of intellectual property, non-Irish shares, land, loan capital, aircraft and ships.

VAT

VAT is an EU transaction-based tax that is chargeable on the supply of goods and services in Ireland by a taxable person in the course or furtherance of a business. The top rate of VAT is 23%, and certain services (such as *"financial services"*) are VAT exempt. VAT is also chargeable on:

- goods imported into Ireland from outside the EU;
- the purchase of certain services from suppliers outside Ireland; and
- the intra-EU acquisition of goods.

Zoned Land Tax

A new zoned land tax was introduced by the Finance Act 2021 to encourage residential construction. The tax applies to land that is zoned as being residential or for a mix of uses, including residential use that is serviced but has not yet been developed for housing. The tax will be based on the market value of the land and apply at a rate of 3% at the outset.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses operating in certain industries may be subject to additional taxes, such as relevant contracts tax (RCT) and professional services withholding tax. Incorporated businesses are also required to withhold income tax on payments to employees and directors of the company (pay-as-you-earn income tax, or PAYE), and to withhold tax at 20% from payments of interest, dividends and certain royalties (unless exempted). They must also pay social insurance contributions in respect of employees.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

Further detail on closely held companies is set out in **3.3 Accumulating Earnings for Investment Purposes**. Closely held companies that are professional services companies are liable to a surcharge on both undistributed investment and rental income and professional income. This surcharge is 15% of 50% of the annual undistributed professional income, and 20% of all of the company's undistributed investment and rental income.

In addition, Irish Revenue guidelines note that the mandating, allocating or routing through a firm or company of remuneration arising from an individual having or exercising an office or employment does not mean that the remuneration is taken outside of that individual's income tax rules.

3.3 Accumulating Earnings for Investment Purposes

For Irish tax purposes, a closely held company is a company controlled by five or fewer *"participators"*, or by any number of participators who are directors. *"participator"* is a shareholder or a person having an interest in the company's capital or interest.

Closely held companies are subject to a tax surcharge on investment income (including interest and distributions) or rental income that is not distributed within 18 months of the end of the company's accounting period. This surcharge is 20% of the undistributed income and is intended to act as a disincentive to individuals using corporates as personal holding companies and availing themselves of corporation tax rates that are lower than the tax rates applicable to individuals.

Closely held companies that are professional services companies are liable to a surcharge on both undistributed investment and rental income and professional income, as further described in **3.2 Individual Rates and Corporate Rates**.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Irish-resident individuals are liable to CGT at a rate of 33% on the sale of shares in an Irish company (whether that company is a closely held company or otherwise).

Non-Irish-resident individuals are generally only liable to Irish CGT on the sale of unquoted shares in an Irish company if those shares derive the majority of their value from land and buildings in Ireland and certain mining or exploration rights. The Irish Key Employee Engagement Programme (KEEP) share option scheme, which applies to SMEs and start-up businesses, provides for a tax-efficient employee share option scheme whereby, broadly, no tax charge arises when KEEP-compliant share options are exercised by an employee. Instead, a CGT liability will arise when the employee actually disposes of them.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The treatment set out in **3.4 Sales of Shares by Individuals in Closely Held Corporations** also applies to dividends from quoted companies and gains on the disposal of shares in quoted companies.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

DWT at the standard income tax rate of 25% applies to dividends and distributions made by Irish tax-resident companies.

There are a wide range of exemptions from DWT where the dividend or distribution is paid by an Irish tax-resident company to certain parties, including:

- another Irish tax-resident company;
- companies that are resident in an EU member state (other than Ireland) or a country with which Ireland has concluded a double tax treaty, and that are not controlled by Irish residents;
- companies that are under the control, directly or indirectly, of a person or persons who are resident in an EU member state or a country with which Ireland has concluded a double tax treaty and are not controlled by persons who are not resident in that country;
- companies whose shares are substantially and regularly traded on a recognised stock exchange in another EU member state or a country with which Ireland has concluded a double tax treaty, or where the recipient company is at least a 75% subsidiary of such a company or is wholly owned by two or more such companies; and
- a company resident in another EU member state with at least a 5% holding in the Irish paying company (under Directive 90/435/EEC on the taxation of parent companies and subsidiaries – the Parent-Subsidiary Directive).

These exemptions are subject to the new Outbound Payment Rules (see below).

Interest Withholding Tax

Irish tax legislation provides that tax at the standard rate of income tax (currently 20%) is required to be withheld from payments of Irish-source interest.

However, a large number of exemptions from the requirement to withhold on payments of interest are available, including:

- interest paid in Ireland to a bank or by a bank in the ordinary course of business;
- interest paid to a company that is resident in an EU member state or a country with which Ireland has signed a double tax treaty, where that territory imposes a tax that generally applies to interest receivable in that territory by companies from outside that territory;
- interest paid to a US corporation that is subject to tax in the USA on its worldwide income;
- interest paid in respect of *"quoted Eurobond"*, provided certain other conditions are met (however, this exemption is also subject to the new outbound payment rules – see below); and

- interest paid to certain Irish entities, including qualifying companies for the purposes of Section 110 of the Taxes Consolidation Act, 1997 (as amended) (TCA), investment undertakings and certain government bodies.

Withholding Tax on Patent Royalties
Withholding tax at a rate of 20% applies to payments of a royalty or other sum paid for the use of a patent.

Withholding tax will not apply to royalty payments that are made to associated companies resident in another EU member state, nor to royalties paid by a company in the course of a trade or business to a company that is resident in a country with which Ireland has a double tax treaty.

It has been Irish Revenue's administrative practice since 2010 not to charge withholding tax on royalties payable under a licence agreement executed in a foreign territory that is subject to the law and jurisdiction of a foreign territory (subject to the Irish company obtaining advance approval from Irish Revenue).

Outbound Payments
The Finance (No 2) Act 2023 introduced new taxation measures that apply to transactions between entities that are *"associated"* where the recipient is resident in or established under the laws of a jurisdiction on the EU list of non-cooperative jurisdictions or *"zero-tax"* jurisdiction (referred to as *"specified territories"*). Where an Irish company makes relevant payments of interest, dividends or royalties to associated entities in specified territories, withholding tax will apply at the standard Irish rate applicable to that payment subject to certain exceptions. Accordingly, the rules potentially override the exemptions for interest and dividends listed above. The rules applied from 1 April 2024 for new transactions and arrangements that were in place prior to 19 October 2023 were grandfathered in from 1 January 2025. The Finance (No 2) Act 2023 provided a look through transparent entities to the entity where the payment is ultimately arising or accruing.

This was extended to where the transparent entity and ultimate entity are in the same jurisdiction in the Finance Act 2024.

4.2 Primary Tax Treaty Countries
Ireland is an open jurisdiction that encourages investment from all countries; no specific countries are preferred for investing in Ireland. Many US, UK, European, Asian and Gulf Cooperation Council companies invest directly in Irish companies.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents
Generally, the use of a treaty by a tax-resident beneficial owner should be respected.

4.4 Transfer Pricing Issues
Ireland first introduced transfer pricing in 2011, which only applied to trading transactions involving the supply and acquisition of goods, services, money or intangible assets between associated persons or companies. Updated Irish transfer pricing provisions introduced in January 2020 extended the rules to non-trading income and capital transactions.

The rules require that transactions between associated persons should take place at arm's length, and that the principles contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, as updated in January 2022, must be followed when analysing whether a transaction has been entered into at arm's length.

If Irish Revenue determines that a transaction was not entered into at arm's length and has had the effect of reducing profits or increasing losses, an adjustment will be made by substituting the arm's length consideration for the actual consideration.

4.5 Related-Party Limited Risk Distribution Arrangements

Ireland should follow OECD norms and guidelines in relation to the application of transfer pricing rules.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Ireland introduced changes to its transfer pricing rules in 2019, partly to bring Ireland's transfer pricing legislation in line with the 2017 OECD Transfer Pricing Guidelines. The amendments have applied since 1 January 2020.

4.7 International Transfer Pricing Disputes

There has been an increasing trend for taxpayers and tax authorities to seek resolutions to transfer pricing disputes through the use of mutual agreement procedures (MAPs). This has been viewed as a success by Irish Revenue, with 92% of transfer pricing MAP cases resolved by agreement to fully eliminate double taxation in 2022. Ireland also tied with Denmark to win the *"co-operation"* category for having the most MAP cases fully resolved through agreement by a pair of jurisdictions in 2022. These statistics demonstrate Ireland's high efficacy rate in processing transfer pricing cases.

Irish Revenue operates a formal bilateral advanced pricing agreement (APA) programme. APAs are conducted under the MAPs of the relevant treaty where there are transfer pricing issues involving more than two tax jurisdictions, of which Ireland is one. If requested by the taxpayer, Irish Revenue is also willing, in such cases, to consider conducting multilateral meetings with the other tax administrations subject to the terms of the relevant double tax treaties and the agreement of the other tax administrations.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Irish Revenue allows for compensating adjustments where a MAP request is made and successfully resolved by Irish Revenue and any other relevant competent authorities. No particular difficulties are faced by claimants where double taxation conventions apply, with Irish Revenue seeking to implement best practice in line with the OECD's Manual on Effective Mutual Agreement Procedures.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Non-resident companies that carry on a trade in Ireland through a branch or agency are subject to corporation tax in the same manner as local companies.

5.3 Capital Gains of Non-Residents

Non-Irish tax-resident companies are liable for tax on gains arising from the disposal of certain assets, including:

- land and buildings in Ireland (relief from CGT may be claimed in respect of real estate acquired between 6 December 2011 and 31 December 2014 if it was held for a period of at least seven years);
- unquoted shares or securities deriving their value or the greater part of their value directly or indirectly from the above assets; and
- assets situated in Ireland that are used, held or acquired for business carried on in Ireland through a branch or agency.

A recent Irish Tax Appeals Commission (TAC) determination (72TACD2023) confirmed that loans secured on Irish land are within the scope of Irish CGT. The TAC applied the decision of the High Court in Cintra v Revenue Commissioners, where it was held that *"land"* for CGT purposes includes a freehold or leasehold estate or one of the lesser interests formally recognised by the Common Law and now codified in Section 11 of the Land and Conveyancing Law Reform Act 2009. Applying this rule, the TAC decided that land included loans secured over Irish land.

5.4 Change of Control Provisions

Change of control provisions could arise in relation to the indirect disposal by a non-resident of an Irish land-rich company, as explained in **5.3 Capital Gains of Non-Residents**.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

OECD standards would be expected to be applied in the determination of the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

The basic rule for the allowance of deductions for Irish corporation tax purposes is that the expenses must have been incurred wholly and exclusively for the purposes of carrying on the trade or profession.

5.7 Constraints on Related-Party Borrowing

Other than as set out below, Ireland does not operate what would be considered statutory thin capitalisation rules.

In broad terms, an Irish-based borrower should be entitled to a tax deduction for payments of interest to a non-local affiliated lender. However, there are certain restrictions that would need to be considered, including but not limited to the following:

- the interest payments should be an arm's length amount;
- the interest payments may be subject to withholding tax if the lender does not fall within relevant exemptions (see **4.1 Withholding Taxes** for details of potential exemptions);
- if the interest expense exceeds its interest equivalent income, the ability to claim a tax deduction for the excess interest may be limited to 30% of EBITDA (see **2.5 Imposed Limits on Deduction of Interest**);
- in certain cases, payments to a non-EU 75%-related affiliate may be recharacterised as a distribution subject to dividend withholding tax and disallowed as a deduction; and
- where a company borrows to finance the acquisition of shares, there may be a restriction if the lender is related to the borrower, under Section 247 of the TCA.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Foreign income is not exempt from corporate tax. A company that is tax-resident in Ireland is subject to corporation tax on all its profits, wherever they arise, at either 12.5%, 15% or 25%.

6.2 Non-Deductible Local Expenses

This is not applicable in Ireland.

6.3 Taxation on Dividends From Foreign Subsidiaries

Foreign dividends received by Irish companies are generally subject to corporation tax at a rate of 25%. However, dividends received by an Irish company from non-resident subsidiaries are subject to corporation tax at 12.5% if such dividends are paid out of the trading profits of a company that is resident in:

- an EU member state;
- a country with which Ireland has a double tax treaty;
- a country that has ratified the Joint Council of Europe/OECD Convention on Mutual Assistance in Tax Matters; or
- a non-treaty country, if the company is directly or indirectly owned by a quoted company.

Companies that are portfolio investors (ie, investors holding not more than 5% of the company and having no more than 5% of the voting rights) and that receive dividends from a company that is resident in an EU member state or a country with which Ireland has a double tax treaty will be subject to corporation tax on those dividends, at the 12.5% rate. Furthermore, where a company is a financial trader, such dividends may be exempt from corporation tax in certain circumstances.

6.4 Use of Intangibles by Non-Local Subsidiaries

If an Irish company licenses intellectual property to a subsidiary, it will be subject to Irish corporation tax on the licence fees (or deemed licence fees if transfer pricing applies) received in respect of the licence. The rate will be 12.5% if licensing is part of the trading activity of the Irish company, or 25% if it is part of non-trading activity.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

CFC income is that which arises to a non-Irish-resident company from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage. CFC income is attributed to the controlling company or a connected company in Ireland where that controlling or connected company has *“significant people functions”* (SPF) in Ireland. The CFC charge is based on an arm’s length measurement of the undistributed profits of the CFC that are attributable to the SPF.

Whether a CFC charge is imposed on an Irish controlling company will depend on the extent to which the CFC is regarded as having *“non-genuine arrangements”* in place, which will be the case in the following circumstances:

- where the CFC would not own the assets or would not have borne the risks that generate all, or part of, its undistributed income but for relevant Irish activities or SPF being undertaken in Ireland in relation to those assets and risks; and

- where it would be reasonable to consider that the relevant Irish activities were instrumental in generating that income.

The concept of SPF is not defined in the Irish implementing legislation but must be construed in a manner consistent with the use of that term in the *"2010 Report on the Attribution of Profits to Permanent Establishments"*. If there is no SPF in Ireland to which the management of assets and business risks can be attributed, no tax will arise under the new CFC rules.

The CFC charge applies to the undistributed profits that have been diverted to the low-taxed CFC pursuant to non-genuine arrangements. The rate of Irish tax chargeable will depend on the nature of the income. In Ireland, trading income is taxed at 12.5% and non-trading income is taxed at 25%. A credit is available for any foreign tax paid by the CFC on its undistributed income.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no applicable Irish rules relating to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Irish companies are subject to CGT on the sale of shares in directly held non-local affiliates under the normal CGT rules at a rate of 33%, unless the substantial shareholder's exemption or group reliefs apply (as described in detail under **2.7 Capital Gains Taxation**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Ireland has a very broad general anti-avoidance rule (GAAR), which is intended to negate the effects of transactions that have little or no commercial reality but are primarily intended to avoid or reduce a tax charge, or to artificially create a tax deduction or tax refund. Irish Revenue may at any time deny or withdraw a tax advantage created through the use of a tax avoidance transaction by making or amending an assessment of that person.

In determining whether a transaction is a tax-avoidance transaction, regard should be had to the form and substance of the transaction, the substance of any other transactions directly or indirectly related to the transaction, and the final outcome of the transaction and any related transactions.

A person who enters into a tax-avoidance transaction shall be liable to pay a 30% surcharge of the amount of the tax advantage. However, no surcharge is payable by a person who has made a valid protective notification. A taxpayer can also avail themselves of a reduced surcharge amount if *"qualifying avoidance disclosure"* is made to Irish Revenue.

Article 6 of the EU ATAD also introduces a broad general anti-avoidance provision. However, the existing GAAR is regarded as being broader than that contained in Article 6, so no further amendment is envisaged at this time.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Ireland does not have a defined audit cycle for tax purposes: companies are subject to audit by the Irish tax authorities at any time. The time limit for enquiry by Irish Revenue into a tax return is four years from the end of the accounting period in which that return was filed, unless fraud or neglect is alleged.

9. BEPS

9.1 Recommended Changes

In response to the BEPS recommended changes, Ireland has introduced country-by-country reporting, updated its transfer pricing legislation and implemented the CFC, anti-hybrid and interest limitation rules under ATAD, among other measures.

Other recent Irish reforms include the EU Directive on minimum taxation, which introduced top-up taxes to achieve a minimum tax rate of 15% for groups with an Irish presence and an annual revenue in excess of EUR750 million (see **9.2 Government Attitudes**).

9.2 Government Attitudes

Ireland has insisted that transparency and substance are key components of the Irish tax regime, and is keen to ensure that Irish tax policy is continually in step with all OECD BEPS proposals. In that regard, Ireland has implemented the Directive that puts the Global Anti-Base Erosion (GloBE) rules on minimum taxation into effect across the EU, with effect for accounting periods beginning from 31 December 2023.

Pillar Two

The GloBE rules primarily operate through three new *"top-up"* taxes.

- The income inclusion rule (IIR) is a top-up tax levied on parent entities in respect of their own low-taxed income or the low-taxed income of their subsidiaries. This is effective from 31 December 2023.
- The undertaxed profits rule (UTPR) imposes tax on affiliate companies if the parent is not subject to an IIR in another jurisdiction. In most cases, this will apply from 31 December 2024.
- The qualified domestic top-up tax (QDTT) raises the effective rate of tax for the constituent entities in a group to at least 15%. This allows a jurisdiction to collect tax in respect of constituent entities in its own territory that another jurisdiction might have otherwise collected under the IIR. The QDTT applies from 31 December 2023.

To determine whether an entity or group is within the scope of the rules, the GloBE rules require an analysis as to what entities are or would be included in consolidated financial statements. Therefore, the accounting position is of primary significance.

A group that is below the EUR750 million revenue threshold will be outside the scope of the rules and there will be no change in the tax paid on its Irish profits. Ireland's long-standing 12.5% trading tax rate will remain applicable.

Pillar One

Ireland has fully supported the Pillar One proposals, in recognition of the fact that the way in which business is conducted has evolved and that the taxation system must evolve with it. It is recognised that there will be a cost to Ireland for this in terms of reduced corporation tax receipts, but overall it is considered that Pillar One will bring stability and certainty to the international tax framework and will help underpin economic growth, from which all can benefit.

Pillar One was initially planned to apply generally from 1 January 2023, but this has now been pushed back given the difficulties in reaching international agreement. A new Multilateral Convention was expected to be finalised by the end of March 2024, with Pillar One entering into force in 2025. However it remains under review given the current political climate.

9.3 Profile of International Tax

The emergence of the double Irish structure and its subsequent phasing out, along with the European Commission's Apple State Aid decision, raised the profile of international taxation in Ireland. The Irish media also comments frequently on international tax matters, such as BEPS and US tax reform, given its importance to Ireland as an open economy.

While this has not influenced Ireland's implementation of BEPS, the Irish government has repeated its commitment to update in line with international rules and best practice.

In September 2024, the Court of Justice (CoJ) ruled on the Apple State Aid case taken by the Commission against Ireland. The judgment of the lower General Court, which previously overturned the Commission's decision, was set aside and the Advocate General's non-binding ruling in 2023 was followed. The CoJ held Apple had incorrectly allocated profits to its Irish branches and as a result underpaid taxes totalling EUR13.1 billion between 2003 and 2014. The technology company was ordered to pay the taxes plus EUR1.2 billion of interest to Ireland.

9.4 Competitive Tax Policy Objective

Ireland has undertaken to review its corporate tax code regularly to ensure that new standards such as BEPS and OECD initiatives that have global consensus are met while remaining competitive as the economy continues to grow. While introducing a minimum rate for larger enterprises (revenue greater than EUR750 million), the Pillar Two reforms are considered as *"accommodating appropriate and acceptable tax competition aligned to key principles, such as substance and creation of real value, including Ireland's 12.5% rate"*.

For Ireland's tax policymakers, the key balancing task is to ensure that the implementation phase of BEPS would result in the country's tax regime being seen as meeting the standards for substance and transparency while maintaining the country's reputation as an open economy that encourages foreign direct investment and has a low rate of corporation tax.

9.5 Features of the Competitive Tax System

The Irish authorities firmly voiced their opposition to the European Commission's interim proposal for *"digital economy tax"*, with the Irish Minister for Finance emphasising the need for unanimity before any EU digital tax proposal can be agreed. Similarly, the Irish government has urged caution in respect of the proposed EU Common Corporate Tax Base, stating that discussions on harmonising tax across the eurozone are at a relatively early stage, and that much more technical analysis and discussion are needed.

9.6 Proposals for Dealing With Hybrid Instruments

Ireland has implemented legislation to address hybrid mismatch arrangements, as required by ATAD. One of the purposes of the anti-hybrid rules is to prevent arrangements that exploit differences in the tax treatment of a financial instrument under the tax laws of two or more jurisdictions to generate a tax advantage – ie, *"hybrid"* situation.

9.7 Territorial Tax Regime

Ireland does not have a territorial regime, but rather taxes companies on a worldwide basis. However, as Ireland is party to a large number of tax treaties, the operation of a foreign tax credit system means that foreign tax paid on income can, in certain cases, be used to offset any Irish tax payable on the same income.

The Minister of Finance announced in 2023 that a participation exemption would be introduced in respect of certain foreign dividends in 2024, following consultation.

Under the new legislation, a participation exemption for foreign dividends was introduced in Ireland which exempts qualifying distributions made on or after 1 January 2025 from Irish corporation tax. Companies can opt into the exemption on an annual basis and it will apply to all in-scope foreign distributions received by that company during the accounting period for which the election is made.

A number of conditions must be satisfied for the participation exemption to apply, including:

- the recipient company must hold a minimum of 5% of the paying company for at least 12 months;
- the dividend must be income in the hands of the recipient; and
- the dividend must either (i) be paid out of profits or (ii) be paid out of assets and in those circumstances, the holding of the recipient company in the paying subsidiary must be one that would qualify for Ireland's substantial shareholding exemption from tax on chargeable gains.

The existing tax credit system for foreign distributions will continue to apply for any accounting period for which a company does not opt into the exemption and for foreign distributions that do not qualify for the exemption.

9.8 Controlled Foreign Corporation Proposals

In Ireland, CFC rules apply to certain foreign subsidiaries, as discussed in **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

9.9 Anti-Avoidance Rules

Ireland signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) in 2017. The MLI came into force in Ireland on 1 May 2019, adopting the principal purpose test (PPT) provisions in its double taxation conventions.

In respect of anti-avoidance rules, Ireland already maintains a long-standing general anti-abuse rule under its tax code. Following a review of the relevant provisions, the Irish tax authorities have indicated that an amendment of the GAAR will not be necessary. Consequently, the proposed double taxation convention limitation of benefit and anti-avoidance rules are unlikely to have a significant impact on Ireland in respect of inbound and outbound investors.

9.10 Transfer Pricing Changes

As Ireland has had transfer pricing rules since 2011, the changes are not expected to present any major hurdles to the Irish regime. The Finance Act 2019 introduced changes with effect from 1 January 2020 to bring the current regime in line with the new 2017 OECD Transfer Pricing Guidelines, which reflect the outcomes of BEPS Actions 8–10 and 13.

9.11 Transparency and Country-by-Country Reporting

Country-by-country (CbC) reporting provisions are part of Action 13 of the OECD BEPS Action Plan and the European Commission's Anti-Tax-Avoidance Package. CbC reporting requires large multinational enterprises (MNEs) to file a CbC Report providing a breakdown of the amount of revenue, profits, taxes and other indicators of economic activities for each tax jurisdiction in which the MNE group does business. An EU Directive implemented these measures in May 2016, and they are applicable to MNE groups with an Irish presence and turnover exceeding EUR750 million.

The EU Directive on public country-by-country reporting (the *"CbCR Directive"*) entered into force on 21 December 2022 and was transposed into Irish law on 22 June 2024.

The new rules require multinational groups with a total consolidated revenue of EUR750 million to report if they are EU-parented or otherwise have EU subsidiaries or branches of a certain size. The report also requires information on all members of the group (including non-EU members) within seven key areas (activities, number of employees, net turnover, profit or loss before tax, tax accrued, tax paid and accumulated earnings). The reporting requirements under the Directive will take effect from the commencement date of the first financial year starting on or after 22 June 2024.

The information must be broken down for each EU member state where the group is active, and also for each jurisdiction deemed to be *"non-co-operative"* by the EU or that has been on the EU's *"grey"* list for a minimum of two years. Reports are to be published in an EU member state business register, and also on the companies' websites, where they are to remain accessible for at least five years. When the ultimate parent is not governed by the law of an EU member state, the reporting will generally have to be done by the EU subsidiaries or branches, unless the ultimate parent publishes a report including those subsidiaries and branches.

9.12 Taxation of Digital Economy Businesses

No changes have been discussed or proposed at a domestic level.

In 2023 the European Commission proposed a new directive entitled *"Business in Europe: Framework for Income Taxation"* (BEFIT). This directive will ultimately lay down a common set of rules for EU companies to calculate their taxable base with an allocation of profits between EU member states based on a formula.

The Commission argues that the proposal will reduce compliance costs by creating a coherent approach to corporate taxation in the EU, but the proposal and its predecessor (the common consolidated corporate tax base) have long been controversial and resisted by a number of member states, including Ireland.

In 2023, the Council of the European Union adopted new tax transparency rules for service providers facilitating transactions in crypto-assets for customers resident in the EU. This has brought crypto-asset providers and platforms providing services in relation to crypto-currencies and crypto-assets into the scope of the automatic exchange of information.

The EU DAC8 Directive (DAC8) will introduce disclosure and reporting obligations for crypto-intermediaries who facilitate transactions by EU customers. It will add digital financial products such as central bank digital currencies (CBDCs) to the scope of reporting under the existing DAC framework, to reflect the updated OECD Common Reporting Standard. DAC8 will also build on the EU's objective to promote global tax transparency in the digital market as it is expected to operate in conjunction with the existing EU Regulation of Markets in Crypto-Assets (MiCA).

These new reporting requirements on crypto-assets, e-money and CBDCs will enter into force on 1 January 2026 through DAC8.

9.13 Digital Taxation

The Irish government opposed the European Commission's interim proposal for *"digital economy tax"*, with the Irish Minister for Finance referencing the OECD reports on digital taxation and the need for broader international consensus on this issue, rather than EU-focused measures. The Irish government also published a reasoned opinion on 16 May 2018, addressed to the President of the EU Council, questioning the necessity of these measures. Accordingly, Ireland does support the OECD Pillar One initiative (see **9.2 Government Attitudes**).

9.14 Taxation of Offshore IP

Payments of patent royalties by an Irish-resident company are typically subject to withholding tax at 20%. Patent royalties paid to associated companies resident in another EU member state or paid in the course of a trade or business to a company resident in a country with which Ireland has a double tax treaty are generally exempt from withholding tax. Irish Revenue issued a Statement of Practice in 2010, which effectively extends the relief from withholding tax on certain patent royalties paid to non-treaty countries. To avail of the exemption, certain conditions must be met, including the fact that the royalty must be paid in respect of a foreign patent and the payment must be made in the course of the Irish paying company's trade. Prior approval from Irish Revenue will be required.

ITALY

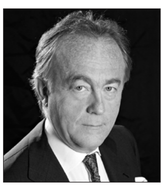
Law and Practice

Contributed by:
Guglielmo Maisto
Maisto e Associati

Contents

Maisto e Associati was established in 1991 and is an independent Italian law firm, specialising in tax law, with offices in Milan, Rome and London. Over the years, the firm has grown in size and reputation, and now has more than 60 professionals, including 15 partners and two of counsels, with consolidated experience in managing complex domestic and multi-jurisdictional cases. Most of the firm's work has an international dimension. Clients include national and international financial institutions, venture capital, private equity and real estate players, large corporations and multinationals, high net worth individuals and wealthy families. Most of the firm's professionals participate in advisory bodies and study groups, are frequent speakers at congresses and contribute to numerous publications and the most prestigious tax journals. Several firm members have substantial experience in international taxation issues, having worked in the Netherlands, the USA and the UK.

Author



Guglielmo Maisto founded Maisto e Associati in 1991. He is a professor of international and comparative tax law at the Università Cattolica di Piacenza. He is President of the International Fiscal Association, member of the Board of Trustees of the International Bureau of Fiscal Documentation (IBFD) in Amsterdam, a member of the Practice Council of New York University (NYU) Law's International Tax Programme and a member of the Board of the American Chamber of Commerce in Italy.

Maisto e Associati

Piazza Filippo Meda 5
20121 Milano
Italy

Tel: +39 02 77 6931
Fax: +39 027 769 3300
Email: g.maisto@maisto.it
Web: www.maisto.it

MAISTO E ASSOCIATI

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Italian businesses frequently carry out their activity through corporate structures.

Forms of Corporate Entities

A corporate entity may adopt one of the following forms:

- a joint-stock company (*società per azioni or SpA*);
- a limited liability company (*società a responsabilità limitata* or Srl); or
- a partnership limited by shares (*società in accomandita per azioni* or Sapa).

Other corporate entities are co-operative companies and Societas Europeae (SE).

The first two corporate forms generally grant shareholders limited liability up to the value of the shares or quotas held in the company's capital.

The incorporation as an SpA is required in order to carry out certain business activities (such as banking) and is generally selected to carry out businesses of medium to large size, while an Srl is typically preferred for small and medium-sized enterprises. Both the Srl and SpA can have a single share/quota-holder.

Shareholders

A Sapa is characterised by the presence of two classes of shareholders:

- general partners (*soci accomandatari*), who are jointly and unlimitedly liable for the company's obligations and act as directors; and
- limited partners (*soci accomandanti*), who are liable for the company obligations up to the amounts of their contributions and cannot be directors.

Other business forms may include individual enterprises and tax-transparent partnerships (see **1.2 Transparent Entities**).

Tax

Corporate entities (SpA, Srl, Sapa, società cooperative and SE) are separate legal entities for tax purposes and are subject to corporate income tax (IRES) and regional tax on business activity (IRAP).

However, subject to certain conditions, corporate entities may opt for a special regime whereby they are treated as transparent for tax purposes (*regime di trasparenza volontaria*).

1.2 Transparent Entities

The most common transparent entities are the general partnership (*società in nome collettivo* or Snc) and the limited partnership (*società in accomandita semplice* or Sas), which are both entitled to carry out business activities.

A third type of partnership, the simple partnership (*società semplice*), is mainly used as a passive holding vehicle and for succession planning purposes, given the flexible rules applicable to its governance. However, Italian law does not allow it to be used for business activities.

The Snc is characterised by the unlimited liability of all of its partners, while the Sas has two classes of shareholders (ie, general partners and limited partners) with different degrees of liability.

From a private law perspective, partnerships are regarded as separate legal entities, whereas, from a tax standpoint, they are treated as transparent for income tax purposes.

Partnerships are not subject to IRES, but they are subject to IRAP. In accordance with tax transparency rules, the income of the partnership is computed at the partnership's level and then attributed to each partner for income tax purposes, regardless of distributions made and in proportion to their share in the partnership's profit. As a general rule, subsequent profit distributions are not taxed in the hands of the partners.

1.3 Determining Residence of Incorporated Businesses

Legislative Decree of 27 December 2023, No 209 recently reformed the definition of tax residence for corporations and partnerships; based on such new rules, these entities are regarded as being tax resident in Italy if they have one or more of the following connecting ties within the Italian territory, for the majority of their tax period:

- their legal seat;
- their place of effective management; or
- their day-to-day management on a main basis.

The legal seat is where the entity's registered office is situated, according to the deed of incorporation.

The place of effective management is defined as the continuous and co-ordinated assumption of strategic decisions regarding the entity (the criterion is regarded as being akin to the place of effective management test under the 2014 OECD Model Tax Convention).

The day-to-day management on a main basis is defined as the continuous and co-ordinated carrying out of the current management of the entity.

Defining Residency

Since Italian law does not envisage the possibility of splitting the tax period for tax residence purposes, whenever one of the above criteria is satisfied for the majority of the tax period, the company/partnership is regarded as being tax resident in Italy for the whole tax period. Conversely, if none of the criteria is met for the majority of the tax period, the company/partnership is regarded as a non-resident person for the whole period.

Any determination on tax residence in accordance with double tax treaties would prevail over the determination for domestic tax rules.

Resident companies are taxable in Italy on their worldwide income, while non-resident companies are subject to IRES and IRAP only on their Italian-sourced income.

With regard to partnerships, residence comes into play as a connecting factor in order to establish the source of the partnership's income. Thus, the income of resident partnerships is regarded as being Italian sourced for the partners, while the income of non-resident partnerships is not.

1.4 Tax Rates

Resident corporate entities are subject to 24% IRES on their worldwide income; they are also subject to IRAP, which is generally levied at a basic rate of 3.9% (such rate may vary, depending on the region and the business sectors). Certain surcharges and increased rates apply to companies operating in specific industries (eg, the banking sector) for the purposes of both IRES and IRAP.

Individuals carrying out a business activity directly (ie, individual entrepreneurs), or carrying out a business through a transparent entity, are subject to individual income tax (IRPEF) levied at the ordinary progressive tax rates, which range from 23% up to 43% on income exceeding EUR50,000. Local surcharges apply. Individual entrepreneurs and partnerships (and not their partners) are subject to IRAP.

Reduced IRES Tax Rate

For the 2025 tax period, companies may benefit from a reduced IRES tax rate of 20%, contingent upon the fulfilment of specific conditions, namely:

- At least 80% of the profits relating to the fiscal year ending 31 December 2024 must be allocated as a specific net equity reserves and not distributed.
- It is necessary to invest in eligible fixed assets designated for production facilities located in Italy, with a value not less than 30% of the retained earnings for the fiscal year 2024 and 24% of the earnings for 2023. Such investment(s) must be executed between 1 January 2025 and 31 October 2026 and in any event not be lower than EUR20,000.
- The number of employees in 2025 must not have decreased compared to the average number of the previous three years.
- The number of employees (including fixed-term employees), taking into account other Italian-resident group companies, in the financial period ending 31 December 2025 is higher by at least 1% than the average number of employees during the tax period ending 31 December 2024.
- The company has not resorted to the use of the wage supplementation fund (*Cassa Integrazione Guadagni*) in the fiscal year ending on 31 December 2024, or in the fiscal year ending on 31 December 2025.

Specific recapture rules apply in case the reserve is distributed within two tax periods or the investments are sold or relocated within five tax periods.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits for IRES purposes are computed on the basis of accounting profits and on an accrual basis (with certain exceptions, such as dividends or directors' fees, which are tax-relevant on a cash basis).

The tax base is determined by applying certain downward and upward adjustments to accounting profits, based on specific rules provided for by Italian tax law. Such adjustments include the non-deductibility of expenses that do not pertain to the business activity and of other expenses exceeding certain thresholds (eg, entertainment and accommodation costs). Further adjustments may arise from differences between depreciation/amortisation rates allowed for tax purposes and those used for accounting purposes.

For instance, unless certain special regimes apply, trade marks and goodwill can be amortised up to one eighteenth of their cost for each tax period, while patents and other IP can be amortised up to one half of their cost. Furthermore, tax law sets out specific limitations for the deduction of bad debts. For instance, in any given tax year, the unsecured bad commercial debts of companies – other than banks, financial institutions and insurance companies – are tax deductible only up to 0.5% of the total receivables gross value, up to a maximum provision of 5% of the gross value of the receivables as of the end of the tax year.

IRAP is levied on the *"net value of production"*, which is computed differently depending on the type of taxpayer and activity carried out (eg, there are different rules for companies, banks and financial institutions, insurance companies and partnerships).

2.2 Special Incentives for Technology Investments

Up until tax year 2020, income from the exploitation of certain qualifying intangibles (eg, software and patents; trade marks were originally included, but were removed in 2017) could benefit from a patent box regime. A company could opt for the regime if it carried out R&D activities (directly or indirectly, by outsourcing to non-related companies, universities or other research institutions).

Effective from tax year 2021, the patent box regime has been replaced with a super-deduction regime whereby the company could benefit from an additional deduction from its taxable income in the amount of 110% of R&D expenses incurred for the purposes of certain qualifying intangibles. Specific interim rules apply for those who already have a patent box ruling in place.

A tax credit is available for certain qualifying R&D and innovation expenses. In order to benefit from the tax credit, the eligible companies shall also meet certain record-keeping requirements (ie, tracing and tracking system and certification by a qualified auditor).

2.3 Other Special Incentives

Innovative Start-ups

Innovative start-ups are companies that satisfy specific requirements, such as having an R&D expenditure that amounts to at least a certain amount established by law. Companies investing in an innovative start-up company and holding the investment for at least three consecutive tax years are allowed to deduct from their taxable income 30% of the amount actually invested, with a maximum yearly tax benefit of EUR540,000; the amount in excess may be carried forward in the subsequent three fiscal years.

Under certain conditions, a tax credit is granted for investments in new tangible and intangible assets intended to be used for production facilities located in the Italian territory.

Shipping

An optional tonnage tax regime, available for good standing companies (ie, those that are not undergoing liquidation or dissolution or are not classified as an *"undertaking in difficulty"* pursuant to Article 2, point 18 of Commission Regulation (EU) No 651/2014), provides for a deemed computation for income tax purposes of the taxable income stemming from the operation of ships. To be eligible for such regime, the entity must operate ships that:

- have a net tonnage greater than 100 tonnes;
- are used to transport goods or passengers, or to perform certain other qualifying activities on seas; and
- are enrolled in the Italian international ships register.

Specific limitations apply for chartered ships (also on a bareboat basis). The regime allows for the determination of a deemed income based on the net tonnage of the ships, apportioned to

365 effective shipping days (in lieu of the determination on the basis of the profits stemming from the financial statements). However, should the ships be leased bareboat, the lessor is entitled to a tax credit calculated using the same apportionment.

Once the option is exercised, it is irrevocable for ten tax years and is deemed to be renewed at the end of such period, unless expressly revoked.

Shipping companies qualifying for the tonnage tax regime are not subject to IRAP. Furthermore, companies opting for the tonnage tax regime cannot be included in the consolidation regime (see **2.6 Basic Rules on Consolidated Tax Grouping**).

Employment

The regime under which companies hiring permanent employees will benefit from a 20% increase in the personnel cost deduction has been extended until the 2027 tax period, provided that the specified conditions are met. Namely, in order to benefit from this regime it is required that:

- the company has been operative for at least 365 days during the financial period including 31 December 2024;
- the number of employees (including fixed-term employees) in the financial period including 31 December 2025 is higher than the average number of employees during the financial period including 31 December 2024; and
- the company is not under liquidation.

The deduction is increased if special categories of individuals are hired (such as people with disabilities and young people eligible for employment incentives).

Relocation of Economic Activities to Italy

Subject to European Commission approval, Italy has introduced an incentive for companies that relocate to Italy: the income generated by the companies that relocate to Italy will contribute to their taxable income for IRES and IRAP purposes, limited to 50% of its amount in the six fiscal periods following the relocation.

In order to access the special regime, the company:

- must not relocate from an EU or EEA country; and
- shall remain in Italy for 11 tax periods (or 16 tax periods, depending on the company) after the relocation, otherwise a clawback provision applies.

2.4 Basic Rules on Loss Relief

Losses may be carried forward without time limitation to offset the corporate tax base in subsequent tax years; no carry back is allowed. In particular, losses incurred in a tax year can offset the corporate tax base of subsequent tax years up to 80% of the latter amount. This limitation does not apply to losses incurred by a company during the first three years of activity. In both cases, no time limitation applies.

If there is a change of control in the person controlling at the company, the losses may be carried forward up to the net equity of the company as shown in the financial statements, provided that certain substance requirements are met (ie, revenues and employment costs exceed 40% of the average for the two preceding tax years).

Similarly, in the case of extraordinary transactions, the losses may be carried forward up to the limit of the net equity of the company, only if the tax losses do not exceed the company's net equity, and the company carrying forward the losses has met, at the time of the merger/demerger, certain substance requirements (such as revenues and employment costs) that have been continuously fulfilled since 1 January of the tax year preceding the merger or demerger.

The above limitations do not apply in the case of intra-group changes of control and/or mergers.

The above loss carry-forward exclusions may be avoided by obtaining a specific ruling confirming the absence of any abuse of law.

With regard to blacklisted countries, expenses arising from transactions with companies or professionals located therein are not deductible up to their market value, unless the actual economic interest and the actual execution of the transactions are proven by the Italian resident company.

2.5 Imposed Limits on Deduction of Interest

Subject to certain minor exceptions, the deductibility of interest – whether relating to intercompany financing or not – is subject to a specific deduction barrier. In particular, interest payable in excess of interest receivable is deductible up to 30% of the company's tax-relevant EBITDA.

Interest expenses that exceed such barrier in a tax year may be carried forward and deducted in subsequent tax years (up to the amount of the 30% tax-relevant EBITDA that exceeds the net interest expenses of those subsequent years), or, if the company is part of a fiscal unity, used by other entities of the fiscal unity. Any excess of the 30% EBITDA over net interest expenses may be carried forward in the following five tax years or, if the company is part of a fiscal unity, may be used by other companies of the fiscal unity.

Moreover, interest income that exceeds interest expenses in a tax year may be carried forward to offset the interest expenses of subsequent tax periods.

Certain companies involved in the financial sector are not subject to the interest limitation rule described above and can deduct up to 96% of their interest payable (under certain conditions, interest payable to companies of the same fiscal unity is not subject to this limitation).

2.6 Basic Rules on Consolidated Tax Grouping

Under the Italian domestic tax consolidation regime, companies belonging to a group may opt for the determination of an overall taxable base (fiscal unity). The tax return of the fiscal unity must be filed by the controlling company, or, in certain cases, by a controlled company designated by the non-resident controlling company (the company filing the tax return of the fiscal unity is generally known as the *"consolidating entity"*).

The regime is available to:

- Italian resident companies controlled by an Italian resident parent;
- Italian resident companies controlled by a non-resident parent with an Italian permanent establishment, provided that the parent is a tax resident of a jurisdiction that has concluded a treaty enabling the exchange of information with Italy; and
- Italian resident companies controlled by a parent that is a tax resident of an EU or EEA member state.

In addition, non-resident companies with an Italian permanent establishment can be included in the fiscal unity as a consolidated entity (if resident in an EU/EEA member state).

Qualification

The consolidating entity must own, from the beginning of the relevant tax period, a participation in the consolidated entities representing more than 50% of the share capital and more than 50% of the rights to the profits (shares without voting rights are not taken into account).

All entities included in the fiscal unity must have tax years ending on the same date.

The perimeter of the tax consolidation may be freely devised by the taxpayers (ie, some companies may be kept out).

Fiscal Unity

In the fiscal unity, the overall tax base is computed as the sum of the taxable bases (with some adjustments) of all participating entities. The taxable bases of the group entities are taken into account for their whole amount, irrespective of the percentage of the participation held by the controlling company.

Once the election for the fiscal unity is made, the option is irrevocable for three years, unless the conditions for the options cease to be met (interruption events).

Furthermore, under certain conditions, a worldwide consolidation tax regime is available, in which case the fiscal unity must include all foreign-controlled companies.

2.7 Capital Gains Taxation

Capital gains are generally treated as ordinary income, subject to corporate income tax levied at 24%.

However, under a specific participation exemption regime, capital gains realised by Italian companies on the disposal of participations in other companies are exempt for 95% of their amount (while capital losses are wholly non-deductible) if the following conditions are met:

- The participations have been held uninterruptedly since the first day of the 12th month preceding the sale (using a last-in, first-out method).
- The participations have been booked as fixed financial assets in the first financial statements after their acquisition.
- The participated company has been carrying out a business activity in the last three tax periods or, if later, since incorporation.
- The participated company has not been resident of a low-tax jurisdiction for all the five tax years prior to the year of sale if the buyer is a non-related party, or for the entire holding period if the buyer is a related company (such condition is waived if it is demonstrated that the ownership of the participation did not – for the same period – have the effect of shifting the income to a low-tax jurisdiction).

With regard to the third bullet point, companies in which the value of assets is mainly represented by real estate not used in the course of a business activity are deemed to not carry out a business activity. This condition does not apply, however, in respect of participations in companies whose shares are listed on a stock exchange.

If the participation exemption regime does not apply, the taxpayer may still opt to spread the capital gain tax base over five tax years if the participation has been booked as fixed financial assets in the last three financial statements or, for other assets, if the capital asset has been held for at least three years.

2.8 Other Taxes Payable by an Incorporated Business

VAT

VAT is a general tax on consumption in Italy. As an EU member state, Italian VAT provisions are in line with the EU VAT Directives.

Where the conditions are met, VAT is levied at a general rate of 22% on transfers of goods and supplies of services. Reduced rates (4%, 5% and 10%) may apply to certain types of transactions.

In general, VAT taxable persons are entrepreneurs, artists and professionals.

Among the most common transactions, the following are subject to Italian VAT:

- the supply of goods and services in Italy by a VAT taxable person;
- the intra-EU acquisition of goods in Italy by a VAT taxable person; and
- the import of goods from outside the EU into Italy by any person (including a non-VAT taxable person).

Exports and intra-EU sales of goods are VAT zero-rated.

Registration Tax, Mortgage and Cadastral Taxes

Registration tax is generally due on deeds (including contracts) executed in Italy. In certain cases (such as transfers of real estate or of a business located in Italy), registration tax is due even if the deed of transfer is executed abroad.

The deed of transfer may be subject to registration tax either at the fixed amount (EUR200) or at a proportional rate, depending on the nature of the deed. If the deed of transfer is within the scope of VAT (even if exempt or zero rated), registration tax applies at the fixed amount (EUR200).

Mortgage and cadastral taxes generally apply to deeds of transfer or mortgages on Italian real estate. These taxes may also apply to the sale of a business if real estate is included. In transfers of real estate assets subject to VAT, a EUR200 mortgage tax and EUR200 cadastral tax are also levied, with certain exceptions (for instance, in the sale of business real estate, a 3% mortgage tax and 1% cadastral tax apply).

Loans guaranteed by a mortgage on real estate are subject to mortgage tax at the rate of 2% of the guaranteed amount (a 0.5% charge may apply on the cancellation of the mortgage), on top of registration tax, which applies at the rate of 0.5% of the guaranteed amount (guarantees granted by the same debtor are subject to registration tax at the fixed amount of EUR200).

However, certain financing transactions and bonds executed in Italy with a medium-long term maturity and granted by qualifying lenders (including resident banks) are not subject to the above-mentioned registration, cadastral and mortgage taxes (as well as other duties) but to an overall 0.25% substitute tax.

Financial Transaction Tax

A financial transaction tax (FTT) is levied on transfers of shares and certain participating financial instruments issued by companies that have their registered office in Italy, regardless of the place of residence of the parties and of where the contract is executed.

The standard tax rate is 0.20% on the transaction value. A reduced tax rate (0.10%) applies to transactions executed on regulated stock markets or in multilateral trading facilities.

2.9 Incorporated Businesses and Notable Taxes

The ownership of real estate located in Italy is subject to municipal real estate tax (IMU), levied at the basic rate of 0.76%, subject to local variations.

Other local taxes connected to the ownership of real estate apply.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held businesses generally operate in the form of Srls or partnerships.

3.2 Individual Rates and Corporate Rates

Even if the corporate rates are lower than individual rates, the total effective tax rate applicable to an individual receiving the profits from an incorporated business (by means of profits distribution) is substantially similar to that deriving from the realisation of income from the carrying out of business activities as an individual entrepreneur. In fact, dividends distributed to individual shareholders are subject to a 26% substitute tax, so that the total effective tax rate is in the range of 44% (while the top progressive tax rate for individuals is 43%).

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules aimed at preventing closely held corporations from accumulating earnings for investment purposes. As a general rule, retained earnings of corporations are taxed in the hands of the shareholders only upon distribution.

On the other hand, there are certain rules that apply with a view to stimulating the re-investment of corporate profits.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Under current rules, dividends from, and gains on, the sale of shares in closely held corporations are taxed in the hand of individual shareholders, at the rate of 26%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no special rules for the taxation of dividends from, and gains on, the sale of shares in publicly traded corporations. The tax regime is the same as described in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In general terms, Italian tax authorities are quite keen on auditing cross-border payments of dividends, interest and royalties to ensure that EU Directives or treaty benefits have been properly applied. In this way, there is increasing attention on tax audits on the satisfaction of the beneficial ownership requirement on the recipient, as well as on the potential abusiveness of structures that give rise to withholding tax exemptions or reductions.

Dividends

Dividends paid to non-residents in respect of participations that are not connected with Italian permanent establishments are generally subject to a 26% withholding tax, which may be reduced by applicable double tax treaties. Non-resident recipients may benefit from a potential refund of the foreign tax paid on dividends up to 11/26 of the Italian withholding tax if they prove that a similar tax has already been paid abroad on a final basis on the same dividends.

A reduced 1.2% withholding tax is levied on dividends that are paid out of profits accrued in fiscal years starting on or after 1 January 2008 if the beneficial owner is a company resident and subject to corporate income tax in another EEA member state that allows an adequate exchange of information with Italy.

Dividends are not subject to tax if they are paid to collective investment vehicles that are established in EU member states or EEA member states and that are either compliant with Directive 2009/65/EC or whose managers are subject to surveillance in the states in which they are established, pursuant to Directive 2011/61/EU.

Dividends paid to EU and EEA pension funds are generally subject to 11% tax, which may be reduced to zero if certain conditions are met.

There is no withholding tax where the EU Parent-Subsidiary Directive applies.

Interest

Interest payments made to non-residents in respect of loans or instruments that are not connected with Italian permanent establishments are generally subject to a 26% withholding tax, which may be reduced by an applicable double tax treaty or eliminated if the EU Interest and Royalties Directive applies. A reduced withholding tax rate (12.5%) is granted to interest arising from government bonds and similar instruments. Some exemptions from withholding tax apply, under specific conditions. For example, no withholding tax is levied on interest from certain bonds paid to residents of jurisdictions with an effective exchange of information with Italy, interest on Italian bank accounts and deposits, and interest payments made in relation to medium- or long-term financing granted by qualifying lenders.

Royalties

Royalties paid to non-residents in respect of loans or instruments that are not connected with Italian permanent establishments are generally subject to a withholding tax rate levied at 30%, with the possibility, under certain conditions, to reduce the taxable base by 25%. The royalty withholding tax may be reduced by an applicable double tax treaty or eliminated if the EU Interest and Royalties Directive applies.

4.2 Primary Tax Treaty Countries

When deciding in which jurisdiction to set up a holding company that will hold participations in Italian resident companies, foreign investors tend to prefer countries that have treaties with Italy granting full tax relief on the capital gains from the disposal of such participations.

For example, treaty residents of Luxembourg, the Netherlands and the United Kingdom are not subject to tax in Italy on gains from the disposal of participations in Italian companies. Other treaties, in certain circumstances, do not provide tax relief on gains from the disposal of similar participations (for example, the treaty with France does not provide relief from Italian tax in the case of disposal of a participation in an Italian company granting the holder the right to receive at least

25% of the profits of the company). However, a 95% exemption from taxation of capital gains on shares has recently been extended, subject to the same conditions mentioned in **2.7 Capital Gains Taxation** for Italian resident companies, to capital gains realised by non-Italian companies that are resident in an EU or EEA member state, thus potentially mitigating the absence of treaty protection.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Italian tax authorities often challenge the applicability of double tax treaties and/or EU Directives based on the argument that the recipient is not the beneficial owner of the relevant income or is an artificial arrangement (ie, with no sufficient substance).

In Circular Letter No 6 of 30 March 2016, the Italian tax authorities held the view that treaty benefits can be disallowed when a non-resident company lacks economic substance, based on a case-by-case analysis of all relevant facts and circumstances. The tax authorities held that, when treaty benefits are so denied to a non-resident company, the ultimate investors of such company could (subject to the relevant conditions) claim the application of the tax treaties signed between Italy and their state of residence (if any).

Furthermore, domestic tax authorities can challenge abusive practices on the basis of Article 10 bis of Law 212, dated 27 July 2000, which contains a general anti-abuse rule that empowers domestic tax authorities to counteract tax advantages arising from abusive transactions, including treaty shopping arrangements.

Finally, it is worth mentioning that, with specific regard to the right of the tax administration to counter abusive tax practices, the Italian Supreme Court has endorsed (see, for example, decision No 14756 of 2020 and decision No 3380 of 2022) the principles affirmed by the Court of Justice of the European Union in joined cases N Luxembourg 1 (c-115/16), X Denmark A/S (c-118/16), C Danmark I (c-119/16) and Z Denmark ApS (c-299/16), dealing with the application of the Interest and Royalties Directive.

4.4 Transfer Pricing Issues

Intercompany cross-border transactions have to be priced under arm's length conditions.

Tax authorities frequently challenge the arm's length value of transactions, having regard to the choice of the set of relevant comparables, the transfer pricing methodologies chosen, the relevant values to be taken into account and the time window of the comparability analysis.

Other aspects of intra-group cross-border transactions that are subject to the scrutiny of Italian tax authorities include:

- challenging the functional profile of the parties to the transactions in light of all facts and circumstances emerging during a tax audit; and
- requalifying the nature of certain transactions – for example, tax authorities may requalify a shareholder's loan as a capital contribution.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited risk distribution arrangements are often used by foreign companies to determine the arm's length remuneration of Italian distributors of the group. In principle, if the functional and risk analysis confirms consistency with a limited-risk feature, such arrangements are treated as being in line with the arm's length principle.

However, as pointed out in **4.4 Transfer Pricing Issues**, the Italian tax authorities may challenge the functional profile of the Italian distributor if the functions actually performed by the latter are not consistent with the arrangement.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Italian transfer pricing rules are essentially patterned on the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).

In that regard, Article 110(7) of the Italian Income Tax Code, containing the primary legislation dealing with transfer pricing, is generally aligned with the OECD Guidelines and includes an express reference to the arm's length principle.

4.7 International Transfer Pricing Disputes

In the last few years, Italian tax authorities have significantly increased their attention towards transfer pricing matters both in the context of the ordinary operations of multinational groups and in the cases of business restructurings. This is also a reflection of the increased knowledge of the matter by tax auditors and general awareness on an international basis.

Over the past few years, the use of mutual agreement procedures – based on either the double tax treaties or the EU Arbitration Convention (90/436/EEC) – has increased as an alternative to, or in concurrence with, domestic litigation.

Recourse to the mutual agreement procedures is increasing following the recent implementation in Italy of EU Directive 2017/1852 of 10 October 2017, overcoming some critical issues with particular regard to the access, duration and effective conclusion of the procedure. The opportunity to gain effective elimination of double taxation together with the fact that under current rules most transfer pricing claims are entitled to penalty protection make the use of mutual agreement procedures increasingly popular.

The Italian tax authorities that take part in the mutual agreement procedures generally discuss the cases with the foreign competent authorities to achieve a resolution that is in line with the arm's length standard.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are allowed under Italian tax law and practice.

On the one hand, it is generally accepted in Italy that the contracts regulating transactions between group companies provide for year-end adjustments, based on the actual financial data, to be carried out before the financial statements are realised and the tax returns filed. Although this practice does not represent a proper instance of compensating adjustment (as it does not lead to a departure of the tax figures from the accounting figures), it offers the taxpayer the possibility to correct – also for tax purposes – the prices initially applied in the relevant transactions in order to take into account facts that became known only thereafter.

On the other hand, proper compensating adjustments (ie, adjustments in which the taxpayer reports a transfer price for tax purposes that differs from the amount actually charged between the associated enterprises) are also accepted in Italy, subject to the ordinary rules on corporate income taxation.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

There are no significant differences between the taxation of Italian permanent establishments of non-resident companies and resident companies.

5.3 Capital Gains of Non-Residents

Capital gains realised by non-residents upon the transfer of shares or other participations in Italian companies are regarded as Italian-sourced and, therefore, are subject to tax in Italy. The applicable rate is generally 26%. There are certain exceptions, such as the following:

- Capital gains on non-substantial shareholdings traded in regulated markets are not subject to tax.
- Capital gains on non-substantial shareholdings are exempt if the non-resident person is tax resident in a state that allows for an adequate exchange of information with Italy, or if such person qualifies as an *“institutional investor”* established in a state that allows for an adequate exchange of information with Italy.
- Capital gains are not subject to tax if they are realised by collective investment vehicles that are established in EU member states or EEA member states and are either compliant with Directive 2009/65/EC or whose managers are subject to surveillance in the states in which they are established, pursuant to Directive 2011/61/EU.
- Capital gains are 95%-exempt if realised, subject to the same conditions mentioned for Italian resident companies in **2.7 Capital Gains Taxation**, by non-Italian companies that are resident in an EU or EEA member state.

A person is regarded as selling a non-substantial shareholding if the amount of participation sold during a 12-month period does not exceed 20% (or 2% in the case of a listed company) of the voting rights or 25% (or 5% in the case of a listed company) of the stated capital. Such threshold should be computed by taking into account all disposals occurring in any 12-month period.

The above taxation could be prevented in case of application of double tax treaties.

There are no provisions explicitly addressing the taxation of indirect disposals of shareholdings in Italian resident companies (ie, disposals of shareholdings in a non-resident company that owns an interest in a resident company).

There is a new special provision for capital gains on participations realised by non-residents, if the value of the distributing company derives mostly from immovable property located in Italy: in this case, subject to certain exceptions, the capital gain is taxable in Italy according to domestic law.

5.4 Change of Control Provisions

In a change of control, the following consequences may arise:

- interruption of any fiscal unit regime (see **2.6 Basic Rules on Consolidated Tax Grouping**); and
- forfeiture of tax losses (see **2.4 Basic Rules on Loss Relief**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In general terms, the Italian tax authorities tend to follow the guidance laid down by the OECD Guidelines and, therefore, do not make use of predetermined formulas to determine the income of resident subsidiaries or Italian permanent establishments.

Article 152(2) of the Income Tax Code explicitly states that the permanent establishment is treated as if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, the risks assumed and the assets held. The *"free capital"* of the permanent establishment (*fondo di dotazione*) is determined based on the OECD principles, taking into account the functions performed, the risks assumed and the assets held.

5.6 Deductions for Payments by Local Affiliates

In general terms, the Italian tax authorities follow the OECD Guidelines and allow the deduction of management and administrative expenses incurred by a non-resident related company on the conditions that the expenses do not qualify as shareholder's costs, the services have been effectively rendered to the Italian resident company, the services are provided for the benefit of the Italian company and the value of the consideration is at arm's length. Proper documentation providing evidence that these conditions are met should be kept by the Italian company.

5.7 Constraints on Related-Party Borrowing

In general terms, interest payments made to non-resident related parties are subject to transfer pricing legislation. In addition, the deductibility of interest expenses is subject to the interest limitation rule explained in **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Resident companies are subject to corporate income tax on their worldwide profits. If such profits include foreign-source income or gains that are also subject to tax in the state of source, the Italian resident company is granted a foreign tax credit.

Resident companies that have permanent establishments abroad may also apply an optional branch exemption regime, instead of the tax credit method. The option must be exercised in the tax return relevant to the year in which the permanent establishment has been set up.

If the option is exercised, it is irrevocable and the regime will apply to all the foreign permanent establishments of the resident company.

The profits attributable to the foreign permanent establishment shall be determined pursuant to the Authorised OECD Approach (AOA). If the foreign jurisdiction does not apply the AOA, the company may apply for a ruling asking for the application for Italian tax purposes of the method used in the foreign jurisdiction to determine the profits attributable to the permanent establishment.

6.2 Non-Deductible Local Expenses

As foreign-source income and foreign-source gains are usually subject to tax in the hands of a resident company, the related expenses are deductible under the same rules applicable to the deduction of domestic-source income and gains. In relation to the income from (and losses of) permanent establishments under the branch exemption regime, see **6.1 Foreign Income of Local Corporations**.

6.3 Taxation on Dividends From Foreign Subsidiaries

Inbound dividends paid by non-resident companies are subject to the same rules as apply to dividends paid by resident companies and are, therefore, 95% exempt in the hands of the recipient (a few tax treaties provide for full exemption of qualified intercompany dividends).

As a general rule, this regime applies on the condition that the payment is fully profit-contingent (ie, the amount distributed has been determined in light of the economic performance of the payer) and the payment is fully non-deductible in the country of the payer. If the payment is partly deductible and the conditions for the application of the Parent Subsidiary Directive (Directive 2011/96/EU) are met, the 95% exemption applies to the part of the dividend payment that is non-deductible.

As an exception to the above, dividends from low-tax jurisdictions are fully taxable.

The EU and the EEA

EU and EEA member states are never considered low-tax jurisdictions. The applicable criteria to determine if a non-EU/EEA jurisdiction is low tax are as follows:

- if the resident company has a non-controlling shareholding in the non-resident company, the jurisdiction is low tax if the nominal tax rate in the foreign jurisdiction – taking into account any special regime applicable therein – is lower than 50% of the tax rate applicable in Italy; and
- if the resident company has a controlling shareholding, the jurisdiction is low tax if the effective tax rate in the foreign jurisdiction is lower than 50% of the effective income tax rate applicable in Italy.

The full taxation of dividends applies:

- if the dividends are paid directly by a company resident in a low-tax jurisdiction; or
- if the Italian resident company has a controlling holding in a foreign company that, in turn, has a shareholding in a company resident in a low-tax jurisdiction (to the extent of dividends deriving from the company resident in the low-tax jurisdiction).

Low-Tax Jurisdictions

Dividends from low-tax jurisdictions can benefit from the 95% exemption under certain conditions. Essentially, pursuant to the current practice of the tax authorities, the shareholder should demonstrate that the profits of the company resident in the low-tax jurisdiction have been subject to an *"appropriate tax burden"* since the time the shareholding was acquired.

Where such conditions are not met, but the resident company provides evidence that the foreign entity carries out an effective business activity through personnel, equipment, assets and premises, then only 50% of the dividends is taxed. Moreover, in such a case, if the recipient controls the foreign entity, it is also granted a credit for 50% of the corporate tax paid by the foreign entity.

The rules on the taxation of dividends from low-tax jurisdictions also apply to profits repatriated from permanent establishments under the branch exemption regime, under the same conditions explained above.

With effect from 1 January 2023, an optional regime has been introduced whereby a flat-rate tax may be paid on the profits and reserves of subsidiaries which are resident in privileged tax jurisdictions. If the option is exercised and the profits are subject to the flat tax, they will not be taxed in the hands of the Italian resident beneficial owner upon distribution. The rate of the flat tax is 9% for corporate taxpayers and 30% for individual entrepreneurs; under certain conditions, the rate may be reduced by 3 percentage points (6% or 27%); the tax is calculated in proportion to the shareholding held in the foreign company (and as it also applies to indirect shareholdings, in this case the de-multiplier effect of the shareholding must be taken into account).

6.4 Use of Intangibles by Non-Local Subsidiaries

If an Italian resident company has developed an intangible that is used by a foreign related company, such dealing is generally subject to transfer pricing legislation. Income from the use of intangibles or R&D expenses relevant to certain qualifying intangibles may benefit from the patent box regime described in **2.2 Special Incentives for Technology Investments**.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

CFC legislation applies if:

- the Italian taxpayer (a resident company or Italian permanent establishment of a non-resident company) has a controlling holding in the foreign entity;
- the foreign entity is subject to an effective tax rate lower than the amounts provided by the law; and
- more than one third of the revenue of the foreign entity is represented by certain tainted income (such as dividends, royalties or interest, revenues from banking, insurance and financial activities, revenues from financial leasing, gains from the sale of shareholdings, or revenues from certain low-value-adding intercompany transactions).

With reference to the second test above, Legislative Decree of 27 December 2023 No 209 introduced *"safe harbour"* provision, according to which, if the non-resident company is subject to an effective tax rate of at least 15% (calculated as the ratio between deferred tax liabilities and current taxes and the accounting pre-tax profit) no CFC legislation applies provided that the foreign accounts are certified by an external auditor and the outcome of such certification is used for the purposes of the audited financial statements of the parent company.

On the other hand, if the non-resident company is subject to an effective tax rate lower than 15% or the above certification requirements are not met, then it is necessary to verify if the effective tax rate is lower than 50% of the effective Italian income tax rate that would have applied to the foreign entity had it been Italian-resident.

If CFC legislation applies, the profits of the foreign entity shall be computed pursuant to Italian tax legislation and attributed for tax purposes to the Italian taxpayer in proportion to its rights to the entity's profits. The CFC income is taxed separately in the hands of the Italian taxpayer (ie, with no possibility to be offset against the losses of the latter). A credit for the taxes paid by the CFC (and any withholding tax paid on the distribution of the CFC profits) may be deducted from the Italian tax due on the CFC income.

An exemption from the CFC legislation is granted:

- if the resident company provides evidence that the foreign entity carries out an effective business activity through personnel, equipment, assets and premises; it is possible to apply for a ruling in order to obtain confirmation from the tax authorities that this condition is met; or
- by paying an optional substitute tax equal to 15% of the accounting net income (gross of taxes, write-downs and risk provisions); this option lasts for three years and is renewable, but needs to be exercised for all companies that realise the passive income test mentioned above.

Foreign permanent establishments whose income is exempted under the branch exemption regime (see **6.1 Foreign Income of Local Corporations**) are subject to CFC legislation if they are located in a jurisdiction that qualifies as low tax, according to the above criteria.

Effective from 1 January 2024, Italy has introduced the Global Minimum Tax.

The groups that fall within the subjective scope of the provision are those that have recorded, in the consolidated tax grouping, an annual income of at least EUR750,000,000 in each of the four financial years prior to 2024.

The minimum tax is due if the tax rate of the companies located in Italy is lower than 15%. In this case, a rate equal to the difference between the effective tax rate and 15% is applied as an additional tax to the excess profit net of the substance-based income exclusion, with the possibility to opt for a domestic minimum tax by local subsidiaries of non-Italian groups.

6.6 Rules Related to the Substance of Non-Local Affiliates

The economic substance of foreign related entities is often looked at by the tax authorities and may trigger challenges.

A common tax challenge concerns the case where the tax authorities tackle the foreign tax residence of a foreign entity with little substance, claiming that such entity should be regarded as a tax resident of Italy because it is actually managed by its Italian parent.

Alternatively, tax authorities may altogether disregard the foreign entity so that all its income and gains will be attributed to the Italian parent as if realised directly by the latter. In the recent practice of the tax authorities, some foreign subsidiaries of Italian parents have been re-characterised as foreign permanent establishments, due to the lack of managerial independence.

The lack of substance of a non-resident company may also lead to a charge denying treaty benefits to the latter.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains made by resident companies on the sale of shareholdings in non-resident companies can be eligible for the 95% participation exemption (see **2.7 Capital Gains Taxation**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

A general anti-avoidance rule empowers the tax authorities to challenge an arrangement or a series of arrangements that do not have economic substance and, although formally compliant with the wording of the law, have been put in place with the main purpose or one of the main purposes of obtaining an undue tax advantage, having regard to all relevant facts and circumstances.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

If a company's turnover exceeds certain thresholds, tax audits are carried out by the competent regional directorate of the Revenue Agency and the company is monitored more strictly and more frequently.

9. BEPS

9.1 Recommended Changes

Several measures recommended within the BEPS project were already part of the Italian tax system before 2015. Others have been added, particularly by the implementation of the ATAD I and II Directives. For example:

- Italy amended the domestic definition of *"permanent establishment"*, aligning it – to a large extent – to the recommendations included in the Final Report on BEPS Action 7;
- even though a number of anti-hybrid provisions have been in place since 2004, in 2018 Italy introduced additional anti-hybrid provisions upon the implementation of ATAD I and II; and
- CFC and interest deduction rules were aligned with the ATAD principles (see **2.5 Imposed Limits on Deduction of Interest** and **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules**).

Italy is a signatory to the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS of November 2016. Such convention has not yet been ratified.

9.2 Government Attitudes

The Italian government actively participated in the BEPS project (see **9.1 Recommended Changes**). There are not yet any formal legislative initiatives in Italy concerning Pillar One, while Pillar Two was enacted in compliance with Directive No 2523/2022.

9.3 Profile of International Tax

Issues concerning the fair taxation of multinationals in Italy are often within the domain of public discussion and under the media spotlight.

9.4 Competitive Tax Policy Objective

In the last few years, Italy has introduced a number of favourable regimes designed to incentivise certain investments and behaviours of taxpayers, such as:

- the Investment Management Exemption, which, in a nutshell, limits the possibility that the managing investments activities carried out on behalf of foreign white-list investment vehicles may constitute both a material or an agency permanent establishment in Italy;
- the patent box regime (see **2.2 Special Incentives for Technology Investments**) originally introduced also with respect to trademarks

(then carved out in compliance with BEPS recommendations) and amended in 2021;
- the branch exemption regime (see **6.1 Foreign Income of Local Corporations**), to boost the competitiveness of resident companies operating directly in foreign jurisdictions; and
- the tonnage tax regime (see **2.3 Other Special Incentives**) for companies operating ships.

Such regimes are not expected to be (further) amended in light of BEPS recommendations.

Being an EU member state, Italy is bound by the EU rules on state aids. Based on publicly available information, the European Commission has not challenged the lawfulness of any of the above-mentioned regime in the light of the state aid legislation.

9.5 Features of the Competitive Tax System

See **9.4 Competitive Tax Policy Objective**.

9.6 Proposals for Dealing With Hybrid Instruments

mentioned at **9.1 Recommended Changes**, Italy introduced limited anti-hybrid legislation effective from 2004, which was meant to counteract the use of certain hybrid instruments. Fully-fledged anti-hybrid legislation was introduced in 2018, in compliance with ATAD I and II. As a consequence of such legislation, there may be instances where expenses borne by local corporations could be non-deductible if connected to hybrid mismatches.

However, in the context of the fiscal reform, Italy has implemented a penalty protection for infringements that may arise from hybrids. This protection can be claimed if appropriate evidence of having implemented measures to avoid hybrid mismatches is provided. The documentation substantiating such implementation must be submitted by taxpayers resident (or located) in Italy and should provide a detailed description of the multinational group, the relevant transactions, and the internal procedures for identifying mismatches. Specific procedures for the preparation and submission of this documentation are outlined, including a deadline for timestamping. Transitional provisions for previous tax periods grant additional time for the preparation of the required documentation.

9.7 Territorial Tax Regime

There are no territorial tax regimes except for the optional application of the branch exemption regime described in **6.1 Foreign Income of Local Corporations**.

Italian interest limitation rules apply in general to all interest expenses of resident companies and Italian permanent establishments, regardless of whether the payee of the interest payments is Italian or foreign and related or not. The regime applicable to interest deduction is in line with Article 4 of ATAD I.

9.8 Controlled Foreign Corporation Proposals

Italian law has featured CFC legislation since 2000; see **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules** for an illustration of the currently applicable rules. A change in the CFC regime has been made with Article 3 of Legislative Decree of 27 December 2023 No 209. In fact, the CFC regime has been harmonised with the Global Minimum Tax enforced by Italy in the context of Pillar Two of the Programme of Work for Addressing the Tax Challenges of the Digitalisation of the Economy agreed upon by the Inclusive Framework.

9.9 Anti-Avoidance Rules

Pursuant to an established practice, Italian tax authorities apply Italian domestic anti-avoidance rules and principles to deny treaty benefits. The case law of the Supreme Court upholds this practice. Therefore, the recommendation of a treaty general anti-avoidance rule of Action 6 is not expected to have an impact on this practice.

Italian treaties do not generally include a limitation on benefits provision (the notable exception being the treaty with the United States). Furthermore, Italy did not opt to apply the Simplified Limitation on Benefits rule included in the MLI and, therefore, such rule should not be included in any of Italy's Covered Tax Agreements (obviously, this conclusion should be further checked when Italy ratifies the MLI and deposits the final list of notifications).

9.10 Transfer Pricing Changes

The changes to the OECD Transfer Pricing Guidelines made pursuant to BEPS Actions 8 to 10 have not resulted in any dramatic change in the Italian regime. Indeed, the approach of the Italian tax authorities within tax audits was already essentially based on the arm's length principle.

Transfer pricing was and continues to be an area carefully and often scrutinised by the tax authorities during audits of companies of multinational groups.

9.11 Transparency and Country-by-Country Reporting

As an EU member state, Italy complies with the obligations on the exchange of information laid down by the Directive on the exchange of information (under Directive 2011/16/EU – DAC). Such exchange of information includes, inter alia, the mandatory exchange of tax rulings and CRS with other member states.

In 2015, Italy introduced country-by-country reporting obligations in line with BEPS Action 13 recommendations and in line with the DAC in relation to information concerning tax years that began on or after 1 January 2016.

Moreover, Italy implemented the provisions of the DAC concerning the automatic exchange of information on certain reportable cross-border arrangements (generally known as DAC 6 provisions).

9.12 Taxation of Digital Economy Businesses

See **9.13 Digital Taxation**.

9.13 Digital Taxation

In 2017, the domestic law definition of permanent establishment was amended to provide that a non-resident company shall be regarded as having a permanent establishment if it has *"a significant and continuous economic presence in the Italian territory that has been arranged in such a way that does not give rise to a physical presence therein"*. The provision seems loosely inspired by BEPS Action 1 Report. However, the exact scope of the provision and its relationship with existing tax treaties (which do not include such a provision in their definition of a permanent establishment) is currently unclear.

In December 2019, Italy introduced a Digital Services Tax (DST), patterned after the European Commission Proposal of March 2018. The DST entered into force on 1 January 2020. Taxable persons shall make the first payment of the DST by 16 March 2021 on the taxable revenues that they realised during 2020, and shall submit the relevant tax return by 30 April 2021.

The DST is a tax on revenues stemming from the provisions of three types of services:

- the placing on a digital interface of advertising targeted at users of that interface;
- the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users; and
- the transmission of data collected about users and generated from users' activities on digital interfaces.

The DST is levied at the rate of 3% on the gross revenues (net of VAT) for the provision of such services that are to be regarded as realised in Italy according to specific territoriality rules based on the location of the users of the services and regardless of the location of the payers.

Like the European Commission's proposal, the DST should not apply to the provision of certain services and the supply of certain goods such as, in particular, the provision of digital contents and e-commerce transactions.

The DST applies to both resident and non-resident entities, with or without an Italian permanent establishment, that in the calendar year preceding the one in which the DST should apply, either on a standalone basis or at the group level, have accrued a total amount of worldwide revenue, reported during the calendar year, not lower than EUR750 million.

The budget law for 2023 introduced a reporting obligation for VAT taxable persons who operate electronic platforms that facilitate indirect e-commerce. These entities are required to provide the Revenue Agency with data on suppliers and transactions carried out.

Furthermore, the budget law for 2025 has introduced the obligation to make a provisional payment, by 30 November of the calendar year in which the revenues are generated, equal to 30% of the DST tax liability for the preceding calendar year.

9.14 Taxation of Offshore IP

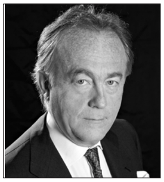
There are no specific provisions dealing with the taxation of offshore intellectual property.

Trends and Developments

Contributed by:
Guglielmo Maisto
Maisto e Associati

Maisto e Associati was established in 1991 and is an independent Italian law firm, specialising in tax law, with offices in Milan, Rome and London. Over the years, the firm has grown in size and reputation, and now has more than 60 professionals, including 15 partners and two of counsels, with consolidated experience in managing complex domestic and multi-jurisdictional cases. Most of the firm's work has an international dimension. Clients include national and international financial institutions, venture capital, private equity and real estate players, large corporations and multinationals, high net worth individuals and wealthy families. Most of the firm's professionals participate in advisory bodies and study groups, are frequent speakers at congresses and contribute to numerous publications and the most prestigious tax journals. Several firm members have substantial experience in international taxation issues, having worked in the Netherlands, the USA and the UK.

Author



Guglielmo Maisto founded Maisto e Associati in 1991. He is a professor of international and comparative tax law at the Università Cattolica di Piacenza. He is President of the International Fiscal Association (IFA), member of the Board of Trustees of the International Bureau of Fiscal Documentation (IBFD) in Amsterdam, a member of the Practice Council of New York University (NYU) Law's International Tax Programme and a member of the Board of the American Chamber of Commerce in Italy.

Maisto e Associati

Piazza Filippo Meda 5
20121 Milano
Italy

Tel: +39 02 77 6931
Fax: +39 027 769 3300
Email: g.maisto@maisto.it
Web: www.maisto.it

Contributed by: Guglielmo Maisto, **Maisto e Associati**

New Tax Legislation and the Consolidation of Regulatory Practice in Italy

There has recently been important progress in the Italian tax environment through the enactment of new pieces of legislation. In most cases, the evolution has been along the lines of the various international developments that took place within the context of the OECD (BEPS Action Plan) and the European Union.

Aside from the legal and administrative evolutions, in the last few years there has been an impressive consolidation of the tax authorities' practice, also showing that authorities can now avail themselves of highly specialised departments (especially in certain areas, such as transfer pricing and international tax) and have access to an increasingly wide range of information about taxpayers and groups.

Overall, several factors make Italy an attractive destination for foreign investment. A combination of appealing incentives and the opportunity for taxpayers to engage in meaningful dialogue with tax authorities offers the potential for advance certainty, thereby mitigating tax risks.

The Ruling Practice of Italian Tax Authorities and the Possibility to Seek Advance Certainty/Risk Prevention

A key advancement in Italian tax administration is the enhanced ability for taxpayers to submit ruling applications for advance certainty on tax rules. This system provides an effective means of securing clarity on applicable tax regimes.

Ordinary tax ruling practice

The tax ruling system has been recently reformed. The new system provides for an ordinary ruling procedure, covering several areas (interpretation of the tax law, qualification of a specific item of income, analysis as to whether a transaction falls within the scope of abuse of law, disapplication of specific anti-avoidance rules and evaluation on the abusiveness of a transaction) whereby any taxpayer can submit a request to the tax authorities to obtain the authorities' opinion with respect to the actual case/transaction.

As of 2024, some ruling procedures will be subject to a fee, which varies depending on the size, the turnover of the company and the complexity of the question(s). These fees will be allocated towards the training and professional development of tax agency staff. The implementing rules concerning such fees have not yet been published.

Depending on the residence, nature and size of the applicant taxpayer, replies to ruling applications are issued either by the central body of the Revenue Agency or by the regional offices. In any event, a reply to the request is guaranteed within 90 days (with the possibility for authorities to have a 60-day extension in case they request additional information) or, in the case of a lack of a reply, it is presumed that the solution proposed by the applicant is confirmed (ie, it is endorsed by the Revenue Agency). The deadline to reply is suspended for the period from 1 August to 31 August of each year.

Ruling replies are generally (but not always) published on a redacted basis on the website of the Revenue Agency and thus contribute to the set of interpretative guidance provided by the tax administration.

Despite the publication, it is to be noted that the position taken in the ruling reply is binding for the Revenue Agency only with respect to the specific taxpayer that filed the application, to the extent that the relevant facts and circumstances are in line with the ones represented to the tax authorities in the application.

In several cases, where rulings affect international matters, rulings may also have to be exchanged by the Italian tax administration with other jurisdictions' tax administration.

"New investments" rulings

Aside from ordinary rulings, taxpayers (both Italian and foreign) can apply for a specific ruling procedure with respect to *"new investments"* that exceed EUR15 million and have a beneficial impact on employment. Such ruling applications, which can refer to any issues connected with the *"new investment"*, are handled by a specialised department of the Revenue Agency and can provide full certainty on the regime applicable to an overall investment (the procedure not only covers all the matters dealt with by ordinary tax rulings, but also the request for confirmation of the existence of the requirements necessary to be eligible for a specific tax regime and questions concerning certain more factual issues – eg, existence of an Italian permanent establishment – may be submitted). Applicants filing for the *"new investments"* ruling can also have facilitated access to the co-operative compliance programme (ie, irrespective of the size of the applicant – see below).

Co-operative compliance

In 2015, Italy introduced *"co-operative compliance"* programme in line with the OECD standards. Groups and companies accessing this programme can benefit from a system of *"enhanced co-operation"* with the Italian tax administration. The system contemplates a regular flow of information between the group or company and a specific department of the Revenue Agency, with the benefit of shorter response times for interpretative queries, also within the context of ruling applications (which can also be aimed at obtaining confirmation on the existence of the requirements necessary to be eligible for a specific tax regime), and reduced penalties in case of challenges/mistakes.

In the context of the recently approved Italian tax reform, the co-operative compliance will be strengthened. In fact, significant changes have been introduced, including:

- the progressive reduction of the revenue or the turnover threshold to access co-operative compliance;
- the enhancement of some benefits deriving from the co-operative compliance regime; and
- the issuance of a code of conduct governing the rights and obligation of both the tax authorities and taxpayers.

The system is available to groups and companies that have an appropriate tax control framework in place. Notwithstanding the amendments in force as of 2025, the regime is limited to quite a small range of companies so far (depending on the size or specific conditions, like having filed the *"new investments"* ruling as mentioned above). As to the size, for the fiscal year 2025, taxpayers with a turnover or revenues of not less than EUR750 million are eligible for this regime. However, the aim is to extend the co-operative compliance regime to a broader range of taxpayers, namely to taxpayers with a turnover or revenue of at least EUR500 million as of 2026 and to taxpayers with a turnover or revenue of at least EUR100 million as of 2028.

As of 2024, should the taxpayer not meet the requirements for admission to the co-operative compliance regime, it may opt for the adoption of a system for the detection, measurement and control of tax risks by filing a specific communication to the tax authorities. This option may allow the companies to access some of the benefits provided for by the co-operative compliance regime.

Recent Developments in the Area of Transfer Pricing

In recent years, Italy has proven to be more aligned with international best practices and trends in the area of transfer pricing.

Starting with a decree in 2018, a new set of rules was enacted where the Italian tax legislation was aligned with the most recent developments on transfer pricing, and the Italian tax authorities set out several guidance documents generally confirming that the Italian approach vis-à-vis transfer pricing is aligned with OECD practice and recommendations. In general, the Italian tax authorities fully endorsed the arm's length principle as interpreted and analysed by the OECD and thus referred to the OECD Guidelines on transfer pricing.

In the same context, along the lines of the OECD BEPS Actions (albeit with some deviation), in 2020 the Italian tax authorities redesigned the rules governing transfer pricing documentation whereby, if an adequate set of documents (comprising Masterfile and Local File) is prepared in advance and maintained by the taxpayer and the taxpayer provides a formal advance communication, there is full protection from administrative penalties in case of transfer pricing adjustments.

Beyond legislative changes, there is a notable trend towards using co-operative instruments with tax authorities to prevent or resolve disputes. These instruments include:

- Unilateral Advance Pricing Agreements (*"Unilteral APAs"*) These agreements, signed between taxpayers and the tax administration, predetermine transfer pricing methods and policies for specific intercompany transactions. Unilateral APAs have a validity of five tax periods starting from the tax period of signature of the agreement, but with the possibility, under certain conditions, to roll back the effects of the ruling to previous tax periods. Such advance pricing agreements can also be used for the purposes of the identification of a permanent establishment, the attribution of income to a permanent establishment and the application of specific double tax treaty provisions;
- Bilateral/Multilateral Advance Pricing Agreements (*"Bilateral or Multilateral APAs"*) These agreements are negotiated through international procedures between Italian competent authorities and the competent authorities of other countries involved. This way of preventing any double taxation has proven quite effective thanks to increased co-operation between Italian tax authorities and the competent authorities of most developed countries. Based on the statistics published in 2021 by the European Commission, Italy has the third-highest bilateral or multilateral APAs in force in Europe. These agreements define appropriate transfer pricing methods and policies across all involved countries, minimising double taxation in advance. Roll-back provisions may also apply here, and filing for these APAs incurs a fee.
- Dispute Resolution Procedures: These encompass mutual agreement procedures and/or arbitration procedures laid down by international tax treaties and, more recently, by the EU Dispute Resolution Directive (within an EU context), on the basis of which it is possible to resolve any double taxation aris-

ing from tax assessments through an agreement between the competent authorities. The enhanced co-operation between these authorities has led to increased positive outcomes for taxpayers. On the occasion of the Tax Certainty Day 2021, held on 22 November, the OECD released the 2020 Mutual Agreement Procedure Statistics and Italy was the co-winner with Spain of the award in Category *"co-operation"*.

Alignment With International Tax Evolutions

The Italian tax system's gradual alignment with international standards extends beyond transfer pricing, encompassing all facets of international taxation. Recent years have seen substantial reforms in this area:

- First, the entire set of rules governing the taxation of controlled foreign companies (CFC) has been reformed. The updated CFC rules are now aligned with the European Directives (commonly referred to as ATAD), broadening the scope of their application. These rules now apply to controlled entities that are subject to low levels of taxation and whose revenues are primarily of a passive nature. Exemption from the application of these rules is only possible if the controlled entity carries out substantial economic activity supported by staff, equipment, assets, and premises in the foreign state. More recently, the CFC rules have been further updated to integrate the newly introduced Global Minimum Tax.
- Second, the Italian legislature has introduced a set of anti-hybrid mismatch rules, which have been designed in accordance with OECD standards and ATAD Directives. These rules impose significant restrictions on the deduction of costs in cases involving hybrid mismatch arrangements or imported hybrid mismatches – situations where hybrid benefits are obtained abroad and indirectly offset through expense deductions in Italy.
- In 2021, the DAC6 Directive introduced specific obligations on taxpayers and intermediaries (including advisers) to report to the tax authorities any cross-border arrangements that have been identified as aggressive.
- Effective from 1 January 2024, in enacting OECD Pillar Two, Italy has introduced the Global Minimum Tax at a rate of 15% for the groups that have recorded, in the consolidated tax grouping, an annual income of at least EUR750 million in each of the four financial years prior to 2025.

The introduction of all these changes was accompanied by public consultation procedures that gave rise to extensive guidelines from the Italian Revenue Agency. These changes are very much in line with the developments in most other European countries. Like in those countries, such rules have to be adequately taken into account given that their application could become quite complex and burdensome for companies.

Available Tax Incentives

Recent legislative activity in Italy has also focused on introducing various tax incentives, generally designed within the parameters set by OECD and EU regulations. These incentives aim to stimulate the economy and attract or retain investments within Italy.

Among the most relevant incentives, the following are worth mentioning.

Incentives for R&D investments

From 2021, a super-deduction regime has been introduced whereby a company can benefit from an additional deduction from its taxable income in the amount of 110% of R&D expenses incurred in connection with certain qualifying intangibles. This rule enhances the deduction of costs linked with the creation of intangibles. This measure was introduced alongside the abolition of the previously applicable *"patent box"* regime.

A further tax credit is available for certain qualifying R&D expenses. In order to benefit from the tax credit, eligible companies shall also meet certain record-keeping requirements (ie, tracing and tracking system and certification by a qualified auditor).

Incentives for new investments

Similarly, costs borne for qualifying new investments (mostly *"highly technological"* assets) are eligible for an enhanced deduction or tax credit mechanism that allows a super deduction benefit.

Incentives for innovative start-up companies

Innovative start-up companies are identified on the basis of certain specific conditions, including, for instance, the carrying out of an innovative activity or project, and having an R&D expenditure that amounts to at least a certain figure established by law. Innovative start-ups are entitled to a number of tax benefits. For example, investors in these start-ups can deduct a portion of their investment from their taxable income, subject to certain limits.

Employment

Italy has introduced a special incentive for newly hired employees with open-ended contracts whereby, for deduction purposes, the cost of newly hired employees is increased by 20% provided that the hiring entity has been operative in the last financial year and in 2025 will have employed more workers than the average of the previous year.

Relocation of economic activities to Italy

Subject to the European Commission's approval, Italy has introduced an incentive for companies that relocate to Italy. Under this scheme, only 50% of the income generated by these relocated companies will be included in their taxable income for IRES and IRAP purposes for the six fiscal periods following the relocation.

Reduced IRES tax rate

For the 2025 tax period, companies may qualify for a reduced IRES tax rate of 20%, subject to specific conditions, namely:

- At least 80% of the profits from the fiscal year ending 31 December 2024 must be allocated to a specific net equity reserve and not distributed.
- Companies must invest in eligible fixed assets for production facilities in Italy, amounting to at least 30% of retained earnings for 2024 and 24% for 2023, with a minimum investment of EUR20,000 to be made between 1 January 2025 and 31 October 2026.
- The number of employees in 2025 must not decrease compared to the average of the previous three years, and it must be at least 1% higher than the 2024 average, considering all Italian-resident group companies.

Additionally, the company must not have used the wage supplementation fund (*Cassa Integrazione Guadagni*) in the fiscal years ending 31 December 2024 or 31 December 2025. Recapture rules apply if the reserve is distributed within two tax periods or if the investments are sold or relocated within five tax periods.

Profit Repatriation – New Rules and the Attitude of Tax Authorities

One of the key concerns for foreign investors in Italy has long been the repatriation of profits.

This is largely due to the increasingly aggressive stance adopted by Italian tax authorities in recent years when auditing and challenging dividend distributions to non-Italian shareholders. In several cases, authorities have disputed the applicability of EU Directives and double tax treaties, often asserting that dividend distributions to foreign shareholders do not qualify for Italian withholding tax exemptions or reductions unless the recipient is deemed the beneficial owner of the dividends and is not classified as an artificial arrangement.

As a result, many corporate groups that manage their investments through European regional holdings or investment funds, particularly those channelling their investments in Italian target companies via intermediate EU holding companies, have faced tax claims relating to withholding tax exposure. A similar approach has also been applied to interest payments.

A significant reduction in these risks has been achieved through recent legislative changes. Under the new rules, dividend distributions to, and capital gains realised by, UCIT funds and AIFs that are compliant with EU regulations and supervised in an EU or EEA state (with an exchange of information agreement in force) are now exempt from withholding tax (or substitute tax in the case of capital gains stemming from the share of sales). This development represents a substantial improvement for foreign funds investing in Italy. Additionally, a 95% exemption from capital gains tax has recently been extended to non-Italian companies that are resident in an EU or EEA member state, provided certain conditions are met. This change may help mitigate the impact of the absence of treaty protection.

In other instances, the audit practice of the Italian tax authorities continues to rigorously assess the conditions for applying EU Directives and tax treaties to determine eligibility for withholding tax exemptions and reductions, often arguing that beneficial ownership conditions are not met, and often applying general anti-abuse rules. Notably, the Italian General Anti-Abuse Rule (Italian GAAR), set forth in Article 10-bis of Law No 212 of 27 July 2000, is frequently invoked in connection with share buy-back transactions.

Another area of heightened scrutiny by the Italian tax Authorities involves the international mobility of companies. Tax authorities have occasionally challenged the correct application of exit tax rules for corporate taxpayers relocating their tax residence outside of Italy.

There have also been instances where tax authorities have claimed that the business model presented in contracts and documentation does not align with the company's actual operations or transactions. Such cases have included claims involving the identification of hidden permanent establishments in Italy or assessments of higher taxes linked to alleged business restructurings, where authorities have argued that the local entity should have received compensation.

Furthermore, there has been a notable increase in the use of the Italian GAAR to challenge both domestic and international reorganisations.

KENYA

Law and Practice

Contributed by:
Ombo Malumbe, Jack Ong'anya, Faith Ngarama and Cindy Ajumbo
Ong'anya Ombo Advocates LLP

Contents

Contributed by: Ombo Malumbe, Jack Ong'anya, Faith Ngarama and Cindy Ajumbo,
Ong'anya Ombo Advocates LLP

Ong'anya Ombo Advocates LLP is a full-service law firm rendering dedicated and curated legal services to mostly non-state entities in and outside Kenya to advance their business interests. The law firm's keen interest in legal, socio-economic and political factors when guiding its clients sets it apart as a full-service business law firm. The services on tax matters are classified under two general umbrellas: tax controversy and tax non-controversy. These services include litigation and ADR, tax structuring, transactional tax structuring, tax restructuring, tax management through estate planning, transfer pricing, double tax agreements, stakeholder engagement, tax policy development, and tax management for start-ups. The firm is a member of ALFA International headquartered in Chicago, USA, with over 10,000 lawyers spread across 60 key countries around the globe. The firm's membership of ALFA International gives its clients the benefit of access to a range of legal talent across key markets.

Authors

Ombo Malumbe is a legal tax strategist who spearheads the corporate, commercial and cross-border practice at Ong'anya Ombo Advocates LLP. He works with local and foreign corporations in developing seamless corporate tax structures and solutions. He has advised a multinational e-commerce company, a multinational marketing company, a search fund, and investors focusing on precious metals. He has also advised on the cross-listing of the OTC securities of a US listed company and transfer pricing considerations. He handles the establishment of family trusts, addresses tax special table issues, and guides fintech start-ups. He has also acted as a consultant for a Europe-based company focusing on energy and water infrastructure.

Jack Ong'anya is the head of tax controversy at Ong'anya Ombo Advocates LLP. He has extensive knowledge and experience in addressing tax and tax-related disputes and has secured favourable outcomes in tax disputes for both taxpayers and the commissioner/regulator. He has advised and represented a multinational distribution company and a shipping company focusing on chartered airplane parts, and he has acted in tax disputes on royalties collected and not paid to the commissioner and in tax assessment queries arising from statutory audits by the commissioner.

Contributed by: Ombo Malumbe, Jack Ong'anya, Faith Ngarama and Cindy Ajumbo,
Ong'anya Ombo Advocates LLP

Faith Ngarama is an associate at Onganya Ombo Advocates LLP specialising in estate planning, corporate governance, tax law and financial transactions. She provides legal services in areas such as transaction restructuring, legal audits, risk management and compliance. With a focus on tax efficiency, Faith advises clients on estate planning strategies, helping them make tax-efficient choices that minimise tax liabilities, including capital gains tax, while ensuring compliance with applicable tax laws. Faith is deeply involved in stakeholder engagement and policy monitoring concerning tax laws, providing advisory reports to clients, and ensuring their business practices remain compliant with current regulations.

Cindy Ajumbo is an associate at Ong'anya Ombo Advocates LLP, specialising in corporate-commercial tax, tax policies, and fintech solutions. She possesses a comprehensive understanding of tax regulations acquired through direct engagement with various regulatory bodies and in-depth analysis of their policies. Cindy provides expert counsel to clients on a range of corporate structures, offering insightful assessments of their tax implications over both the short and long term. Beyond advisory work, Cindy has a strong background in tax litigation. She has successfully managed a diverse portfolio of complex tax litigation cases at the Tax Appeals Tribunal and High Court.

Ong'anya Ombo Advocates LLP

Mayfair Suites, 4th Floor
Parklands Gardens, Westlands
Parklands Road
PO Box 15598 – 00400
Nairobi
Kenya

Tel: +254 208 400 629
Email: hello@onganyaombo.com
Web: www.onganyaombo.com

O'BANG LAW

Contributed by: Ombo Malumbe, Jack Ong'anya, Faith Ngarama and Cindy Ajumbo,
Ong'anya Ombo Advocates LLP

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Types of Business Forms

The corporate form a business takes is influenced by various factors, which may include promoters' operational interests, statutory compliance issues, tax implications or budget factors. Generally, the laws in place provide for business forms such as sole proprietorship, limited partnership (LP), limited liability partnership (LLP), limited liability company (LTD), public limited company (PLC), and foreign company (FC).

Key Differences Concerning Business Forms

The primary differences among these structures are tax, sector-specific statutory requirements, and liability towards the promoters of the entity.

Whether entities are taxed as separate entities

In general, there are entities that are tax pass-through and those where tax is applied to the entity. For instance, for a sole proprietor, LP and LLP, tax applies to the founder(s) or partners, while for an LTD, PLC and FC, tax applies to the corporate structure. However, there can be a further distinction between the tax applied to an FC and a subsidiary of a foreign company (LTD).

Tax liability post-dissolution of a limited liability entity

If an entity such as an LLP, LTD or PLC is struck off the Companies Register, the closure of the entity does not obliterate any tax liability that the entity may have to the relevant government agencies. This means that the tax liability linked to the personal identification number (*"Tax PIN"*) of the entity remains active post-closure and the Tax PIN can only be closed upon addressing such liabilities.

1.2 Transparent Entities

The three key transparent entities are:

- sole proprietor, mostly preferred for their simple formation and flexible arrangements of sharing of profits;
- limited partnership, preferred for the flexibility with limitation of liability for passive investors; and
- limited liability partnership, which is the most preferred of partnerships for the purposes of limited liability protection for the founders and partners.

All these entities are preferred because of the pass-through nature of taxation which helps avoid double taxation. Private equity firms may take the form of an LLP due to the near replication of an LTD in terms of limiting the founders' liability. With regard to venture capital firms and for the purposes of enjoying certain tax benefits, there is no option to opt in for transparent entities, since the Income Tax (Venture Capital Enterprises) Rules require the venture capital firm to be a corporate structure as per the Companies Act. Hedge funds will most often take the shape of Limited Partnerships and Limited Companies especially for the purposes of accommodating foreign investors. While taxation will apply as per the form used, the investors could benefit from various tax incentives offered in Kenya, including the existing double taxation agreements.

1.3 Determining Residence of Incorporated Businesses

An entity's residence, other than its incorporation in Kenya, is determined through various operational factors. A business is considered to be resident in Kenya if its management and control of its activities take place in Kenya or the Cabinet Secretary declares a given entity to be a resident entity through a Gazette Notice. Therefore, there are instances where a non-resident entity may be considered to have a permanent establishment (PE) in Kenya. Some of the key factors that are used to determine a PE are set out below.

Fixed Place of Business

A fixed place of business wholly or partly serves as a place of management, branch, workshop, office, mine, factory, oil/gas well, quarry, place of extraction/exploitation, warehouse (providing storage facilities), farm, plantation or place for related activities and a sale outlet. For digital nomads, if they stay in Kenya for over 183 days or establish a significant presence, their activities could trigger a fixed place of business and create tax obligations in the country. This could impact both the nomad's tax residency and the tax residence of their employer, potentially leading to dual tax obligations. Double tax agreements (DTAs) may provide relief in such cases, helping to allocate taxing rights between the home and host countries and reduce the chances of double taxation.

Timeline-Based Activities

183 days

Activities under this category include work on a building site, a construction, assembly or installation project, or any supervisory activity linked to the site or project. There are, however, other factors such as aggregated timelines and related entities, that would be factored in to determine whether an entity is a PE.

91 days

The provision of services or consultancies by a person through employees or other personnel in Kenya where such an activity continues for a period (including an aggregated period) exceeding 91 days within a 12-month period, commencing or ending in the year of income, is also a factor used to determine whether an entity is a PE.

An installation or structure used in the exploration of natural resources for a period exceeding 91 days will also be considered to be a PE.

Dependent Agent

A person that has a dependent agent in Kenya who assumes any role, including concluding contracts and playing the principal role in a business entity with no serious supervision, will be deemed to have a PE in Kenya. However, there are some limitations on applying the dependent agent provision, when the activities are what could be defined by law as being of a preparatory or auxiliary nature.

1.4 Tax Rates

The tax rates in Kenya vary depending on the structure of the entity and certain regulatory factors, such as entities being in the Export Processing Zone (EPZ), Special Economic Zone (SEZ), or entities being involved in shipping, housing development or motor vehicle assembly, among other businesses, for which there are special arrangements with the government. See **2.3 Other Special Incentives** for further detail.

General Tax Rates for Incorporated Businesses

The general applicable rate is 30% for a resident entity and 30% and an additional repatriation tax of 15% for a non-resident entity.

Sector-Specific Tax for Incorporated Businesses

- EPZ entities are exempt from paying any corporation tax for a period of ten years from the date on which their EPZ business commenced, which will be revised to 25% upon the lapse of the exemption period for the next ten years.

- SEZ entities are subject to corporation tax of 10% for the first ten years in which they are resident in the SEZ, after which, 15% tax will apply for the next ten years.
- An entity engaging in the local assembly of motor vehicles will pay 15% corporate tax for the first five years from commencement of operations. This period will be extended for a further five years should the entity meet the local content requirements.
- If an entity has entered into an agreement with the government for a preferential tax rate, such tax rate will apply.
- An entity engaged in shipping business will pay 15% corporate tax for the first ten years from commencement of operations.
- An entity engaged in operating a carbon market exchange or emission trading system that is certified by the Nairobi International Financial Centre Authority will pay 15% corporate tax for the first ten years from the year of commencement.

Sole Proprietor/LP/LLP

An individual-owned business or pass-through entity's tax rates are applied on an individual level rather than as *"trading as"* or pass-through entity. The rates are applied in bands or scales ranging from 10% to a maximum of 35%, as follows (the figures refer to yearly income computation):

- first KES288,000 – 10%;
- next KES100,000 – 25%;
- next KES5.612 million – 30%;
- next KES3.6 million – 32.5%;
- all above KES9.6 million – 35%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Allowable Deductions and Exemptions

Taxable profits are calculated based on accounting profits, but with certain adjustments in terms of deductions and exemptions that a person may apply to their gross profit for the purpose of establishing their net profit, which will be taxable. The Kenya Revenue Authority (KRA) is implementing measures to bring taxpayers into the system and there is a requirement that for allowable deductions to be accepted, all tax receipts must be generated from KRA's electronic tax invoice management systems (eTIMs), save where there are exemptions. Allowable deductions include business-related expenditure, bad debts, expenditure on scientific research, certain expenditures arising prior to commencement of the business, certain investment costs, certain costs under extractive industries, and a person may consider income that is exempt from tax when determining taxable profits. Taxable profits are generally calculated on an accrual basis as income is recognised when earned as opposed to when received.

2.2 Special Incentives for Technology Investments

Scientific Research Incentive

A business that has expenses of a capital nature or not of a capital nature concerning scientific research will have the right to deduct the expense as an allowable deduction, and this equally applies to funds paid to a scientific research association that has been approved by the Commissioner.

Qualifying Intellectual Property

There is a clearer approach on how to qualify intellectual property (IP) income that is subject to determining preferential tax rates. The IP income subject to tax benefits is determined through the division of the taxpayer's research and development (R&D) costs by the taxpayer's R&D costs plus acquisition costs and related-party sourcing costs, and the outcome is multiplied by IP income (including royalties, capital gains, any income from the sale of IP assets, and embedded IP income per transfer pricing principles).

2.3 Other Special Incentives

Carbon Market Exchange or Emission Trading System

An entity certified by the Nairobi International Financial Centre Authority (NIFCA) to operate a carbon market exchange or emission trading system will be taxed at the rate of 15% for the first ten years from commencement of its operation. In addition, 50% of the investment cost of renewable energy projects is deductible annually on a reducing balance basis. Interest income earned from green bonds listed in the Nairobi Securities Exchange (NSE) is exempt from tax.

Economic and Processing Zones

There are various corporate tax benefits for entities that embrace the use of the EPZ or SEZ. The former is more focused on export from Kenya while the latter provides room to transact with the local market and export while still benefiting from tax incentives.

Manufacture of Human Vaccines

An entity engaged in the manufacture of human vaccines is exempt from tax for income accrued in, derived from or received in Kenya. These exemptions apply to payments made to a non-resident service provider without a PE in Kenya, the income of the entity, compensating tax, and dividends paid to a non-resident person.

Motor Vehicle Assembly

An entity engaged in local assembly of motor vehicles will pay 15% corporate tax for the first five years from the commencement of operations. This period will be extended for a further five years should the entity meet the local content requirements.

ICT and Digital Services

Tax rebates are applicable for software development and ICT equipment manufacturing. Locally developed software and digital services that are exported are zero-rated. Investors in ICT hubs benefit from the SEZ incentives including reduced corporate tax and VAT exemptions.

Special Arrangements

The government offers a special tax rate if an entity enters a special operating framework with the government, an entity is incorporated for manufacturing human vaccines or other manufacturing activities including mining, and the capital investment is about KES10 billion.

2.4 Basic Rules on Loss Relief

Where a loss is in line with the regulations on allowable deductions, the law allows a deduction to be carried forward for a maximum period of ten years. However, a person may apply to the Commissioner for an extension due to its inability to extinguish the deficit deduction.

2.5 Imposed Limits on Deduction of Interest

There are parameters when deducting interest as one of the allowable deductions under the relevant law. The interest should arise from funds borrowed with a view to advancing a particular investment income (excluding qualifying dividends and interests) for a particular taxable income. If the amount deductible exceeds the income with tax obligation, the same excess will be carried forward to the following income year.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated Tax Group

The Commissioner requires an entity with Kenyan residence that is an ultimate parent or constituent of a multinational enterprise to file its financial activities concerning Kenya and other jurisdictions in which it has a tax presence. An entity that qualifies for this category is one with a gross turnover of KES95 billion. This qualifying entity will file country-by-country (CBC) reports through a master file and local file. The master file will include the consolidated financial statements of the group.

Exemptions

Resident surrogate parent entity

There are exemptions on CBC reporting based on the fact that the ultimate parent entity has a reporting obligation at its jurisdiction, its jurisdiction has an international agreement coupled with the competent authority, and there is no arising systemic failure notification by the Commissioner.

Resident constituent entity

There are exemptions on CBC reporting if the non-resident surrogate entity files the CBC, the jurisdiction of the non-resident surrogate requires CBC reporting, no notification is made to Kenya for systemic failure, or the non-resident parent entity has issued a notification to a competent authority that it is the designated surrogate parent entity of the group.

2.7 Capital Gains Taxation

Capital gains tax (CGT) in Kenya is currently at the rate of 15%, which is applicable to gains made upon selling of shares. An entity can determine what amounts to gains, subject to CGT, by calculating the difference between the transfer value and the adjusted cost. The former being the consideration paid, while the latter refers to the various costs incurred that can be deducted from the transfer value.

In the event there is a different tax applicable to what would be classified as capital gains, then CGT will not be applied because of the other applicable tax. In addition, one is limited from deducting costs for any securities transacted on and listed on any security exchange approved under the Capital Markets Act.

The CGT applicable when transferring a property will not apply when the title of the property is being transferred to a family trust.

2.8 Other Taxes Payable by an Incorporated Business

The type or sector specific to a transaction will influence the type of tax that will be applied in a particular transaction. In this regard, the following are some of the taxes included.

Value Added Tax (VAT)

This is applicable on various goods and services rendered to an entity or when rendering the same to another entity if the goods or services are not exempted or zero-rated.

Excise Duty

This is commonly applicable in various transactions, such as bank transactions, gains in the gaming industry, and for certain products/goods per a given Harmonised System (HS) Code, among others.

Withholding Tax (WHT)

This is applicable to various classes of transaction and an incorporated business ought to know when to apply for the same. Some instances where WHT is applicable include consultancy fees, royalties, and gaming-related winnings, among others.

Gambling Industry-Based Tax

This is applicable to winnings. The taxes, which are rated at 15% of the gaming revenue (gross turnover less the amount paid out to customers as winnings), are known as betting tax, lottery tax, gaming tax, and prize competition tax. The taxes are paid to the Sports, Arts and Social Development Fund.

Minimum Top-Up Tax

This is applicable to a resident entity or an entity with a permanent establishment in Kenya that is a part of a multinational group with a consolidated annual turnover of about KES104 billion or more in the consolidated financial statements of the ultimate parent entity in at least two of the previous four years of income immediately preceding the first year of income. This is generally the difference between 15% of the net income or loss for the year of income of the entity and the combined effective tax rate for the year of income, multiplied by the excess profit of the entity.

2.9 Incorporated Businesses and Notable Taxes

Other Notable Taxes

There are several tax classifications that apply to various businesses based on the sector that a particular business ventures into during that tax period. Some of the notable taxes, other than VAT and WHT, are as follows.

Affordable housing levy

According to the Finance Act, 2023, the Affordable Housing Levy (AHL) was applicable at a rate of 1.5% of the gross salary of the employee, whereby the employee and employer both contributed 1.5% per month. This levy was, however, declared unconstitutional. As a result, the government passed the Affordable Housing Act, which was accepted into law on 18 March 2024.

Compensating tax

This tax is applicable to any untaxed dividend that is being distributed. A corporate entity will have an obligation to apply compensating tax at the rate of corporate tax, which is 30%.

Digital service tax

A digital service tax (DST) at a rate of 1.5% is applicable as a final tax on a non-resident entity without a PE that offers digital services.

National industrial training authority levy

This levy is paid at a rate of KES50 per employee monthly. This amount is a contribution by the employer; therefore, it is not deducted from the staff payroll.

Turnover tax

Turnover tax is applicable to all resident entities with revenues ranging between KES1 million and KES25 million in a given year (including pass-through entities) at a rate of 3% of the gross receipts paid monthly. Entities receiving such revenue in the form of rental income, management fees, professional fees and training fees, among others, are exempt from turnover tax, and an entity may apply for an exemption.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

It is common practice for founders, the majority of whom operate small and medium enterprises, to prefer to start their businesses in the form of a sole proprietorship because of its low costs and simple structures, and later to convert, mostly to an LTD or LLP after significant growth in the business. However, some founders who prefer the benefits that come with corporate forms opt for the same from the beginning.

3.2 Individual Rates and Corporate Rates

Individual Tax Rates

The current individual income tax rate is on a scale from 10–35% depending on the individual's annual income. This means that the rate is equally applicable to a sole proprietorship, LP or LLP due to the open nature of income tax.

Corporate Tax Rates

There are various tax rates ranging from 0–30% of the income of a corporate entity in a given year. However, there are various ways to achieve tax benefits, such as, in the manufacture of human vaccines, being in the SEZ or EPZ, or by being involved in the motor industry, among others.

Other Options

While lawyers are limited to sole proprietorship, LP and LLP due to the belief that having shareholders would lead to diversion from the public interest to shareholders' interests, many other professionals prefer to adopt LTD structures.

3.3 Accumulating Earnings for Investment Purposes

There are no regulatory measures that limit a closely held corporation in the accumulation of funds for investment purposes. However, where an amount that would have been distributed as dividends, upon other deductions (such as investments) being made, has not been distributed within 12 months of the accounting period, the Commissioner will deem the amount as having been paid, thereby resulting in the applicable tax being applied.

3.4 Sales of Shares by Individuals in Closely Held Corporations

CGT is the tax applicable to dividends from, and gain on the sale of, shares. The rate is 15%. There are exemptions, depending on whether there is a gain or a loss, which could result in the CGT not being applied to a particular transaction.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The traded shares are subject to WHT that is applied by the relevant stockbroker trading the shares on behalf of the individual. The WHT must be remitted to the KRA on or before the 20th day of the following month. The WHT rate applicable to a resident person is 5% (this extends to a citizen of East African Community partner states) and for a non-resident person the WHT rate is 15%. There are limited exemptions on such dividends.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The rates for WHT vary according to the transaction activity, for instance, interest, dividends and royalties will attract WHT at rates of 15%, 5% (voting rights matter) and 5%, respectively, for a resident person, while a non-resident person will pay a WHT of 0%, 15% and 20% for interest (qualifying interest), dividends and royalties, respectively. These examples are not conclusive as there are various types of royalties and interest, which an investor should be familiar with prior to any dealings.

4.2 Primary Tax Treaty Countries

Kenya has about 14 active double tax agreements (DTAs), some of which are in the process of being negotiated or signed by the relevant states. These DTAs are essentially meant to manage the possible taxes applied on cross-border transactions. Which country will receive the tax is influenced by myriad factors, which can include IP structuring for licensing, accessibility to investors, and socio-political factors. Therefore, an entity is advised to assess its commercial interest before exploring the structures under DTAs.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

A DTA's use is limited to the parties to that DTA. A person needing any consensus with the Commissioner on an item where a DTA does not apply, will have to reach out directly to the Commissioner. This is even more important where there is a grey area and the use of a DTA, or international agreement, will help in providing a solution.

4.4 Transfer Pricing Issues

The Kenyan government is keen to update its Transfer Pricing Rules due to the challenges arising when implementing the Transfer Pricing Rules 2006, which are not in line with other market players or current events. To curb the challenges the Commissioner faces when interacting with inbound investors, transfer pricing principles have been adopted which will give the inbound investor a sense of direction when tabulating the relevant charges on an arm's length basis.

4.5 Related-Party Limited Risk Distribution Arrangements

Related entities are required, as a matter of policy, to have policies that govern their respective relationships or arrangements. This is a bare minimum requirement in the transfer pricing realm; however, the same ought to be structured in line with the best international practices, which will help in easing tension between the entity and the Commissioner.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Kenya, being a member of the OECD, is required to revamp its regulatory framework to match the OECD standards; however, while there are limiting factors due to the current regulatory framework having been in use since 2006, the courts have embraced the OECD guiding principles for the purposes of better application or interpretation of the tax laws.

4.7 International Transfer Pricing Disputes

Kenya's interest in revamping its Transfer Pricing Rules gives a clear impression that the relevant regulator is experiencing challenges in this area. Even the adoption of certain OECD standards may not have had much impact due to the need to translate the same into local law. Hence the appearance of the new proposed Transfer Pricing Rules, 2023, which are more detailed.

There have been instances where differences of opinion on the application of the Transfer Pricing

Rules, 2006, have escalated between the regulator and corporate entities at the domestic level, which still tends to be fairly manageable. However, there have been instances where the DTAs have also come into play, which requires diplomacy and mutual respect. In such cases, where there is a DTA and a taxpayer feels aggrieved by the position of the tax regulator over the possibility of double taxation, the taxpayer can adopt a mutual agreement procedure to resolve the dispute.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating tax is applicable at a rate of 30% when a corporate entity wishes to distribute its dividends out of gains or profits, and no tax is paid against such dividends.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches and local subsidiaries are subject to corporate tax of 37.5% and 30% respectively for the declared net profits in a particular year of income. Furthermore, the allowable deductions for a local branch and local subsidiary will vary based on various transactional factors.

5.3 Capital Gains of Non-Residents

CGT is applicable to non-residents at a rate of 15% and is applied on any property, which includes shares held in Kenya that are transacted on by any person, including a non-local holding entity that holds shares in a local entity directly. There is room to explore the provisions of the DTA, which boils down to the place where the alienator of the shares is resident.

5.4 Change of Control Provisions

What Amounts to Change of Control?

There are provisions addressing what amounts to change of control, which include factors such as shares held, guarantees, financial facilities, ownership of know-how, and authority to appoint more than half of the board members. Any activity touching on the mentioned factors may show an aspect of change of control.

Liability of a Company

There are instances where the senior officers of the company, including a controlling member, will take full responsibility for the company's tax if it can be established that the senior officers or controlling member put in place measures that made the company fail, or intended to have it fail, to comply with the tax laws.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no unique formulas other than the applicable regulatory framework, and accounting standards that are fronted by the Institute of Certified Public Accountants of Kenya (ICPAK) as favourable international practice.

5.6 Deductions for Payments by Local Affiliates

The bare minimum condition is that for a deduction to be allowed, the same ought to have been spent wholly and exclusively by the business for the purposes of generating the income. There are limitations on the application of the same, based on various factors, including where the spending involves a branch of a non-local entity and a local subsidiary of a non-local entity.

5.7 Constraints on Related-Party Borrowing

The regulatory framework in place provides that all transactions ought to be conducted at arm's length for the purposes of enhancing compliance with the Transfer Pricing Rules, 2006. Generally, in an attempt to comply with the Transfer Pricing Rules, risks arise, such as currency stability and interest rates meant for the actual loan and interest rates meant to cover the possible unpredictable fluctuation between the Kenya shilling (KES) and other favourably stable currencies that are stronger than the KES.

All in all, there are limitations on deductions should the payable interest to a related entity, including third parties, be in excess of 30% of the earnings before interest, taxes, depreciation and amortisation (EBIDTA) in any financial year of the borrower. There are, however, some exemptions that an entity may use where the purpose of the limitation is not applicable.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

As Kenya has adopted a territorial tax-based system, from a general perspective, foreign income will not be subject to tax, save where there are certain requirements that the local corporation fails to meet. Therefore, where the Commissioner determines that to generate a certain income, the local corporation must partly conduct business inside and outside Kenya, then the whole income will be subject to tax per the classification of that tax.

6.2 Non-Deductible Local Expenses

If the income is exempt, there will be no applicable deductions. However, as indicated in **6.1 Foreign Income of Local Corporations**, there are instances when foreign income will be classified as taxable income, which will result in the application of allowable deductions, while observing the non-deductible expenses per the applicable regulatory framework.

6.3 Taxation on Dividends From Foreign Subsidiaries

Generally, dividends received by a local corporation from a foreign subsidiary, as a result of which, the local corporation holds more than 12.5% of the shares, is tax exempt and, as such, there is no allowable deduction on expenses linked to that tax-exempt income.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangible assets, while considering the arm's length principle, will be licensed to the non-local subsidiary, which translates to income received in Kenya by the local corporation. The income will be subject to the applicable regulations such as the Income Tax Act, Transfer Pricing Rules and DTA (if any).

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

There are BEPS-influenced laws focusing on country-by-country reporting and common reporting standards, which will lead to the disclosure of more information concerning entities' activities for better taxation. However, while in general the status is that there is no defined framework for a controlled foreign corporation (CFC), an entity controlling a foreign entity still has a defined position in Kenya for tax purposes.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no economic substance regulations in place; however, the approach by the Commissioner is limited to the activities of the entity as compared to a mere description. Therefore, the regulatory framework on what amounts to a resident, non-resident or PE entity will influence how the Commissioner defines an entity's tax obligations.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Generally, alienation of shares in a non-local entity attracts no tax, save for where within 365 days before the alienation, at least 20% of the value of the shares was derived from an immovable property in Kenya.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

There are anti-avoidance provisions that are structured to operate both prospectively and retrospectively. The provisions focus on transactions designed to avoid a person's liability to pay tax. Also, there is a provision focusing on private companies that may opt to delay the distribution of dividends that would ordinarily have been disbursed to the shareholders.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Commissioner does not have a specific timeline according to which it will initiate an audit; however, there are certain statutory limitations, with exemptions to limitations towards the Commissioner. By law, the Commissioner may effect an assessment based on the information it has, limited to a period not exceeding five years from the date of the last report. However, the five-year statutory limitation will not apply in the event the taxpayer engages in what can be classified as gross or wilful neglect, evasion, or fraud.

9. BEPS

9.1 Recommended Changes

Kenya is making a remarkable effort to achieve the BEPS recommended changes. As it stands, there is interest in providing new Transfer Pricing Rules and country-by-country reporting laws are already in place, not to mention provision of penalties for non-compliance.

Kenya is also implementing the common reporting standards (CRS), which will require defined financial institutions to disclose their customers' information to the Commissioner. This is a process that will lead to the realisation of the automatic exchange of information between relevant countries.

9.2 Government Attitudes

The Kenyan government is keen on implementing BEPS to align with its national interests, while also factoring in the interests of its international partners. Some actions have been taken that could be considered as steps towards the implementation of Pillars One and Two, since the Cabinet Secretary for the National Treasury and Economic Planning released a draft Transfer Pricing Rules, 2023, which is intended to replace the Transfer Pricing Rules, 2006. There is also a regulatory framework in place requiring country-by-country reporting for entities that have revenues of at least KES95 billion, as well as common reporting standards.

9.3 Profile of International Tax

Kenya is progressively finding its place in the international tax sphere by enhancing its interest in taxing what could reasonably be considered as income accrued in, derived from, or received in Kenya. Recent taxes such as the digital services tax, content creator tax, and the digital assets tax; the intention to revamp the Transfer Pricing Rules; the introduction of country-by-country reporting; and the implementation of common reporting standards, give the impression that Kenya is keen to give international tax a high public profile.

9.4 Competitive Tax Policy Objective

Kenya has been advancing its tax models (introducing new taxes and bringing taxpayers into the system) by making various amendments and adopting various OECD-related guidelines or principles. However, as a developing country with low labour costs and with local and international loan facilities that need to be serviced, not to mention the fact that Africa is considered to be the next big business frontier, Kenya will need to achieve a balance in how to remain attractive to serious investors while still trying to keep up with certain international compliances.

9.5 Features of the Competitive Tax System

The Kenyan government's urge to develop a tax policy that is investor friendly, which, as per the current regulatory framework, includes tax benefits for entities engaged in manufacturing human vaccines, assembling motor vehicles, certain classifications of manufacturers and mining entities, and SEZ and EPZ companies, has created a better chance for investors to interact with Kenya. However, there are grey areas that need to be factored in, which include operational taxes such as VAT and payroll-related taxes, which, if well balanced, will make the tax system in Kenya more competitive.

9.6 Proposals for Dealing With Hybrid Instruments

Kenya has taken a step towards ratifying the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Regardless of reservations in place, there are moves towards implementing measures on how to deal with hybrid instruments.

9.7 Territorial Tax Regime

Kenya has adopted a territorial tax regime and there are certain parts of the tax requirements that extend to cover foreign income. In instances where income from a foreign jurisdiction is deemed taxable, and the same income has already been taxed in a foreign country, the taxpayer must notify the Commissioner of its intention to claim the tax paid in the foreign country as deductible.

9.8 Controlled Foreign Corporation Proposals

There is no defined framework on controlled foreign corporation (CFC) proposals. However, an entity controlling a foreign entity still has a defined position in Kenya for tax purposes.

9.9 Anti-Avoidance Rules

Kenya has a limited number of active DTAs, which, in general, seem to mirror each other on standard provisions, while certain areas come with favourable terms that may enhance the possibility of improving inbound and outbound investment, not to mention that a DTA with certain suitable markets encourages multinationals to establish headquarters in Kenya, thereby enhancing the viability of the country.

The DTAs, while in place to curb double taxation, provide room for taxation to take effect at reasonable rates, or factoring in what would be described as territorial tax, as compared to a generalised worldwide tax model.

9.10 Transfer Pricing Changes

Kenya recently amended its laws to provide for qualifying elements on determining intellectual property value for the purposes of applying preferential tax treatment. This may be a need considering the recent exemptions issued towards manufacturing and mining entities, and those interested in the manufacture of human vaccines. Furthermore, the Cabinet Secretary of the National Treasury and Economic Planning has proposed new Transfer Pricing Rules, 2023, that should replace the current Transfer Pricing Rules, 2006.

9.11 Transparency and Country-by-Country Reporting

Kenya is in favour of country-by-country reporting and there are some exemptions applicable based on the corporate structure, jurisdictional factors, availability of international agreements, and competent authority in place, among others. An entity may opt to assess the favourable structure per the relevant laws for the purpose of managing its country-by-country reporting.

9.12 Taxation of Digital Economy Businesses

Content Creators

The government has advanced its interests towards digital content creators. In recent amendments, the government introduced a tax applicable to content creators at a rate of 20% of the gross amount.

Digital Assets

The government has finally expressed interest in digital assets by introducing a specific digital assets tax at a rate of 3% of the transfer or exchange value.

9.13 Digital Taxation

Kenya has replaced its digital service tax (DST) with the significant economic presence (SEP) tax, payable by non-resident persons earning income from providing services through the digital marketplace in Kenya. A non-resident is considered to have a significant economic presence if the user of the digital service is located in Kenya. This aligns with international best practices advocated by the OECD, such as abolishing DST and applying a global minimum tax. While the DST rate was at 1.5% of the gross turnover. The change now stipulates that the effective tax rate is 3%. This rate is determined as 30% of the deemed taxable profit, which is calculated as 10% of the gross turnover earned by the non-resident. However, this change will likely increase the overall tax liability for non-resident providers, potentially impacting their profitability and pricing strategies, and ultimately leading to higher costs for Kenyan consumers using these digital services.

9.14 Taxation of Offshore IP

The Kenyan government has expressed interest in determining the value of IP for the purposes of better taxation. One solution is a preferential tax to be applied on IP (currently law: see **2.2 Special Incentives for Technology Investments**). On the other hand, the Cabinet Secretary of the National Treasury and Economic Planning recently proposed new Transfer Pricing Rules, 2023, which should replace the Transfer Pricing Rules, 2006 (see **9.10 Transfer Pricing Changes**).

LIECHTENSTEIN

Law and Practice

Contributed by:
Andreas Schurti and Simon Oberhofer
Schurti Partners Attorneys at Law Ltd

Contents

Schurti Partners Attorneys at Law Ltd is a Liechtenstein-based full-service law firm with a strong focus on international matters. Its lawyers are trained and qualified in several jurisdictions (Liechtenstein, New York, California, England and Wales, Ireland, Switzerland, Germany and Austria), and have gained work experience abroad in some of the most prestigious international law firms. The firm was founded in 1991 as a partnership and incorporated in 2015, and has become one of the largest and most renowned law firms in Liechtenstein. It started as a traditional Liechtenstein law office and evolved into a modern full-service law firm with a strong focus on corporate, commercial, tax, trust and foundation law, providing transactional and litigation services. It can count on the support of its affiliated trust companies for administrative and accounting work, and for tax filings.

Authors

Andreas Schurti is a founding partner of Schurti Partners Attorneys at Law Ltd, with admissions in Liechtenstein and New York. He has profound knowledge of corporate, commercial, tax, trust and foundation law, and has been advising and representing international and domestic clients for more than three decades. Andreas is a co-director of affiliated licensed trust companies serving private clients and businesses.

Simon Oberhofer is a specialist who is admitted as a Certified Tax Adviser and a Certified Auditor in Austria. He studied at the Vienna University of Economics and Business and earned an LLM in International Taxation from the University of Liechtenstein. Simon has been advising international corporations and private clients in Liechtenstein and Austria for more than ten years.

Schurti Partners Attorneys at Law Ltd

Zollstrasse 2
9490 Vaduz
Liechtenstein

Tel: +41 44 244 2000
Fax: +41 44 244 2100
Email: andreas.schurti@schurtipartners.com
Web: www.schurtipartners.com

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Contributed by: Andreas Schurti and Simon Oberhofer, **Schurti Partners Attorneys at Law Ltd**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Liechtenstein Incorporated

In Liechtenstein, most businesses adopt a corporate form, which is always taxed on its profits as a separate legal entity.

The most frequently used corporate forms are:

- the company limited by shares (*Aktiengesellschaft*);
- the establishment (*Anstalt*);
- the trust enterprise (*Treuunternehmen*); and
- the limited liability company (*Gesellschaft mit beschränkter Haftung*).

The company limited by shares and the limited liability company are subject to and must be fully compliant with the European rules and regulations. The establishment and the trust enterprise are more flexible and less severely regulated, and are therefore less costly to administer.

Due to Liechtenstein's membership of the EEA, European companies (*Europäische Aktiengesellschaft*) and European co-operatives (*Europäische Genossenschaft*) can also be established in Liechtenstein.

Liechtenstein Managed

The introduction of the Economic Substance Rule in many Caribbean jurisdictions has made the running of their companies more complicated and expensive. Furthermore, the list of countries with strategic anti-money laundering deficiencies still includes Panama and countries that have pending commitments and are subject to the EU screening procedure, such as Belize or the British Virgin Islands. Companies incorporated in these jurisdictions face severe difficulties in banking, so many have moved their actual place of business to Liechtenstein, where they are subject to Liechtenstein taxation. This move allows them to fulfil the economic substance requirements easily, or to find a bank that is willing to deal with them.

Foundations

Foundations (*Stiftungen*) can be used for estate planning in general and for the passing on of businesses and specific assets to next generations, and as holding entities and voting trusts. They are taxed as all other legal entities.

Trusts

The (common law type) trust serves similar needs as the foundation. It is subject to an annual minimum tax of CHF1,800 only, and is not subject to (tax) filing duties.

Withholding Tax

There is no withholding tax on distributions of Liechtenstein legal entities.

Transparent Partnerships

In addition to legal entities, there are legal forms of sole proprietorships (*Einzelunternehmen*) and partnerships (*Personengesellschaften*). These undertakings are transparent and are not taxed, but their income is attributed to their owner(s) or partners, respectively.

Transparent entities are not taxed in Liechtenstein, but their partners are. Transparent entities have their seat in Liechtenstein if:

- they are governed by Liechtenstein law;
- they have their main place of management in Liechtenstein; or

- at least half of the partners are residing in Liechtenstein.

1.2 Transparent Entities

Transparent entities are rare in practice. The most commonly used transparent entities are sole proprietorships (*Einzelunternehmen*) for small businesses, and simple partnerships (*einfache Gesellschaft*) and general partnerships (*Kollektivgesellschaft*) for professionals. The limited partnership (*Kommanditgesellschaft*) is used for investment purposes where non-Liechtenstein (tax and other) rules put non-transparent legal entities at a disadvantage. In general, transparent entities are not heavily used.

1.3 Determining Residence of Incorporated Businesses

Incorporated businesses (legal entities) are considered to reside in Liechtenstein if their statutory seat or their place of effective management is in Liechtenstein. The statutory seat is where the entity is registered, while the place of effective management is where the strategic management decisions are taken.

1.4 Tax Rates

12.5% Single Corporate Rate

The net profits of incorporated businesses minus the income that is tax free (ie, most dividends and capital gains on participations in legal entities) minus the notional interest deduction on equity are taxed at the rate of 12.5%. However, apart from some small businesses, every incorporated business has to pay a minimum tax of CHF1,800 per year.

Progressive Rates for Individuals' Businesses

Businesses owned by an individual directly or through a transparent entity are taxed solely on the level of the individual or the partners. The personal income tax rate of such individual or partners depends on their income, wealth, deductibles and place of residency (municipality) within Liechtenstein. The progressive income tax rates can reach 22.4%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Accrual Basis

The Persons and Companies Act (*Personen- und Gesellschaftsrecht*) requires incorporated businesses to maintain proper accounting records using the accrual basis.

Taxable Income

The taxable income is the accounting income, subject to adjustment for tax purposes and excluding income from dividends, capital gains from sales of shares in legal entities, foreign real estate and permanent establishments abroad, and distributions from foundations.

Loss Carry Forward

Loss carry forward from (all) former years can be set off against 70% of the profits of the respective current year. Loss carry forwards are not subject to a time limit and can therefore be carried forward without restriction.

Notional Interest Deduction on Equity

A 4% notional interest on equity may be deducted as an expense, but such deduction may not result in a loss or an increased loss.

2.2 Special Incentives for Technology Investments

As technology tax incentives can be a potential tool for profit shifting, all tax incentives for technology investments have been abolished in Liechtenstein.

2.3 Other Special Incentives

Private Asset Structures

Any incorporated business (domestic or foreign) that is resident for tax purposes in Liechtenstein can apply for treatment as a Private Asset Structure if it does not pursue active commercial activities but just invests its assets as a passive investor.

Benefits

Private Asset Structures do not have to file accounts and tax returns; they just have to pay the minimum tax of CHF1,800 per year.

Activities

Private Asset Structures may not conduct commercial activities. Typically, they hold *"bankable assets"* on their own behalf, real estate for their owners or beneficiaries, and art collections, liquid funds or participations.

Participations held by Private Asset Structures

Private Asset Structures and their shareholders or beneficiaries must not exert actual control over the management of participations by means of direct or indirect influence. However, the mere use of the shareholder's voting rights is not harmful. The shares or ownership interests (if any) of a Private Asset Structure may not be publicly placed or traded. Private Asset Structures are often used as top holdings of companies that are not run by members of the family of the founder and beneficiaries.

Typical use

Private Asset Structures are frequently used by passive private investors/wealthy individuals. They can also benefit from the lack of withholding taxes on any kind of distributions (dividends from companies limited by shares, distributions from foundations, establishments, etc).

EFTA Surveillance Authority approval

The favourable taxation of Private Asset Structures was approved by the EFTA Surveillance Authority as being compliant with European competition law.

Trusts

Liechtenstein trusts are subject to the minimum corporate income tax of CHF1,800. As opposed to Private Asset Structures, trusts do not have to fulfil certain prerequisites and are not subject to certain restrictions, including in relation to the holding of participations.

2.4 Basic Rules on Loss Relief

Loss Carry Forward

Losses may be carried forward to offset income for an unlimited period following the year of loss. The loss that can be offset is limited to 70% of the taxable income of the respective financial year. The remainder of the losses carried forward can be used in the following years.

Losses from activities that are not subject to taxation, such as the sale of participations in legal entities, cannot be set off against taxable income.

Loss Carry Back

Losses may not be carried back.

2.5 Imposed Limits on Deduction of Interest

There are no specific thin capitalisation rules in Liechtenstein. However, interest payments to related parties must be at arm's length.

The Liechtenstein tax authority issues safe harbour interest rates for various currencies annually, in relation to related parties.

Due to the fact that a 4% notional interest deduction can be applied and because there are no thin capitalisation rules, there is no great incentive to pay high interest rates.

2.6 Basic Rules on Consolidated Tax Grouping

Upon application, affiliated legal entities can form a group of entities for tax purposes and offset the losses incurred within one year against the profits of other group members generated in the same year. The compensation takes place by way of the losses from the group members being attributed to the group parent or – if there is a loss after offsetting any attributable losses against the taxable net income of the group parent – the losses from the group parent being attributed to a group member that is fully taxable in Liechtenstein.

The following conditions apply to group taxation, among others:

- the parent entity must reside in Liechtenstein for tax purposes (either because it is registered in Liechtenstein or because it is managed out of Liechtenstein); and
- the parent entity must hold at least 50% of the voting rights and the capital of the (domestic or foreign) subsidiaries as of the beginning of the respective year.

2.7 Capital Gains Taxation

Capital Gains on Sale of Legal Entities

Capital gains from the sale of or the liquidation of interest in legal entities are tax-free, provided the anti-avoidance rules do not apply.

In order to be tax-exempt, the anti-avoidance rules require – in relation to holdings of foreign entities – either that the total gross revenue of the respective foreign entity derived from passive sources is less than 50% of the overall income or that the net profits of the respective foreign entity are not subject to overall low taxation (considering potential foreign taxes). Low taxation is assumed if the total tax burden abroad is less than half of that which would result from a comparable situation in Liechtenstein. In practice, the anti-avoidance rules disadvantage participations in typical (Caribbean) offshore jurisdictions where there is hardly any taxation (less than 6.25%).

Real Estate

Profits earned on the sale of domestic real estate are subject to a special tax, with a maximum rate of 24%. Foreign real estate is not subject to taxation in Liechtenstein.

2.8 Other Taxes Payable by an Incorporated Business

On the basis of the Swiss–Liechtenstein Customs Treaty, Swiss stamp duties are levied in Liechtenstein. Stamp duties are payable on the issue and transfer of certain securities.

2.9 Incorporated Businesses and Notable Taxes

Due to the Customs Union with Switzerland, a value-added tax has been implemented in Liechtenstein, which is identical to the Swiss value-added tax and is levied on goods and services and their import. The standard rate is 8.1%, with reduced rates of 3.8% applying to hotel accommodations and 2.6% applying to basic goods.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a corporate form. Only micro-enterprises operate in a non-corporate form.

3.2 Individual Rates and Corporate Rates

There are no specific rules to prevent individual professionals such as architects, engineers, consultants, accountants and lawyers from earning income at the corporate rate. However, if they are residing or domiciled in Liechtenstein, they are subject to taxation on their respective worldwide net assets, which include their corporate entity.

Professionals who have not incorporated their businesses are generally taxed as self-employed persons and are subject to income and wealth tax.

3.3 Accumulating Earnings for Investment Purposes

There are no rules to prevent closely held corporations from accumulating earnings for investment purposes. The accumulation of the profits increases the value of the entity, thereby also increasing the basis for the wealth tax of the individual as owner of the entity.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends and gains from the sale of shares in closely held Liechtenstein and foreign corporations are tax-free for individuals residing in Liechtenstein. However, as with the accumulated earnings, the gains of such sales increase the basis for the wealth tax if the individual resides and is taxed in Liechtenstein.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The same rules apply to closely held and publicly traded corporations: dividends and gains from the sale of shares in Liechtenstein and foreign companies are tax-free for individuals in Liechtenstein. However, as with the accumulated earnings, the gains of such sales increase the basis for the wealth tax if the individual resides and is taxed in Liechtenstein.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Liechtenstein does not levy withholding taxes on interest, dividends or royalties.

4.2 Primary Tax Treaty Countries

Liechtenstein has concluded double taxation treaties with 22 countries, including Germany, Austria, Switzerland, the UK, the Netherlands, the UAE, Hong Kong, Singapore, Luxembourg, Malta, the Czech Republic, Hungary and Uruguay. The number is constantly increasing, with treaties with Italy, Ireland, Belgium and Croatia having been initialled.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Liechtenstein tax authority does not unilaterally challenge the use of treaty country entities by non-treaty country residents.

4.4 Transfer Pricing Issues

Liechtenstein domestic law does not provide for any specific transfer pricing rules or regulations. Liechtenstein applies the OECD guidelines on transfer pricing issues and has fully implemented BEPS Action 13.

Inbound investors operating through a local entity must document the appropriateness of the transfer prices of significant transactions with related parties and permanent establishments.

4.5 Related-Party Limited Risk Distribution Arrangements

There are no specific rules with respect to the use of related-party limited risk distribution arrangements in Liechtenstein law. However, the Liechtenstein tax authority can review and challenge such an arrangement based on the arm's length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Liechtenstein has modelled its local transfer pricing rules and enforcement on the OECD standards for transfer pricing issues.

4.7 International Transfer Pricing Disputes

Number of Disputes

Normally, fewer than ten cases per year require the initiation of a mutual agreement procedure based on a double taxation treaty due to transfer pricing issues.

Tax Authority's View

The tax authority considers mutual agreement procedures to be a useful tool in discussing double taxation issues with the respective partner state. In most cases, an agreement can be reached with the partner state.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The tax assessment is adjusted according to the outcome of the mutual agreement procedure.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

The profits of the local subsidiaries of non-local corporations and the profits of the local branches of non-local corporations are subject to the same corporate income tax rules, and are therefore taxed similarly.

5.3 Capital Gains of Non-Residents

Capital gains of non-residents on the sale of stock in local corporations are not subject to taxation in Liechtenstein.

5.4 Change of Control Provisions

In Liechtenstein, there are no change of control provisions triggering tax or duty charges.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no specific formulas to determine the income of foreign-owned local affiliates.

5.6 Deductions for Payments by Local Affiliates

Payments by local affiliates for management and administrative expenses incurred by a non-local affiliate are deductible to the extent that they are economically related to the domestic income of the paying domestic affiliate.

Management and administrative services must be charged at arm's length.

5.7 Constraints on Related-Party Borrowing

Interest Barrier

Apart from the arm's length test, there are no restrictions regarding borrowings between related parties in relation to payable interest.

Safe Harbour Rules

The tax administration issues safe harbour interest rates in relation to interest rates applied among related parties.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Resident corporations are subject to unlimited tax liability on their worldwide income, except for income generated by foreign permanent establishments, income from the management of foreign real estate, and distributions and capital gains from Liechtenstein and foreign participations (see **2.7 Capital Gains Taxation**).

6.2 Non-Deductible Local Expenses

Expenses that are proportionally attributable to foreign income that is not subject to tax in Liechtenstein are not deductible. However, losses from foreign permanent establishments in Liechtenstein can be taken into account under certain circumstances.

6.3 Taxation on Dividends From Foreign Subsidiaries

In general, dividends from the foreign subsidiaries of local corporations are not taxed. However, following the implementation of BEPS Action 5, dividends are taxable if the foreign subsidiary is subject to no or low taxation and generates mainly passive income (see **2.7 Capital Gains Taxation**).

6.4 Use of Intangibles by Non-Local Subsidiaries

There are no specific rules related to the taxation of intangibles, so the income from intangibles is subject to ordinary income taxation.

Non-local subsidiaries are not subject to Liechtenstein taxation, including in relation to the intangibles developed by local entities. However, based on the arm's length rule, the tax authority could tax the local entity that developed the intangible, and attribute a respective royalty fee to its profits.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

CFC Rules

Liechtenstein has not implemented BEPS Action 3 and therefore has not established CFC-type rules. Earnings from foreign subsidiaries are not attributed to the Liechtenstein entity. Instead, dividends from foreign low-taxed companies with income derived primarily from passive income are taxable (see **2.7 Capital Gains Taxation**).

Place of Management

Entities that are registered abroad but are effectively managed in Liechtenstein are subject to Liechtenstein income tax.

Branches

Non-local branches are treated the same as non-local corporations.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no rules in Liechtenstein related to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

In principle, the gains on the sale of shares in non-local affiliates are tax-free, provided that the anti-avoidance rules do not apply (see **2.7 Capital Gains Taxation**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

General Rules

Legal or factual arrangements are deemed to be abusive if they appear to be inappropriate in the economic circumstances and if their sole economic purpose is to obtain tax advantages. If there is an abuse, the inappropriate arrangement is disregarded for tax purposes and taxes are levied as if the inappropriate arrangement would not exist.

Arm's Length Principle

The arm's length principle must be observed in all transactions between related parties. If a taxpayer's income or expenses from a business relationship with related parties or with a permanent establishment are changed by applying different terms and conditions to those with unrelated parties, such different terms and conditions are not acceptable for tax purposes.

Documentation

Taxpayers must document that the transfer prices of material transactions with related parties and permanent establishments are reasonable.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Income Tax

Tax audits in relation to regular income taxes are rare. If there are no reasons or indications for the assumption of irregularities, there might be no tax audit for decades.

Value-Added Tax

Regular audits are conducted in relation to value-added tax. In practice, there is a cycle of about five years.

Private Asset Structures

The tax authority verifies whether the conditions for the granting of the status of Private Asset Structure are fulfilled (ie, no commercial activities – see **2.3 Other Special Incentives**). There is currently a cycle of about three to five years.

Rules of Tax Audits

Liechtenstein law does not outline the specifics and frequency of the audit process.

Entities must complete a tax return annually and are obliged to provide the tax authority with the requested information and documents. The tax authority's assessment is based on these documents and information, and on any other subsequently requested documents or explanations. The tax authority may also call in experts, carry out inspections, request information or certificates from the entities, and inspect their books. The assessment is concluded with a decision of the tax authority, which can be appealed to the Tax Commission and the Administrative Court.

9. BEPS

9.1 Recommended Changes

Multilateral Instrument

On 7 June 2017, Liechtenstein signed the Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting (MLI).

Implemented BEPS Standards

Liechtenstein has implemented the minimum standards and amended double taxation agreements to counter treaty abuse. In accordance with the MLI, Liechtenstein has implemented the following:

- BEPS Action 5 (Counter Harmful Tax Practices and Patent Boxes);
- BEPS Action 6 (Prevention of Treaty Abuse);
- BEPS Action 13 (Country-by-Country Reporting); and
- BEPS Action 14 (Dispute Resolution Mechanism).

Liechtenstein has implemented the Global Anti-Base Erosion (GloBE) minimum taxation of 15% (Pillar Two) as of 1 January 2024. The implementation will take place through the Liechtenstein GloBE Act, which follows the OECD standards and provides the legal basis for the levying of the top-up tax.

Non-Implemented BEPS Standards

However, Liechtenstein has reserved the right not to apply the following MLI articles:

- Article 3 (Transparent Entities);
- Article 4 (Dual Resident Entities);
- Article 8 (Dividend Transfer Transactions);
- Article 9 (Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property);
- Article 10 (Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions);
- Article 11 (Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents);
- Article 12 (Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies);
- Article 13 (Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions);
- Article 14 (Splitting-up of Contracts); and
- Article 15 (Definition of a Person Closely Related to an Enterprise) in its entirety.

9.2 Government Attitudes

Liechtenstein fully supports the BEPS project, which essentially provides for the taxation of profits in the jurisdiction where the value was generated, and has implemented the MLI and the minimum standards accordingly (BEPS Actions 5, 6, 13 and 14). The government focuses on Pillar One and Pillar Two, and on the following issues in particular:

- patent boxes (abolished as of 1 January 2017);
- the prevention of treaty abuse;
- country-by-country reporting;
- dispute resolution mechanisms; and
- implementation of the global minimum taxation.

Impact

The new tax law, introduced in 2011, was designed to be in line with international and European standards. Therefore, for example, the Liechtenstein government was keen to obtain the approval of the EFTA Surveillance Authority in relation to Private Asset Structures. At the same time, it was possible to adopt attractive and competitive rules and a reasonable tax rate of 12.5%.

The new Liechtenstein tax rules essentially fulfil all OECD requirements, so only the following few changes had to be made for the implementation of BEPS:

- the abolition of the IP Box;
- the abolition of the asymmetric treatment of capital gains and losses from participations;
- the introduction of an anti-abuse provision; and
- implementation of the GloBE Act with effect from 1 January 2024 to ensure the minimum taxation of 15%.

9.3 Profile of International Tax

Entrepreneurial Spirit

Liechtenstein society and politics support private enterprises and entrepreneurs. There is one enterprise per eight residents, which is significantly higher than in most other countries. As a consequence, in Liechtenstein the government spending ratio in relation to the GDP is stable, at a low level of around 20%. This low ratio allows a reasonable level of taxation and is the basis for the competitive tax system. Despite such reasonable level of taxation, Liechtenstein is debt-free and regularly generates a budget surplus. Liechtenstein is AAA rated and has a cushion that will allow the payment of government spending for about a year.

Political System

Due to Liechtenstein's grass roots democracy (referendum and initiative), people are interested in and are monitoring the new tax legislation. This has triggered a cautious approach by the government, with international taxation earning public attention. International tax rules could potentially undermine the (direct) democracy.

Economics

Nevertheless, the Liechtenstein people know that their country is embedded in an international system, with the manufacturing industry accounting for about 35% of all jobs, and almost 100% of what is produced in Liechtenstein being exported. Likewise, the Liechtenstein financial industry – supported by the Swiss franc as the national currency – attracts clients from most parts of the world. Therefore, it is understood and accepted that compliance with international standards is key.

9.4 Competitive Tax Policy Objective

Liechtenstein is aware of the necessity to implement international standards (BEPS), and will continue to implement them in the future.

Nevertheless, Liechtenstein is an extremely attractive place in terms of tax and corporate law: it has modern, new and attractive tax rules that are adjusted regularly to international standards, and it has no debts, despite a reasonable corporate tax rate of 12.5% and progressive tax rates for individuals of up to 22.4%. Liechtenstein has no need to increase taxes. If it should be forced to increase the level of taxation, it would keep its competitive edge as long as there is a level playing field.

9.5 Features of the Competitive Tax System

The income tax rate of 12.5% in Liechtenstein is below the minimum tax rate under Pillar Two. Following the implementation of Pillar Two from 1 January 2024, companies that are members of a group with a consolidated revenue of at least EUR750 million are subject to a minimum tax rate of 15%.

9.6 Proposals for Dealing With Hybrid Instruments

Hybrid instruments have only minor significance in Liechtenstein. To avoid tax structuring with these instruments, dividend payments from affiliated companies are taxable if they can claim the distribution as an expense for tax purposes.

9.7 Territorial Tax Regime

In principle, Liechtenstein applies a worldwide tax regime. Territoriality applies only in certain areas, such as foreign branches, subsidiaries or real estate. Currently, no interest deduction restrictions in line with BEPS Action 4 have been implemented, nor are any expected to be implemented.

9.8 Controlled Foreign Corporation Proposals

Liechtenstein does not have CFC legislation, as Liechtenstein residents are not taxed on profits earned by foreign legal entities. Dividends from foreign legal entities are not tax-exempt if the foreign entity is low taxed and sustainably earns more than 50% passive income.

9.9 Anti-Avoidance Rules

Double Taxation Agreements

Private Asset Structures, which are subject only to the minimum corporate income tax of CHF1,800, cannot benefit from the double tax treaties – eg, with Switzerland, Austria, the Czech Republic, Germany and the United Kingdom.

MLI

Furthermore, the MLI (to which Liechtenstein is a party) includes the principal purpose test, which hinders the use of layered structures based on the provisions of multiple tax treaties.

9.10 Transfer Pricing Changes

Modern Tax Law

Liechtenstein revised its tax rules in 2011 according to modern international standards, so only a few BEPS-related amendments and changes were necessary, with the most significant being the introduction of the anti-abuse provisions for participations with predominantly passive income in low-tax countries, the abolition of the IP Box and the implementation of the minimum taxation according to Pillar Two.

Transfer Price Documentation

The introduction of transfer pricing documentation has not led to radical changes in the Liechtenstein tax regime, since it embraces the OECD guidelines. Furthermore, the regulatory burden is deemed manageable, since the Master File and the Local File are internationally recognised.

Intellectual Property

Liechtenstein abolished the IP Box regulation with effect from 1 January 2017, as it did not comply with the OECD standard (BEPS Action 5).

9.11 Transparency and Country-by-Country Reporting

Country-by-Country Reporting

Group parent entities residing in Liechtenstein with a consolidated revenue of more than CHF900 million or surrogate parent entities must comply with country-by-country reporting. The reports must be submitted to the Liechtenstein tax authority.

Effect

The preparation of the transfer pricing documentation and the exchange of information represent a high administrative burden for the companies concerned.

9.12 Taxation of Digital Economy Businesses

Liechtenstein has not yet taken any action with regards to the taxation of digital economy businesses.

9.13 Digital Taxation

Liechtenstein is open regarding the introduction of digital taxation, but no proposals have yet been brought forward.

9.14 Taxation of Offshore IP

Liechtenstein has so far not introduced any specific provision dealing with the taxation of domestic offshore intellectual property.

Royalties constitute passive income in Liechtenstein, so dividends from foreign companies in low-tax jurisdictions are taxable if the foreign company's passive income constitutes more than 50% of its overall income.

LUXEMBOURG

Law and Practice

Contributed by:
Peter Adriaansen, Julius Heino and Robin Pollet
Loyens & Loeff

Contents

Loyens & Loeff is a leading law firm providing comprehensive and fully integrated legal and tax advice, handling all matters relating to investment fund formation, regulatory and fund financing, corporate and commercial law, banking and financial law, real estate, mergers and acquisitions and tax law. The Luxembourg team advises clients such as fund managers, cross-border and institutional investors, multinational enterprises, financial institutions, governments and high net worth individuals with a special focus on multinationals, private equity and real estate. The firm is a well-respected professional service provider, renowned for exceptional client service, responsiveness, and in-depth industry knowledge. Thanks to a full-service practice, specific sector experience and a thorough understanding of the market, Loyens & Loeff's legal and tax professionals help their clients to fulfil their strategies and grow their businesses.

Authors

Peter Adriaansen is a partner at Loyens & Loeff, and a member of the tax practice group in Luxembourg. He focuses on tax structuring for Luxembourg-based multinational enterprises and international family offices and private clients.

Julius Heino is an associate at Loyens & Loeff, and a member of the tax practice group in Luxembourg. He specialises in Luxembourg and international tax matters, with a focus on tax structuring for multinational enterprises, private equity funds and transfer pricing.

Robin Pollet is an associate at Loyens & Loeff, and a member of the tax practice group in Luxembourg. He specialises in Luxembourg and international tax matters, with a focus on family-owned businesses and private wealth.

Loyens & Loeff

18-20, rue Edward Steichen
L-2540
Luxembourg
Luxembourg

Tel: +352 46 62 30
Fax: +352 46 62 34
Email: info@loyensloeff.lu
Web: loyensloeff.com

LOYENS LOEFF
Law & Tax

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Luxembourg has several forms of entities with separate legal personality. Businesses generally incorporate an entity with limited liability set up in one of the following forms:

- a public limited company (*société anonyme*, SA);
- a private limited company (*société à rèsponsable limitée*, SARL); or
- a partnership limited by shares (*société en commandite par actions*, SCA).

A SARL is likely the most popular corporate form to conduct a business through. Both a SARL and an SA are incorporated through a deed before a Luxembourg notary and are governed by a board of managers/directors (an SA can also be governed using a two-tier structure with a management board and a supervisory board). The minimum capitalisation requirement amounts to EUR12,000 for a SARL and EUR30,000 for an SA. In contrast to an SA, shares in a SARL cannot be publicly traded and a SARL is limited to a maximum of 100 shareholders.

An SCA is a partnership limited by shares. It is created through a notarial deed and has characteristics of both a limited partnership and a public limited company. There must be at least one general partner and one limited partner. In contrast to a limited partnership, the shares of an SCA can be freely transferred to individuals who are not shareholders, unless stated otherwise in the articles of association.

These corporate forms are considered opaque from a Luxembourg tax perspective and are fully subject to corporate income tax (CIT) and municipal business tax (MBT) at an aggregate tax rate of 23.87% (in Luxembourg City), and net wealth tax (NWT).

Fully taxable Luxembourg corporate entities that are part of the same group are eligible for group taxation (fiscal unity). Under this regime, each entity's taxable income is determined on a standalone basis, with the taxable results of all participants ultimately added together. As a result, intra-group transactions remain fully recognised.

Less common corporate entities are:

- the simplified joint stock company (*société par actions simplifiée*, SAS);
- the simplified private limited liability company (*société à responsabilité limitée simplifiée*, or SARL-S);
- the European company (*Societas Europaea*, SE);
- the co-operative company (*société cooperative*, SCOP); and
- the European co-operative company (*société coopérative européenne*, or SE SCOP).

1.2 Transparent Entities

Luxembourg has several forms of transparent entities, some with legal personality:

- a general partnership (*société en nom collectif*, SNC);
- a limited partnership (*société en commandite simple*, SCS);
- a special limited partnership (*société en commandite speciale*, SCSp); and
- a civil company (*société civil*, SC).

The two most common forms are the SCS and the SCSp. Both can be established through a partnership agreement or through a notarial deed. There must be at least one general partner and one limited partner. There is no limitation on the number of partners. A general partner has unlimited, joint, and several liability for all the partnership's obligations. A limited partner is in principle only liable up to the amounts pledged as a contribution to the partnership. The difference between the two forms of partnership is that an SCS has legal personality while an SCSp does not. An SCSp is commonly used in the private equity and alternative investment fund sectors.

Subject to the so-called reverse hybrid rules, an SCS and SCSp are considered tax transparent entities. The partners of the partnership are considered to (indirectly) hold the assets of the partnership, and taxation should occur at the level of the partners, irrespective of whether the partnership distributes income.

If a partnership is engaged in, or deemed to be engaged in, a commercial activity (in Luxembourg), Luxembourg MBT is levied at the level of the partnership.

1.3 Determining Residence of Incorporated Businesses

Corporate entities are deemed to be residents of Luxembourg for tax purposes if their legal seat or central administration is located in Luxembourg. This means that both collective entities registered in Luxembourg, and those registered abroad but with their central administration or registered office in Luxembourg, are considered tax residents.

The central administration of an entity is in Luxembourg if the entity's affairs are managed there. This is determined based on facts through a substance-over-form analysis. Generally, the location of the entity's central accounting and archives, as well as where the shareholders' and board meetings are held, are considered important factors in this determination.

A company established under Luxembourg law is by definition a Luxembourg tax resident, irrespective of its substance (physical and economical footprint) in Luxembourg.

Transparent entities are not considered Luxembourg tax residents.

1.4 Tax Rates

For the year 2025, the applicable CIT rate amounts to:

- 14%, if the corporation's taxable worldwide income is EUR175,000 or less;
- EUR24,500 plus 30% of income on the portion exceeding EUR175,000, if the taxable income is between EUR175,000 and EUR200,000; or
- 16%, if the taxable income is more than EUR200,000.

Additionally, a solidarity surcharge of 7% is levied as a contribution to the unemployment fund.

A local MBT on profits from trade or business is levied by the different municipalities. The rate varies depending on the municipality, but is often 6.75% (eg, in Luxembourg City).

The aggregate effective tax rate on income for a company located in Luxembourg City is generally 23.87%.

Luxembourg corporate resident taxpayers are subject to NWT levied on the fair market value of the taxable net wealth on 1 January of each year. The rates as from fiscal year 2025 are:

- 0.5% on taxable net wealth up to EUR500 million; and
- 0.05% on the portion of taxable net wealth in excess of EUR500 million.

NWT is levied on the net wealth of the company (ie, non-exempt assets minus deductible liabilities, in both cases valued at their fair market value, unless a specific provision prescribes a different valuation). A minimum NWT is applicable, which is levied if it is higher than the NWT liability determined on the basis of the taxable net wealth of the entity. The minimum tax depends on the total balance sheet of the resident corporate taxpayer and ranges from EUR535 to EUR4,815.

Business Through a Transparent Entity

Businesses in Luxembourg that are operated by resident individuals, either directly or via a transparent entity, are liable to pay progressive income tax. The tax rate applicable for 2025 depends on the tax class of the individual. The tax brackets range from 8% to 42%. Additionally, there is a 7% unemployment fund contribution, which increases to 9% on taxable income above EUR150,000 or EUR300,000 (in the case of joint taxation). Therefore, the highest possible marginal tax rate reaches up to 45.78%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Resident corporate entities of Luxembourg are taxed annually on their global income, while non-resident entities are only taxed on certain types of income originating in Luxembourg.

Typically, each category of income is determined and taxed separately. However, all income generated by corporations and commercial partnerships is considered business income.

The business profit of an entity is generally defined as the increase in its net assets over the fiscal year, adjusted for capital contributions, repayments, and distributed profits. This is based on the entity's annual accounts (in Luxembourg GAAP), meaning that the taxable profit usually aligns with the financial result and is determined on an accrual basis, unless specific tax rules or a special tax regime apply.

A fiscal balance sheet is prepared for this purpose, where the accounting values of assets and liabilities are replaced by their tax values if they differ. Generally, all business-related expenses of a commercially active company are deductible unless they relate to exempt income. Some expenses are explicitly classified as deductible (eg, non-creditable foreign taxes and value-added tax, real estate tax and capital duty, depreciation and amortisation), while others are explicitly non-deductible (eg, CIT, MBT, NWT, directors' fees for supervisory services, fines, non-qualifying gifts and profit distributions).

For MBT purposes, profits and losses from a foreign permanent establishment (PE) or those already taxed at the level of a commercial partnership (of which the taxpayer is a member) are not considered.

2.2 Special Incentives for Technology Investments

Investment Tax Credit

Luxembourg tax law provides for two types of investment tax credits. First, a company carrying out a digital transformation or ecological/energy transition project can benefit from an investment tax credit that is calculated based on investments and operating expenses incurred as part of that project. To be eligible, the project needs to comply with at least one of the objectives listed in the law.

The rate of the tax credit is 18% for investments and operating expenses, except for investments in tangible depreciable assets, which benefit from a rate of 6%, in addition to the 12% rate applicable to the overall investment tax credit (effectively reaching 18%).

Secondly, a company that makes investments during an operating year may qualify for a 12% overall investment tax credit. The tax credit for overall investment is based on the acquisition price or production costs of qualifying assets acquired. The qualifying investments encompass investments in tangible depreciable assets, as well as investments in sanitary and central heating installations in hotel buildings and buildings used for social activities. The rate is increased to 14% for investments that qualify for special depreciation. The credit for the acquisition of software is capped at 10% of the CIT due for the fiscal year in which the acquisition was made.

IP Regime

In 2018, Luxembourg adopted a new intellectual property (IP) regime that aligns with the guidelines set out by the OECD in its Base Erosion and Profit Shifting (BEPS) Action Plan 5. It adopted a nexus approach to ensure that only the R&D activities that have a direct connection with the Luxembourg taxpayer can benefit from the tax regime. This new regime came into effect on 1 January 2018.

Under the IP regime, net income from qualifying IP assets that meet the eligibility criteria may benefit from an 80% exemption from CIT and MBT, and a 100% exemption from NWT. The eligible assets should have been established, developed, or enhanced after 31 December 2007. These assets include patents, utility models, supplementary protection certificates for a patent on medicine and plant protection, plant variety certificates, extensions of a complementary protection certificate for paediatric use, orphan drug designations, and software protected by copyrights.

Income that qualifies for the IP regime include:

- income derived from the use of, or a concession to use, a qualifying asset;
- income related to a qualifying asset that is embedded in the sales price of products or services directly related to the eligible IP asset;
- capital gains derived from the sale of a qualifying asset; and
- the indemnities received based on an arbitration ruling or a court decision concerning a qualifying asset.

The part of the IP income that benefits from the favourable tax treatment is determined by a ratio that considers the research and development (R&D) costs. This ratio is the eligible R&D costs divided by the total R&D expenses. Luxembourg permits a 30% uplift of the eligible R&D costs, provided that the resulting ratio does not surpass the total expenditure. To be eligible, expenses must be incurred as part of an R&D

activity. These activities can be carried out by the taxpayer or outsourced.

2.3 Other Special Incentives

Holding Regime

Proceeds derived by a Luxembourg taxable resident company from shares in a subsidiary company (such as dividends, liquidation distributions, capital gains and foreign exchange results) are subject to CIT and MBT, unless the domestic participation exemption applies. Pursuant to this exemption, dividends (including liquidation distributions) and capital gains received by a Luxembourg company are exempt from CIT and MBT provided that, at the time of the received distribution:

- a minimum participation of 10% or with an acquisition price of at least EUR1.2 million (EUR6 million for capital gains) is held;
- the participation is held in (i) a capital company that is fully subject to Luxembourg CIT or a comparable foreign tax (ie, a tax rate of at least 8.5% and a comparable tax base) or (ii) an EU entity qualifying under the EU Parent-Subsidiary Directive; and
- on the date on which the dividend is received (or capital gain is realised), the company has held (or commits itself to hold) a qualifying participation continuously for at least 12 months.

Once the minimum threshold and holding period are met, newly acquired shares of a qualifying participation immediately qualify for the participation exemption.

A taxpayer may opt to waive the participation exemption for participations which qualify on the basis of the acquisition price being above EUR1.2 million (EUR6 million for capital gains). The waiver option is intended to allow taxpayers who are in scope of the so-called Pillar Two Rules to avoid a mismatch between the exclusion of income under the Pillar Two Rules and the Luxembourg domestic participation exemption. Such mismatch may potentially give rise to (cash) top-up taxes, which may be avoided (eg, if tax losses carried forward would be utilised to offset the otherwise exempt income).

Meeting the EUR1.2 million acquisition price threshold also makes a participation exempt from NWT.

Costs and losses related to an exempt participation, such as financing expenses and impairments, are tax deductible to the extent that the related costs and/or losses exceed the amount of exempt income in a given year. At the time of sale of the exempt participation, any appreciation in value is taxable up to the historical acquisition price (ie, recaptured), which would otherwise be an exempt capital gain.

2.4 Basic Rules on Loss Relief

The taxpayer that generated losses can carry them forward and offset them against the taxable income (on the condition that they result from acceptable accounts) for a maximum of 17 consecutive years. Losses generated before 2017 can be carried forward indefinitely. Usage of tax losses follows the *"first-in, first-out"* principle. Tax losses cannot be carried back.

The deductibility of the tax losses can be denied by the Luxembourg tax authority if a change in the taxpayer's control and activity (which has generated the tax losses) has the purposes of circumventing the personal nature of the right to carry forward tax losses and avoiding taxation of subsequently realised profits.

In case of a fiscal unity, pre-fiscal unity losses can only be used to offset income in relation to the entity that sustained such tax losses.

2.5 Imposed Limits on Deduction of Interest

Luxembourg applies the interest deduction limitation rule (IDLR) in accordance with the EU anti-tax avoidance directive. Subject to certain exclusions that are discussed below, the IDLR limits the deduction of the net amount of interest expenses and economically equivalent expenses (ie, the excess, if any, of such expenses over interest and economically equivalent income) in a taxable year to the higher of:

- 30% of EBITDA for tax purposes; or
- EUR3 million.

The IDLR does not distinguish between third-party and related-party interest. However, the rule contains a grandfathering rule pursuant to which interest and economically equivalent expenses incurred in respect of loans that were concluded prior to 17 June 2016 and were not modified after such date fall outside the scope of the earning stripping rules. Furthermore, taxpayers that qualify as *"financial undertakings"* or *"standalone entities"* within the meaning of the IDLR are excluded from their scope. Moreover, in case the ratio of equity to assets of a taxpayer is equal to or higher than such ratio for the consolidated group to which it belongs, such taxpayer is excluded from the scope of the rules.

The EBITDA is calculated on a Luxembourg tax basis, which means that dividends that qualify for the participation exemption are not included in the EBITDA. Any interest that is not deductible pursuant to the IDLR can be carried forward indefinitely. In addition, any unused deduction capacity can be carried forward for five years. Luxembourg taxpayers that have opted for the fiscal unity regime can decide whether the IDLR applies at the level of each Luxembourg taxpayer on a standalone basis or at fiscal unity level.

2.6 Basic Rules on Consolidated Tax Grouping

The fiscal unity regime allows certain group companies to consolidate their results for CIT and MBT purposes, provided a joint written request is submitted before the end of the financial year for which the application is sought. This regime permits both horizontal and vertical integration, or a mix of both.

Vertical fiscal unity is available to a Luxembourg parent company or a Luxembourg Permanent Establishment (PE) of a foreign company that is subject to a tax comparable to the Luxembourg corporate tax, as well as to qualified subsidiaries. Horizontal fiscal unity is available to Luxembourg subsidiaries of a non-integrating parent company.

A non-integrating parent can be a Luxembourg parent company or a Luxembourg PE of a foreign company fully subject to a tax comparable to the domestic corporate tax, or a capital company resident in the European Economic Area (EEA) subject to a tax comparable to the Luxembourg corporate tax, or a PE of such an entity in the EEA. The non-integrating parent is not part of the fiscal unity itself. The consolidation occurs at the level of the integrating subsidiary.

A consolidated tax grouping in Luxembourg is possible if the following conditions are met:

- the qualified subsidiaries and the integrating subsidiary must be either a Luxembourg-resident fully taxable company or a local PE of a non-resident capital company fully subject to a tax comparable to the domestic tax;

- Luxembourg subsidiaries can be included when they are controlled, directly or indirectly, by the group parent or the non-integrating parent company for at least 95% of their capital since the beginning of the fiscal year for which the option is exercised:
- the book year must coincide for all companies included in the fiscal unity; and
- the request for a fiscal unity is filed jointly by all the intended parties.

Taxable income and losses of each company pertaining to the fiscal unity are determined individually (as if they were not integrated) and then aggregated at the level of the group parent or the integrating subsidiary with adjustments to eliminate double taxation and double deduction of the same items of income or expenses. The tax due on such aggregated result is then levied from the group parent or the integrating subsidiary.

Inter-corporate dividends paid within the fiscal unity regime are fully exempt and do not need to be adjusted when determining the profit of the group, as the requirements for the application of the participation exemption regime are less strict than the requirements for the application of the fiscal unity regime. Losses generated prior to the fiscal unity can only be used to offset the income of the group up to the taxable income of the integrated subsidiary that generated them. Once the regime ends, losses generated during the tax unity have to be left at the level of the group parent or the integrating subsidiary.

2.7 Capital Gains Taxation

Capital gains derived by a Luxembourg taxable resident company are subject to CIT and MBT, unless the domestic participation exemption applies (see **2.3 Other Special Incentives**).

2.8 Other Taxes Payable by an Incorporated Business

VAT

As a member of the European Union, Luxembourg adheres to the EU VAT Directive 2006/112/EC and has a standard 17% VAT rate. Luxembourg also applies lower rates (3%, 8%, and 14%) to a variety of goods and services.

Unlike other member states, Luxembourg has not adopted the *"use and enjoyment"* rule, which requires non-registered holding companies to pay VAT on services received from non-EU suppliers without the ability to recover it.

Following rulings from the Court of Justice of the European Union (CJEU), Luxembourg has strictly confined the VAT exemption for an *"independent group of persons"* (cost-sharing) to taxable entities carrying out activities of public interest. In response to the near elimination of the cost-sharing exemption for the financial, fund, and insurance sectors, Luxembourg has introduced the VAT grouping mechanism, based on Article 11 of the EU VAT Directive 2006/112/EC.

Recently, the CJEU ruled that a member of the board of directors of a public limited company incorporated under Luxembourg law carries out an economic activity within the meaning of Directive 2006/112/EC (VAT Directive), but does not carry out that economic activity independently, insofar as the person concerned does not act on his/her own behalf or under his/her own responsibility and does not bear the economic risk associated with the activity. As a result, directors' fees, subject to the above reservations, are not subject to VAT.

Customs/Excise Duties

Besides VAT, goods imported into the EU may also be liable for customs or import tariffs. The rates applied can differ based on the type and amount of the products.

In Luxembourg, items such as electricity, mineral oils, manufactured tobacco, and alcohol are subject to excise duties.

Capital Duty or Registration Tax

A registration tax of EUR75 is levied in several instances, such as for the incorporation of a company, when the legal seat or effective management of a foreign company is transferred to Luxembourg, or when a local branch of a foreign company is established.

Depending on the assets or documents registered, other registration duties or stamp duties may be applicable.

Real Estate Taxation

An annual real estate tax is imposed on the unitary value of properties in Luxembourg, with the rate varying based on the property's classification and location. The unitary value, determined by the Luxembourg tax authority, typically does not surpass 10% of the property's market value.

Sales and transfers of real estate are subject to a registration duty of 6% and a transcription tax of 1% (plus a city surtax). Contributions of real estate are also subject to a registration tax of 1.1% (if contributed in exchange for shares) or 7% if contributed in exchange for other than shares.

2.9 Incorporated Businesses and Notable Taxes

Pillar Two

Luxembourg has implemented the EU Directive on a global minimum income tax (Pillar Two), which imposes a minimum effective tax rate of 15% on multinational groups and large-scale domestic groups that have had consolidated revenues exceeding EUR750 million in at least two out of the previous four years. Pillar Two includes three related tax measures: the income inclusion rule (IIR), the undertaxed profits rule (UTPR) and the qualified domestic top-up tax (QDMTT). In Luxembourg, the IIR and a QDMTT apply as from fiscal years starting on or after 31 December 2023, with the UTPR applying a year later. Luxembourg has implemented the transitional *"CbCR Safe Harbours"*, which apply for the first three years that a group is considered in scope, beginning on or after 31 December 2026 and ending before 1 July 2028 (eg, fiscal years 2024, 2025 and 2026 if the fiscal year aligns with the calendar year).

Luxembourg parent entities may be subject to top-up tax under the IIR, to the extent that the group does not meet the 15% minimum tax rate in a jurisdiction where the Luxembourg parent holds a subsidiary, as determined under the Pillar Two rules.

Under the UTPR, Luxembourg entities are subject to top-up tax in cases where a parent entity of the group is in a jurisdiction that has not implemented Pillar Two. The top-up tax due under the UTPR would be the sum of the difference of the effective tax rate for all jurisdictions where the group is active and the minimum tax rate of 15%, and is allocated between all entities of the group that are located in jurisdictions that have implemented a UTPR, using an allocation key based on tangible assets and the number of employees.

The starting point for the Pillar Two calculations is the *"standalone pre-consolidation"* financial statements of the group, in the accounting standard used for consolidation.

Furthermore, all Luxembourg entities of an in-scope group are subject to the Luxembourg QDMTT, under which top-up tax may be levied if Luxembourg as a jurisdiction of the group does not meet the 15% minimum tax rate. Provided that all Luxembourg entities of a group apply Luxembourg GAAP and apply the same fiscal year as the consolidating entity, the calculations for the QDMTT may be performed based on Luxembourg GAAP accounts, rather than the accounting standard used for consolidation purposes by the group.

The currency applied for QDMTT purposes is either the euro or the currency used for group consolidation purposes. If the QDMTT is determined on the basis of the accounting standard used for consolidation purposes, the currency used in the consolidated financial statements shall be used. If the QDMTT is based on a Luxembourg domestic accounting standard (ie, Luxembourg GAAP or IFRS), and all Luxembourg entities of the group apply the euro as their functional currency, the euro shall be applied for QDMTT purposes. If there are Luxembourg entities that apply a non-euro currency as their functional currency, a five-year election is provided to the group on whether to apply the euro or the currency used for consolidation for the purposes of the QDMTT.

The Pillar Two rules further place new compliance obligations on Luxembourg resident entities. All Luxembourg entities that are part of an in-scope group would have to register with the Luxembourg tax authority within 15 months after the end of a relevant fiscal year (18 months for the transition year). Further, a Pillar Two information return would have to be filed; such information return can be filed by a designated group entity in any qualifying jurisdiction (ie, a jurisdiction that has implemented the Pillar Two rules). Luxembourg entities would have to notify the Luxembourg tax authority about such designated reporting entity. Finally, to the extent that the IIR, UTPR and QDMTT apply, Pillar Two tax returns would have to be filed. For such purposes, a Luxembourg entity of the group can also be designated as the filing entity.

Payment of top-up tax is due within a month of the filing deadline.

NWT

Luxembourg corporate resident taxpayers are subject to NWT levied on the fair market value of the taxable net wealth on 1 January of each year. The rates for fiscal year 2024 are:

- 0.5% on taxable net wealth up to EUR500 million; and
- 0.05% on the portion of taxable net wealth in excess of EUR500 million.

The unitary value is typically determined using accounting book values and adjusted as needed. For real estate in Luxembourg, the unitary value is based on cadastral values.

Assets that yield exempt or partially exempt income (like exempt participations and qualifying intellectual property rights) are generally also exempt from NWT. Assets allocated to a foreign permanent establishment and foreign real estate are usually exempt due to tax treaties Luxembourg has signed.

Liabilities are generally deductible unless they relate to exempt assets. Provisions for uncertain liabilities (like provisions for risks) are not deductible. NWT is not deductible for income tax purposes and is generally not creditable in foreign jurisdictions. Net wealth tax is considered *"covered tax"* for Pillar Two purposes.

In the company's first year of existence, NWT is not due as the assets as of 1 January are considered to be nil. A minimum NWT applies and depends on the resident corporate taxpayer's balance sheet total and ranges from EUR535 to EUR4,815.

The NWT liability can be decreased by adopting an NWT reserve. This decrease is limited to the amount of CIT (not including MBT) that the entity is liable to pay. It is further required that the established reserve be five times the requested NWT reduction. This reserve must be maintained for a minimum of five years. If not adhered to, the granted NWT reduction will be reclaimed in its entirety.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

It is more common for local businesses to operate in a corporate form, usually a SARL.

3.2 Individual Rates and Corporate Rates

Corporate entities are subject to an aggregate tax rate of 23.87% (in Luxembourg City), which is lower than the maximum tax rate of 45.78% applicable to individuals. Dividend income is taxed according to the progressive tax rate of the recipient individual, however half of the dividends distributed from a regularly taxed EU entity, or a regularly taxed entity resident in a jurisdiction with which Luxembourg has concluded a tax treaty are exempted.

3.3 Accumulating Earnings for Investment Purposes

Luxembourg enforces controlled foreign company (CFC) rules based on so-called Model B per the EU anti-tax avoidance directive from 2016 (ATAD 1).

A CFC is an entity or a permanent establishment of an entity that fulfils the following conditions:

- a Luxembourg taxpayer, either alone or in conjunction with one or more associated enterprises, holds a direct or indirect stake of more than 50% in the voting rights, capital, or profit entitlement of such an entity; and
- the entity or permanent establishment is subject to an effective tax rate that is less than 50% of the Luxembourg CIT rate (ie, for 2024, an effective rate lower than 8.5%) that would be applicable if the entity or permanent establishment were located in Luxembourg.

Luxembourg corporate taxpayers are taxed on the undistributed net income of a CFC, proportionate to their ownership or control of the entity (held directly and/or indirectly), provided that such income is associated with significant functions performed by the Luxembourg corporate taxpayer and only if the CFC in question was essentially established to gain a tax advantage. This CFC income is only subject to CIT, augmented by the solidarity surtax (resulting in a combined effective CIT rate of 17.12%), but it is not subject to MBT.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends

In general, dividends received by individuals residing in Luxembourg are fully subject to personal income tax but may qualify for a 50% exemption under certain circumstances.

Dividends fall under the 50% exemption if they are derived from a shareholding that qualifies as:

- a Luxembourg resident entity that is fully subject to Luxembourg income taxes;
- a non-resident capital company that is subject to an income tax in its country of residence (and that is a country with which Luxembourg has concluded a double tax treaty) that is comparable to the Luxembourg CIT (ie, a minimum 8% CIT rate on a comparable tax basis); or
- an entity resident in an EU member state as defined in Article 2 of the Parent-Subsidiary Directive.

Dividends further benefit from a EUR1,500 annual deduction (double in the case of joint taxation).

Capital Gains

Capital gains earned by Luxembourg resident individuals from the sale of shares are subject to personal income tax in the following manner:

- If the shares are sold less than six months after acquisition, they are taxed at the normal progressive income tax rate.
- If the shares are sold more than six months after acquisition:
  - (a) the capital gain is fully tax-exempt if the shares represent less than a 10% shareholding; or
  - (b) the capital gain is taxed at 50% of the applicable personal income tax rate if the shares represent more than 10%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are taxed on dividends from and gains on the sale of shares in publicly traded companies under the same rules applicable in relation to non-listed companies.

Dividends

In general, dividends received by individuals residing in Luxembourg are fully subject to personal income tax but may qualify for a 50% exemption under certain circumstances.

Dividends fall under the 50% exemption if they are derived from a shareholding that qualifies as:

- a Luxembourg resident entity that is fully subject to Luxembourg income taxes;
- a non-resident capital company that is subject to an income tax in its country of residence (and that is a country with which Luxembourg has concluded a double tax treaty) that is comparable to the Luxembourg CIT (ie, a minimum 8% CIT rate on a comparable tax basis); or
- an entity resident in a member state of the EU as defined in Article 2 of the Parent-Subsidiary Directive.

Dividends further benefit from a EUR1,500 annual deduction (double in the case of joint taxation).

Capital Gains

Capital gains earned by Luxembourg resident individuals from the sale of shares are subject to personal income tax in the following manner:

- If the shares are sold less than six months after acquisition, they are taxed at the progressive personal income tax rate.
- If the shares are sold more than six months after acquisition:
  - (a) the capital gain is fully tax-exempt if the shares represent less than a 10% shareholding; or
  - (b) the capital gain is taxed at 50% of the applicable personal income tax rate if the shares represent more than 10%.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Luxembourg imposes a 15% withholding tax on dividends (and hidden distributions), unless a tax treaty limits the amount Luxembourg can levy.

A domestic exemption for withholding tax on dividends applies in case:

- the recipient is a company that is:
  - (a) a Luxembourg resident entity;
  - (b) an entity which is covered by Article 2 of the Parent-Subsidiary Directive; or
  - (c) a capital company subject in its country of residence to income tax comparable with the Luxembourg CIT rate (ie, subject to a CIT rate of at least 8% on a similar taxable basis) and is resident in a country with which Luxembourg has concluded a double tax treaty; and
- the recipient holds, or commits itself to hold, a participation of at least 10% in the share capital of the Luxembourg company paying the dividend or, an acquisition price of at least EUR1,200,000 for an uninterrupted period of at least 12 months.

No withholding tax is levied on arm's length interest payments made to corporate entities, except for profit-sharing interest which, under certain circumstances, is subject to 15% withholding tax (subject to reduction under tax treaties).

Interest payments made to Luxembourg resident individuals by a Luxembourg *"paying agent"* are subject to 20% Luxembourg withholding tax. The 20% withholding tax operates as a full discharge of personal income tax for Luxembourg resident individuals acting in the context of the management of their private wealth.

Luxembourg does not apply any withholding tax on arm's length royalty payments or on distributions of liquidation proceeds.

4.2 Primary Tax Treaty Countries

Luxembourg has currently 92 tax treaties in force, and most are based on the OECD Model Convention.

On 7 June 2017, Luxembourg signed the Multilateral Convention (MLI) to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS), also known as the MLI. The MLI came into effect in Luxembourg on 1 August 2019. However, due to the necessary national ratification process, as well as the schedule outlined in the MLI, the widespread effects varied in terms of timing. Nevertheless, for many of Luxembourg's treaties, the principal purpose test (PPT) entered into force on 1 January 2020.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

It is uncommon for Luxembourg to challenge the use of treaties. However, national law contains a general anti-abuse rule, as well as the EU Parent Subsidiary Directive anti-abuse rule, under which tax benefits can be denied if the main purpose of an arrangement is to obtain a tax benefit.

The domestic general anti-abuse rule, amended on 1 January 2019 to align the provision with the wording of the general anti-abuse rule in ATAD 1, includes the concept of *"non-genuine arrangement"*. A transaction will be disregarded or requalified if the following elements are met: the use of one or more legal form(s) or institution(s) of law; (ii) the main purpose, or one of the main purposes, of such use of legal form(s) or institution(s) of law is to avoid or reduce a tax liability in a manner that goes against the object or purpose of the tax law; and (iii) such use of legal form(s) or institution(s) of law is non-genuine.

Since 1 January 2020, the PPT entered into force for tax treaties concluded by Luxembourg. Tax benefits can be denied under this rule, if it can be reasonably concluded that obtaining the treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly caused the benefit.

4.4 Transfer Pricing Issues

In 2014, the arm's length principle, which was already in practice, was officially incorporated into Luxembourg tax law. In 2016, a new article was introduced that outlined the main principles for conducting a transfer pricing functional analysis. This analysis focuses on the commercial and financial relations between affiliated companies and the economically significant circumstances of these relations.

The law also includes a requirement for taxpayers to provide transfer pricing documentation at the request of the tax authority. This documentation should validate the arm's length nature of transactions between related parties. Therefore, the taxpayer carries the initial burden of proof.

At the end of 2016, the Luxembourg tax authority issued guidance that clearly states the criteria for determining arm's length remuneration on intra-group financing transactions. The Circular applies to group companies whose main activity, aside from holding activities, involves intra-group financing transactions. These transactions are defined as the provision of loans or advances to associated companies, financed by any means. While the guidance does not address other intra-group situations, its principles should be largely applicable to those transactions.

Among other things, the guidance outlines the main substantive requirements that a group financing company established in Luxembourg must meet to enter into an advance pricing agreement with the tax authority. In this context, and among other substance requirements, the financing company should have adequate capital to handle the functions performed and the risks assumed in relation to its financing activity.

4.5 Related-Party Limited Risk Distribution Arrangements

The arm's length principle applies to related-party limited risk distribution arrangements.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Luxembourg tax authority applies the arm's length principle in line with the OECD standards.

4.7 International Transfer Pricing Disputes

Generally, the tax treaties concluded by Luxembourg contain an article on the mutual agreement procedure. This article establishes a mutual agreement procedure for the settlement of difficulties arising from the application of the Convention. The Luxembourg tax authority issued guidance on 11 March 2011 concerning the modalities for the implementation of the mutual agreement procedure and specified which information and documents need to be included for such a procedure.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Upward and downward adjustments of taxable income are in principle allowed in Luxembourg.

If a foreign tax authority unilaterally makes an adjustment of the taxable income, resulting in an increase of the taxable income, the taxpayer may initiate a mutual agreement procedure (MAP) before the directorate or the economic division of the Luxembourg tax authority, provided that the applicable double tax treaty contains a MAP article.

The Luxembourg tax authority will verify the request and assess whether the taxpayer's objection appears to be well-founded. If the request is well-founded, the Luxembourg tax authority will try to provide a solution unilaterally, or if it is unable to provide such a unilateral solution, the Luxemburg tax authority is obliged to contact the competent authority in the other state to resolve the case by mutual agreement.

The Director of the Luxembourg tax authority issued an update on the guidance on MAPs filed under a bilateral tax treaty concluded by Luxembourg.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

In Luxembourg, local branches of non-local corporations are treated the same as Luxembourg resident companies for CIT purposes. A branch is subject to MBT if it conducts a commercial activity in the territory of Luxembourg.

5.3 Capital Gains of Non-Residents

Non-residents are subject to taxation of the income generated in Luxembourg. Gains realised on the alienation of a substantial interest in a Luxembourg company (more than 10% shareholding) by non-residents are taxable, if the gain is realised within a period of six months following the acquisition of the shares. The foregoing may equally apply to distributions received upon liquidation and proceeds from a redemption of shares.

Non-resident capital gains tax will also be levied in case where the shareholder has been a Luxembourg resident for more than 15 years and became a non-resident less than five years prior to selling the participation in the Luxembourg company.

5.4 Change of Control Provisions

No provisions in Luxembourg tax law address the change of control of resident companies.

However, a change in control can have consequences for the carry-forward of losses if the change of the taxpayer's control and activity (which has generated the tax losses), has the purposes of circumventing the personal nature of the right to carry forward tax losses and avoiding taxation of subsequently realised profits.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No provisions in Luxembourg tax law, other than the general arm's length principle for transactions between related parties, are used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

The deduction of expenses incurred by a non-local affiliate is only possible when:

- the expenses are charged to the Luxembourg company;
- the charge is beneficial to the business; and
- the expense adheres to the arm's length principle.

5.7 Constraints on Related-Party Borrowing

Related-party borrowings paid by foreign-owned Luxembourg subsidiaries to foreign companies are subject to the arm's length principle and the IDLR.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Resident taxpayers in Luxembourg are subject to tax on their worldwide income. Foreign income is therefore subject to tax in Luxembourg, unless a double tax treaty restricts the taxation rights of Luxembourg.

If double taxation of the same income is not prevented, Luxembourg allows a credit for foreign tax paid, limited to the tax amount the taxpayer is required to pay under Luxembourg tax law. However, it is required that the foreign tax correspond to Luxembourg CIT.

6.2 Non-Deductible Local Expenses

Costs directly and economically related to tax-exempt participations (eg, impairments or interest expenses on a loan financing an exempt participation) are only deductible to the extent that the expenses exceed the exempt income. Any deductible expenses on an exempt participation are subject to *"recapture"* upon a sale of the participation, up to the historical acquisition cost.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by a Luxembourg tax resident are subject to CIT and MBT, unless the participation exemption applies (see **2.3 Other Special Incentives**).

6.4 Use of Intangibles by Non-Local Subsidiaries

A foreign subsidiary that uses intangibles developed by a Luxembourg resident company should compensate the latter in line with the arm's length principle.

The income derived by a Luxembourg resident company from intangibles is subject to Luxembourg taxation.

Under the IP regime, net income from qualifying IP assets that meet the eligibility criteria may benefit from an 80% exemption from CIT and MBT and a 100% exemption from NWT. The eligible assets should have been established, developed, or enhanced after 31 December 2007. These assets include patents, utility models, supplementary protection certificates for a patent on medicine and plant protection, plant variety certificates, extensions of a complementary protection certificate for paediatric use, orphan drug designations, and software protected by copyrights.

Income that qualifies for the IP regime includes:

- income derived from the use of, or a concession to use, a qualifying asset;
- income related to a qualifying asset that is embedded in the sales price of products or services directly related to the eligible IP asset;
- capital gains derived from the sale of a qualifying asset; and
- the indemnities received based on an arbitration ruling or a court decision concerning a qualifying asset.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

ATAD 1 introduced a CFC rule into Luxembourg domestic tax law. Under this rule, if a CFC is essentially established to obtain a tax advantage, Luxembourg corporate taxpayers are taxed on the undistributed net income of the CFC. This is proportional to their ownership or control of the foreign branch or subsidiary (held directly and indirectly), but only if such income is associated with significant functions performed by the Luxembourg corporate taxpayer (see **3.3 Accumulating Earnings for Investment Purposes**).

The Luxembourg tax authority has issued administrative guidance requiring Luxembourg resident taxpayers to annually document the functions and risks undertaken by the foreign entities in relation to any CFC income. If a Luxembourg company can demonstrate, through sufficient documentation of its activities or functions, that it does not perform significant functions related to the CFC's activities, the CFC rules should not result in a negative tax impact.

However, if the foreign entities' accounting profits are less than EUR750,000 or their accounting profits constitute less than 10% of their operating costs for a given year, the CFC rule does not apply.

6.6 Rules Related to the Substance of Non-Local Affiliates

The general anti-abuse rule in Luxembourg domestic law also applies to the substance of non-local affiliates.

The domestic general anti-abuse rule, amended on 1 January 2019 to align the provision with the wording of the general anti-abuse rule in ATAD 1, includes the concept of *"non-genuine arrangement"*. A transaction will be disregarded or requalified if the following elements are met: the use of one or more legal form(s) or institution(s) of law; (ii) the main purpose, or one of the main purposes, of such use of legal form(s) or institution(s) of law is to avoid or reduce a tax liability in a manner that goes against the object or purpose of the tax law; and (iii) such use of legal form(s) or institution(s) of law is non-genuine.

Since 1 January 2020, the PPT entered into force for the tax treaties concluded by Luxembourg. Tax benefits can be denied under this rule if it can be reasonably concluded that obtaining the treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly caused the benefit.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains derived by a Luxembourg taxable resident company from shares in a subsidiary company are subject to CIT and MBT, unless the domestic participation exemption applies (see **2.3 Other Special Incentives**).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Luxembourg's domestic tax law contains several anti-abuse measures with a general anti-abuse provision, that has been amended in light of ATAD 1.

Furthermore, the substance-over-form is a principle underlying Luxembourg tax law. This principle dictates that the tax treatment of a structure or transaction is not bound to its legal classification, and taxation is determined solely based on the substance of the structure or transaction.

This approach has been used for the evaluation of a debt/equity instrument which has been confirmed by parliamentary history and Luxemburg case law.

Furthermore, the domestic general anti-abuse rule, amended on 1 January 2019 to align the provision with the wording of the general anti-abuse rule in ATAD 1, includes the concept of *"non-genuine arrangement"*. A transaction will be disregarded or requalified if the following elements are met: (i) the use of one or more legal form(s) or institution(s) of law; (ii) the main purpose, or one of the main purposes, of such use of legal form(s) or institution(s) of law is to avoid or reduce a tax liability in a manner that goes against the object or purpose of the tax law; and (iii) such use of legal form(s) or institution(s) of law is non-genuine.

Since 1 January 2020, the PPT entered into force for the tax treaties concluded by Luxembourg. Tax benefits can be denied under this rule if it can be reasonably concluded that obtaining the treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly caused the benefit.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

For CIT, MBT and NWT, a tax return needs to be filed every year and will be used to determine the taxable income and tax liability. The Luxembourg tax authority will usually issue *"preliminary"* tax assessment based on the tax return filed. A five-year limitation period applies for the Luxembourg tax authority to issue a revised tax assessment if it disagrees with the *"preliminary"* tax assessment. An exception to the five-year limitation period applies if the tax return is found to be incomplete or incorrect, irrespective of an intent of fraud.

The Luxembourg tax authority has dedicated departments that have the competence to conduct on-site tax audits. The *Service de révision* is responsible for periodically auditing the accounts and other accounting documents of taxpayers subject to audit and drawing up audit reports proposing any resulting changes to taxation.

9. BEPS

9.1 Recommended Changes

Most of the BEPS-recommended action points have been implemented in Luxembourg via the transposition of related European directives (ATAD 1 and 2):

- Action 2 – anti-hybrid rules;

- Action 3 – CFC;
- Action 4 – interest deduction limitation rules;
- Action 5 – IP box;
- Action 6 – treaty abuse;
- Action 8-10 – transfer pricing;
- Action 13 – country-by-country reporting (CbCR); and
- Action 15 – multilateral instrument.

9.2 Government Attitudes

Luxembourg is fully committed to combating detrimental tax competition and supports the BEPS initiative (which led to ATAD 1 and 2 and the MLI).

In its effort to back tax developments, Luxembourg transposed the Pillar Two Directive on minimum taxation for corporations in December 2023. Pillar Two is implemented in Luxembourg, with the IIR and Luxembourg QDMTT applying for fiscal years starting on or after 31 December 2023, and the UTPR applying for fiscal years starting on or after 31 December 2024.

The Luxembourg legislature has also tried to implement most of the OECD Pillar Two administrative guidance released up to autumn of 2024, and it has also confirmed in parliamentary documents the intention to (i) treat existing and additional OECD guidance as a relevant source of interpretation of the rules, and (ii) implement (if appropriate) additional OECD guidance that may require a change of law.

In particular, a recent amendment law which includes additional clarifications for the fund industry and clarifications on the Luxembourg QDMTT was passed in December 2024.

9.3 Profile of International Tax

For many years, Luxembourg has been known as a key European jurisdiction for cross-border investment structures for large multinational corporations worldwide, as well as for the largest collective investment structures, both regulated and unregulated, such as undertakings for collective investment in transferable securities and alternative investment funds.

9.4 Competitive Tax Policy Objective

Luxembourg continues to stay competitive with other EU member states in terms of taxation, fully committing to all fair taxation initiatives.

9.5 Features of the Competitive Tax System

Taxpayers can obtain advance tax confirmations.

9.6 Proposals for Dealing With Hybrid Instruments

Luxembourg has transposed the hybrid mismatch rules from ATAD 2. The purpose of the hybrid mismatch rules is to neutralise the tax effects of hybrid mismatches by limiting the deduction of payments or by including the payments in the taxable income of a Luxembourg corporate taxpayer. The rules target double deduction and deduction-non-inclusion outcomes.

The hybrid mismatches covered by the rules include (i) payments on hybrid financial instruments, (ii) payments to or by hybrid entities, (iii) payments to or by hybrid permanent establishments, (iv) payments by dual resident entities and (v) payments made on a non-hybrid instrument that directly or indirectly finance a payment that leads to a hybrid mismatch (*"imported mismatches"*). Exceptions may apply, depending on the specific facts and circumstances.

If certain conditions regarding hybrid mismatches are met, Luxembourg transparent vehicles (eg, limited partnerships) may constitute so-called reverse hybrid entities and become (fully or partially) subject to Luxembourg CIT.

9.7 Territorial Tax Regime

Luxembourg does not have a territorial tax regime, but taxes residents on their worldwide income (subject to limitations in any applicable double tax treaty).

9.8 Controlled Foreign Corporation Proposals

There is no applicable information in this jurisdiction.

9.9 Anti-Avoidance Rules

Luxembourg is Europe's main hub for investment funds. Its success is partially due to the vast amount of tax treaties that the country has signed.

As part of the MLI, the PPT came into effect in Luxembourg on 1 January 2020. This general anti-abuse rule could have an effect on certain investment structures.

9.10 Transfer Pricing Changes

Luxembourg legislation on transfer pricing, including the arm's length principle, has been aligned with the OECD standard. The transposition of the BEPS project mainly affected intra-group transactions.

9.11 Transparency and Country-by-Country Reporting

Luxembourg tax legislation and regulations will continue to combat tax avoidance and improve transparency.

9.12 Taxation of Digital Economy Businesses

Luxembourg has not made any standalone changes or proposals in relation to the taxation of transactions effected or profits generated by digital economy businesses operating largely from outside its territory, nor are any such proposals being discussed.

9.13 Digital Taxation

Digital taxation in Luxembourg is expected to align with EU proposals on the topic. Luxembourg has implemented the EU Directive (DAC 7) concerning platform operators, which enacts transparency rules for digital platforms.

9.14 Taxation of Offshore IP

Luxembourg has not introduced any provisions dealing with the taxation of offshore intellectual property that is deployed within its territory.

Trends and Developments

Contributed by:
Romain Tiffon
ATOZ Tax Advisers

ATOZ Tax Advisers is a high-end independent advisory firm based in Luxembourg, founded in 2004. The firm offers a comprehensive and integrated range of direct and indirect tax solutions as well as transfer pricing, corporate and aviation finance and tax litigation services to both local and international clients. ATOZ has a team of carefully selected professionals who possess extensive experience in serving the local market as well as multinational corporations. The entire team works together to ensure consistently high standards of client service from beginning to end. Acknowledged experts in their respective fields, the firm's partners take a rigorous approach to researching and understanding the facts before drawing conclusions. They lead each engagement with a steadfast commitment to objectivity and the highest professional, legal, regulatory and ethical standards.

Author

Romain Tiffon is a partner in the international and corporate tax department at ATOZ. A tax professional since 2006, Romain has experience in structuring pan-European alternative investment funds across all asset classes, as well as co-ordinating tax structuring advice and implementation for a wide range of institutional investors. He also has extensive experience in structured finance, M&A transactions, and sovereign wealth funds. Romain is a member of the Tax Committee of the American Bar Association (ABA), New York State Bar Association (NYSBA), International Bar Association (IBA), and the Tax Group of the British Chamber of Commerce (BCC) in Luxembourg.

ATOZ S.A.

1B Heienhaff
Aerogolf Center
L-1736 Senningerberg
Luxembourg

Tel: +352 26 940 1
Email: info@atoz.lu
Web: www.atoz.lu

ATOZ
TAX ADVISERS LUXEMBOURG

Introduction

Luxembourg has long been a leading hub for the financial industry, attracting talent and investment from around the world. The challenges posed by the current global economic environment are prompting Luxembourg to take action not only to maintain but also to improve that position. As a result, at the end of 2024, a number of important legislative changes aimed at having a positive impact on Luxembourg's attractiveness and competitiveness were adopted. In this respect, attracting and retaining talent has notably been defined as one of the priorities of the new government, as reflected in its 2023-2028 coalition agreement.

Mainly with effect from the 2025 tax year, Luxembourg introduced targeted tax measures for both businesses (primarily a 1% cut of the corporate income tax rate and a subscription tax exemption for actively managed exchange-traded funds) and individuals (eg, an improved employee profit-share regime, a more favourable impatriate regime, a new bonus for young employees and a new tax credit for cross-border workers), so that Luxembourg remains a suitable jurisdiction for workers, companies and investment funds. They should further stimulate the Luxembourg fund industry.

Talent Attraction to Luxembourg

A more favourable impatriate regime

With effect from the 2025 tax year, Luxembourg repealed its impatriate regime and replaced it with a new one. The repealed impatriate regime provided for a 50% partial exemption of the gross annual remuneration paid in the form of a bonus by employers to impatriates and an exemption of certain costs borne by the employer and generated by the expatriate's move to Luxembourg. However, this regime was considered too complex and not sufficiently attractive compared to other foreign impatriate regimes.

The new Luxembourg impatriate regime, inspired by the Italian and French regimes, is thus a simplified one. It provides for an exemption of 50% of the gross annual remuneration, including all benefits in kind, paid to the impatriate, capped at an annual gross amount of EUR400,000. As a result, impatriates with a gross annual remuneration of EUR400,000 will be taxed at a maximum of 50% of the marginal tax rate of 45.78% for the income bracket exceeding EUR220,788, including the solidarity surcharge (ie, a maximum tax rate of 22.89%). This measure aims at strengthening the attractiveness of Luxembourg for talent and highly specialised profiles taking into account attractive regimes set up in other countries in the European Union.

It benefits employees directly recruited from abroad or seconded from an undertaking of an international group located outside Luxembourg to carry out an activity as an employee in Luxembourg.

Most conditions for benefitting from the new regime are identical to the ones already applicable under the repealed regime. To be applicable, the following conditions must notably be met:

- the impatriate must be tax domiciled or have their habitual residence in the Grand Duchy of Luxembourg;
- during the five tax years preceding the year in which the impatriate took up employment in the Grand Duchy of Luxembourg, the employee has not been subject to personal income tax in the Grand Duchy of Luxembourg on professional income;

- the impatriate carries out the qualifying professional activity for at least 75% of his/her working time; and
- the impatriate earns a fixed annual gross remuneration of at least EUR75,000.

Employee profit-share regime

With effect from the tax year 2021, a profit-share regime (prime participative) has been introduced for Luxembourg employees. As a result of this regime, a profit share paid by a Luxembourg company to its employee(s) benefitted from a 50% income tax exemption, provided the two following conditions/limitations were met: (i) the total amount of profit share paid by the employer to its employees did not exceed 5% of the accounting profit of the employer as of the end of the accounting year preceding the allocation of the profit share and (ii) the amount of profit share paid by the employer to the employee did not exceed 25% of the annual gross salary (excluding the amount of profit share) of the employee concerned.

To retain and attract more talent, Luxembourg has improved its employee profit-share regime. Effective from the 2025 tax year, the maximum total amount of profit share an employer can grant to its employees has been increased from 5% to 7.5% of the positive result of the employer for the operating year immediately preceding the one for which the profit share is allocated to the employees. Additionally, the maximum amount of the partially tax-exempt bonus has been increased from 25% to 30% of the beneficiary's gross annual remuneration, before incorporation of benefits in cash and in kind.

This employee profit-share regime is in addition to the favourable Luxembourg carried interest regime attracting investment fund executives to Luxembourg, notably private equity funds. In summary, under the Luxembourg carried interest tax regime, applicable to individuals who are employees of AIFMs, the carried interest is categorised as miscellaneous income, in the subcategory speculative gains (ie, a form of capital gain) and not as employment income. The law then determines under what conditions these speculative gains are taxable at the progressive rate (the marginal tax rate being 45.78%, including the solidarity surcharge) or at a quarter of that rate, or are exempt as a long-term capital gain.

New bonus exemption for young employees

Effective from the 2025 tax year, Luxembourg has also introduced a new bonus exemption aimed at young employees under the age of 30 who conclude a first permanent employment contract in Luxembourg. The granting of the bonus is at the discretion of the employer and the exemption is correlated to the gross remuneration of the employee. The tax-exempt bonus amount decreases as the salary increases, and if the gross annual salary of the young employee exceeds EUR100,000, bonuses are no longer eligible for this new exemption regime.

The bonus exemption is granted for a maximum period of five years, and the benefit of this exemption is lost in case of employment change. This measure is designed to attract young talent to Luxembourg but also encourages stable employment.

Tax credit for cross-border workers

When employees working in Luxembourg are tax resident in a country with which Luxembourg has signed a double tax treaty and receive gross remuneration for overtime work for which the taxing right is attributed to Luxembourg, they may effectively be subject to tax in their state of residence on this overtime remuneration when they are fully exempt on this remuneration in Luxembourg.

With retroactive effect from the 2024 tax year, Luxembourg has thus introduced a new overtime tax credit of a maximum of EUR700 per year for cross-border workers working in Luxembourg. This measure aims to provide compensation for the loss of income suffered by cross-border workers who are an important source of manpower for local employers. The tax credit is designed to maintain Luxembourg's attractiveness for cross-border workers.

New Tax Measures in Favour of Businesses and the Financial Centre

In 2024, several new tax measures designed to enhance the competitiveness of Luxembourg as a global fund centre were also adopted in favour of Luxembourg businesses in general and the Luxembourg fund industry in particular.

Corporate income tax rate cut

First, from 2025, Luxembourg has introduced a 1% cut in the corporate income tax rate, reducing it from 17% to 16% for taxable income exceeding EUR200,000 and from 15% to 14% for taxable income not exceeding EUR175,000. It also introduced an intermediate rate to smoothen the transition from the minimum rate of 14% to the maximum rate of 16% when taxable income is between EUR175,000 and EUR200,001.

The overall corporate income tax rate for companies located in Luxembourg City with taxable income exceeding EUR200,000 will therefore be 23.87% instead of the current 24.94% (including the solidarity surcharge and the municipal business tax in Luxembourg City). For small businesses, the rate will decrease from 22.80% in 2024 to 21.73% in 2025. This measure aims to strengthen the competitiveness of businesses and to encourage investment, innovation, and job creation.

Subscription tax exemption for ETFs

Appearing in Europe really only a few years ago, and after its impressive growth in 2024, actively managed exchange-traded funds (ETFs) are rapidly gaining favour with European investors. Some analysts believe that the European active ETF market could expand to USD800 billion in assets under management by 2030.

Recently, Luxembourg shifted its focus towards this rapidly growing sector and introduced a subscription tax exemption for actively managed ETFs, effective from 1 January 2025 (ie, the first day of the quarter following the publication of the law implementing this exemption). This measure aims to promote the development and competitiveness of the ETF sector in Luxembourg. It is designed to improve the tax framework of Luxembourg-listed undertakings for collective investment in transferable securities (UCITS ETFs) and to preserve the position of Luxembourg as a leading centre for traditional investment funds.

Minimum net wealth tax amendments

Luxembourg amended its minimum net wealth tax (NWT) rules to make them compliant with the Luxembourg Constitution, following a ruling from the Constitutional Court stating that the previous regime introduced a non-justified difference of treatment between comparable taxpayers. To address this issue, the new minimum NWT rules remove the distinction based on the types of assets held by the company (ie, whether the company qualifies as a SOPARFI) and provide that the minimum NWT will amount to EUR535, EUR1,605, or EUR4,815, depending only on the size of the total balance sheet of the company. This measure aims to simplify the minimum net wealth tax system and provide greater legal certainty.

Participation exemption regime

The new tax measures introduce the possibility for a corporate taxpayer to waive the benefits of the Luxembourg participation exemption for dividends and capital gains under certain circumstances. This option will be available where the conditions for the participation exemption are met solely by virtue of the threshold of the acquisition price of the shareholding (ie, if it is at least equal to EUR1.2 million in the case of dividends or EUR6 million in the case of capital gains). In other words, when the conditions for the exemption are met on the basis of a shareholding of at least 10%, it will not be possible to exercise this waiver. The limitation of the waiver to these cases is due to the constraints arising from the Parent-Subsidiary Directive and its interplay with the determination of the taxable base under Pillar Two principles.

The waiver aims to provide greater flexibility for certain entities and align with the participation exemption regime existing in other EU member states.

Luxembourg Pillar Two law

In late 2024, the Luxembourg law of 22 December 2023 implementing the EU Directive of 15 December 2022 on ensuring a global minimum level of taxation for multinational enterprise (MNE) groups and large-scale domestic groups in the Union, known as the Pillar Two Directive, was amended. The amendments incorporate clarifications, interpretations, and additional technical provisions resulting from the OECD/G20 Inclusive Framework on BEPS. These amendments aim to guide taxpayers on how to interpret and apply the rules of the Luxembourg Pillar Two law and ensure compliance with OECD guidelines.

For the application of the *"deemed consolidation test"* under Pillar Two, the OECD Administrative Guidance clarified that certain investment entities (eg, under IFRS 10) that are exempt from line-by-line consolidation and that are merely required to fair value their investments (including where majority stakes are held in subsidiary companies) do not fall within the deemed consolidation rule – ie, such entities do not qualify as parent entities of a group. The commentaries to the Luxembourg Pillar Two law now confirm that Luxembourg-specific exemptions from consolidation for most investment funds based on the respective special laws such as for reserved alternative investment funds (RAIF), specialised investment funds (SIF) or companies in risk capital (SICAR) are consolidation exemptions comparable to the IFRS 10 investment entity exception. This clarification provides legal certainty for Luxembourg investment fund vehicles concerned.

The amended Luxembourg Pillar Two law also clarifies that an investment fund or real estate investment vehicle, which is not an ultimate parent entity for the sole reason that it is not required to prepare consolidated financial statements under the qualifying financial accounting standard or an accepted financial accounting standard, is to be assimilated to an excluded entity. This is intended to clarify that entities held by such investment fund or real estate investment vehicles in the sense of Pillar Two are to be considered excluded entities for the purposes of the Luxembourg Pillar Two law. However, such entities still must be taken into account for verifying whether the EUR750 million group's annual turnover threshold is met.

In early 2025, the OECD confirmed that the Luxembourg law is considered qualified – ie, to comply with the OECD framework. The recognition of that qualified status is important for determining the order in which global minimum tax rules apply – ie, to ensure co-ordinated outcomes and provide tax certainty for MNE Groups. Additionally, this qualified status also confirms that Luxembourg can benefit from the qualified domestic top-up tax (QDMTT) Safe Harbour, which eases things for MNE groups established in Luxembourg. This allows these groups to perform the necessary QDMTT calculations solely at Luxembourg level, without needing to repeat them in the jurisdiction of the Ultimate Parent Entity – eg, for Income Inclusion Rule purposes.

Securitisation entities

The amended Luxembourg Pillar Two law clarifies that a Securitisation Entity is not excluded from the scope of the Luxembourg QDMTT, but it ensures that a Securitisation Entity that is *"constituent entity"* of MNE group cannot be designated as a top-tier Luxembourg constituent entity for the purposes of the QDMTT and provides that the potential top-up tax calculated for a Securitisation Entity is, in principle, allocated to other Luxembourg constituent entities of the group. However, in the absence of other Luxembourg constituent entities of the group, the Luxembourg QDMTT that has been determined for a Securitisation Entity is levied on that entity. Additionally, Securitisation Entities are exempt from the joint and several liability mechanisms.

On another aspect, Luxembourg also introduced the concept of *"single-entity group"*, exempt from the interest limitation rules, applicable from financial years beginning on or after 1 January 2024. The single-entity group complements the standalone entity exception, and its expected scope is the orphan securitisation structure to which the standalone entity exception does not apply.

Clarification of the partial liquidation regime applicable to share class redemptions

The new Luxembourg tax measures clarify the tax treatment of share class redemptions under the partial liquidation regime. That regime was already confirmed by the Luxembourg case law, but Luxembourg now has a clear legal framework.

From now on, the Luxembourg law mentions that to be treated as a partial liquidation not subject to Luxembourg withholding tax, the redemption or withdrawal of a class of shares or corporate units must meet the following cumulative conditions:

- The redemption or withdrawal must relate to an entire class of shares or corporate units.
- The classes of shares or corporate units must have been set up at the time of the incorporation or capital increase of the undertaking.
- Each class of shares or corporate units must have distinct economic rights, defined in the undertaking's articles of association, from those of the other classes of shares or corporate units. A distinct economic right is characterised by a specific right in relation to the rights of other classes of shares or corporate units, such as shares giving entitlement to reference dividends, securities giving an exclusive right to the profits of a specific or determinable period, or securities whose respective financial rights are linked to the performance of one or more direct or indirect assets or activities of the entity.
- The redemption or withdrawal price of a class of shares or corporate units must be determined based on criteria laid down in the undertaking's articles of association or any

other document referred to in those articles of association, reflecting the estimated market value of the said class of shares or shares at the time of redemption or withdrawal.

The clarification provides greater legal certainty for fund managers and investors by clearly defining the conditions under which the redemption or withdrawal of a class of shares or corporate units will be treated as a partial liquidation. This ensures that fund managers can confidently structure funds and share classes in a way that complies with Luxembourg tax laws, reducing the risk of unexpected tax liabilities. The clarification allows fund managers to invest in classes of shares with distinct economic rights, tailored to the specific needs and preferences of different investors. This flexibility in fund structuring can enhance the appeal of Luxembourg-domiciled funds and their underlying platforms to a broader range of investors, including those seeking specific investment strategies or risk profiles.

The clarification of the partial liquidation regime applicable to share class redemptions enhances the attractiveness of Luxembourg as a domicile for investment funds by providing legal certainty, tax efficiency, flexibility in fund structuring, and a competitive advantage in the global fund industry.

Modernisation of the Luxembourg Tax Procedure

The Luxembourg government is working to introduce measures to modernise the tax procedure, including the digitalisation of the tax procedure, administrative co-operation, and the tax recovery procedure. Luxembourg seems committed to simplifying the direct tax procedure for the tax authorities and providing greater legal certainty for taxpayers.

Conclusion

Luxembourg continues to be a prime destination for talent and investment in the financial industry. The government's proactive approach in implementing initiatives for talent attraction and introducing new tax measures has further strengthened Luxembourg's position as a leading global financial hub. As these trends and developments continue to evolve, Luxembourg is well-positioned to maintain its competitive edge in the global financial market.

MALTA

Law and Practice

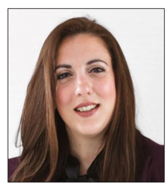
Contributed by:
Donald Vella and Kirsten Debono Huskinson
Camilleri Preziosi Advocates

Contents

Camilleri Preziosi Advocates offers tax expertise ranging from advising clients on direct and indirect tax matters to representing clients in front of fiscal courts and tribunals. Most of the international transactions the firm deals with relate to the use of Maltese vehicles in the context of larger transactions, be they M&A or group restructuring exercises. The Camilleri Preziosi tax department is made up of five lawyers who, though specialised in taxation matters, can be said to be *"all-rounders"* able to provide insight to clients on a wide range of matters that might have an impact on a particular transaction and that might not be strictly related to the fiscal implications of a transaction. Camilleri Preziosi's primary practice areas in the tax sector are corporate tax, cross-border tax issues, tax structuring, personal tax, value added tax advice and stamp duty.

Authors

Donald Vella heads the tax practice at Camilleri Preziosi. He advises clients on domestic and international tax and tax restructuring. Donald also regularly represents clients in courts and fiscal tribunals on direct and indirect taxation matters. His expertise accordingly lies in taxation, as well as corporate restructurings, trusts, foundations and corporate services. Donald joined the firm in 2005. His key practice areas are corporate tax, international tax, corporate and commercial, M&A, trusts and foundations. He is a member of the International Tax Planning Association and the Institute of Financial Services Practitioners, and he also sits on the Council of the Chamber of Advocates, where he occupies the role of professional development officer.



Kirsten Debono Huskinson is a partner at Camilleri Preziosi. She primarily assists in the provision of domestic and international tax advice, particularly identifying the implications of, and devising tax-efficient structures for, local as well as cross-border transactions. She also regularly assists in advising clients on the corporate law aspects of a wide range of transactions, and in other areas including corporate finance, M&A and capital markets. Kirsten joined the firm in 2013. She is a member of the International Tax Planning Association, and her key practice areas are corporate tax, international tax, corporate and commercial, M&A, trusts and foundations, the IFSP and the EU Affairs Subcommittee.

Camilleri Preziosi Advocates

Level 3
Valletta Buildings
South Street
Valletta VLT1103
Malta

Tel: +356 2123 8989
Fax: +356 2122 3048
Email: info@camilleripreziosi.com
Web: www.camilleripreziosi.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Persons looking to establish a presence in Malta may choose to adopt one of various different types of available legal forms, depending on the purpose and aims of the stakeholders involved in the conduct of the business or activities in question.

The Companies Act (Chapter 386 of the Laws of Malta) contemplates the possibility of setting up commercial partnerships, which can themselves take distinct forms, such as a partnership *en nom collectif* or general partnership, or a partnership *en commandite* or limited partnership.

A Maltese commercial partnership has its own separate legal personality, distinct from its partners, and is capable of owning and holding property under any title at law and of being sued.

It is also possible to establish civil partnerships under the Maltese Civil Code (Chapter 16 of the Laws of Malta) – these are typically adopted by professionals coming together to exercise their profession (including lawyers, accountants and auditors). These entities are fiscally transparent.

In terms of the Maltese Income Tax Act (Chapter 123 of the Laws of Malta) (ITA), all partnerships may be taxed as separate legal entities.

The most common corporate form adopted for the purpose of conducting business in Malta is the limited liability company.

Maltese legislation also contemplates a framework for establishing trusts, foundations and associations. Trusts can either be taxed as separate legal entities or treated as transparent entities, depending on the election made by the trustee. Foundations and associations are taxed as separate legal entities.

1.2 Transparent Entities

As noted in **1.1 Corporate Structures and Tax Treatment**, very few Maltese corporate forms are treated as transparent entities from a Maltese tax perspective. None of these entities are commonly adopted in business sectors, other than civil partnerships.

1.3 Determining Residence of Incorporated Businesses

For the purposes of Maltese tax legislation, bodies of persons such as companies or partnerships – whether corporate or unincorporated – are deemed to be resident in Malta when the control and management thereof are exercised in Malta. Furthermore, companies incorporated in Malta under the Companies Act are deemed to be resident in Malta by virtue of their incorporation.

In practice, the place where the control and management of a body of persons is carried out is usually deemed to be the place where the director(s) of such a company are resident and/or the place where the key decisions regarding the company's strategy and policy are taken (among other factors).

1.4 Tax Rates

Malta tax-resident companies are subject to Maltese tax on their worldwide income and capital gains, irrespective of where their income or gains arise, and irrespective of the remittance of such income or gains to Malta. The chargeable income of a company resident in Malta is subject to tax at a flat rate of 35%. Certain tax refunds may be available, as further set out in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

The tax paid by individuals in respect of income attributable to such individuals through transparent entities depends on their country of residence. Malta-resident persons are subject to the following progressive rates of income tax.

- Single rates:
  - (a) up to EUR12,000: 0% (subtract nothing);
  - (b) EUR12,001 to EUR16,000: 15% (subtract EUR1,800);
  - (c) EUR16,001 to EUR60,000: 25% (subtract EUR3,400); and
  - (d) EUR60,001 and over: 35% (subtract EUR9,400).
- Married rates:
  - (a) up to EUR15,000: 0% (subtract nothing);
  - (b) EUR15,001 to EUR23,000: 15% (subtract EUR2,250);
  - (c) EUR23,001 to EUR60,000: 25% (subtract EUR4,550); and
  - (d) EUR60,001 and over: 35% (subtract EUR10,550).
- Parent rates:
  - (a) up to EUR13,000: 0% (subtract nothing);
  - (b) EUR13,001 to EUR17,500: 15% (subtract EUR1,950);
  - (c) EUR17,501 to EUR60,000: 25% (subtract EUR3,700); and
  - (d) EUR60,001 and over: 35% (subtract EUR9,700).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The accounts of a Maltese company are drawn up in accordance with the accounting standards set out in the International Financial Reporting Standards (IFRS). Before arriving at the taxable income for a certain year of assessment, a determination of profits made according to the IFRS principles may be subject to adjustments as imposed by the ITA, such as fiscally deductible expenses and elements of the profits deemed to be exempt from income tax by virtue of a specific exemption contemplated by the ITA.

A number of expenses that may reduce the profits of a Maltese company from an accounting perspective may not be allowable or deductible from a tax perspective, and would therefore need to be added back to the profit figure in order to calculate the chargeable income for Maltese tax purposes. This mainly applies in respect of provisions, unrealised expenses and foreign exchange differences, as well as gratuitous payments (such as donations).

Conversely, Maltese tax law may allow for certain deductions to the taxable profits of a company that are not contemplated by the applicable accounting principles.

One of the more notable adjustments relevant from a tax perspective is that expenses that are wholly and exclusively incurred in the production of the income of the business are allowable deductions for income tax purposes. On the other hand, expenses that are not business-related, are of a capital nature, are recoverable from any insurance or are of a gratuitous nature are, in principle, not deductible for income tax purposes. That being said, the ITA does present a number of specific instances where it explicitly departs from the general principle that only expenditure of a revenue nature is allowable as a deduction against chargeable income, as is evident from the permissible deductions for certain capital allowances in terms of wear and tear of specific categories of fixed assets. Expenses or amounts that have not actually been incurred, such as unrealised exchange differences or provisions, are not deductible for Maltese income tax purposes.

2.2 Special Incentives for Technology Investments

The Maltese legislature has introduced certain incentives to support companies investing in research and development (R&D) in different areas of science and technology. The aim of these incentives is to encourage the development of innovative scientific products and solutions.

The following regulations are of particular note.

- The Research and Development Activities Regulations, 2024, assist with industrial research and experimental development activities addressing specific scientific or technological uncertainties, leading to the development of innovative products and solutions. This support measure is provided in the form of a tax credit or a cash grant, or a combination thereof, and cannot exceed 80% of the eligible costs.
- The Patent Box Deduction Rules, 2019, establish a fiscal regime for income arising from patents, similar intellectual property (IP) rights and copyrighted software. The Rules additionally provide that small companies may utilise the patent box rules in relation to income from any IP based on an invention that could be patented. A taxpayer qualifying for the patent box deduction will be entitled to deduct a percentage of its income from taxable income. This deduction will be adjusted depending on the percentage resulting from dividing the qualifying IP expenditure by the total expenditure related to the particular IP.
- The Exploring Research Grant Regulations, 2024, assist companies carrying out feasibility studies to determine technical and commercial challenges and activities that that will enable businesses to make informed decisions on the development of intended R&D projects; the Regulations allow for a cash grant of up to EUR100,000 to support the carrying out of a feasibility study.
- The Start-Up Finance Regulations, 2024, afford financial aid in the form of a repayable advance to start-ups or similar organisations

providing services or products, or utilising processes, which are new or substantially improved compared to similar products on the market, for instance in relation to software development and activities relating to health, biotechnology, pharmaceuticals and life sciences.
- The Invest (2024) Regulations, 2024, support small to medium-sized enterprises (SMEs) – through a cash grant of up to EUR250,000 – in carrying out projects leading to product, process and organisational innovation (through collaboration with research and knowledge-dissemination organisations, or through innovation advisory services via funding for the secondment of highly qualified personnel, and via access to innovation advisory and support services).

2.3 Other Special Incentives

Malta Enterprise has developed various incentives for the promotion and expansion of industry and the development of innovative enterprises, including:

- investment aid tax credits;
- financial assistance to start-ups;
- cash grants and/or tax credits available to companies requiring industrial space to carry out their business activities; and
- support for SMEs and large undertakings in providing training to their workforce.

2.4 Basic Rules on Loss Relief

The ITA provides that trading losses that are incurred by a person or company in a certain year, in any trade, business, profession or vocation, can be set off against the income from other trading activities or income streams and capital gains of that person or company in the same year. Trading losses are deductible under the condition that such loss would have been assessable under the ITA if it had been a profit. A loss is computed in the same way as a profit and therefore can be deemed to be a negative profit for the purposes of deductibility.

Where a loss cannot be (wholly) set off against capital gains or income for a given year, it may – to the extent to which it cannot be set off – be carried forward and set off against the income and capital gains for subsequent years. It should be noted that a capital gain is brought to charge as part of the total chargeable income of a company. However, a capital loss cannot be set off against other income for the year of assessment; it must be carried forward and set off against capital gains in respect of subsequent years of assessment until the full loss is absorbed.

Losses cannot be set off against types of company income that stand to be allocated to the final tax account (FTA), such as any investment income subject to 15% final withholding tax. Losses that are generated from sources of income that are to be allocated to the FTA are excluded from the scope of this provision and can therefore not be deducted.

The group relief provisions contemplated by the ITA also allow the surrendering of losses between companies that are considered to form part of the same group, and which are exclusively resident in Malta.

2.5 Imposed Limits on Deduction of Interest

The ITA allows the deduction of interest from the income of a local company, if it can be shown to the Commissioner for Tax and Customs that the interest was payable on capital employed in the production of income by that company. This initial test constitutes the most notable limitation imposed on local companies regarding the deductibility of interest expenses: the underlying loan must be used in the production of income that, under normal circumstances, should give rise to taxability under the ITA.

The Anti-Tax Avoidance Directive (ATAD) has also introduced interest limitation rules that limit the deductibility of borrowing costs, detailed in **7.1 Overarching Anti-Avoidance Provisions**.

2.6 Basic Rules on Consolidated Tax Grouping

Legal Notice 110 of 2019 introduced the possibility of income tax consolidation in Malta. Companies that form part of a group may elect to be treated as a single taxpayer if they satisfy certain conditions. Upon successful registration, a parent company is considered the *"principal taxpayer"* of the fiscal unit, thus becoming the sole chargeable fiscal unit for the entire group.

Transactions taking place between persons forming part of the *"fiscal unit"* (excluding those involving immovable property in Malta) fall wholly outside the scope of Maltese income tax.

The ITA also contemplates group relief provisions. Companies resident in Malta can form a company group for the purpose of setting off losses against the profits of other companies forming part of the same group.

Two companies are deemed to be part of the same company group when such companies are both resident in Malta and are not deemed to be resident for tax purposes in any other jurisdiction. Furthermore, one company must be a 51% subsidiary of the other company, or both companies must be the 51% subsidiary of a third mother company, which also must be resident in Malta.

The 51% holding that the parent company must retain in the subsidiary should entitle the parent company to more than 50% of the voting rights in the subsidiary, more than 50% of the profits available for distribution to the ordinary shareholders of the subsidiary and more than 50% of any assets of the subsidiary upon liquidation of the subsidiary.

Once the requirements to classify as a group of companies have been met, allowable losses from one company within the group can be surrendered to another company, which can set off the surrendered losses against its profits.

These group relief provisions contain certain general and specific anti-abuse provisions, which, inter alia, restrict the surrendering of losses made by companies whose activities are related to immovable property situated in Malta.

2.7 Capital Gains Taxation

The ITA imposes tax on capital gains in respect of transfers of those assets listed specifically and exhaustively by the ITA. There are specific rules on how to calculate capital gains derived from the disposal of certain assets, contemplating certain adjustments. Once calculated, a capital gain is brought to charge as part of the chargeable income.

Companies that derive capital gains from *"participating holding"* may, to the extent that the conditions are satisfied, qualify to apply the *"participation exemption"*, in which case any gains derived from such participating holding would be exempt from tax. Alternatively, a Maltese company may elect to be subject to tax and pay income tax on capital gains arising from the transfer of a participating holding. Then, upon the distribution of profits, the shareholder may, to the extent that the conditions are satisfied, claim a full refund of the tax paid by the company on such capital gains.

A holding of equity will qualify as a participating holding for the purposes of applying this exemption to capital gains in the following circumstances.

- When the holding constitutes a direct holding of 5% or more of the equity shares or partnership capital – this participating holding entitles the company holding the shares to two out of the following three equity rights:
  - (a) voting rights;
  - (b) rights to profits available for distribution; or
  - (c) rights to assets available for distribution in the case of a winding up of the company in which the shares are held.
- When a company is an equity shareholder in a company, and the equity shareholder company is entitled at its option to call for and acquire the entire balance of the equity shares not held by that equity shareholder company, to the extent permitted by the law of the country in which the equity shares are held.
- When a company is an equity shareholder in a company and the equity shareholder company is entitled to first refusal in the event of the proposed disposal, redemption or cancellation of all of the equity shares of that company not held by that equity shareholder company.
- When the amount invested in the holding is at least EUR1,164,000 (or the equivalent sum in a foreign currency) and is held for an uninterrupted period of at least 183 days.
- When the shareholder in question is entitled to sit or be represented on the board of directors of the company in which the equity holding is held.
- When the equity shares are held for the furtherance of the business, and the holding is not held as trading stock for the purpose of a trade.

2.8 Other Taxes Payable by an Incorporated Business

Maltese entities may be subject to the following additional taxes when undertaking a transaction.

Malta imposes *"stamp duty"* on certain legal documents, such as policies of insurance and notarial deeds, and also on transfers in certain transactions (including deemed transfers), such as transfers of immovable property situated in Malta, certain marketable securities and certain other transactions.

In addition, Malta imposes value added tax, at a standard rate of 18%, on the supply of goods and services that are not exempt or subject to a reduced rate of 5%, 7% or 12%.

2.9 Incorporated Businesses and Notable Taxes

Maltese entities may be subject to customs duties, which are levied on certain imports from non-EU countries. Excise duties are levied on particular classes of goods, such as alcohol and tobacco.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

The majority of local business is conducted in corporate form. The most common legal form for businesses in Malta is the private limited liability company.

3.2 Individual Rates and Corporate Rates

The income tax rate applicable to companies and the majority of other corporate entities is 35%. The highest personal tax rate imposed on Maltese tax-resident individuals is also 35%. Accordingly, there is no need for rules to prevent individual professionals from earning income at corporate rates.

3.3 Accumulating Earnings for Investment Purposes

In principle, companies established in Malta can accumulate earnings and profits for investment purposes, free from rules constricting or impacting such accumulation of profits. A capital tax or duty is not imposed through the ITA or any other form of fiscal legislation. In this context, no distinction is made between closely held companies and other types of companies.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends

Malta operates a full imputation system, which means that profits will first be taxed at the level of the company at the flat rate of 35%. However, when distributed to shareholders by way of dividend, the dividend carries an imputation credit of the tax paid by the company on the profits so distributed. The credit results in the elimination of the Maltese tax chargeable at the shareholder level on dividends received. As stated earlier, the highest personal tax rate imposed in Malta is 35%. Where a shareholder is not subject to tax or qualifies for a lower rate of tax than the 35% already paid by the company, such shareholder will be entitled to a tax refund equivalent to the *"excess percentage"* of the tax paid by the company. This system avoids economic double taxation of distributed corporate profits.

Shareholders in receipt of dividends distributed out of certain profits of a Maltese company may be entitled to claim a refund of the tax paid in Malta on those profits. The rate of tax refund to which a shareholder will be entitled depends on a number of factors, including:

- the nature of the underlying profits (allocated to one of the five tax accounts – namely the Maltese taxed account, the foreign income account, the FTA, the immovable property account or the untaxed account) out of which dividends will be distributed by the Maltese company, including whether the income is of an active or passive nature; and
- the application of any double taxation relief by the Maltese company on such profits.

The possible refunds, and the resulting effective tax rates, are as follows.

- 6/7 refund – in most cases, the tax refund entitlement of a registered shareholder is 6/7ths of the Maltese tax suffered on the profits out of which the dividend is distributed, particularly in the case of profits derived from trading activities. The effective tax rate would equate to 5% in such cases.
- 5/7 refund – this refund applies where the profit out of which a dividend is distributed consists of passive interest or royalties. It also applies to Maltese companies holding shares in an underlying company that does not qualify as *"participating holding"* and is therefore not eligible for a participation exemption. The 5/7 refund results in an ultimate tax leakage of 10%.
- 2/3 refund – this applies to dividends distributed out of profits in respect of which the Maltese distributing company would have claimed double tax relief (including double tax

treaty relief). The effective tax rate in this case would be between 2.49% and 6.25%.
- 100% refund – this applies where the company is entitled to claim the participation exemption but chooses not to. This is an exemption in respect of income derived from a participating holding or the gains that it derives from the transfer of such a holding, as long as certain conditions are met (as detailed in **2.7 Capital Gains Taxation**).

As a general rule, Malta does not charge any type of withholding tax on inbound or outbound dividends, except where a distribution of a dividend is made from the *"untaxed account"* of a Maltese company to certain persons, including any Maltese-resident individuals and any non-resident persons who are owned and controlled by, or act on behalf of, an individual ordinarily resident and domiciled in Malta. As the payor of the dividend, the Maltese company would need to withhold tax at the rate of 15% upon any such dividend distribution.

The participation exemption detailed in **2.7 Capital Gains Taxation** can also be applied to dividend income; however, this is subject to the satisfaction of certain anti-abuse provisions, as detailed in **6.3 Taxation on Dividends From Foreign Subsidiaries**.

Capital Gains

Maltese tax-resident persons are subject to income tax on capital gains derived from the transfer of certain chargeable capital assets, as contemplated by the ITA, at the progressive rates detailed in **1.4 Tax Rates**, which go up to 35%.

It may be pertinent to note that persons who are resident but not domiciled, or domiciled but not resident, in Malta are not subject to tax on foreign source capital gains, regardless of whether or not they are remitted to Malta.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The receipt by individuals of dividends from a publicly traded company is treated from a tax perspective in the same manner as when such dividends are paid by closely held companies (ie, the full imputation system applies). The same applies to capital gains; however, it is pertinent to note that gains or profits derived from the transfer of securities listed, or in consequence of a listing, on a stock exchange recognised by the Commissioner for Tax and Customs (not being securities in a collective scheme) are not subject to tax in Malta.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Subject to any applicable provisions in double tax treaties, distributions of dividends and payments of interest or royalties from a Maltese company to a resident or non-resident person are not generally subject to any withholding tax. However, a 15% withholding tax may apply where profits are distributed to a resident person of the payer company's *"untaxed account"*, and on certain investment income, as detailed in **3.4 Dividends**.

Moreover, payments of any income chargeable to tax under the provisions of the ITA to non-resident persons (other than a company or other person deriving income from entertainment activities exercised in Malta), or to persons resident in Malta on behalf of such non-resident persons, shall be subject to a withholding tax at the rate of 25%. Where the payment is made to a non-resident company or to resident persons on behalf of such non-resident company, a withholding tax at the rate of 35% shall apply.

4.2 Primary Tax Treaty Countries

Malta has concluded bilateral double taxation treaties with more than 70 jurisdictions, both within and outside the EU. The majority of these double tax treaties are based on the OECD Model Tax Convention and have also been modified as a result of the implementation of the multilateral instrument (MLI) in Malta.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The local tax authorities in Malta do not specifically challenge the use by non-treaty country residents of corporate entities established in countries that have concluded a double tax treaty with Malta. Maltese tax law does not impose any specific rules or requirements on the entitlement to treaty benefits of non-treaty country residents when such non-treaty country residents have established an entity in a country with which Malta has concluded a treaty.

However, company activities and transactions from and to Maltese companies are subject to a corporate general anti-abuse rule contemplated by the ITA. The tax authorities have the power to disregard any structure or scheme that reduces the amount of tax payable, where such a scheme can be deemed to be of an artificial or fictitious nature.

Principal Purpose Test

It should be noted that Malta has approved of and adopted a number of the OECD's anti-tax avoidance initiatives and pieces of research and anti-abuse legislation. One such initiative was the introduction of a principal purpose test for certain existing double tax treaties as a minimum-standard anti-abuse provision.

The principal purpose test is designed to assess whether one of the principal purposes of a certain transaction (the provision of a loan, for example) or a certain structure (the establishment of a subsidiary in a specific jurisdiction, for example) is to obtain a treaty benefit granted by the tax treaties concluded between that jurisdiction and the other contracting state. Both the Maltese and foreign tax authorities might use the indicators set out in this test to challenge the use of entities established in the tax treaty partner of Malta when they believe that the use of such entities is mainly for the purpose of gaining access to certain treaty benefits.

4.4 Transfer Pricing Issues

Following updates to the ITA in 2021 authorising the Minister for Finance to make rules in connection with transfer pricing in general, Malta introduced formal transfer pricing rules in November 2022 through Legal Notice 284 of 2022. The rules, which apply for basis years commencing on or after 1 January 2023, are largely based on the draft rules that were published alongside the public consultation carried out by the Commissioner for Tax and Customs in December 2021. The rules apply to any arrangement entered into on or after 1 January 2024. For arrangements entered into before that date, application of the rules is limited to those arrangements that are materially altered on or after that date. The transfer pricing regulations were revised in 2024 to clarify that said rules shall apply in the case of arrangements entered into before 1 January 2024, and which were not materially altered on or after that date, for basis years commencing on or after 1 January 2027.

4.5 Related-Party Limited Risk Distribution Arrangements

The Maltese tax authorities do not impose any specific limitations or restrictions on the use of related-party limited risk distribution. The general anti-abuse rule laid down in the ITA could potentially challenge the use of such arrangements where it is shown that such an arrangement is artificial or fictitious in nature and reduces the amount of tax payable upon a certain income.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Malta published formal transfer pricing rules (see **4.4 Transfer Pricing Issues**) together with accompanying guidelines on the application of such rules. The OECD transfer pricing guidelines constitute an important reference for the application of the rules.

4.7 International Transfer Pricing Disputes

Parties involved in a transfer pricing dispute may have recourse to the EU Arbitration Convention, to which Malta is a party, in relation to the elimination of double taxation in connection with the adjustments of profits of associated enterprises. Another potential avenue for dispute resolution has been created through the European Union Tax Dispute Resolution Mechanisms Directive Implementation Regulations, which provide for mechanisms to resolve disputes between Malta and other EU member states that may arise from conflicting interpretations of agreements and conventions that provide for the elimination of double taxation of income.

Local authorities are also proactive in assisting taxpayers in solving cross-border issues through the mutual agreement procedure (MAP) and follow OECD guidelines in this regard.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Malta's transfer pricing regime is relatively new; therefore, there is little practical experience insofar as transfer pricing claims are concerned.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

A Maltese subsidiary (ie, a Maltese company) is subject to tax on a worldwide basis, subject to any credits, relief or refunds that may be applicable on a case-by-case basis. However, branches of non-local corporations would only be subject to tax in Malta on income that is attributable to the branch. The computation of the taxable income follows the same principles adopted in respect of local companies. It would be possible for the branch to deduct a proportion of its head office expenses if these are related to the income-generating activities of the Maltese branch. By way of net effect, there should be a minor distinction between the taxation of a branch and a locally registered subsidiary.

5.3 Capital Gains of Non-Residents

Any gain or profit derived by any person not resident in Malta on a transfer of shares or securities in a local company is exempt from tax in Malta if the beneficial owner of such gain or profit is a person who is not resident in Malta and is not owned and controlled by, directly or indirectly, nor acts on behalf of, an individual or individuals who are ordinarily resident and domiciled in Malta.

5.4 Change of Control Provisions

Maltese tax legislation provides a type of change of control provision that is applicable to Maltese companies, namely value-shifting provisions. However, these are applicable in limited instances and should not come into effect vis-à-vis a disposal in a foreign indirect holding within the overseas group. Rather, they apply to certain changes to the share capital of certain Maltese companies.

For instance, when the market value of shares held by a person (the transferor) in a company is reduced as a result of a change in the issued share capital of the company or a change in voting rights attached to such shares, and this difference in value is passed onto other shares in or rights over the company held by another person (the transferee), the transferor shall be deemed to have made a taxable transfer of shares amounting to this value to the transferee. Any gains or profits shall be calculated for the transferor by taking into account the difference between the market value of the shares held immediately before and after said change.

These value-shifting provisions should not apply to bona fide commercial transactions in Maltese companies that do not own, directly or indirectly, immovable property situated in Malta.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

IFRS are used to determine the income of local companies from an accounting perspective. This determination is then subject to adjustments imposed by the ITA (deductions, exemptions, corrections for taxable period, etc).

5.6 Deductions for Payments by Local Affiliates

The ITA sets out a list of expenses that may be deductible for tax purposes. All expenses and outgoings incurred by a person or company, including management and administrative expenses, could be deductible to the extent to which such outgoings and expenses were wholly and exclusively incurred in the production of income. This connection between expenses and taxable income is also a requirement for the expenses expressly listed in this provision.

5.7 Constraints on Related-Party Borrowing

The tax-related anti-abuse measures based on ATAD that have been introduced in Malta include an interest limitation rule, which limits the deductibility of borrowing costs to a certain level. ATAD caps the deductibility of interest expenses at 30% of a taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). The limitation is not applicable where borrowing costs do not exceed EUR3 million and will also not apply to financial undertakings.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Malta tax-resident companies are subject to Maltese tax on their worldwide income and capital gains, irrespective of where their income or gains arise, and irrespective of remittance of such income or gains to Malta. The chargeable income of a company resident in Malta is subject to tax at a flat rate of 35%. Certain tax refunds and exemptions may be available, as further set out in **2.7 Capital Gains Taxation** and **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

In addition to the participation exemption (see **2.7 Capital Gains Taxation**), the ITA entitles companies registered in Malta to claim an exemption in respect of income that is attributable to a permanent establishment situated outside Malta or gains derived from the transfer of such a permanent establishment. The income attributable to the permanent establishment is calculated as though the permanent establishment were an independent enterprise operating in similar conditions and at arm's length. This exemption applies regardless of whether such a permanent establishment belongs exclusively or in part to the Maltese company.

6.2 Non-Deductible Local Expenses

Foreign income is, in principle, taxable at the level of local corporations. Therefore, no limitations on the deductibility of expenses are currently being contemplated.

6.3 Taxation on Dividends From Foreign Subsidiaries

The specific tax treatment of dividends sourced from foreign subsidiaries depends on whether the dividends fall within the scope of the participation exemption. If the participation exemption is applicable, such dividends would be exempt from corporate income tax.

Additional conditions for the participation exemption are applicable in the case of dividends. The participating holding must satisfy any one of the following additional three anti-abuse conditions:

- it is resident or incorporated in the EU;
- it is subject to foreign tax of a minimum of 15%; or
- it does not derive more than 50% of its income from passive interest and royalties.

Alternatively, it must satisfy both of the following two conditions:

- the shares in a body of persons not resident in Malta must not be held as a portfolio investment; and
- the body of persons not resident in Malta, or its passive interest or royalties, has been subject to tax at a rate not less than 5%.

Dividends that derive from an equity holding that does not qualify as a participating holding in relation to the participation exemption will be taxable in Malta, in the hands of the Maltese corporate shareholder, under the corporate income tax rate of 35%. Tax refunds may be claimed by the shareholder of the Maltese company in certain instances, as well as relief in respect of any double taxation, when these dividends have already been subject to a foreign tax or withholding tax in their country of origin.

6.4 Use of Intangibles by Non-Local Subsidiaries

In principle, any gains on the transfer of IP or profits from royalties derived from the licensing of IP would be subject to tax at the level of the local company. However, certain deductions may be applicable.

It may be useful to note in this context that Maltese tax law allows as a deduction against royalty income any capital expenditure on the acquisition of IP or IP rights incurred by a company (not exceeding the fair market value of such IP or IP rights) when it is proved to the satisfaction of the Commissioner for Tax and Customs that such assets are used or employed in the production of the income of such company.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

A number of tax-related anti-abuse measures based on ATAD have been introduced into Maltese legislation, including a controlled foreign corporation (CFC) rule that includes in the tax base of a Malta-based company diverse types of income not distributed by a foreign-based subsidiary or permanent establishment of the company, bringing these profits to tax in Malta, to the extent that said income derives from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage.

6.6 Rules Related to the Substance of Non-Local Affiliates

No specific regulations or guidance in Maltese legislation apply to the substance of non-local affiliates at this time.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Depending on the circumstances, Maltese companies can apply the participation exemption in respect of gains on the sale of shares in foreign companies or affiliates. If the relevant conditions are not satisfied, such gains would form part of the taxable income of the company that is calculable and taxable under the general rules.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The ITA sets out a general anti-avoidance rule, which is applicable to any scheme that reduces the amount of tax payable and is deemed by the Commissioner for Tax and Customs to be artificial or fictitious in nature. In such a case, the Commissioner has the competence to assess the tax payable by that person as if the scheme in question were not present.

The following tax-related anti-abuse measures based on ATAD have been introduced.

- Interest limitation rules that limit the deductibility of borrowing costs to a certain level. ATAD caps the deductibility of interest expenses at 30% of a taxpayer's earnings before EBITDA. The limitation is not applicable where borrowing costs do not exceed EUR3 million and will also not apply to financial undertakings.
- An exit tax rule that applies when a company either changes its place of residence or decides to transfer its assets/business to a different tax jurisdiction. In such cases, the taxpayer is liable to be taxed at an amount equal to the market value of the transferred asset.
- An extension to the current general anti-avoidance provision already contemplated by Maltese tax legislation aiming to further target artificial arrangements put in place for the main purpose of obtaining a tax advantage in conflict with the spirit of the law.
- A CFC rule that includes in the tax base of a Maltese-based company diverse types of income not distributed by a foreign-based subsidiary or permanent establishment of this company, bringing these profits to tax liability in Malta.
- New rules to counteract a broader range of arrangements relying on hybrid mismatches that exploit differences between the tax treatment of an entity or instrument under the laws of two or more jurisdictions, with a view to achieving double non-taxation.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

No regular routine audit cycle is in place. The Commissioner for Tax and Customs generally has the power to initiate an income tax audit in respect of any Maltese tax-resident person within five years from the end of the year in which the tax return of income or further return for that year was furnished.

9. BEPS

9.1 Recommended Changes

While not a member of the OECD, Malta can nevertheless be deemed to have implemented a number of the action points of the OECD's base erosion and profit shifting (BEPS) project within its tax framework, through the transposition of various EU Directives that in themselves take on board specific BEPS recommendations.

9.2 Government Attitudes

Malta has adopted a number of EU Directives, some of which appear to have been a reaction to the BEPS initiative. These include:

- the EU Administrative Co-operation Directive, which also includes country-by-country reporting;
- the EU ATAD, which includes various recommendations derived from the BEPS initiative;
- the anti-abuse rules in the Parent-Subsidiary Directive; and
- the sixth and seventh iterations of the Directive on Administrative Co-operation (*"DAC 6"*and *"DAC 7"*, respectively), which, in line with Action 12 of BEPS, introduce mandatory disclosure rules enhancing information transparency between tax authorities.

The ratification of the MLI (see **9.3 Profile of International Tax**) has further shown Malta's commitment to supporting developments in the areas of BEPS and anti-tax avoidance initiatives.

Malta is one of 137 members of the OECD Inclusive Framework that agreed to the *"Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy"* made by the OECD in October 2021. On 15 December 2022, following a unanimous agreement, EU member states, including Malta, adopted the EU Minimum Tax Directive (Pillar Two).

During the Budget Speech for 2024 held on 30 October 2023, the Minister of Finance confirmed that Malta will be exercising its right to apply the derogation allowed by the EU Minimum Tax Directive, as a consequence of which Malta will be deferring the introduction of the 15% minimum top-up tax under Pillar 2 past 2024. Accordingly, the three main components of the Pillar 2 rules, namely the Income Inclusion Rule (IIR), the Undertaxed Profits Rule (UTPR) and the qualified domestic minimum top-up tax (QDMTT), have not yet been transposed into Maltese law. As announced during the 2025 budget speech, plans are firmly underway for new forms of statutory grants and tax credits (referred to as qualified refundable tax credits (QRTCs)) to be introduced, as part of the Maltese government's commitment to ensure compatibility with rules imposed by both the EU and the OECD.

9.3 Profile of International Tax

International tax has a relatively high public profile in Malta, given recent international pressures. Malta presents a stable business climate for companies forming part of international groups aiming to establish a subsidiary or a company branch.

While fostering competitive tax policies, the Maltese authorities have continued to closely monitor developments in the OECD and BEPS projects over recent years. A relatively important BEPS-related development has been the ongoing ratification of the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, commonly referred to as the MLI. Malta was an early adopter of the MLI, in mid-2017.

At the time of signing the MLI, Malta defined 71 tax treaties as agreements it wishes to be covered by the MLI and opted to apply the following:

- the minimum standard, which includes provisions dealing with the purpose of covered tax agreements, the prevention of treaty abuse and MAP (and corresponding adjustments);
- provisions of the MLI in connection with capital gains from the alienation of shares or interests of entities deriving their value principally from immovable property; and
- provisions dealing with arbitration procedures subject to certain reservations.

9.4 Competitive Tax Policy Objective

The Maltese government and authorities continue to confirm Malta's commitment to countering aggressive tax planning structures. Mechanisms and compliance processes aimed at identifying and countering elements and arrangements indicating harmful tax practices and artificial structures are already in place, and are being implemented in Malta. Malta has introduced such measures and safeguards without compromising the fundamental principles on which the Maltese tax system is built. The transposition of the ATAD directives and other multinational initiatives resulting from the BEPS Project, such as the adoption of the two-pillar solution to address the tax challenges arising from the digitalisation of the economy, should see Malta continuing in this direction.

9.5 Features of the Competitive Tax System

As a member of the EU, the Maltese government is prohibited from supporting companies in a way that would grant them an unfair advantage over their competitors. These state aid rules, which emanate from Article 107 of the Treaty on the Functioning of the European Union (TFEU), include interventions in the form of grants, interest and tax reliefs and guarantees.

European law provides that state aid may exceptionally be justified, as in the case of Malta's tonnage tax system.

9.6 Proposals for Dealing With Hybrid Instruments

Malta is fully committed to counteracting abusive tax practices involving hybrid mismatches. For instance, following recommendations from the Code of Conduct Group in 2010, the Maltese tax authorities took action and published guidelines targeting abusive tax practices related to hybrid financial instruments giving rise to double non-taxation. The Commissioner for Tax and Customs has issued a guideline that clarifies the position vis-à-vis profit-participating loans, which states that interest thereunder is chargeable to tax under the provisions of the ITA. Interest received from sources situated outside Malta is taxable in Malta and does not benefit from an exemption related to income from participating holdings under the ITA or any other law. The guideline clarified that income from a loan – including a loan that has characteristics of both debt and equity – shall be considered to be interest and taxable under the ITA, and is not considered to be income from share capital or from an equity holding for tax purposes that could result in the relative income being exempt from tax in Malta. Malta has further transposed ATAD's anti-abuse measures, seeking to counteract a broader range of arrangements relying on hybrid mismatches.

9.7 Territorial Tax Regime

Companies registered in Malta are considered to be resident and domiciled in Malta, so are subject to tax on their worldwide income minus permitted deductions in the corporate income tax rate, which currently stands at 35%.

One of the introduced tax-related anti-abuse measures based on ATAD is an interest limitation rule that limits the deductibility of borrowing costs to a certain level. ATAD caps the deductibility of interest expenses at 30% of a taxpayer's earnings before EBITDA. The limitation is not applicable where borrowing costs do not exceed EUR3 million and will also not apply to financial undertakings.

9.8 Controlled Foreign Corporation Proposals

The consequences of CFC rules for investment and financial services-oriented countries must be carefully monitored at this time.

9.9 Anti-Avoidance Rules

It does not appear that the additional anti-abuse legislation implemented in this area, such as a double taxation convention limitation, has had any significant effect on the current level of inbound and outbound investments in Malta.

9.10 Transfer Pricing Changes

The introduction of formal transfer pricing rules (see **4.4 Transfer Pricing Issues**) has undoubtedly brought about certain changes within Malta's tax regime, with effect from 1 January 2024.

Profits from IP are generally not a source of controversy in the Maltese tax jurisdiction (other than the old patent box regime, which has now been replaced by a new regime).

9.11 Transparency and Country-by-Country Reporting

Malta supports proposals in country-by-country reporting and related areas, including with respect to what they aim to address. The exchange of information between tax authorities and tax subjects can help the Maltese tax authorities to more effectively identify and combat abusive structures that may involve Malta.

Malta has adopted country-by-country reporting regulations and applies these regulations to companies established within the Maltese jurisdiction. A parent company of a multinational entity established in Malta is obliged to file an annual report with the Commissioner for Tax and Customs when the consolidated turnover of the group exceeds EUR750 million worldwide. Such a yearly report is compliant with the requirements of the OECD and covers all the jurisdictions in which the parent company and each subsidiary conducts business activities.

9.12 Taxation of Digital Economy Businesses

In December 2022, EU member states reached an agreement to implement, at the EU level, the minimum tax component (Pillar Two) of the OECD's global international tax reform initiative. Malta will, however, be deferring the introduction of the 15% minimum top-up tax under Pillar 2 past 2024, as permitted under the EU Minimum Tax Directive. For the time being, therefore, there do not seem to be any concrete plans to alter Malta's current corporate tax system. Accordingly, the full imputation system of taxation (see **3.4 Sales of Shares by Individuals in Closely Held Corporations**) and the tax refund system will continue to apply.

9.13 Digital Taxation

The implementation of any of the proposed BEPS actions should be carefully assessed prior to the introduction of any new measures or laws. Once such measure or laws have been introduced, it might not be possible to undo their relative effects and consequences, and trying to do so may result in large sunk costs for society and businesses.

9.14 Taxation of Offshore IP

Malta has not yet introduced provisions dealing with the taxation of offshore IP deployed within its territory.

Trends and Developments

Contributed by:
Juanita Brockdorff
Brockdorff Grech Law

Brockdorff Grech Law is a boutique law firm providing international and domestic tax advice, as well as corporate and company law support. The firm is known for the experience held and hands-on approach adopted by its two partners, with both founding lawyers also being known for their solution-oriented mindset. Each partner draws from a breadth of experience gained over the years while working at international outfits based in Malta. The firm's clients are sourced through word-of-mouth recommendations, and through other local and foreign service providers requiring specialised support for their client base. The firm provides guidance on international tax structuring, acquisitions and exits to multinationals, family offices, collective investment vehicles, insurance undertakings, pharmaceutical and biotechnology enterprises, gaming providers and IT businesses. It also supports high net worth individuals in estate planning by means of trusts and foundations. Brockdorff Grech Law supports taxpayers in managing the exchange of information requests, as well as multilateral and domestic tax controversies.

Author

Juanita Brockdorff holds a Master of Laws in International Tax Law and spent 13 years as an international tax partner at a Big Four firm advising on international corporate tax optimisation, exchange of information, cross-border double tax relief and servicing multinationals in financial services and gaming, as well as advising high net worth individuals on succession planning. Through her role at the Institute of Financial Services Practitioners (IFSP; chair of the tax committee for over a decade), Juanita provided advice to the government on tax legislation. Juanita used to lecture, currently acts as the branch secretary of the International Fiscal Association (IFA) in Malta and is a member of STEP.

Contributed by: Juanita Brockdorff, **Brockdorff Grech Law**

Brockdorff Grech Law

Aragon House
Dragonara Road
St Julians
STJ 3140
Malta

Tel: +356 9983 5021
Email: jb@brockdorffgrechlaw.com
Web: www.brockdorffgrechlaw.com

Recent Developments in Maltese Taxation of Corporate Income

In recent years, Malta has continued along a path of re-establishing its reputation as a domicile of choice for international investment, making efforts to be recognised as a compliant jurisdiction mindful of its international obligations towards the EU as a member state, and more broadly towards treaty partners, and introducing or updating legislation to attract foreign investment.

Investment management

Developments targeted at the financial service sector concern the nature of regulation with ramifications for taxpayers in the fund industry. The following two amendments to the asset management field in 2025 have the effect of increasing the tax attractiveness of Malta as a fund domicile.

Firstly, in February 2025, the Maltese financial regulator introduced the possibility of establishing regulated funds as limited partnerships without separate legal personality, known as special limited partnership funds (SLPFs). For the first time in Malta, collective investment vehicles can be set up as limited partnerships not constituting a separate juridical person. Non-retail funds aimed at qualified and professional investors may be either fully licensed or notified, with EU/European Economic Area (EEA) passporting granted to alternative investment funds (AIFs) and notified alternative investment funds (NAIFs). Though guidance by the Malta Tax and Customs Administration (MTCA) is yet to be issued, when set up as SLPFs, fund income should either be exempt or not taxed at the fund level, instead being passed through to investors – who are in turn taxed according to their jurisdiction of residence – eliminating exposure to double taxation. For securing tax residence in Malta, the SLPF's general partner (GP) and alternative investment fund manager (AIFM) should be resident in Malta. Notably, Malta does not impede the flow of funds by levying withholding taxes, nor does it impose subscription taxes on a fund's net asset value (NAV).

Against this background, Malta is expected to become more attractive for redomiciling offshore funds to the EU via the passporting ability provided by the AIFM framework. An SLPF provides the contractual flexibility often demanded by private equity – though also being of relevance to venture capital, real estate funds and family offices – through a private limited partnership agreement drawn up between the general and limited partners and not necessarily governed by Maltese law.

Secondly, as of January 2025, setting up notified professional investor funds (NPIFs) – ie, funds for professional and qualified investors without passporting, will be allowed without the requirement of appointing an external manager; it will be sufficient to merely appoint an internal investment committee (ie, to be self- or internally managed). Furthermore, such committee need not have a local member, though a local member would be expected at board level. An NPIF, even when not set up as an SLPF, will be able to access an exemption from tax on corporate profits, other than income and gains related to real estate in Malta, as already afforded to non-prescribed funds (namely funds with assets under management located, for the most part, outside of Malta).

Insurance undertakings adopting International Financial Reporting Standard 17

Mindful of the impact of international accounting developments on the insurance industry, and in order to address the tax impact of adopting International Financial Reporting Standard (IFRS) 17, Malta introduced subsidiary legislation in 2024, applicable from the financial year starting 1 January 2023, with a view to prescribing the computation of total income for insurance undertakings adopting IFRS 17. Such rules provide a means of managing the impact of changes in the recognition of profits under IFRS 17 compared to the previous standard, IFRS 4.

In view of the substantial one-off impact of adopting IFRS 17, resulting in either significant gains or losses in the first year of implementation, Malta provided support for the insurance industry through a transitory measure allowing for deferral. In this sense, the country introduced measures allowing insurance undertakings the option to spread tax payable on adoption gains over a maximum period of five years, starting from the year immediately following the first accounting period for which IFRS 17 would be applied. The MTCA also issued a guidance note providing additional guidance on the manner of election for the deferral, including instalment settlement dates.

Investment services and insurance

With the aim of enabling business to attract skilled resources from abroad, investment services including asset managers, fund administrators, custodians, depositaries and investment advisory entities, as well as insurance entities including insurance managers and brokers, may secure an indirect benefit from engaging expatriate resources in their Maltese enterprises. In this respect, while still entitled to claim deductions against their corporate taxable income, certain fringe benefits provided to said expatriates are exempt from personal taxation.

In 2024, the guidelines on the application of the aforementioned optional exemption from income tax were updated. The principal update provides a clarification in relation to the tax exemption on fringe benefits that an investment services expatriate or insurance expatriate may opt to claim, in that, where an exemption is to be claimed, an employer will not be obliged to withhold income tax that would have resulted from said fringe benefit.

An investment services expatriate and an insurance expatriate may choose to not be subject to Maltese tax in respect of the following income (otherwise liable to tax) relating to expenditures incurred for the benefit of the expatriate, or their immediate family, by the investment service or insurance company for the first ten years of assessment from when said expatriate becomes liable to Maltese tax. Expenses incurred for the benefit of the expatriates and their immediate family members include removal costs when relocating to or from Malta, accommodation expenses incurred in Malta, cost of travel to or from Malta, providing a motor vehicle for use in Malta, a subvention/cost of living allowance of not more than EUR600 per month, medical expenses, medical insurance and children's school fees.

Furthermore, said expatriates will be deemed to be non-resident for the purposes of acceding to exemptions from taxation of interest, royalties and capital gains on the disposal of units in collective investment schemes and shares or securities in companies or interest in partnerships that are not property companies or partnerships holding real estate interests in Malta.

Update to the full deduction on intellectual property expenditure

Intellectual property (IP) is more often than not the principal asset of value in a business. Malta demonstrated its cognisance of such fact by its tax treatment of IP expenses, introducing accelerated tax amortisation from financial year 2023. In September 2024, the accelerated tax depreciation available on IP expenditure was updated and clarified by means of amending subsidiary legislation. The amendments consist of provisions governing deductions for capital expenditure on IP and IP rights, establishing a new definition of *"qualifying income"* for the purpose of the deduction. Said income is determined in a broad manner as income produced through the use or employment of the IP or IP rights chargeable to tax in accordance with the provisions of the Income Tax Act before claiming relevant deductions.

Accelerated amortisation refers to the difference between the total capital expenditure incurred in a year on qualifying IP and the standard amortisation. The amendments confirm that accelerated amortisation can only be deducted against income produced through the use or employment of the qualifying IP, generally subsequent to the utilisation of other available deductions. In the event that accelerated amortisation for a year exceeds the qualifying income, unutilised accelerated amortisation would not be available as a deduction for such year and would have to be carried forward, upon which it would be converted into standard amortisation, a point regulated in guidance issued in the same month complimenting the rules.

The amendments also expand on the manner in which the full deduction may be taken, including the part deductible under ordinary tax rules or standard amortisation (where a deduction for amortisation of expenditure of a capital nature on IP or any IP rights may be claimed over a period of not less than three consecutive years), where standard amortisation may be deducted in full by the taxpayer in the first year even when the taxpayer would not have sufficient chargeable income to give full effect to the entire standard amortisation. In contrast, any unutilised accelerated amortisation, or any excess of the remaining part thereof, resulting in a 100% deduction in the first year (of incurring expenditure on or using IP in generating income), would have to be carried forward.

Furthermore, it stands to reason that the clarificatory amendment provides that the aggregate of the standard and accelerated amortisation is not allowed to exceed the amount of capital expenditure on qualifying IP. Other amendments to the accelerated amortisation cover the treatment of expenditure on IP brought forward from previous years, co-ordinating deductions.

Guidance published by the Malta Tax and Customs Administration (MTCA) in September 2024 confirms flexibility for taxpayers, who upon incurring expenditure in respect of more than one IP or IP right may elect to claim a full deduction in respect of each asset independently. Thus, a different approach of selecting between standard and accelerated tax amortisation may be adopted by a taxpayer in relation to separate IP assets.

Seed investment tax credits

In an effort to attract innovation, Malta had introduced seed investment tax credits for start-ups. Though granted to individuals resident or operating in Malta as credits against their tax liability, seed investment tax credits benefit the target company being invested in, facilitating its raising of equity capital. In 2024, seed investment tax credits were extended to the end of 2026.

Under the seed investment scheme, qualifying investors are granted access to a tax credit equivalent to 35% of the aggregate value of the investments in one or more qualifying companies, with investors receiving a maximumtax credit of EUR250,000 in any single tax year. The benefit is capped at a maximum investment in qualifying companies of EUR5 million. Under the scheme, a new or recently incorporated company based in Malta with assets of less than EUR250,000 and no more than ten employees can raise up to EUR750,000 via the seed investment scheme.

To preclude abuse of the scheme, investments would have to be held for at least three years for qualification, with the investor being unrelated to the company prior to making the investment. Also, the investment would have to be made within the first two years of the company being issued with a compliance certificate. Additionally, capital gains made within three years of an investment would be calculated on the basis of the higher of the market value of such investment and the consideration received by the qualifying investor, with no deductions allowed for losses on the disposal or liquidation of investments.

Pillar 2: limited transposition

To soften the compliance burden on multinational groups, Malta opted to take advantage of the temporary derogation granted to EU member states with fewer than 12 multinational groups headquartered in a given member state. Malta has transposed the global minimum tax on large multinationals, limited to the mandatory rules applicable to all member states under the Pillar 2 Directive. The relevant regulations apply to constituent entities (CEs) located in Malta and members of a multinational enterprise (MNE) group, or of a large-scale domestic group, with an annual group-wide revenue of EUR750,000,000 or more.

Malta opted to avail of the temporary exception for up to six consecutive fiscal years from 31 December 2023, allowing it to delay the application of the income inclusion rule (IIR) and the undertaxed profits rule (UTPR). However, in ensuring compliance, limited transposition obliges domestic ultimate parent entities (UPEs) of in-scope MNE groups to nominate a designated filing entity in another member state, or a third country, and for CEs to provide the information required for the application of such rules by other jurisdictions. In other words, since the so-called top-up tax return cannot be filed in Malta during the derogation, transposition requires CEs located in Malta to notify the MTCA of which entity is responsible for filing the top-up tax information return, and of the country such entity is located in. Guidance issued by the MTCA expounds on the obligation, ensuring proper functioning of the Directive.

Recently, the MTCA's complimentary guidance has provided clarification regarding the interaction between domestic legislation and the transposition framework. Guidelines have expressly confirmed that domestic law will continue to apply insofar as Malta continues to defer adopting the IIR and UTPR, with all provisions of the Directive being transposable into domestic legislation only at the earliest of the following points in time:

(a) the lapse of the maximum six-year derogation period;
(b) when Malta rescinds such election prior to the end of the derogation period; or
(c) when Malta elects to introduce a qualified domestic top-up tax (QDTT).

In relation to the last option, the guidance note states that in the circumstance that Malta introduces a QDTT prior to the lapse of the events under (a) and (b) above, the application of the IIR and UTPR provisions would not be triggered; their deferral would continue until conditional event (a) or (b) occurred. Such clarification provides additional comfort to in-scope corporate taxpayers on the delayed timing of the Pillar 2 rules. Incidentally, in taking cognisance of the impact of such rules, the guidance note provides further reassurance that should Malta rescind the election or introduce a QDTT, such events would be communicated in advance in order to grant taxpayers sufficient time for adoption and adaptation.

Obligations under the EU's Directive of Administrative Cooperation 7

Digital platforms

Markets are increasingly online. Reflecting this phenomenon, subsidiary legislation published in Malta in early 2025 replaced the earlier 2023 transposition of certain provisions of the EU Directive of Administrative Cooperation (DAC), aligning the law with the seventh amendment to said Directive, extending EU transparency rules to digital platforms and imposing reporting obligations on platform operators with effect from 20 January 2023. The DAC7 Directive introduced an obligation for digital platform operators to provide information on income gained by sellers from relevant activities provided through such platforms. DAC7 imposes reporting obligations on the operators of platforms allowing sellers and users to interact to facilitate immovable property rental, the provision of personal services for time- or task-based work, the sale of goods and the rental of any mode of transport. Platform operators have been obliged to collect said information since the 2023 reporting period, with reporting obligations extending to both cross-border and domestic border activities, as well to third-country platform operators.

Guidance for digital platforms was issued in 2023 and has since been updated twice by the MTCA. The introduction in the amendments of a mechanism allowing platform operators to re-register with the MTCA following the revocation of their registration constitutes a laudable addition enabling adherence with ongoing compliance obligations.

Royalties

A lacuna in reporting royalties in the Directive was plugged by DAC7, and the same update to Maltese subsidiary legislation expressly added information on royalties received by residents of member states to the specific categories of income and capital. EU member states are required to exchange such information with other member states retroactive to 1st January 2024.

Joint audits

Furthermore, DAC7 includes a legal framework to enable joint audits, which was transposed by the aforementioned update to the subsidiary legislation. In a joint audit, countries' tax authorities come together to form a single audit team to conduct a taxpayer examination. Since joint audits should result in faster issue resolution, more streamlined fact-finding and increased compliance, Malta signalled its continued commitment to EU-wide co-operation in tax enforcement through the update.

Enforcement

Last but not least, a recently published legal notice revised administrative penalties upwards for breaches of obligations under its purview, giving the rules more bite.

Double tax treaty network

Expanding its treaty network, as well as updating its existing one, remains a priority for Malta, reflected in notices of the coming into force of a new treaty and of amendment of the protocol of the existing one.

Malta-Netherlands (Cura ç ao)

By means of subsidiary legislation published in 2024, 1 September 2024 was indicated as the date of coming into force of the Malta double tax treaty with the Netherlands in respect of Curaçao. Given the number of online gaming entities with a presence in both jurisdictions, such treaty is pertinent to defining each jurisdiction's tax remit.

The double tax treaty sets the maximum Curaçao withholding tax at 0% on dividends distributed to a Maltese resident corporate shareholder directly holding at least 10% of the capital of the Curaçao company declaring the dividends. In all other cases, the Curaçao withholding tax cannot exceed 5%.

At the domestic level, Malta does not levy withholding tax on dividends, interest and royalties distributed to non-residents. The quid pro quo inserted in the treaty provides that interest and royalties arising in Curaçao would be taxable only in Malta.

Malta-Switzerland

In 2024, a commencement notice was published by means of which the protocol amending the double tax treaty between Malta and the Swiss Confederation was deemed to have come into force on 3 November 2021. The protocol implements the minimum standards for double taxation agreements of the OECD's base erosion and profit shifting (BEPS) project, and contains an anti-abuse clause that refers to the main purpose of an arrangement or transaction, thus ensuring that the treaty is not abused in such instance.

Through pursuing the above developments in its tax treaty network, Malta has continued to reiterate its commitment to international compliance while ensuring that its tax system facilitates, rather than hinders, global trade by addressing and alleviating instances of double or multiple taxation.

MEXICO

Law and Practice

Contributed by:
Edgar Klee and Joel Gonzalez Lopez
Haynes and Boone, S.C.

Contents

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Haynes and Boone, S.C. has nearly 700 lawyers who practice across 19 global offices located in Mexico City, California, Colorado, Illinois, New York, North Carolina, Texas, Virginia, Washington D.C., London, and Shanghai. The firm's Mexico City office has been serving clients for 30 years, with 25 lawyers specialising in: tax; M&A; joint ventures; estate planning; real estate; finance; trade; regulatory and compliance; labour and employment; dispute resolution and litigation in a variety of sectors, including: energy; private equity; manufacturing; chemical; automotive; aviation; shipping; telecommunications; banking and financial services; retail; franchising; and technology. Its recent tax work includes advising a major automaker on tax compliance matters in Mexico, advising a major airline on customs and tax audits and advising several shipping and real estate companies on tax matters.

Authors

Edgar Klee is a partner in the tax practice group at Haynes and Boone, S.C. in the Mexico City office. He has been practising law for 25 years and focuses on offering sophisticated corporate tax advice on international taxation, tax counselling for individuals, legal structuring, customs and foreign trade and general tax litigation. He is a member of the Mexican Bar (Barra Mexicana Colegio de Abogados), Public Accounting Academy for Tax Studies (Academia de Estudios Fiscales de la Contaduría Pública) and the International Fiscal Association (IFA). He frequently speaks and writes on tax-related issues.

Joel Gonzalez Lopez is an associate at Haynes and Boone, S.C. in Mexico City. He has been practising law for 15 years and his practice focuses on providing corporate and tax legal advice to companies in Mexico, including on corporate and regulatory compliance, corporate tax matters, foreign investment and antitrust regulations, internal investigations, mergers and acquisitions, restructurings, contracts and regulatory issues in general. He has also represented clients in complex internal investigations and regulatory compliance matters, as well as cross-border transactional and M&A work. Additionally, he has been involved in corporate, contractual and tax strategies developed for both domestic and international corporations, the design and implementation of efficient corporate structures that involve international estate planning, international tax and cross-border mergers and acquisitions. His practice focuses on Mexican investment structures, cross-border transactions, tax treaty planning, withholding obligations and reporting compliance on domestic and international transactions.

Contributed by: Edgar Klee and Joel Gonzalez Lopez, **Haynes and Boone, S.C.**

Haynes and Boone, S.C.

Torre Chapultepec Uno
Av. Paseo de la Reforma 509
Piso 21
Col. Cuauhtémoc
Alcaldía Cuauhtémoc CP. 06500
CDMX Mexico

Tel: +52 55 5249 1800
Fax: +52 55 5249 1801
Email: edgar.klee@haynesboone.com
Web: www.haynesboone.com

HAYNES BOONE

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

There are various types of corporate forms in Mexico, and the most common is the *Sociedad Anonima* (commonly referred to as an SA). There is also a *Sociedad de Responsabilidad Limitada*, also referred to as an SRL, which is analogous to a US limited liability company. In respect of both types of entities, the liability of their shareholders and members are limited.

A more sophisticated form of SA is a *Sociedad Anónima Promotora de Inversiones* or SAPI. The SAPI has a more modern corporate governance framework than an SA and offers more flexibility to set up differentiated rights related to dividend distribution among categories of shareholders.

From a Mexican tax perspective, these entities are taxed as a separate entity from their members/shareholders and generally have the same tax treatment (30% on profits) and have identical income recognition, applicable deductions and foreign tax credit rules.

1.2 Transparent Entities

There are no Mexican legal entities that are treated as transparent for tax purposes. However, there are certain *"agreements"* that give this treatment, such as the *Fideicomiso* (which has some similarities to the common law trust).

Fideicomisos provide a flexible and efficient way to hold a separate patrimony from the settlor and their beneficiaries and represent an efficient form of administration of assets. They are often used in real estate and investment transactions.

From a tax perspective, *Fideicomisos* that generate mostly passive income are completely transparent. However, those which carry out business activities (active income, ie, sale of assets) will need to calculate the taxable profit and allocate it to the beneficiaries.

Specific examples of *Fideicomisos* are:

- *Fideicomisos de Inversión en Bienes Raíces* (FIBRAs), which are real estate investment

vehicles that offer a tax-efficient way to invest in income-generating real estate. They distribute most of their income to shareholders and benefit from tax transparency; and
- *Fondos de Inversión* (investment funds), which are investment vehicles providing a pooling mechanism for investors, allowing them to invest in a diversified portfolio. They are often used by private equity firms and hedge funds because of the flexibility and tax advantages derived from their tax transparency.

Mexican income tax law recognises tax transparency for foreign entities solely for the purposes of determining the taxable income generated by Mexican residents abroad from these entities.

1.3 Determining Residence of Incorporated Businesses

Mexican law follows the *"place of effective management"* criterion to determine the Mexican tax residency of an entity. This refers to the location where key decision-makers, who control, manage and operate the entity and its activities are based. Consequently, a foreign entity is deemed a Mexican taxpayer if its *"place of effective management"* is in Mexico.

As for transparent foreign entities, their tax transparency is not recognised and will be taxed as any other legal entity (not considering that the tax effect is on their members/shareholders), apart from the exception outlined in **1.2 Transparent Entities**.

Under most of the tax treaties that Mexico has in place, tax residency will also be determined by the place from which the company or entity is effectively managed. Tax transparency is not recognised under most of those treaties (there are certain exceptions such as the tax treaty with Germany). With respect to the Mexico-US tax treaty, a certain transparency effect is recognised for LLCs, as long as its members are resident in the US.

In the case of a dual resident company, under most of the tax treaties entered into by Mexico, a mutual agreement procedure (MAP) is required. The Mexico-US tax treaty will directly deny treaty benefits.

1.4 Tax Rates

Incorporated businesses pay a 30% income tax rate.

According to Article 4-B of the Income Tax Law, Mexican entities must regard the income generated abroad by tax transparent entities or legal vehicles as taxable income (in some cases only the profits), according to the degree of participation by the Mexican resident, even if these entities or legal vehicles do not distribute the income. The tax triggered will be 35% + 10% for dividend distribution.

If taxpayers have operations through these entities or legal vehicles (transparent or not) they will have to file a tax report with the Tax Administration Service. The income will be directly attributed to the Mexican taxpayer and the tax paid abroad by these entities or vehicles will be considered as paid by the Mexican resident only for the taxable income that was considered.

The tax paid will create a tax credit for the Mexican resident in the proportion that the income received by the entity or legal vehicle was considered by the taxpayer as taxable income.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are calculated by considering all taxable income (on an accrual and worldwide basis) and reduced by authorised deductions (including the profit-sharing payment made in the last year).

Income encompasses all increases in wealth. Entities also need to consider inflationary gains. Dividends distributed from a Mexican entity will not be considered as income.

Normal deductions or business expenses are allowed (depreciation and amortisation of assets, cost of goods, interest payments, other expenses, etc). To qualify for these deductions, there are general requirements that must be fulfilled. These include ensuring that the expenses are properly documented, they are strictly necessary for the business's operation and they are supported by relevant invoices. Additionally, each type of deduction has specific requirements that must be met. For example, there are particular criteria for deductions related to bad debts, charitable contributions and interest expenses.

Taxpayers are required to make advance income tax payments on the 17th of each month. These advance payments should be made on the basis of estimated annual taxable income. Advance payments are not required during the first year of operation of a business.

2.2 Special Incentives for Technology Investments

Mexico does not have specific incentives such as a patent box or special tax treatment exclusively designed for technology investments. However, Mexico, like many countries, has a general framework of tax incentives and deductions that may indirectly benefit technology-related investments and research and development (R&D) activities.

Some of the general incentives that could be relevant to technology investments in Mexico include deductions for R&D expenses incurred by businesses. Eligible expenses may include costs related to technological innovation and development.

2.3 Other Special Incentives

Accelerated Depreciation

Businesses in Mexico may benefit from accelerated depreciation for certain assets, including technology-related equipment and machinery.

Maquila Programme

While not specific to technology, the Maquila programme in Mexico allows companies to operate manufacturing activities with certain tax benefits. This programme is often utilised by industries with significant technology components.

Investment Promotion Programmes

Mexico has various investment promotion programmes that provide general incentives for companies making investments in the country. While not technology-specific, these programmes may indirectly benefit technology-related investments.

2.4 Basic Rules on Loss Relief

When authorised deductions, in addition to the participation of workers in profits (PTU) paid, exceed the accumulable income in a fiscal year, the difference is considered a fiscal loss for that year. This fiscal loss can be offset against the fiscal income of the following ten fiscal years until it is exhausted.

Additionally, if a company fails to offset the fiscal loss from previous years in a given fiscal period, when it had the opportunity to do so, it will forfeit the right to offset it in subsequent fiscal years, up to the amount that could have been utilised previously.

The right to offset tax losses exists provided there is a tax profit, and none of the circumstances limiting their offsetting are met. These circumstances are:

- a change in shareholders or partners exercising over 51% of the voting rights of the entity, or offsetting only against profits obtained from the same line of business in which the loss was generated in cases of mergers where the loss-making company acts as the merging entity;
- a prohibition on transferring losses in the case of a merger if the loss-making company acts as the merged entity; or
- the right to transfer them, exceptionally granted in the case of a split, depending on certain forms and amounts of transfer.

The tax authority may presume an improper transfer of the right to amortise tax losses when a taxpayer is involved in corporate restructurings or changes of shareholders, resulting in a significant decrease in its material capacity to operate.

This presumption is triggered if certain conditions are met, such as obtaining greater tax losses than the value of assets or a sudden increase in deductions from related-party transactions, among others. The taxpayer will be notified of this presumption and will have the opportunity to defend itself. If it fails to refute the facts, a list of affected taxpayers will be published, confirming the improper transfer of tax losses and the inadmissibility of their decrease. Taxpayers are given a period to regularise their situation before the authority can exercise its verification powers and impose penalties.

2.5 Imposed Limits on Deduction of Interest

Under the general regime, taxpayers can benefit from deductions such as accrued interest during the tax year without adjustment. To qualify for the deductibility of interest payments, the taxpayer must adhere to several conditions. These are as follows.

- The principal amount must be invested in the primary activity of the borrower (directly associated with their business).
- If the interest comes from abroad, the corresponding withholding tax must be applied.
- The taxpayer must issue a digital tax receipt detailing payment amounts and the tax withheld from the lender.
- The taxpayer must submit a return, known as a multiple informative declaration, by February 15 of each tax year, disclosing loan-related information and the interest paid to the foreign tax resident.

The Income Tax Law imposes a limitation on interest deductibility, applying to the net interest amount (taxable accrued interest less deductible interest) exceeding 30% of adjusted taxable profit. This limitation only applies to taxpayers whose interest accrued from debt in the fiscal year exceeds MXN20 million.

This limitation does not apply to members of the financial system. Any non-deductible net interest will be able to be carried forward for up to ten years until the outstanding amount has been paid.

Under thin capitalisation rules, interest paid by a Mexican resident to a non-resident related-party is non-deductible for income tax purposes if the debt exceeds three times the equity of the Mexican subsidiary (thin capitalisation rules only apply to related-party transactions).

2.6 Basic Rules on Consolidated Tax Grouping

Limited tax grouping rules exist and enable Mexican entities holding 80% directly or indirectly of equity to apply for authorisation to offset losses against profits of other entities of the group for a period of three years, considering the deferred income payable at the end of the period.

2.7 Capital Gains Taxation

Capital gains from the sale of shares or other assets are generally considered part of the company's taxable income. The basic rules for calculating capital gains on the sale of shares include deducting the cost of acquisition from the sale price. The resulting amount is then subject to corporate income tax.

There are no specific exemptions or relief for capital gains from the sale of shares under Mexican law. Specific tax treaties might offer relief.

2.8 Other Taxes Payable by an Incorporated Business

Besides income tax, several other taxes may be payable by an incorporated business.

VAT

This is a consumption tax that is levied on the sale of goods, the provision of services, use of goods and the importation of goods into Mexico. The standard rate is 16% but there are reduced rates and exemptions for certain goods and services.

Special Tax on Production and Services (IEPS)

This is an excise tax on the production and sale of specific goods and services. It applies to items such as gasoline, diesel, tobacco, alcoholic beverages and certain energy products and services.

Local Transfer Tax (ISAI)

This tax is levied on the acquisition of real estate and is typically paid by the buyer.

Social Security Quotas

Employers are required to contribute to social security and other employee-related taxes, including contributions to retirement funds and housing funds.

Payroll Tax

This is a local tax that is currently effective in the 32 states of Mexico and represents one of their principal sources of income.

It is levied on all employers for the payment of payroll or salaries, ie, it is imposed on employers for the employment relationships they maintain, including the payment of salaries and other items corresponding to their obligations with their employees.

Environmental Taxes

Environmental taxes are imposed at the estates level. These taxes aim to regulate and discourage greenhouse gas emissions by establishing financial obligations based on the volume of pollutants released into the atmosphere. Local governments often determine the taxable emissions threshold and applicable rates, aligning their regulations with broader environmental policies and international commitments. Compliance with these local tax obligations typically requires entities to register their emissions and fulfil reporting requirements to ensure proper enforcement.

2.9 Incorporated Businesses and Notable Taxes

See **2.8 Other Taxes Payable by an Incorporated Business**.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses owned by individuals normally operate in a corporate form. In certain transactions, the use of a non-corporate form such as the Mexican trust or *fideicomiso* is common. The *fideicomiso* is particularly useful in cases involving foreign ownership restrictions, estate planning, asset protection or structured financing arrangements. For example, in the real estate sector, foreign investors often acquire property in restricted zones through a *fideicomiso* to comply with Mexican legal requirements. Similarly, business owners may use a *fideicomiso* to manage assets, facilitate succession planning or structure investment vehicles in a tax-efficient manner.

Additionally, closely held businesses may also consider hybrid structures, such as joint ventures or contractual arrangements, to achieve specific commercial or regulatory objectives. The choice of structure depends on factors like tax implications, liability concerns, governance preferences and the nature of the business activities.

3.2 Individual Rates and Corporate Rates

The corporate rate is 30% plus the 10% employee profit sharing rate. Individual professionals will be taxed at 35% (in certain cases a 2.5% special regime applies for individuals if their annual profits are lower than MXN3 million). Any dividend distribution will be subject to an extra 10%.

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules that prevent closely held local corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Capital gains are taxable by subtracting the tax basis adjusted by inflation from the purchase price and reducing it with certain adjustments that consider net retained earnings. There are certain variations on how to calculate the basis if the shares have been owned for less than 12 months.

Dividends are taxable for individuals at the applicable tax rate (maximum of 35%). The corporate tax rate paid (30%) at the level of the entity can be credited. An extra 10% has to be withheld by the entity paying the dividend.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

A tax rate of 10% is applicable on the net gain realised from the sale of shares in corporations on the Mexican stock exchange or other publicly traded companies.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Mexican entities that make payments to foreign entities or individuals are required to withhold and pay tax before the tax authorities on behalf of the recipient.

Dividend Distribution for Mexican Subsidiaries

If the dividend is paid to foreign residents it will be subject to an additional 10% withholding rate.

Capital Gains

The eventual sale of the shares of the Mexican subsidiary will trigger a tax of 25% on the gross amount or 35% on the net profit if the non-resident has a representative in Mexico. A tax return related to the sale must be filed and a fiscal opinion obtained from a Mexican public accountant certifying that the reported profit has been calculated correctly.

Interest

If a foreign shareholder granted a loan to the Mexican subsidiary, interest is considered to be sourced in Mexico where the capital is placed or invested in Mexico or where the party paying the interest is a Mexican resident or a non-resident with a permanent establishment.

Interest paid to a non-resident is subject to withholding tax at rates ranging from 4.9% to 35%.

A 4.9% rate applies to interest paid to foreign banks registered as banks in Mexico and resident in tax treaty countries and interest paid to non-resident financial institutions in which the federal government owns a percentage of the paid-up capital, provided certain conditions are satisfied and they are the beneficial owners of the interest. The 4.9% rate also applies to interest paid in respect of publicly traded securities in Mexico and securities publicly traded abroad through banks and stockbroking firms in a country that has concluded a tax treaty with Mexico. However if these conditions are not satisfied, the rate is 10%.

A 15% rate applies to interest paid to reinsurance companies and interest on finance leases.

A 21% rate applies to interest that is not subject to the 4.9% or 10% rates and interest paid to non-resident suppliers financing the acquisition of machinery and equipment that is included in the fixed assets of the acquirer.

A 40% rate applies to interest paid to a related-party located in a tax haven.

A 35% rate applies in all other cases.

Royalties

Payments made for technical assistance, know-how, use of models, plans, formulae and similar technology transfer, including use of commercial, industrial or scientific information or equipment are considered royalties.

Royalties paid to non-Mexican residents are deemed Mexican-sourced when the payer is a Mexican resident for tax purposes. A 25% income tax withholding rate on the gross amount of the transaction would be applicable unless the rate is reduced under an applicable tax treaty.

Payments carried out by a Mexican subsidiary to foreign shareholders for the right to use a brand or technology would be considered royalties for income tax purposes and, generally, the former would have to withhold the corresponding income tax.

As of 2022, the concept of royalties has included the right to an image, specifying that for these purposes this right implies the use or concession of use of a copyright to a literary, artistic or scientific work.

In this regard, the tax treatment applied to royalties also extends to the taxable income resulting from the exploitation of the copyright associated with the image itself.

Know-How

Know-how is considered to be the transfer of confidential information regarding industrial, commercial or scientific experience.

The payments derived from this transfer would be considered royalties subject to a 25% income tax rate. However, a preferential income tax rate provided in the relevant tax treaty could be applied.

Technical Assistance

Technical assistance is defined as the rendering of independent personal services whereby the provider undertakes to provide non-patentable knowledge, which does not involve the transmission of confidential information relating to industrial, commercial or scientific experience, and undertakes to participate with the provider in the application of this knowledge.

A 25% withholding tax rate is applicable to technical assistance payments.

In general, the different tax treaties entered into by Mexico do not specifically contemplate the tax treatment of technical assistance (except in the case of Belgium and Holland), so in general terms it should fall under the concept of business benefits (Article 7 of the treaties), independent personal services (Article 14 of the treaties) or other income (generally Article 21 of the treaties). If it is included in Articles 7 or 14, the payments derived from it can only be subject to taxation in the state of residence and not in the state of source.

Recent Tax Court rulings have denied access to treaties principally on the grounds that technical assistance should not be considered a commercial activity for Mexican Federal Tax Code purposes, but rather as a service of a civil nature, as the Commercial Code does not explicitly list technical assistance as a commercial act. However, the list of commercial acts contained in the Commercial Code is not exhaustive.

4.2 Primary Tax Treaty Countries

Mexico has entered into several tax treaties with other countries to avoid double taxation and promote cross-border investments. The choice of tax treaty country for foreign investors depends on various factors, including the investor's home country, the nature of the investment and the specific provisions of each treaty. The countries with which Mexico has entered into tax treaties commonly used by foreign investors include the United States, Canada, Spain, the United Kingdom, Germany and the Netherlands.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The use of treaty country entities by non-treaty country residents, often known as *"treaty shopping"*, can sometimes be subject to scrutiny by Mexican tax authorities.

Mexican law contains general anti-avoidance rules that allow tax authorities to challenge transactions or arrangements that have the primary purpose of obtaining a tax benefit in violation of the principles of the tax laws.

Mexican authorities may scrutinise the substance and purpose of the arrangements to determine whether they comply with the intended purpose of tax treaties. If they find that the primary motive of the structure is tax avoidance rather than a genuine business purpose, they may challenge the arrangement and deny the treaty benefits.

4.4 Transfer Pricing Issues

For inbound investors operating through a local corporation in Mexico, several significant transfer pricing issues may arise. It is crucial for investors to be aware of these issues to ensure they comply with Mexican transfer pricing regulations. Some of the key transfer pricing issues are outlined below.

Documentation Requirements

Mexico has stringent documentation requirements for transfer pricing. Inbound investors need to maintain comprehensive documentation to support the pricing of transactions with related parties. This includes documentation on the selection of the transfer pricing method, comparability analysis and financial information.

Comparability Analysis

Performing a robust comparability analysis is crucial to determine the appropriate transfer pricing method. The challenge lies in finding reliable and comparable data for benchmarking purposes. Differences in industry practices and economic conditions between Mexico and other countries can complicate the analysis.

A key aspect of these transactions is analysing the business rationale behind the migration or recognition of intangible assets. It is essential to assess the reasonably expected economic benefit, as required by the Mexican Federal Tax Code, ensuring that the business purpose is not solely based on tax advantages. Additionally, the proper delineation of related-party transactions must follow OECD Transfer Pricing Guidelines, which emphasise the economic substance of the transaction, including functions performed, assets used and risks assumed before and after migration.

Use of Profit Level Indicators (PLIs)

Determining the appropriate PLI for benchmarking can be complex.

In Mexico, the choice of PLI depends on the nature of the transaction, and identifying the most suitable indicator can be challenging for certain industries.

Intangibles and Royalties

Transfers of intangible assets and the calculation of royalties present specific transfer pricing challenges. Establishing the arm's length pricing for the use of intangibles requires a careful analysis and ensuring alignment with the OECD Guidelines is crucial. Mexican courts have held that taxpayers must substantiate the economic rationale for royalty payments and demonstrate their arm's length nature. Transactions lacking proper economic substance have been disregarded, leading to tax recharacterisations.

Management and Service Fees

Determining the appropriate pricing for management and service fees charged by a foreign parent to its Mexican subsidiary is a common challenge. It requires demonstrating that the services provided add value and are consistent with arm's length principles.

Profit Attribution to Permanent Establishments

For multinational corporations with a presence in Mexico, attributing profits to a permanent establishment (PE) can be complex. It involves evaluating the functions performed, risks assumed and assets employed by the PE within the overall business structure.

Advance Pricing Agreements

Inbound investors may consider seeking advance pricing agreements (APAs) with the Mexican tax authorities to provide certainty on transfer pricing matters. However, the APA process can be time-consuming and negotiating terms that satisfy both parties can be challenging.

APAs offer a viable mechanism for taxpayers and authorities. They allow taxpayers to request a transfer pricing ruling regarding the sale of intangible assets and related transactions, such as royalty payments for licences. These agreements can be unilateral, involving only the Mexican tax authority, or bilateral, negotiated between the authorities of Mexico and the related entity's jurisdiction.

While APAs provide technical support and tax certainty, unilateral APAs often face scrutiny and potential challenges from authorities regarding valuation variables and royalty payments. Bilateral APAs offer greater balance but can take two to three years to resolve. Recent amendments to the Mexican Federal Tax Code have introduced a suspension of audit timelines during the APA process, allowing authorities to initiate audits post-APA if deemed necessary.

Country-by-Country Reporting (CbCR)

In line with international standards, Mexico requires the filing of country-by-country reports for multinational groups exceeding certain revenue thresholds. Ensuring alignment with global reporting requirements and addressing potential discrepancies is essential.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited risk distribution arrangements are valid agreements whose supply chains have been structured and restructured. These types of transactions are normally subject to review and scrutiny by the tax authorities.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Mexico follows OECD standards with minimum variations.

4.7 International Transfer Pricing Disputes

Transfer pricing audits are definitely more aggressive and thorough nowadays. It is common for the Tax Administration Service to initiate transfer pricing audits and, if new information emerges, may reopen audits for earlier years.

Although Mexico has a robust set of rules and legislation governing MAPs in the practical sense, it is difficult for the tax authorities to agree to initiate one.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensation adjustments are valid in Mexico providing certain rules and steps are followed. Adequate documentation is crucial in these cases.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

There are no substantial differences in the taxation regimes between local branches and local subsidiaries of non-local corporations in Mexico.

5.3 Capital Gains of Non-Residents

Capital gains from the sale of stock in a local corporation are taxed at 25% on the gross amount (purchase price) or there is an option to be taxed at 35% on the net gain provided certain requirements are met (such as appointing a local legal representative and obtaining an auditor opinion on how the net basis was calculated).

Furthermore, indirect sales are taxable if more than 50% of the accounting value of the foreign entity being sold is represented by immovable property located in Mexico.

Certain treaties can eliminate direct or indirect capital gains, depending on the ownership percentage (normally more than 50%) and the length of time of ownership (normally more than 12 months).

5.4 Change of Control Provisions

When there is a change of control in a foreign holding company that owns a subsidiary in Mexico, taxation in Mexico can apply to the sale of shares. This tax is applicable if more than 50% of the foreign holding's accounting value is represented by immovable property located in Mexico. However, certain tax treaties may provide relief in these scenarios.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no specific rules governing how to determine the taxable income of foreign-owned local affiliates. Transfer pricing provisions will apply. There are certain rules applicable to Mexican entities with an IMMEX authorisation (manufacturers) where the annual profit must be determined based on a percentage of the cost or assets used in the manufacturing process.

5.6 Deductions for Payments by Local Affiliates

Deduction for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate are allowed as long as transfer pricing rules are complied with. A withholding tax is applied in these cases. These payments are normally considered business profits under a tax treaty.

The expense must be considered strictly indispensable for business operations and sufficiently documented to prove that the service was rendered.

Specific rules govern the allocation of expenses incurred by the non-local affiliate. These rules dictate how the expenses are distributed between the foreign entity and its Mexican subsidiary.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing will be subject to transfer pricing rules and income deduction limitations as stated in **2.5 Imposed Limits on Deduction of Interest**. Payments made to a related-party or derived from a structured agreement will not be deductible items if the income for the counterparty is subject to a preferential tax regime, if the party that directly or indirectly receives the payment uses the payment to make other deductible payments to other members of the same group or is derived from a structured agreement subject to a preferential tax regime.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations is not exempt from corporate tax. Tax credits are available if certain requirements are met. Monthly advance payments will not constitute foreign income (it is only computed for annual returns).

6.2 Non-Deductible Local Expenses

Foreign income of local corporations is not exempt. Local expenses will follow the general rules for deductions (strict indispensability, proper registration, materiality, etc) and the specific rules applicable to interest, royalties, etc.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are treated as ordinary income and are subject to a 30% tax rate. Income tax paid by the non-local subsidiary can be credited (some limitations apply). There is a second-tier indirect tax credit.

6.4 Use of Intangibles by Non-Local Subsidiaries

The use of intangibles developed by local corporations by non-local subsidiaries is subject to transfer pricing regulations and the arm's length principle in Mexico. Consideration for the use or the transfer will therefore be required.

The tax authorities have issued non-binding criteria addressing the transfer of intangible assets abroad. According to these criteria, the deduction of royalties for licensing intangible assets that were transferred out of Mexico at a price below their arm's length value is considered an improper tax practice.

This might qualify as a business restructure subject to further scrutiny under recent OECD Transfer Pricing Guidelines. Tax authorities, exercising their audit powers, scrutinise intercompany transactions, with a particular focus on intangible assets. The significance of functional and comparability analyses is emphasised in addressing these transactions.

Additionally, since 2020, the Mexican Federal Tax Code has included a business purpose test. This empowers tax authorities to disregard artificial transactions lacking a business purpose when taxpayers derive a tax benefit greater than the reasonably expected economic benefit. Transactions involving the use of intangibles between local corporations and non-local subsidiaries should therefore comply with transfer pricing regulations, ensuring that the pricing aligns with the arm's length principle and serves a legitimate business purpose to avoid potential challenges from tax authorities.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

A local entity will be taxed on the income (in some cases only the profits) generated abroad by a controlled non-local subsidiary, according to the participation of the Mexican resident, even if the entities do not distribute this income. The tax triggered will be 35% + 10% for the distribution of dividends.

These CFC rules are applicable if there is control and if the revenue obtained is not subject to tax or subject to a tax rate of less than 22.5% in the foreign country. Active business income will not be considered subject to these rules.

If taxpayers have operations through these entities, they will have to file a tax report with the Tax Administration Service.

The income will be attributed directly to the Mexican taxpayer and the tax paid abroad by these entities will be considered paid by the Mexican resident only for the taxable income taken into account.

The tax paid will generate a tax credit for the Mexican resident in the proportion that the income received by the entity or legal vehicle was considered taxable income by the taxpayer.

The exception of being considered a CFC when the taxpayer does not have *"effective control"* over the foreign entity still applies. Nevertheless, the rules to determine if there is *"effective control"* are substantially modified. Under these new rules there is *"effective control"* over the foreign entity if the taxpayer holds more than 50% of the shares or rights, which allows the taxpayer to obtain the profits or the assets in case of a capital reduction or liquidation.

To determine if the participation exceeds the 50% threshold, and therefore if *"effective control"* over the foreign entity exists, all rights owned by any related-party or linked individuals will be taken into account.

6.6 Rules Related to the Substance of Non-Local Affiliates

General anti-avoidance rules (GAAR) apply to transactions that lack a genuine business purpose and are primarily aimed at achieving a tax benefit. Under the GAAR, if certain transactions with non-local affiliates are deemed to lack a substantive business purpose, they may be subject to a recalculation of their tax effects.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Local corporations are taxed on the gain on the sale of shares in non-local affiliates. The taxable income is determined by subtracting the average cost per share from the sale price per share. The average cost per share for shares issued by foreign resident entities is calculated based on the adjusted original amount of the shares, which includes the verified acquisition cost reduced by any reimbursements paid, with adjustments for inflation.

Reimbursements paid include amortisations and capital reductions. However, taxpayers should only consider amortisations, reimbursements or capital reductions applicable to shares that have not been cancelled due to these operations.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Tax authorities, in the exercise of their audit authority, are entitled to recharacterise any transaction that does not have a legitimate business purpose and results in a tax benefit for the taxpayer. In these cases, the authorities can attribute the tax effects that would have been expected had they been carried out to achieve a reasonable economic benefit to these transactions.

For the application of the anti-avoidance rule, *"favourable opinion"* of a committee (officials of the Ministry of Finance and Public Credit and the Tax Administration Service) must be issued. If the opinion is not issued within a two-month period, it will be considered a negative resolution.

It is legally assumed, unless the taxpayer proves otherwise, that a transaction does not have a legitimate business purpose when:

- the measurable economic benefit is a smaller amount than the tax benefit obtained; or
- the reasonably expected economic benefit could have been achieved with fewer transactions, resulting in a higher tax effect (referred to as the fragmentation of operations).

Any reduction, elimination or temporary deferral is considered a tax benefit.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Tax authorities in Mexico are investing heavily in technological solutions to improve their ability to automatically access taxpayers' information and gain a better understanding of their transactions.

Among the technological measures that have allowed for greater oversight of taxpayers are:

- the obligation of taxpayers to maintain electronic accounting, which is uploaded monthly to the tax authority's portal;
- the use of the Taxpayer Mailbox for efficient communication; and
- the mandatory issuance of electronic invoices.

Utilising this advanced data analysis, tax authorities can efficiently detect inconsistencies within the electronic systems, prompting the issuance of *"invitations"* for further clarification. These *"invitations"* are not formal audits but serve as initial inquiries to address potential irregularities.

The Tax Administration Service has also identified specific sectors which are routinely audited (such as large taxpayers, retail, automotive, export-import activities, real estate, pharma and oil and gas).

9. BEPS

9.1 Recommended Changes

As a member of the OECD, Mexico has been actively involved in the design and development of BEPS and has been implementing these recommended Actions since 2014:

- taxation of the digital economy (Action 1);
- anti-hybrid rules (Action 2);
- limiting base erosion involving interest deductions and other financial payments (Action 4);
- preventing the artificial avoidance of permanent establishment status (Action 7);
- a form of mandatory disclosure requirement for taxpayers (Form 76) (Action 12);
- an obligation for taxpayers to present a country-by-country report, master file and local file (Action 13); and
- new OECD Transfer Pricing Guidelines (Actions 8 to 10).

Mexico is a party to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the *"MLI"*). It has elected to supplement the principal purpose test (PPT) with a simplified limitation on benefits (LOB) provision. On 12 October 2022, Mexico ratified the MLI, and on 15 March 2023, the Mexican Senate finally deposited the MLI with the OECD. The MLI came into force in Mexico on 1 January 2024, resulting in the amendment of several provisions of the tax treaties in force in Mexico.

As a result, the MLI introduced significant changes to Mexico's tax treaty network, primarily aimed at preventing treaty abuse and aggressive tax planning. The PPT now serves as a general anti-abuse rule, denying treaty benefits if one of the principal purposes of an arrangement or transaction is to obtain a tax advantage that contradicts the intention of the treaty. Additionally, the simplified LOB provision imposes specific eligibility criteria for claiming treaty benefits, further restricting access to reduced withholding tax rates and other treaty protections. These modifications increase scrutiny on cross-border transactions, requiring multinational entities operating in Mexico to reassess their tax structures and ensure compliance with the new anti-abuse standards set out by the MLI.

9.2 Government Attitudes

Mexico has shown a commitment to addressing BEPS issues. The government aims to prevent multinational companies from shifting profits to low-tax jurisdictions and ensure that they pay their fair share of taxes in Mexico.

With respect to Pillars One and Two, Mexico has participated in discussions but has not yet committed to their implementation. However, given the global momentum and Mexico's active participation in international tax co-operation, it is possible that Pillars One and Two could be adopted in the future. If Mexico decides to implement Pillars One and Two, it will likely take some time to enact the necessary legislative and administrative changes.

The impact of implementing these measures would be significant, particularly for multinational companies operating in Mexico. It could result in increased tax revenues for the Mexican government, greater tax transparency and a more level playing field for domestic companies. However, it could also mean additional compliance burdens for multinational companies and potential changes in their tax planning strategies.

Mexico has expressed its intention to apply these rules once adopted, with an estimated 100 organisations in Mexico falling within the scope of Pillar Two. Mexico's tax treaties often include restrictions to prevent double taxation or the application of lower tax rates to certain income.

9.3 Profile of International Tax

International tax has garnered increased attention in Mexico, especially with the implementation of BEPS recommendations. The actions taken by Mexico, such as amending various articles of the Mexican Federal Tax Code and Income Tax Law to address issues like VAT for non-resident taxpayers, hybrid mechanisms, base erosion through financing operations and aggressive tax planning, demonstrate a commitment to aligning with international standards.

Additionally, the adoption of the MLI in 2022 further underscored Mexico's commitment to enhance tax transparency and prevent treaty abuse, which aligns with the broader goals of the BEPS initiative. Overall, the high public profile of international tax in Mexico is likely to drive continued efforts to implement BEPS recommendations effectively.

9.4 Competitive Tax Policy Objective

Balancing competitive tax policy objectives with the pressures of BEPS is a major challenge for any jurisdiction, including Mexico. Mexico, as a member of the OECD, is a major driver of BEPS action. The main challenge for Mexico is to remain competitive in the global market to attract investment and promote economic growth, which must go hand in hand with the implementation of BEPS measures, as these measures ensure tax equity/equality, protect the tax base and prevent tax evasion by multinational companies, which obviously has a positive impact on tax collection in Mexico.

9.5 Features of the Competitive Tax System

The IMMEX or Maquila programme can be considered key features of the Mexican competitive tax system, which might be more vulnerable than other areas of the Mexican tax regime.

9.6 Proposals for Dealing With Hybrid Instruments

Several amendments were included in the Mexican 2020 tax reform, in line with BEPS Action 2 by introducing new anti-hybrid rules for entities or legal arrangements treated as fiscally transparent under foreign tax regulations.

9.7 Territorial Tax Regime

Mexico has a worldwide system. Interest deductibility restrictions could discourage investment and increase financing costs or affect loans.

9.8 Controlled Foreign Corporation Proposals

Mexico has a worldwide taxation system and has been using CFC rules for more than 25 years.

9.9 Anti-Avoidance Rules

The limitations on benefits and anti-avoidance rules outlined by the authorities, particularly regarding presumptions of transactions lacking a business rationale and generating direct or indirect tax benefits, are likely to impact both inbound and outbound investors by adding an extra layer of compliance, ie, the need to have documents/information to prove that the economic benefit of a transaction surpasses its possible tax benefit.

9.10 Transfer Pricing Changes

In Mexico, changes suggested by BEPS in the transfer pricing area have not yet been adopted, such as those proposed in Action 13, ie, the local file, master file and country-by-country reports. These changes were challenged and the Mexican Supreme Court ruled in favour of the tax authorities.

9.11 Transparency and Country-by-Country Reporting

Provisions for transparency and country-by-country reporting are welcome, but it is important that the rules governing them are minimally invasive and do not impose excessive burdens on taxpayers.

9.12 Taxation of Digital Economy Businesses

The Income Tax Law has established a new regime applicable to individuals engaged in business activities such as selling goods or providing services through digital platforms, computer applications and similar technologies. It should be noted that the new regime has been extended to cover hosting services, the sale of goods and any other service beyond transportation.

Under this new regime, intermediary entities, both resident and non-resident, facilitating transactions through these digital platforms have to withhold income tax from service providers. Non-resident intermediaries must register with the Federal Taxpayer Registry as withholding agents and issue the required electronic invoices.

Mexico has implemented a new regime to tax digital services at a VAT rate of 16% when consideration is charged. The taxed services include downloading or accessing digital content, online clubs and dating pages, digital intermediation services and distance learning or exercises.

9.13 Digital Taxation

As explained in **9.12 Taxation of Digital Economy Businesses**, Mexico has imposed VAT rules related to digital taxation and a regulation for certain activities performed using digital platforms. There are currently no proposals to implement new reforms.

9.14 Taxation of Offshore IP

As explained in **6.4 Use of Intangibles by Non-Local Subsidiaries**, the use by non-local subsidiaries of intangibles developed by local corporations in Mexico is subject to transfer pricing regulations and the arm's length principle.

Trends and Developments

Contributed by:
Ernesto F. Castañeda Baños, José Luis Rodríguez Domínguez,
Roberto Martínez Herrera and Luisa Fernanda Mora
Sainz Abogados, S.C.

Sainz Abogados, S.C. is a Mexican firm with more than 80 lawyers and accountants who actively participate in dynamic and complex national and cross-border practices, representing a broad client base ranging from the world's largest companies to domestic entrepreneurs. It has 24 years of experience in providing legal services and three offices in Mexico City, Cancún and Queretaro. Its practice areas include: corporate and transactional; litigation and dispute resolution; energy and natural resources financing; financial instruments and private equity insolvency and restructuring (concurso proceedings); real estate; labour and employment; tax (consulting and litigation); games and raffles; intellectual property; infrastructure; immigration; corporate governance and ESG; compliance and investigations; banking and financial regulation; and antitrust and competition. The firm is part of the Ibero-American Legal Network, which connects it to prestigious firms in Latin America and Spain and enables it to advise and represent multinational companies doing business in Mexico and Latin America on their cross-border transactions.

Authors

Ernesto F. Castañeda Baños is the leading partner of Sainz Abogados, S.C.'s litigation and tax consulting practice. He has 19 years of experience in advising domestic and foreign clients. His practice mainly focuses on the design and implementation of defence strategies in tax matters for clients from different sectors, as well as in the attention of audit procedures by the tax authorities and the implementation of alternative dispute resolution. Likewise, his practice consists of advising clients in corporate restructurings, financings, private equity and mergers and acquisitions, among others.

José Luis Rodríguez Domínguez joined Sainz Abogados, S.C. in 2022 as tax consulting partner. He specialises in tax matters related to M&A transactions, private equity and real estate structuring, public issuances, corporate restructurings and tax compliance, as well as supporting taxpayers in audit reviews performed by the Mexican tax authorities. Over the last 25 years, his practice has focused on tax consulting and planning for private and public and national and international companies, including those listed on the Mexican Stock Exchange (BMV). He has also advised individuals and family offices on patrimonial tax matters.

Contributed by: Ernesto F. Castañeda Baños, José Luis Rodríguez Domínguez, Roberto Martínez Herrera and Luisa Fernanda Mora, **Sainz Abogados, S.C.**

Roberto Martínez Herrera has been an associate at Sainz Abogados, S.C. since 2023. His practice focuses on tax matters, with an emphasis on tax consulting to individuals and corporations residing in Mexico and abroad. With more than ten years of experience, he has served as advisor and representative of private and public companies, many of them listed on the Mexican Stock Exchange (BMV), in tax and equity matters. An expert in national and international transactions, he has focused on corporate restructurings, audits, controversies and management of tax and fiscal procedures.

Luisa Fernanda Mora joined Sainz Abogados, S.C. in 2023. Her practice focuses on tax litigation, drafting legal remedies against acts of tax authorities, handling and following up on matters before the tax authorities and different jurisdictional considerations throughout the various stages of proceedings and tax consulting.

Sainz Abogados, S.C.

Blvd. Manuel Ávila Camacho 24
20th and 21st Floor
Lomas de Chapultepec,
Miguel Hidalgo, 11000
CDMX Mexico

Tel: +52 55 9178 5052
Email: info@sainzmx.com
Web: www.sainzmx.com

SAINZ

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Evolution of Business Reasoning Rules in Mexico

Introduction

This article focuses on the evolution of business reasoning rules in Mexico. It focuses in particular on the general anti-abuse rule set out in Article 5-A of the Mexican Federal Fiscal Code, its background, interpretation and the procedure that must be followed when the Mexican authorities consider that transactions entered into by taxpayers lack *"business reasons"* and are therefore assumed to have been undertaken to obtain a tax benefit.

International context

In 2013, the member countries of the Organisation for Economic Co-operation and Development (the *"OECD"*) and the G20 endorsed and implemented an Action Plan (the *"OECD/G20 Project"*) comprised of 15 Actions which were designed to address the challenges related to base erosion and profit shifting (BEPS) and were focused on promoting consistency in domestic regulations applicable to cross-border activities, strengthening the substantial activity criterion in international provisions and ensuring greater transparency and legal certainty for taxpayers (OECD, 2016).

Action 6 of the OECD/G20 Project identifies the abusive use of tax treaties and treaty shopping as one of the main reasons why BEPS becomes a problem. It considers that taxpayers who engage in these practices, violate the tax sovereignty of the affected states when they unduly claim advantages derived from the application of a treaty that may not be applicable. In addition, the performance of legal acts to set up operations with the objective of being in a more favourable tax position than others, causes a tax avoidance problem that has repercussions for tax collection.

Several countries have therefore decided to include general anti-abuse clauses in their respective tax treaties, including a basic standard against treaty shopping. They have also agreed on the need for a certain degree of flexibility in the application of the standard.

Similarly, as a result of the recommendations arising from Action 6 of the OECD/G20 Project, several countries have introduced general and specific anti-abuse rules in their domestic legislation, including Australia, Belgium, Germany, Israel, Italy, Finland, France, the Netherlands, New Zealand, Canada, South Korea, Hong Kong, India, Ireland, Spain, Sweden, South Africa and the United States, among others, in order to prevent the use of schemes or operations aimed at evading taxes or avoiding the tax law.

It has been identified that the incorporation of the anti-abuse rules is based on the specific circumstances of each country and consider several aspects such as taxpayers having the main purpose of avoiding a tax payment, making reference to concepts such as *"operations carried out without business reasons"* and *"substance of the operation or economic benefit"*. In some cases, tax authorities are allowed to restore the true nature of the transactions, as is the case in France, or to tax transactions in line with the substance or economic benefit of the transactions, as is the case in South Korea (Mexico's Parliamentary Gazette, 2019).

According to international doctrine, provisions aiming to prevent abuses in tax matters are usually categorised into:

- general anti-abuse rules, which are considered potentially applicable to any transaction that may be considered abusive for tax purposes; and

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- specific anti-abuse rules, which seek to prevent specific transactions which are recognised as abusive and whose scope of application is limited to the specific cases provided for in the legislation of each country.

According to the OECD, the general anti-abuse rules, which have been incorporated in various member countries, seek to limit the tax benefits that can be obtained from transactions that do not have sufficient economic substance. This encompasses transactions that do not have a reasonable *"business reason"* or whose main purpose is to directly or indirectly alter the tax burden arising from a given transaction.

The Mexican context

The first attempt to integrate a general anti-abuse rule in the Mexican tax legislation was in 2005, with the proposal to incorporate the so-called *"pre-eminence of substance over form"* principle into the Mexican Federal Fiscal Code, in response to the need to ensure that the provisions of domestic tax law were applied taking the substance into account and seeking to prevent taxpayers from carrying out operations to avoid complying with their tax obligations.

In 2013, it was proposed to incorporate an anti-avoidance rule into the Mexican Federal Fiscal Code that sought to perfect the power of the tax authorities to apply the law in a strict manner, considering the formal and material aspect of the tax provisions.

However, it was not until 2020 that the Mexican Federal Fiscal Code was amended to incorporate a general anti-abuse rule, for the first time, through Article 5-A of the Mexican Federal Fiscal Code, specifying, in line with the international trend, several requirements and consequences for its application, as well as the concept of *"business reason"*, which will be detailed below.

Pursuant to the congressional declaration of purpose that gave rise to the general anti-abuse rule, its inclusion in the Mexican Federal Fiscal Code mainly responded to the need to counteract elusive practices that, in addition to having a direct impact on federal tax collection, also violated the principle of tax equity with the execution of legal acts that allowed certain taxpayers to find themselves in a more favourable tax position than others who carried out a similar economic transaction.

It should be noted that the incorporation of the general anti-abuse rule in the Mexican Federal Fiscal Code is not the first attempt to prevent tax avoidance practices since, before the 2020 reform, several federal courts had issued judgments tending to recognise the effectiveness of the anti-abuse rules against tax avoidance, as well as declare that the legal fictions in tax matters created by the legislator as a public policy to prevent tax avoidance or evasion, are presumed legal.

In addition, several judgments were issued to recognise the concept of *"business reason"* as one of the elements to be considered by the tax authorities to determine whether the transactions carried out by taxpayers were regular and legitimate, or whether they constituted non-existent or simulated acts for tax avoidance purposes, and determined that the burden of proof was on the taxpayer.

Legal application of Article 5-A of the Mexican Federal Fiscal Code

Article 5-A of the Mexican Federal Fiscal Code establishes that *"legal acts lacking business reasons and generating a direct or indirect tax ben-*

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efit, will have the tax effects that correspond to those that would have been carried out to obtain the reasonably expected economic benefit by the taxpayer".

To understand the scope of the application of the rule, the following items have to be analysed.

Lack of "business reason"

The rule contemplates the characteristics under which it may be considered, unless there is evidence to the contrary, that certain legal acts lack *"business reason"*, as follows:

- when the reasonably expected quantifiable economic benefit is less than the tax benefit; or
- in a series of legal acts, when the reasonably expected economic benefit could be achieved through the performance of a lesser number of legal acts and the tax effect of these would have been more burdensome.

Notwithstanding the fact that the provision under analysis does not establish an express and concrete definition of what should be understood by *"business reason"*, the congressional declaration of purpose that gave rise to the general anti-abuse rule being considered, specifies that the term *"business reason"* is an indeterminate legal concept, which has been considered by the legislator as the most objective expression that could have been used for taxpayers to demonstrate the purpose and validity of their operations.

In light of the ambiguity of the legal concept, criticisms were made around the wording of Article 5-A, considering that the lack of clarity and precision in the degree of definition, which the constituent elements of the tax must have, goes against the fundamental principle of legal certainty, as it is a rule with indeterminable concepts (Mexico's Parliamentary Gazette, 2019).

In this regard, the Mexican Federal Court on Administrative Matters, when issuing case number VIII-J-1aS-99, stated that, although there is no legal definition of the term *"business reason"*, in the financial field it is understood to mean:

- the reason for performing an act;
- to which one is entitled;
- related to a lucrative occupation and aimed at obtaining a profit, that is, the reason for the existence of any economic unit that involves seeking results; and
- promotes the generation of value, creation and development of long-term relationships with customers, suppliers, employees, partners and third parties involved.

This is relevant since Mexico's Supreme Court of Justice recognised that the legislator, not knowing all the future circumstances of the application of the rules, finds it necessary to use indeterminate legal concepts whose conditions of application cannot be foreseen in all their possible scenarios. However, this does not imply that the rule necessarily lacks legal certainty, becomes unconstitutional or mean that the authority has the power to arbitrarily issue the corresponding resolution.

Therefore, although the legislation does not provide an express and specific definition of *"business reason"*, there is case law that provides elements to clarify the meaning of the concept.

Reasonably expected economic benefit

The reasonably expected economic benefit is a criterion used to ensure that economic decisions of taxpayers have a genuine purpose beyond tax optimisation. Article 5-A uses this principle

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as the basis for determining when a transaction can be considered legitimate from an economic standpoint.

In particular, the provision establishes that there is a reasonably expected economic benefit when the taxpayer's operations are intended, among other things, to:

- generate income;
- reduce costs;
- increase the value of the assets owned by the taxpayer; or
- improve its market positioning.

These are fundamental assumptions as they provide a general framework to evaluate the economic validity of an operation, under multiple legitimate business activity scenarios.

In addition, this provision establishes that the contemporary information related to the transaction performed will be considered to quantify the reasonably expected economic benefit, including the projected economic benefit, to the extent that the information is reasonable and duly supported. By specifying that the economic benefit must be quantified and supported, it implies a detailed and documented analysis that includes both the economic projections of the transactions and the reasons justifying them.

A relevant aspect of this provision is the explicit exclusion of the tax benefit as part of the reasonably expected economic benefit. This distinguishes the legislator's intention to prevent the simulation of operations whose sole purpose may be to take advantage of tax loopholes or generate tax advantages.

In the tax and business fields, strategic decision-making is inevitably linked to the evaluation of costs and benefits. However, beyond the immediate economic results, the reasonably expected economic benefit seeks to ensure that the operations carried out by taxpayers have a legitimate purpose and a real economic impact, so it has become a tool that seeks to promote transparency, tax equity and sustainability.

However, at present, the Mexican Federal Fiscal Code does not contemplate the procedure that the tax authorities or the taxpayers themselves must apply to determine the reasonably expected economic benefit of the transactions carried out by the taxpayers subject to review.

Direct or indirect tax benefit

Article 5-A states that any reduction, elimination or temporary deferral of a tax, including those obtained through:

- deductions;
- exemptions;
- non-subjections;
- non-recognition of an accruable gain or income;
- adjustments or absence of adjustments to the taxable base of the tax;
- the crediting of taxes;
- the recharacterisation of a payment or activity; or
- a change of tax regime, among others, will be considered as tax benefits.

However, the fact that the operation implemented has a given tax effect should not be considered enough to determine the existence of a benefit. For these purposes, it is important to analyse, and compare, if the difference between the tax effect obtained and that which would have been generated if the operation was carried out in a different form, constitutes a reduction, elimination or temporary deferral of a contribution.

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This is consistent with the main objective pursued by this provision, as stated in the congressional declaration of purpose that gave rise to it, since, to comply with this purpose, it is essential to make a detailed comparison of the tax effects generated in each of the potential scenarios. Otherwise, there would be a lack of elements to establish with clarity and certainty whether a taxpayer has obtained a more advantaged tax position or has been granted a benefit significantly higher than the one that would have granted.

General anti-abuse rule application procedure

Under Article 5-A, the tax authorities, while exercising their audit powers, may presume that the legal acts entered by the taxpayer under review lack *"business reasons"* based on the facts and circumstances of the taxpayer known under these powers, as well as the evaluation of the information and documentation obtained during the audit.

Notwithstanding this, since it is a presumption, these authorities may not disregard the legal acts for tax purposes, without informing the taxpayer about the:

- situation in the last partial assessment;
- the official notice of observations; or
- the provisional resolution in question, as the case may be, and the legal periods for taxpayers being able to state what they deem appropriate and provide the information and documentation tending to disprove the presumption have lapsed.

It is worth mentioning that, prior to the issuance of the applicable legal resolution derived from the audit, the tax authorities must submit the case to a collegiate body formed by officers of the Ministry of Finance (*Secretaría de Hacienda y Crédito Público* or SHCP) and the Tax Administration Service (*Servicio de Administración Tributaria* or SAT) and obtain a favourable opinion issued by the collegiate body confirming the applicability of the rule. If the referred opinion is not received within two months from the filing of the corresponding case by the tax authority, it will be considered to be resolved in a negative sense.

An administrative tax rule provides that the collegiate body will be formed by the following people:

- a co-ordinator presiding over the meetings;
- a technical secretary and an assistant secretary;
- the head officers of Tax Units of the SHCP; and
- the head officers of the Administrative Units of the SAT.

Although this procedure has been in effect since 2020, as of the time of writing, there is no public record of the formal application of this procedure by the tax authorities.

Additionally, it is important to point out that the procedure establishes that the effects that the tax authorities grant to the legal acts carried out by the taxpayers will be limited to the determination of taxes, their accessories and corresponding penalties, without affecting the investigations and criminal liability that may arise in relation to the commission of the tax crimes set out in the Mexican Federal Fiscal Code.

This implies that, in the event that the tax authorities, in the exercise of their verification powers, decide to apply the procedure described for the application of the rule, a tax deficiency assessment could be made. This could include an

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increase of taxable income or the rejection of deductible items but leaving their faculties safe to initiate investigations if those authorities consider that the taxpayer's actions could constitute a tax crime.

While the general anti-abuse rule was designed as a tool for the tax authorities to tackle abusive tax practices by reclassifying legal acts that lack *"business reason"* and create undue tax benefits, in practice, it has been noticed that the procedure laid out in Article 5-A has not been applied effectively or in line with its original purpose as, on occasions, it may only be used as an argument to justify tax assessments.

The lack of specific and adequate application of Article 5-A could lead to a distortion as to the nature of the legal acts, by creating differences between the civil and/or commercial reasons of a transaction and the tax effects that the authority could determine. This would not only generate legal uncertainty for taxpayers but could also alter the frame of reference and application between civil/commercial and tax provisions.

Conclusions

Since Article 5-A of the Mexican Federal Fiscal Code does not specify in detail what amounts to *"business reasons"* or the evidence that must be collected to prove their existence, taxpayers need to perform a case-by-case analysis; particularly, in those cases in which the *"business reasons"* followed to undertake a given transaction are not obvious or easy to prove.

A recommended practice for taxpayers will be that, even when they have not been subject to verification powers, they should analyse the most adequate way of supporting the *"business reasons"* of their main operations. The following preventive actions, in particular could be useful:

- justification and effective support of the *"business reasons"* for which the operations were carried out;
- quantify the expected economic benefit of the operations carried out, by using reasonable criterions from a commercial and/or financial standpoint;
- analyse what could hypothetically be considered, within the scope of the transactions carried out, as a tax benefit obtained, in order to contrast that with the reasonably expected economic benefit determined;
- analyse if the transactions could have been performed with a lesser number of legal acts and if the tax effects of those could have been more burdensome; or
- all of the above, in order to be in a position to move with greater chances of success before any review by the tax authorities.

The incorporation of the *"business reason"* clause in Mexico represents an important step towards a more equitable and robust tax system. However, its success will depend on the clarity of its application, the criterion used by the tax authorities and the strengthening of the operating procedures that have been described. Only with these adjustments will it be possible to ensure that this rule promotes tax fairness and transparency without affecting the legal security of taxpayers.

NETHERLANDS

Law and Practice

Contributed by:
Michael Molenaars, Jeroen Smits, Reinout de Boer
and Rogier van der Struijk
Stibbe

Contents

Stibbe handles complex legal challenges, both locally and cross border, from its main offices in Amsterdam, Brussels and Luxembourg as well as a branch office in London. By understanding the commercial objectives of clients, their position in the market and their sector or industry, Stibbe can render suitable and effective advice. From an international perspective, Stibbe works closely with other top-tier firms on cross-border matters in various jurisdictions. These relationships are non-exclusive, enabling Stibbe to assemble tailor-made integrated teams of lawyers with the best expertise and contacts for each specific project. This guarantees efficient co-ordination on cross-border transactions throughout a multitude of legal areas, irrespective of their nature and complexity.

Authors

Michael Molenaars is head of Stibbe's tax practice group. His specialisms include domestic and international taxation, with an emphasis on M&A and private equity transactions, corporate reorganisations and investment fund structures. Michael guides large multinational companies, financial institutions and private equity firms through every stage of technically complex issues, including contentious issues. He is also a frequent speaker on international tax issues and has co-authored several books and articles on international taxation.

Jeroen Smits is a partner in Stibbe's Amsterdam tax practice group. He specialises in Dutch domestic and international taxation, with a focus on M&A, private equity and capital markets transactions. In addition, he is part of Stibbe's investment management practice and advises on the Dutch tax aspects of fund structuring. Jeroen is a member of the Dutch Bar Association, the Dutch Association of Tax Advisers and the International Fiscal Association.

Reinout de Boer is a partner in Stibbe's Amsterdam tax practice group and specialises in domestic and international taxation with an emphasis on M&A, private equity transactions and corporate reorganisations. He heads the Dutch tax controversy practice of Stibbe and advises in a wide range of (international) tax litigation cases.

Rogier van der Struijk specialises in international corporate taxation of Dutch and foreign multinationals, advising clients on complex matters such as tax-efficient structuring of investments and divestments. He has experience in various industries – such as financial services – advising clients on the tax aspects of large cross-border investments. Furthermore, he has experience with tax controversy work, including (tax) litigation, and is a member of Stibbe's tax controversy practice. He has written several articles in Dutch tax journals. He is also a member of the Dutch Bar Association and the Dutch Association of Tax Advisers.

Stibbe

Beethovenplein 10
1077 WM
Amsterdam
Netherlands

Tel: +31 20 546 06 06
Email: amsterdam@stibbe.com
Web: www.stibbe.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Large businesses in the Netherlands typically carry out their activities via a limited liability company (*besloten vennootschap* or BV) or – to a lesser extent, typically in the case of a listed company – via a public limited company (*naamloze vennootschap* or NV) or a no-liability co-operative (*coöperatieve UA*). Each of these legal forms has a legal personality so that the entity can own assets in its own name, and the shareholders (membership right-holders in the case of a co-operative) cannot, at least as a starting point, be held personally liable for corporate obligations.

A BV, NV and co-operative are separate taxpayers for Dutch corporate income tax purposes.

Reverse Hybrid Rules

A reverse hybrid entity is an entity that for Dutch tax purposes is considered transparent (generally a partnership), whereas the jurisdiction of one or more related participants holding in aggregate (directly or indirectly) at least 50% of the votes, interest or profit entitlements, qualifies the entity as non-transparent (ie, leads to the entity being considered a taxpayer for profit tax purposes). Pursuant to the reverse hybrid rule, entities incorporated or established in the Netherlands that in principle qualify as tax transparent, may nevertheless be considered non-transparent and integrally subject to Dutch corporate income tax. If, and to the extent that, the income of the reverse hybrid entity is directly allocated to participants in jurisdictions that classify the entity as transparent, the reverse hybrid rules provide for a deduction of the income at the level of the reverse hybrid entity.

If a Dutch transparent entity is considered a reverse hybrid entity, distributions by the reverse hybrid entity would in principle become subject to Dutch dividend withholding tax to the extent the recipient of the distribution is a participant that leads to the entity in its jurisdiction being classified as non-transparent. In addition, interest, royalty and dividend payments by a reverse hybrid entity will in principle become subject to a conditional withholding tax provided that the recipient of the payment treats the reverse hybrid entity as non-transparent and provided certain conditions are met. See **4.1 Withholding Taxes**.

Furthermore, foreign participants could – in (deemed) abusive situations – be subject to Dutch corporate income tax in respect of capital gains and/or dividends derived from its participation in a reverse hybrid entity. See **5.3 Capital Gains of Non-Residents**.

1.2 Transparent Entities

In the Netherlands, the tax-transparent entities typically used are a limited partnership (*commanditaire vennootschap* or CV), a general partnership (*vennootschap onder firma* or VOF) and a fund for joint account (*fonds voor gemene rekening* or FGR). Each of these legal forms lacks legal personality and should be considered as a contractual business arrangement.

VOFs

As a VOF is tax transparent, it is not a taxpayer for Dutch (corporate) income tax purposes. Instead, the underlying participants are taxed for their participation in a VOF. Distributions by a VOF are not subject to Dutch dividend withholding tax.

CVs and FGRs

With respect to a CV and an FGR, up to and including 2024, the Dutch corporate income tax treatment depended on whether the entity was considered open or closed. An open CV/FGR was subject to Dutch corporate income taxation as such, whereas in the case of a closed CV/FGR, the underlying participants were taxable for the income derived from their interest in the CV/FGR. A CV or FGR was (in short) deemed to be closed (ie, transparent) if all limited and general/managing partners separately and upfront had to approve each accession, resignation or replacement of participants (the *"unanimous consent requirement"*). Alternatively, an FGR was also considered closed if participations could be transferred exclusively to the FGR itself.

However, on 1 January 2025, new classification rules for (among other entities) Dutch CVs and FGRs entered into force. These rules entail the abolition of all Dutch non-transparent partnerships by revoking the *"unanimous consent requirement"*. Consequently, Dutch CVs are by default transparent for Dutch tax purposes as of 1 January 2025. The tax classification rules for the FGR have also changed as of that date. An FGR can be either transparent or non-transparent for Dutch corporate income tax purposes. An FGR may maintain its non-transparent status only if it is regulated following the Dutch Financial Supervision Act and if the participations in the FGR are tradeable. Participations are not considered tradeable if the sale can only be to the FGR – ie, where it acts as *"repurchase fund"*.

Foreign Vehicles

Specific guidance is in place, by way of a decree, to classify foreign vehicles (both transparent and non-transparent) for Dutch tax purposes. New tax classification rules for foreign entities have also entered into force as of 1 January 2025. Under the new rules, it must still first be determined whether a foreign entity is sufficiently similar to a Dutch entity (the similarity approach). If so, the tax classification of the entity's Dutch equivalent will be applied. If this is not the case, two additional methods to classify foreign entities have been introduced. First, foreign entities without a clear Dutch equivalent that are resident in the Netherlands are deemed to be non-transparent (the fixed method). Second, for foreign entities located outside of the Netherlands, the symmetrical approach generally applies, meaning that the tax classification of the jurisdiction where the entity is located, will be followed for Dutch tax purposes.

As the similarity approach will continue to apply to foreign legal entities which can be compared to Dutch legal entities and given the above-mentioned amendments to the classification rules for CVs/FGRs, the Netherlands will in principle also classify foreign partnerships that are similar to Dutch partnerships as transparent for tax purposes from 2025 onwards. Nonetheless, provided conditions are met (which still need to further crystalise in practice) a foreign partnership may also qualify as an FGR and thus still qualify as non-transparent for Dutch tax purposes under the qualification rules as applicable to FGRs.

1.3 Determining Residence of Incorporated Businesses

For Dutch corporate income tax purposes (with the exception of certain provisions, such as the fiscal unity regime and the participation exemption), a BV, NV or co-operative is deemed to be a corporate income tax resident in the Netherlands (regardless of the place of effective management of the entity) if it is incorporated under the laws of the Netherlands (the *"incorporation principle"*). If a double tax convention is applicable that includes a tie-breaker rule and both treaty-contracting states consider a company to be a resident of their state, typically the place of effective management of a company is conclusive for the place of residence for tax treaty purposes, which is the place where the strategic commercial and management decisions take place. Important elements for determining this place are, for example, the residency of board members and the location of board meetings.

In several treaties, the residency is determined on the basis of a mutual agreement procedure (MAP) between the two states if both treaty-contracting states consider a company a resident of their state.

1.4 Tax Rates

Corporate income taxpayers are subject to a corporate income tax rate of 25.8% (2025) with a step-up rate of 19% for the first EUR200,000 of the taxable amount.

An individual who is a personal income tax resident of the Netherlands is liable for personal income taxation on their taxable income, including business income, at the following progressive rates (brackets and rates for 2025):

- EUR0 to EUR38,441 – 8.17% tax rate, 27.65% social security rate, which equals 35.82% combined rate;
- EUR38,441 to EUR76,817 – 37.48% tax rate; and
- EUR76,817 upwards – 49.50% tax rate.

The social security rate applied to individuals who are retired is 9.75%, resulting in a combined rate of 17.92%. The official retirement age in the Netherlands in 2025 is 67 years. The retirement age will be raised to 67 years and three months in 2028.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The business income of personal income taxpayers and corporate income taxpayers is determined on the basis of two main principles, which have been shaped through extensive case law. The first is the at arm's length principle (which serves to establish the correct overall amount of profit or the *totaalwinst*) and the second is the sound business principle also known as sound business practice (*goed koopmansgebruik*, which serves to attribute the profit to the correct financial year, the *jaarwinst*).

It should be noted that the Dutch fiscal concept of business income is, strictly speaking, independent of the statutory accounting rules. In practice, both regimes overlap to a certain extent.

Based on the at arm's length principle, business income is adjusted to the extent that it is not in line with arm's length pricing. Thus, both income and expenses can be imputed in a group context for Dutch tax purposes, regardless of whether the accounting system is statutory or commercial. For corporate income taxpayers this can result in informal capital or hidden dividends. As of 1 January 2022, legislation has entered into force targeting transfer pricing mismatches resulting from the application of the arm's length principle (eg, no imputation of arm's length expense without inclusion of the corresponding income). The legislation aims, inter alia, to render the arm's length principle ineffective between related parties in cross-border situations to the extent that it will deny the deduction of at arm's length expenses, so that the corresponding income is not included in the basis of a (local) profit tax at the level of the recipient.

2.2 Special Incentives for Technology Investments

The Two Main Tax Incentives

Innovation box

The first main tax incentive is the innovation box which, subject to certain requirements, taxes income in relation to qualifying income from intangible assets against an effective tax rate of 9%, instead of the statutory rate of 25.8%. Only R&D activities that take place in the Netherlands are eligible for the beneficial tax treatment (eg, the *"nexus approach"*). Qualifying intangible assets are R&D activities for which a so-called R&D certificate has been issued or that have been patented (or for which an application to this effect has been filed). Software can also qualify as an intangible asset.

Wage withholding

The second main tax incentive is the wage withholding tax credit. This allows employers to reduce the amount of wage withholding tax that has to be remitted to the tax authorities, with 36% up to an amount of wage expenses in relation to R&D activities of EUR380,000, and 16% for the remainder in 2025. The wage withholding tax credit for start-up entrepreneurs in 2025 is, under certain conditions, 50% up to an amount of wage expenses in relation to R&D activities of EUR380,000.

Tax Incentives for Sustainability

In addition, special tax incentives apply to stimulate sustainability. For example, businesses that invest in energy-efficient assets, technologies or sustainable energy may benefit from the Energy Investment Allowance (*Energie, Investeringsaftrek* or EIA). As for environmentally sustainable investments, the Environment Investment Allowance (*Milieu Investerinsgaftrek* or MIA) and the Arbitrary Depreciation of Environmental Investments (*Willekeurige afschrijving milieubedrijfsmiddelen* or VAMIL) may apply.

2.3 Other Special Incentives

Shipping companies can apply for the so-called tonnage tax regime, whereby the income from shipping activities is essentially determined on the basis of the tonnage of the respective vessel, which should result in a low effective corporate income tax rate. Qualifying income from shipping activities is, for example, income earned from the exploitation of the vessel in relation to the transportation of persons and goods within international traffic.

2.4 Basic Rules on Loss Relief

Before 1 January 2022, taxable losses could in principle be carried back one year and carried forward six years. From 1 January 2022, tax loss carry-forwards are limited to 50% of the taxable income exceeding EUR1 million for that year. At the same time, the six-year tax loss carry-forward period has been abolished so that tax losses can be carried forward indefinitely (but limited to 50% of the taxable income in a financial year).

A waiver of debt may lead to taxable income at the level of a Dutch debtor. Dutch tax law provides for a debt waiver exemption if certain specific conditions are met. The concurrence between the above-mentioned loss relief rules from 2022 and the so-called debt cancellation profit exemption (*kwijtscheldingswinstvrijstelling*) meant that tax would still have to be paid if the taxable income exceeded EUR1 million, even if this profit stemmed from a debt cancellation profit. This levy impeded the restructuring of companies and therefore, from 1 January 2025 onwards, new legislation has entered into force to fix this unintended outcome for situations in which the taxpayer has past-year tax losses available that exceed EUR1 million. In such a case, the adverse effect for taxpayers should be removed by a full debt waiver exemption (ie, the requirement to first utilise past-year tax losses will be removed and only in-year losses should be taken into account). However, the available loss carry forward will be reduced by the amount of the debt waiver exemption. If the tax losses available for carry forward do not exceed EUR1 million, nothing will change for taxpayers.

Specific anti-abuse rules may apply in some cases, due to which, losses cease to exist in the case of a substantial change of ultimate ownership of the shares in the company which suffered the tax losses. For financial years starting on or after 1 January 2019, the so-called holding and financing losses regime has been abolished. Until that date, such losses are ring-fenced and can only be offset against holding and financing income.

2.5 Imposed Limits on Deduction of Interest

As a starting point, at arm's length interest expenses should in principle be deductible for Dutch corporate income tax purposes. A remuneration only classifies as *"interest"* if the financial instrument is considered *"debt"* for tax law purposes. In addition, a number of interest deduction limitation rules have to be observed to determine if interest expenses are deductible in the case at hand. The most important rules are detailed below.

- If a loan agreement economically resembles equity (eg, since the loan is subordinated, the interest accrual is dependent on the profit and the term exceeds 50 years), the loan may be requalified as equity for Dutch corporate income tax purposes, as a consequence of which the interest would be requalified as a dividend, which is not deductible.
- If a granted loan is considered to be a non-businesslike loan (*onzakelijke lening*) from a tax perspective, it may effectively result in limitation of deductible interest because of a possible (downward) adjustment of the applied interest rate for Dutch tax purposes.
- Interest expenses due on a loan taken on from a group company that is used to fund capital contributions or repayments, dividend distributions or the acquisition of a sharehold-

ing may, under certain circumstances, not be deductible (irrespective of the presence of a Dutch tax group).

- Interest expenses due on loans taken on from a group company should not be deductible, if the loan has no fixed maturity or a maturity of at least ten years, while de jure or de facto no-interest remuneration or an interest remuneration that is substantially lower than the at arm's length remuneration has been agreed upon.
- For financial years starting on or after 1 January 2019, as part of the implementation of the EU's Anti-Tax Avoidance Directive (ATAD), the deduction of interest expenses is limited to the highest of 30% of a taxpayer's EBITDA or EUR1 million (so-called *"earnings stripping rules"*). Since 1 January 2022, this has been further limited to the highest of 20% of a taxpayer's EBITDA or EUR1 million. As of 1 January 2025, the EBITDA cap has been increased to 24.5%.
- As a result of ATAD 2, interest deductions may be limited or denied in case of hybrid mismatches resulting in mismatch outcomes between associated enterprises (ie, in short, situations with a double deduction or a deduction without inclusion).
- For Dutch corporate income tax purposes, interest deductions for banks and insurers are limited where the debt financing (*vreemd vermogen*) exceeds more than 89.4% of the total assets (in 2025). The equity ratio is determined on 31 December of the preceding book year of the taxpayer.

2.6 Basic Rules on Consolidated Tax Grouping

For Dutch corporate income tax purposes, corporate taxpayers that meet certain requirements can form a so-called fiscal unit. The key benefits of forming a fiscal unit are that losses can be settled with positive results within the same year (horizontal loss compensation) and only one corporate income tax return need be filed, which includes the consolidated tax balance sheet and profit-and-loss account of the entities consolidated therein. The main requirements for forming a fiscal unit are that a parent company should have 95% of the legal and economic ownership of the shares in a given subsidiary.

Moreover, the Dutch legislature has newly responded to the obligations following from further EU case law to arrive at an equal tax treatment of cross-border situations when compared to domestic situations, by means of limiting the positive effects of fiscal unity in domestic situations (instead of extending those positive effects to cross-border situations). Mostly with retroactive effect to 1 January 2018, several corporate income tax regimes (ie, various interest limitation rules, elements of the participation exemption regime and anti-abuse rules in relation to the transfer of losses) are applied to companies included in a fiscal unit (ie, a Dutch tax group) as if no fiscal unit has ever existed. This emergency legislation should be followed up by a new, future-proof Dutch tax group regime that is expected to replace the current regime in several years' time.

2.7 Capital Gains Taxation

Capital gains (and losses) realised on the assets of a Dutch corporate income taxpayer are in principle considered taxable income that is taxable at the statutory tax rate, unless it concerns a capital gain on a shareholding that meets all the requirements to apply the participation exemption. Based on the participation exemption, capital gains and dividend income from qualified shareholdings are fully exempt from the Dutch corporate income tax base.

Essentially, the participation exemption applies to shareholdings that amount to at least 5% of the nominal paid-up capital of the subsidiary, the capital of which is divided into shares while these shares are not held for portfolio investment purposes. The latter should generally be the case if a company has substantial operational activities and no group financing or group leasing activities are carried out, or a company is sufficiently taxed with a profit-based tax.

In relation to the application of the Dutch participation exemption by Dutch intermediary holding companies with little or no substance, the Dutch government has decided (for the time being) not to introduce legislation to enable the exchange of information with other jurisdictions. A possible amendment of the Dutch rules on exchange of information will be reviewed by taking into consideration the proposed directive on the misuse of shell entities that was published by the European Commission at the end of 2021(*"ATAD 3"*). In December 2022, an amended proposal was published, which was approved by the European Parliament in January 2023. Multiple alternative approaches have been suggested since 2023 (including one in June 2024 that focussed on the exchange of information, where the fiscal implications would be at the discretion of the member states), which are currently still being discussed and which are under review for a final decision by the European Council.

Liquidation Loss

Under the former rules, a shareholder that held at least 5% of the shares in a Dutch company was allowed to deduct a so-called liquidation loss, upon the completion of the dissolution of such company and provided certain conditions were met. This liquidation loss broadly equals the total capital invested in that company by the shareholder minus any liquidation proceeds received.

As of 1 January 2021, additional requirements (eg, the residence of the liquidated company should be within the EU/EEA and the Dutch shareholder of the liquidated company must have decisive control to influence the decision-making of the company that is liquidated) need to be met in order to deduct liquidation losses exceeding the threshold of EUR5 million.

2.8 Other Taxes Payable by an Incorporated Business

An enterprise, be it transparent or opaque, may become subject to value added tax (VAT) when selling services or goods in the Netherlands.

Real estate transfer tax (RETT) at a rate of 10.4% should, in principle, be due upon the transfer of real estate or shares in real estate companies. For residential real estate, a rate of 2% applies and, since 2021, this rate can only be applied by individuals to the acquisition of their primary residence. As a result of the foregoing, real estate investors can no longer apply the 2% rate. As of 2021, there is a RETT exemption for *"starters"* (ie, persons between the ages of 18 and 35 buying their first primary residence). From 1 January 2025, this RETT exemption only applies to real estate worth less than EUR525,000.

2.9 Incorporated Businesses and Notable Taxes

The transfer of shares in companies that predominantly own real estate as portfolio investment may, under certain conditions, become taxable at 10.4% RETT.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Typically, but not always, only small businesses and self-employed entrepreneurs, partially including small independent businesses without staff (*zelfstandigen zonder personeel* or ZZP), operate through non-corporate forms while medium and large businesses manage their activities via one or more legal entities (eg, BVs).

3.2 Individual Rates and Corporate Rates

There are no particular rules that prevent individual professionals from earning business income at corporate rates. For tax purposes, an individual is free to conduct a business through a legal entity or in person. However, despite the legal and tax differences between those situations, the effective tax burden on the business income will often largely align. The combined corporate income tax rate and the personal income tax rate for substantial shareholders almost equals the personal income tax rate for individuals.

Broad Balance Between Taxation of Incorporated and Non-Incorporated Business Income

Under the current substantial shareholding regime (which roughly applies to individuals holding an interest in a company of at least 5% of the share capital), dividend income (as well as capital gains) is subject to personal income tax at a rate of 26.9% up to EUR 67,804 and 31% on amounts exceeding this threshold (2025). The corporate income taxation on the underlying profit currently amounts to 19% for the first EUR200,000 and 25.8% beyond that. This is a combined effective tax rate of approximately 48.88% (2025).

The top personal income tax rate amounts to 49.50% in 2025 (applied to a taxable income exceeding EUR76,817 per annum). Due to the application of several exemptions for individuals earning non-incorporated business income, the effective tax rate is substantially lower.

3.3 Accumulating Earnings for Investment Purposes

It is mandatory for substantial shareholders to earn a minimum salary from the BV of which they are a substantial shareholder, to avoid all earnings remaining undistributed and due to which the substantial shareholder may unintendedly benefit from social security benefits. In principle, the mandatory minimum salary amounts to the highest salary of the most comparable job, that is, the highest salary earned by an employee of a company or a related entity, or EUR56,000 (2025).

If it can be demonstrated that the highest amount exceeds the salary of the most comparable job, the minimum salary is set to the salary of the most comparable job, with a minimum of EUR56,000 (2025).

On 1 January 2023, new legislation was introduced to prevent entities from granting excessive loan amounts (in 2025, EUR500,000 or more) to individual shareholders.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Typically, individuals can conduct business activities in person or as a substantial shareholder of a legal entity (eg, a BV). In the case of business activities that are carried out in person (either alone or as a participant in a tax-transparent partnership), the net result of the enterprise is taxed with Dutch personal income taxation at a top rate of 49.50% in 2025, to the extent that the amount of taxable profits exceeds EUR76,817. Note, however, that a base exemption of 12.70% (2025) applies, which lowers the effective tax rate. The gain on the transfer of the enterprise (eg, the transfer of the assets, liabilities and goodwill) is also taxable at the same rates as regular profits.

Where business activities are carried out via a BV, the shares of which are owned by substantial shareholders, the business income is subject to corporate income taxation. To the extent that the profit after tax is distributed to a substantial shareholder in the Netherlands, personal income tax is due at a rate of 26.9% on amounts up to EUR 67,804 and 31% on amounts exceeding this threshold. A capital gain realised by a substantial shareholder will also be taxed at these rates in 2025.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividend income that is not considered part of business income and is received by individuals that do not qualify as a substantial shareholder (essentially shareholders who are not entrepreneurs and who hold less than 5% of the shares in the relevant companies) is not taxed as such.

In 2021, the Dutch Supreme Court ruled that the Dutch income tax levy on savings and investments in 2017 and 2018, under specific circumstances, violated the European Convention on Human Rights and the First Protocol thereto. In response to this, the Dutch government amended the Dutch regime for income from savings and investments for the years 2023, 2024 and 2025. Under this amended regime, the income from portfolio investments (including portfolio dividends) is deemed to be 5.88% of the fair market value of the underlying shares (and other investments held by the taxpayer) minus 2.62% (preliminary percentage, subject to final determination at the end of the year) of the value of the debts owed by it in 2025. This deemed income is taxable at a rate of 36%, to the extent that the net value of the underlying shares exceeds the exempt amount of EUR57,684 (2025).

However, in June 2024, the Dutch Supreme Court ruled that the above-mentioned amended regime still violates the prohibition of non-discrimination and property rights if the deemed return exceeds the actual return. In this ruling, the Dutch Supreme Court also provided further guidance for calculating actual returns.

In September 2023, the Dutch government published a legislative proposal (*"Wet werkelijk rendement box 3"*) outlining a new tax regime for income received by individuals who do not qualify as a substantial shareholder. Unlike the previous and existing systems, the newly proposed capital gains taxation (*"Box 3"*) will assess an individual's actual return, allowing for the deduction of related expenses. These returns may encompass both realised and unrealised income from various assets. While currently unspecified, it is anticipated that the specific tax rate will fall within the range of 33% to 37%. This revised taxation system could enter into force not earlier then 2028.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The Netherlands has a withholding tax on profit distributions that, in principle, taxes dividends at a rate of 15%. Based on the EU Parent-Subsidiary Directive, a full exemption should be applicable for shareholders (entities) with a shareholding of at least 5%, subject to certain requirements (see below). If all requirements are met, under Dutch domestic law, a full exemption should also be available if the shareholder is a resident of a state with which the Netherlands has concluded a double taxation treaty, even in cases where the double taxation treaty would still allow the Netherlands to levy dividend withholding tax. An exemption is only available if the structure or transaction, in line with EU case law, is not abusive and is entered into for valid commercial business reasons.

Anti-Dividend-Stripping Cases

The Dutch dividend withholding tax exemption is denied in so-called dividend-stripping cases (ie, in cases where it appears that the person receiving the dividend is not considered the beneficial owner of the dividend). Dividend stripping may, for example, occur in cases where a shareholder transfers its shares to a third party which is entitled to a more beneficial withholding tax treatment, thereby holding its interest in the shares. As the current Dutch measures to avoid dividend-stripping have not always proved to be effective in practice, new legislation was introduced as of 1 January 2024 containing several measures to counter dividend-stripping more adequately (eg, a shift in the burden of proof from the tax inspector to the individual seeking tax benefits, and the codification of the dividend record date for publicly traded shares in Dutch tax law). Recent case law of the Dutch Supreme Court has made it clear that the anti-dividend stripping rules do not leave room for an *"extensive"* interpretation.

Apart from national measures, it is the opinion of the Dutch government that dividend-stripping could be addressed most effectively in a European and international context. In this regard, the Dutch government has expressed support for the European Commission's proposal for a Council Directive on Faster and Safer Relief of Excess Withholding Taxes (the *"FASTER Directive"*). The Faster Directive was adopted by the European Counsel on 10 December 2024 and aims to simplify withholding tax procedures for dividend and interest payments on publicly traded instruments and to prevent tax fraud and abuse. EU member states have until 31 December 2028 to transpose the FASTER Directive into domestic law, with the rules to apply from 1 January 2030.

In 2020, the first version of an initiative legislative proposal for a conditional final-dividend withholding tax levy emergency act was proposed. The proposal introduced a taxable event (ie, a DWT exit levy) in the case of, for example, a cross-border relocation of the (corporate) tax seat or a cross-border merger of a Dutch company, provided certain conditions have been met. The proposal is currently still pending. However, the Dutch Council of State and the Cabinet both advised the House of Representatives against adopting the initiative legislative proposal.

Conditional Withholding Tax

As of 1 January 2021, a conditional withholding tax was implemented on interest, royalty and (as of 1 January 2024) on dividend payments made to related entities in so-called *"low-tax jurisdictions"*, to hybrid entities and in certain abusive situations. The low-tax jurisdictions are listed in a ministerial decree and concern jurisdictions:

- with a profit tax applying a statutory rate of less than 9% (updated annually based on an assessment as per 1 October of the year prior to the tax year); or
- included on the EU list of non-cooperative jurisdictions.

The tax rate is equal to the highest corporate income tax rate (ie, 25.8%). The payer and payee of the interest, royalties and dividends are considered to be related where there is *"qualifying interest"* (a qualifying interest generally being an interest that provides a controlling influence on the decision-making and activities).

4.2 Primary Tax Treaty Countries

The largest foreign investor in the Netherlands is the United States, followed by the United Kingdom, Germany, Luxembourg and Belgium. The Netherlands has concluded double taxation treaties with all these countries.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

So far, the Dutch tax authorities have not in general challenged the use of treaty country entities by non-treaty country residents. Only in the case, for example, of specific anti-conduit/anti-abuse rules being breached are the tax authorities expected to challenge such a structure.

Targeting Abuse

It should be noted, however, that in light of the ongoing international public debate on aggressive international tax planning in the context of the G20/OECD, the Inclusive Framework on BEPS and recent case law of the ECJ, the Dutch tax authorities are increasingly monitoring structures and investments more closely and will target those that are perceived as constituting *"abuse"*. In this respect, the importance of business motives, commercial and economic considerations and justification, and relevant substance seems to be rapidly increasing.

From 1 January 2020, the presence of substance will only play a role in the division of the burden of proof between the taxpayer and the Dutch tax authorities. If the substance requirements are met, this will lead to the presumption of *"non-abuse"*, which in principle is respected, unless the tax authorities provide evidence to the contrary. If the substance requirements are not met, the taxpayer is allowed to provide other proof that the structure at hand is not abusive. See **6.6 Rules Related to the Substance of Non-Local Affiliates**.

Furthermore, the Netherlands, as a member of the Inclusive Framework and a party to the Multilateral Instrument (MLI), agrees to the minimum standards included in Articles 6 and 7 of the MLI, which among other things, prohibit the use of a tax treaty by – effectively – residents of third states.

The Dutch government aims to discourage the use of so-called letterbox companies (ie, companies with no or very limited activities that add no value to the real economy). As part of this policy, among others, the Dutch tax authorities are more closely monitoring whether companies that claim to be a resident of the Netherlands can indeed be considered as such based on their substance. In 2021, a report on letterbox companies was published, providing an overview on the (mis)use of letterbox companies. The report also contains (tax-related) recommendations which have not yet led to legislative proposals.

4.4 Transfer Pricing Issues

The Dutch tax authorities strictly apply the at arm's length principle as included in Dutch tax law, in Article 9 of most double taxation treaties and elaborated on in the OECD's Transfer Pricing Guidelines, as amended under BEPS. Therefore, transactions between affiliated companies should be at arm's length, while proper documentation should be available to substantiate the at arm's length nature of the transactions.

4.5 Related-Party Limited Risk Distribution Arrangements

Where a remuneration is based on a certain (limited risk) profile, the Dutch tax authorities scrutinise whether the services and risks of that company do indeed match the remuneration. For example, if a limited-risk distributor has, in fact, a stock risk, the remuneration should be increased to reflect coverage of that risk.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Netherlands generally follows the OECD's Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

International transfer pricing disputes are, in some cases, resolved through a MAP process. At the beginning of 2023 there were 650 MAPs outstanding, 209 of which were international transfer pricing disputes. In 2023, 323 MAPs were closed, 79 of which were international transfer pricing disputes. There is no data with respect to international transfer pricing disputes being resolved through double taxation treaties. Generally, the Dutch tax authorities are open to MAPs and willing to co-operate in these procedures. MAPS are becoming more common on the back of more inquiries and disputes in the Netherlands.

In practice, the Dutch tax authorities perform audits during which the transfer pricing methodology applied by a Dutch company is also reviewed for many years.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally speaking, if a transfer pricing claim is settled, the Dutch tax authorities act in accordance with the settlement. Hence, if a downward adjustment of the Dutch income has been agreed, it will in principle be allowed. However, since 1 January 2022, legislation has been in force targeting mismatches resulting from the application of the at arm's length principle. The legislation aims to render the at arm's length principle ineffective in cross-border situations and will, in that respect, deny the deduction of at arm's length expenses, to the extent that the corresponding income is not included in the basis of a local profit tax at the level of the recipient.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches (permanent establishments in fiscal terms) are generally taxed on the basis of the same rules and principles as subsidiaries of non-local corporations. However, due to the fundamental difference between a permanent establishment and a legal entity, in practice, differences may occur.

5.3 Capital Gains of Non-Residents

Dutch tax law includes so-called substantial shareholding rules that enable taxation of capital gains on shareholdings realised by non-residents of the Netherlands in the case of abuse. Based on the current domestic tax rules, capital gains are taxable if a shareholder holds an interest of at least 5% of the capital in a Dutch BV with the main purpose, or one of its main purposes, being to avoid personal income tax and, in this case, the structure should be considered artificial, having not been created for legitimate business reasons that reflect economic reality.

In the case where the shareholder is resident in a country with which the Netherlands has concluded a double taxation treaty, depending on the specific treaty, the Netherlands may be prohibited from levying capital gains taxation.

5.4 Change of Control Provisions

The change of control due to the disposal of shares by a holding company at a tier higher in the corporate chain (eg, above the Netherlands) as such should, in principle, not trigger corporate income taxation (unless the substantial shareholding rules apply, as referred to in **5.3 Capital Gains of Non-Residents**). However, Dutch tax law includes anti-abuse rules that lead to the cancellation of tax losses in the case of a change of control of certain companies (which, broadly speaking, have or are going to have limited activities). Also see **5.3 Capital Gains of Non-Residents** in relation to capital gains realised on the (indirect) sale of shares in a related Dutch entity.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The Netherlands typically does not determine the income of (foreign-owned) Dutch taxpayers based on formulary apportionment. Instead, remuneration for the rendering of services or the sale of goods between related companies is governed by the at arm's length principle.

5.6 Deductions for Payments by Local Affiliates

Regarding the deduction of cross charges by foreign group companies to the Netherlands, the at arm's length principle applies. For example, head office charges should be deductible by a Dutch corporate income taxpayer, provided the expenses are at arm's length. It should be noted that in some cases a mark-up is allowed. Cross-charged shareholder costs are not deductible.

5.7 Constraints on Related-Party Borrowing

Other than the interest deduction limitations discussed in **2.5 Imposed Limits on Deduction of Interest**, there are no other/specific rules that particularly constrain the borrowings of a Dutch subsidiary from a foreign subsidiary as such.

As discussed in **4.1 Withholding Taxes**, since 1 January 2021, a conditional withholding tax has applied on interest, royalty and (since 1 January 2024) dividend payments to related entities in low-tax jurisdictions, to hybrid entities and in certain abusive situations.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

If a permanent establishment (PE) is recognised to which the assets, risks and functions that generate the foreign income can be allocated, the foreign income should in principle be fully exempt from the Dutch corporate income tax base. Currency translation results between the head office and the PE are not exempt.

If certain conditions are met, losses that a PE has suffered on balance may be deductible, provided (among other things) that the losses are not utilised in any way in the PE state by the taxpayer (eg, the head office) or a related entity of the taxpayer. Since 2021, losses resulting from the dissolution of a PE in excess of EUR5 million are generally also limited to EU/EEA situations, similar to the rules that apply to participations.

6.2 Non-Deductible Local Expenses

As a starting point, the income that is allocated to a PE is determined based on a functional analysis, taking into account the assets, risks and functions carried out by the PE. Because of the outcome of the functional analysis, expenses are allocated to the PE and are, as such, exempt (eg, non-deductible) from the Dutch corporate income tax base. Furthermore, in some cases, expenses charged by the PE to the head office in consideration for services provided to the head office by the PE may be ignored. Other than that, there are no specific rules due to which local expenses are treated as non-deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividend income distributed to a Dutch company is in principle fully exempt if the participation exemption is applicable. The participation exemption should, broadly speaking, be applicable to shareholdings of 5% of the paid-up capital, divided into shares that are not held as a portfolio investment company. A shareholding should essentially not be held as a portfolio investment if the company has operational activities and has no substantial group financing or group leasing activities, or the company is taxed at an effective tax rate of at least 10% based on Dutch standards.

The Dutch rules on exchange of information may have to be amended as a result of the proposed directive on the misuse of shell entities that was published by the European Commission at the end of 2021 (ATAD 3), but the ATAD3 proposal is currently still in flux. See **2.7 Capital Gains Taxation**.

6.4 Use of Intangibles by Non-Local Subsidiaries

Group transactions in the Netherlands adhere to the at arm's length principle (including amendments to the transfer pricing guidelines under the BEPS project, such as in relation to hard-to-value intangibles), so the use of locally developed intangibles by non-local subsidiaries should trigger Dutch corporate income taxation.

If the intangibles are going to be developed under the innovation box, the qualifying income (a capital gain or a licence fee) may be taxable at an effective tax rate of 9%.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

As part of the implementation of ATAD, the Netherlands introduced a controlled foreign companies (CFC) regime on 1 January 2019.

Under a somewhat CFC-like rule, in the case of shareholdings of at least 25% in foreign companies that are not taxed reasonably according to Dutch standards and in which the assets of the company are portfolio investments or assets that are not related to the operational activities of the company, the shareholding should be revalued at fair market value annually. The gain recognised as a result of this is subject to corporate income tax at the standard rates. See also **9.1 Recommended Changes**.

Assuming that passive activities led to the recognition of a PE, the income that can be allocated to that PE should not be exempt, as the object exemption is in principle not applicable to low-taxed passive investments.

6.6 Rules Related to the Substance of Non-Local Affiliates

In general, no specific substance requirements apply to non-local affiliates (except for the CFC rules). In a broader sense, low substance of non-local affiliates could trigger anti-abuse rules (eg, non-application of the participation exemption due to which inbound dividend income may be taxable, the annual mandatory revaluation of low-substance participations against fair market value, etc).

Furthermore, under certain corporate income tax and dividend withholding tax anti-abuse rules, shareholders of Dutch intermediary holding companies, subject to certain requirements, should have so-called relevant substance and perform relevant economic activities, including that shareholders must use an office space for at least 24 months that is properly equipped to perform holding activities, and wage expenses of at least EUR100,000 should be incurred by the shareholder.

Abuse of EU Law

It must be emphasised that following the CJEU cases of 26 February 2019 on the EU Parent-Subsidiary Directive (PSD) and on the Interest and Royalties Directive (IRD), the Netherlands, being an EU member state, is obliged to target *"abuse of EU law"*. The assessment of whether a structure or investment may be considered *"abusive"* is made based on an analysis of all relevant facts and circumstances. There are no legal safe harbour or irrefutable presumptions.

Consequently, from 1 January 2020, the presence of substance will only play a role in the division of the burden of proof between the taxpayer and the tax authorities. If the substance requirements are met, this will lead to the presumption of *"non-abuse"*, which is respected, unless the tax authorities provide evidence to the contrary. If the substance requirements are not met, the taxpayer is allowed to provide other proof that the structure at hand is not abusive.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains derived from the alienation of a qualifying shareholding in a foreign company by a Dutch company are fully exempt from Dutch corporate income tax if the participation exemption is applicable.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Apart from specific anti-abuse rules, the Dutch Supreme Court has developed the doctrine of abuse of law (fraus legis) as a general anti-abuse rule. Under this rule, transactions can be ignored or re-characterised for tax purposes if the transaction is predominantly driven by tax reasons and not driven by commercial considerations while the object and purpose of the law are being breached. So far, the Supreme Court has been reluctant to apply the doctrine in cases where a tax treaty is applicable.

As part of the implementation of ATAD, the legislature did originally state that the doctrine of abuse of law (fraus legis) is very similar to the general anti-abuse rule included in the directive, so that effectively no additional provision has to be included in Dutch law in this respect. However, as part of the Tax Plan 2025 and at the request of the European Commission, the General Anti-Abuse Rule (GAAR) has now been codified into Dutch corporate income tax legislation. The statutory implementation of the GAAR is not intended to effect any material change in the Dutch fraus legis doctrine, nor does it aim to affect any other (Dutch) taxes or the currently existing special anti-abuse provisions.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Netherlands has no periodic routine audit cycle. Tax audits are typically carried out at the discretion of the tax authorities but some companies (eg, those active in the oil and gas industry) are typically audited on a regular basis. Tax audits are extraordinary in the sense that the Dutch tax inspector, upon the filing of the corporate tax return, has the opportunity to scrutinise the filed tax return, raise questions, ask for additional information and, if necessary, make an adjustment upon issuing a final assessment. Provided certain conditions are met the tax authorities may also have impose additional tax assessments on taxpayers.

9. BEPS

9.1 Recommended Changes

Some of the developments most relevant to Dutch taxpayers that have taken place since the outcomes of the BEPS Project are set out below in chronological order.

Dividend Income Deductibility

Following the amendment of the EU Parent-Subsidiary Directive to counter abuse, the Dutch participation exemption regime was amended, as a result of which, broadly speaking, dividend income is no longer exempt from the Dutch corporate income tax base if the dividend is deductible at the level of the entity distributing the dividend.

ATAD

To adopt ATAD, the Netherlands implemented the earnings stripping rule on 1 January 2019, and also implemented a CFC regime. Furthermore, as of 1 January 2025 the Netherlands has also implemented ATAD's General Anti-Abuse Rule into its domestic tax law.

Earnings stripping rules

The earnings stripping rules of EBITDA were further tightened from 2022 onwards as the deduction of the balance of interest amounts was limited to the highest of 24.5% (2025) of the adjusted profit or EUR1 million. The Dutch earnings stripping rules are more restrictive than required under ATAD which prescribes a threshold of 30% or EUR3 million. The Dutch government has investigated the implementation of a budget neutral introduction of a deduction on equity, accompanied by the tightening of the Dutch earnings stripping rules, in order to achieve a more balanced tax treatment of capital (equity) and debt. The Dutch government concluded that a unilateral introduction of a deduction on equity is not desirable in respect of tax avoidance and that it should therefore wait for a multilateral introduction of a deduction on equity.

CFC regime

Under the Dutch CFC regime, in certain cases, undistributed passive income (eg, interest, royalties, dividends, capital gains on shares) derived by a CFC will be subject to corporate income tax. A foreign entity qualifies as a CFC if the Dutch taxpayer directly, or together with related companies, has an interest of more than 50%, provided that the entity is a tax resident in a low-tax jurisdiction (statutory rate of less than 9%) or a state included on the EU list of non-cooperative jurisdictions. Undistributed passive income derived by a CFC that is a tax resident of a jurisdiction mentioned on the list can be excluded from Dutch taxation if: (i) the CFC's income usually consists of 70% or more non-passive income; (ii) the CFC qualifies as a financial undertaking; or (iii) the CFC carries out meaningful economic activity. A list of substance elements has been published to determine whether a CFC carries out a meaningful economic activity. If all of the substance elements are met, the meaningful economic activity test is deemed to be satisfied unless the Dutch tax inspector can prove that this is not the case. See 6.6 Rules Related to the Substance of Non-local Affiliates.

GAAR

The Netherlands initially opted not to incorporate the GAAR into the Dutch Corporate Income Tax Act, as the Dutch State Secretary considered the GAAR to be sufficiently embedded in Dutch tax law through the fraus legis doctrine. However, at the request of the European Commission, the Netherlands formally codified the GAAR into Dutch corporate income tax legislation, effective as of 1 January 2025.

MLI

The Netherlands has signed and ratified the MLI that includes the BEPS measures that require amendment of (Dutch) bilateral double taxation treaties. The Netherlands has taken the position that all material provisions of the MLI should be included in the Dutch double taxation treaties, except for the so-called savings clause included in Article 11 of the MLI. As such, a general anti-abuse provision (in most cases, the so-called principal purpose test) should likely be included in many Dutch double taxation treaties, as well as a range of specific anti-abuse rules.

Dividend Withholding

The Dividend Withholding Tax Act 1965 has been amended whereby co-operatives that are mainly involved in holding and/or financing activities (and that up to now were able to distribute profits without triggering dividend withholding tax except in cases of abuse) become subject to Dutch dividend withholding tax upon distributing profits. If the recipient of the profit distribution is a tax resident in a country with which the Netherlands has concluded a comprehensive double taxation treaty, an exemption from that tax should be available provided that the relevant structure is not abusive. The Corporate Income Tax Act 1969 has also been amended in relation to the above (ie, the substantial shareholding rules).

Country-by-Country Reporting and Exchange of Information

A law has been enacted to meet the obligations of the Netherlands in respect of country-by-country reporting (BEPS Action 13).

A law has been enacted to meet the obligations of the Netherlands in respect of the automatic exchange of rulings. Furthermore, the Dutch innovation box regime has been amended to align it with BEPS Action 5 (countering harmful tax practices).

Interest and/or Royalty Conduits and Withholding Tax applies on Royalties, Interest and Dividends

Further enhancement of the substance requirements for interest and/or royalty conduit companies has been introduced, due to which, information is automatically exchanged with the respective foreign tax authorities in the case of interest and/or royalty conduit companies not meeting these enhanced substance requirements (eg, a minimum of EUR100,000 salary expenses and the availability of a properly equipped office space for at least 24 months).

As from 1 January 2021, a conditional withholding tax applies on royalties, interest and (as of 1 January 2024) dividends paid to group companies in low-tax jurisdictions, to hybrid entities or in certain abusive situations.

Safe Harbours, Economic Nexus, Permanent Establishments and Opknippen

The minimum substance requirements no longer function as a safe harbour.

The Dutch practice regarding international tax rulings was revised on 1 July 2019. To obtain an international tax ruling from the Dutch tax authorities, among other things, a sufficient *"economic nexus"* with the Netherlands is required.

The national definition of a permanent establishment has been brought in line with the 2017-OECD Model Tax Convention (which reflects the BEPS outcomes).

Furthermore, the government has investigated the extent to which group companies are breaking up (*opknippen*) activities in order to obtain tax benefits, specifically the benefit arising from the multiple application of the low tax rate levied on the first part of a taxpayer's profit. As a result, the first bracket on which Dutch corporate income tax is levied was lowered in 2023 (and still applies for 2025) to 19% over the first EUR200,000 (instead of 15% over the first EUR395,000 in 2022).

9.2 Government Attitudes

The central aim of the Dutch government is to find a balance between, on the one hand, ending aggressive international tax planning by promoting transparency and making rules abuse-proof, and, on the other, not harming the Dutch economy and thus seeking to take measures that are in step with international developments, thus avoiding unilateral measures that might disproportionately harm Dutch corporations, and to establish favourable Dutch tax regimes to safeguard the attractive business and investment climate.

The Dutch government has announced that it will fully commit to the rules of Pillar One and Pillar Two. Pillar One may substantially impact the allocation of tax revenues to jurisdictions. Pillar Two, as implemented in Dutch domestic law as of 1 January 2024 following an EU Directive on Pillar Two, introduces certain technical rules to ensure the effective tax rate of 15%, the so-called *"Income Inclusion Rule"*, the so-called *"Undertaxed Payments Rule"* and the so-called Qualified Domestic Minimum Top-up Tax (QDMTT) rule.

Pillar Two

The Income Inclusion Rule

In short, the Income Inclusion Rule applies to a parent entity in the Netherlands in respect of low-taxed group entities (*"constituent entities"*) to bring taxation in line with the minimum effective tax rate of 15%. Under the Income Inclusion Rule, the minimum effective tax rate is paid at the level of the ultimate parent entity, in proportion to its ownership rights in subsidiaries that are taxed at a low effective tax rate (ie, lower than 15%). Briefly stated, the effective tax rate is calculated by dividing the corporate tax due by the net qualifying income.

The Undertaxed Payments Rule

The Undertaxed Payments Rule functions as a backstop rule, in addition to the Income Inclusion Rule. The Undertaxed Payments Rule applies in situations where, for example, a group is based in a non-EU country and that country does not impose the minimum rate. The share of the top-up tax is calculated based on a formula proportionate to the relative share of assets and employees.

The Qualified Domestic Minimum Top-up Tax

In addition, the Netherlands opted to include the Qualified Domestic Minimum Top-up Tax, whereby any top-up tax to be paid by Dutch resident entities with an effective tax rate of less than 15% that are part of an in-scope group, will be collected by the Netherlands (instead of by the ultimate parent entity in another jurisdiction).

Pillar Two may substantially impact the sovereignty of states as regards the taxation of business profits and their ability to employ an international tax policy based on the principle of *"capital import neutrality"*. In addition, the implementation of Pillar Two will most likely lead to a higher administrative burden as the effective tax rate should be determined in each jurisdiction in which a multinational is active.

9.3 Profile of International Tax

International taxation, especially over the last decade, has gained a high public profile due to extensive coverage of – alleged – aggressive tax planning in leading Dutch newspapers and other media, as well as the exposure generated by NGOs such as Oxfam Novib and Tax Justice.

Over the last decade, members of parliament have raised their concerns on a regular basis regarding the attitude of multinational corporations and their supposed unwillingness to contribute their fair share. This is, for example, also reflected in the notifications made by the Dutch government for the application of the MLI, which reflect the Dutch position to apply nearly all anti-abuse measures included in the MLI.

9.4 Competitive Tax Policy Objective

The Netherlands has a competitive tax policy, driven by the fact that the Dutch economy relies for a large part on foreign markets, as the domestic market is relatively small. In a letter from October 2022, the Dutch government set out its (updated) international tax policy. As a starting point, the Dutch government considers it to be important that the Netherlands is not out of line with other countries when it comes to the area of taxation. Therefore, the approach of tax avoidance should be accompanied by (satisfactory) international agreements. At the same time, the Dutch government strives for a stable tax business climate in which tax legislation does not change every few years. When implementing new legislation for corporate entities, the Dutch government seeks to find a balance between mitigating the risk of abuse by international taxpayers while avoiding unnecessary hindrance of real corporate activities.

9.5 Features of the Competitive Tax System

The Dutch government generally takes a balanced approach to each measure it employs; consideration will therefore be given to the pros and cons of existing practices, and their relevance for real business activities, including the accounting and legal services industry. Thus, it is difficult to say which areas are vulnerable to scrutiny, except for structures with low substance and structures that are clearly tax driven while bearing little or no relevance to the real economy. Dutch law does not restrict state aid in general with a specific rule, except for the state aid rules as laid down in EU law.

9.6 Proposals for Dealing With Hybrid Instruments

The BEPS and ATAD proposals addressing hybrid instruments have been implemented by the Dutch government and as such are included in Dutch tax law and/or Dutch double taxation treaties.

9.7 Territorial Tax Regime

The Netherlands has no territorial tax regime. As a starting point, it taxes resident (corporate) taxpayers on their worldwide income, subject to the application of double taxation treaties and unilateral rules for relief for double taxation.

It is difficult to make a general prediction as to the impact of the interest limitation rules for Dutch taxpayers, as this is to a large extent fact driven, while the Netherlands already has a range of interest limitation rules and it has been proposed to abolish two of the existing interest limitation rules.

9.8 Controlled Foreign Corporation Proposals

A cornerstone of Dutch international policy for decades has been to avoid economic double (including juridical double) taxation within corporate structures, which is why the Netherlands has exempted dividend income received from foreign group companies (under the so-called participation exemption regime). Furthermore, the Netherlands has so far been advocating the principle of so-called capital import neutrality, by which a resident state should exempt foreign-sourced income from taxation to allow its corporations to make foreign investments on a level playing field (in terms of taxation).

The Netherlands therefore used to be reluctant to let go of its position to exempt foreign income. However, as part of the implementation of the ATAD, CFC rules were introduced in the Netherlands on 1 January 2019. See **9.1 Recommended Changes.**

9.9 Anti-Avoidance Rules

The Netherlands favours (as reflected in the Dutch notification to Article 7 of the MLI) a principal purpose test as opposed to a limitation on benefits provision, mainly because the principal purpose test is thought to work out proportionately in most situations. Thus, truly business-driven structures, either inbound or outbound, should not be harmed. Nevertheless, the principal purpose test is principle driven rather than rule driven, which makes it less clear which structures will be affected by the principal purpose test.

In other words, there may be legal uncertainty, especially in the beginning when there is also little practical experience. Furthermore, some countries might apply the principal purpose test liberally, which might make corporations decide to avoid the Netherlands. However, this remains to be seen, especially as in other countries the same issues should come up.

9.10 Transfer Pricing Changes

Aside from the introduction of country-by-country reporting and, to a lesser extent, the documentation requirements (eg, master file and local file), the Netherlands has already applied the at arm's length principle as a cornerstone of its transfer pricing regime. As such, these changes should not lead to a radical change, and this should also apply to intangibles.

However, as stated before, legislation that entered into force on 1 January 2022, targeted mismatches resulting from the application of the at arm's length principle. Among other things, this legislation aims to render the arm's length principle ineffective between related parties in cross-border situations to the extent that it will deny the deduction of at arm's length expenses if the corresponding income is not included in the basis of a local profit tax at the level of the recipient.

9.11 Transparency and Country-by-Country Reporting

The Netherlands is in favour of increasing transparency in international tax matters, provided an agreement can be reached on an international level that is as broad as possible to avoid national economies being harmed by multinational corporations' decisions to avoid jurisdictions that have transparency requirements.

In addition to the BEPS country-by-country reporting obligation, in 2024, the Netherlands introduced mandatory public country-by-country reporting rules for large multinationals. This additional reporting obligation stems from the EU Public Country-by-Country Reporting Directive of 2021 and adds a new angle to the reporting obligation by making such data publicly available to a wider audience.

9.12 Taxation of Digital Economy Businesses

No legislative proposals have been published in this area yet.

9.13 Digital Taxation

The State Secretary for Finance favours an international, co-ordinated (unified) approach, rather than jurisdictions implementing domestic legislation independently, such as Pillar One and Pillar Two. Consequently, the Dutch government has already implemented Pillar 2 in Dutch domestic law as of 1 January2024.

It should also be noted that as of 1 January 2023, the Directive on Administrative Cooperation (DAC7) has been implemented into Dutch law. DAC7 contains rules on information exchange regarding digital platforms. Furthermore, the Dutch Ministry of Finance published a new draft bill in October 2024 implementing the EU Directive amending EU rules on Administrative Cooperation (DAC8). DAC8 introduces rules on information exchange regarding crypto-assets and advance tax rulings for the wealthiest individuals. The new rules should be transposed into national law by 31 December 2025 with first application for most provisions from 1 January 2026. In 2024, the European Commission published another proposal again amending the Directive on Administrative Cooperation (DAC9), this time to facilitate the filing and exchanging of Pillar Two-related information in the EU. If adopted, these rules should be transposed into national law by 31 December 2025.

9.14 Taxation of Offshore IP

The Netherlands has no specific provisions as to the taxation of offshore intellectual property. It is worth noting however that, since 1 January 2021, a conditional withholding tax has applied to interest and royalty payments to states qualified as low-tax jurisdictions. Furthermore, in the case of passive offshore IP structures, the Dutch CFC rules may apply and would require a review from a transfer pricing perspective.

Trends and Developments

Contributed by:
Margriet Lukkien, Michiel Beudeker, Vincent van der Lans and Louis Lutz
Loyens & Loeff

Loyens & Loeff is proud of the unique service they offer multinational enterprises, financial institutions, investors and high net-worth individuals. With home offices in the Netherlands, Belgium, Luxembourg and Switzerland; offices in key financial centres such as New York, London and Paris; and a global partner network, they reach out and support clients wherever they need. The firm's strength is particularly evident in aspects of international taxation that in some way involve the national tax laws and regulatory regimes in their home markets and global transfer pricing. As a leading law firm in continental Europe, they have a particular focus on multinational enterprises, private equity and funds, real estate, life sciences and healthcare, and energy and infrastructure. They integrate tax, civil law and notarial expertise to support clients with smart and efficient solutions through advice, transactions and litigation.

Authors

Margriet Lukkien is a tax partner with Loyens & Loeff. She is a core member of the US team. She advises US and other multinationals, financial institutions and sovereign wealth funds on Dutch corporate tax and dividend tax aspects, international tax aspects and international (re)structurings, where the OECD and EU tax developments typically play a key role as well. She is a board member of the Dutch Association of Tax Advisers (NOB). She is an active member of the International Bar Association.

Michiel Beudeker is a tax partner with Loyens & Loeff in the firm's investment management practice. He focuses on cross-border operations involving the Benelux countries, the UK and Italy. His clients are primarily foreign private equity clients investing in the Netherlands (real estate and/or other investments). Michiel has specific expertise in the field of partnerships. Michiel is a member of the International Fiscal Association (IFA) and of the Dutch Association of Tax Advisers (NOB). He is the official Loyens & Loeff representative in the Dutch Fund and Asset Management Association (DUFAS) and also a member of the tax committee of DUFAS.

Vincent van der Lans is a tax partner with Loyens & Loeff in the firm's international tax services America practice and a core member of the US team and the life sciences and healthcare team. He specialises in international tax matters, particularly for multinationals, financial institutions and investment funds based in North America. His work includes M&A, corporate reorganisations, and assisting businesses in establishing operations in Europe. He is a member of the International Fiscal Association (IFA), the Dutch Association of Tax Advisers (NOB) and the AmCham Netherlands Tax Committee.

Louis Lutz is a tax partner with Loyens & Loeff in the firm's transactional tax practice. He is a member of the private equity team. He specialises in Dutch domestic and international tax law with a focus on (cross-border) M&A, private equity and debt/equity capital markets transactions as well as restructurings. He has experience in private equity and real estate fund formation and structured finance. He advises on the tax aspects of such transactions, including structuring and drafting and negotiating tax related provisions in the transaction documents. He is a member of the Dutch Association of Tax Advisers (NOB).

Loyens & Loeff

Parnassusweg 300
1081 LC Amsterdam
The Netherlands

Tel: +31 20 578 57 85
Fax: +31 20 578 58 00
Email: jurgen.kuiper@loyensloeff.com
Web: www.loyensloeff.com

LOYENS & LOEFF
Law & Tax

Since the OECD/G20's final reports on Base Erosion and Profit Shifting (BEPS) were published in 2015 there have been several tax developments in the Netherlands, many of which have been the result of EU implementation of OECD-originated standards and recommendations. This article explores important current EU and Dutch tax developments that are relevant for multinational groups.

European Tax Developments

Introduction and future outlook

There were a number of significant developments in the field of EU tax law in 2024. These include the national implementation of the Pillar Two Directive by most member states, the filing of a legal action on the compatibility of the Undertaxed Profit Rule (UTPR) with the Belgian Constitution and EU law before the Belgian Constitutional Court, the adoption of the FASTER Directive and the political agreement reached on VAT in the Digital Age (ViDA).

When looking at 2025, EU tax law developments are expected in several areas.

However, because of the strong opposition to the Pillar Two rules recently expressed by the Trump administration and the threat of retaliatory trade measures being adopted by the United States, the European Commission might have to reassess part of its plans. The United States has begun an investigation into whether some foreign governments' tax rules, such as the UTPR, are extraterritorial, or whether they disproportionally affect US companies, like the digital service taxes (DSTs) that were put on hold until mid-2024. The European Commission will have to reassess its political position regarding the implementation of the UTPR and DSTs, both at the level of member states and the European Union, as well as to determine the response to possible US trade measures.

In 2025, discussions are furthermore envisaged on the role that taxation can play in contributing to the EU's competitiveness and climate ambitions. Based on the recommendations made by both the Draghi report released in 2024 and the EU Competitiveness Compass of early 2025, it is expected that the 2025 EU tax agenda will be centred on decluttering, simplification and reduction of existing tax and regulatory burdens, as well as on the introduction of tax incentives to support innovation, R&D and digitalisation. To make such tax incentives possible, a revision of the EU state aid framework has also been announced.

Furthermore, in 2025 discussions are anticipated in relation to possible revisions of the Anti-Tax Avoidance Directive (ATAD) and the Directive on Administrative Co-operation in the field of taxation (DAC), which were both evaluated by the European Commission in 2024.

In addition, a legal proposal for a 28th legal regime for innovative companies (ie, a single, harmonised set of EU-wide rules instead of 27 distinct national regimes, which aims to simplify applicable rules for all corporate law, insolvency, labour and tax law purposes) is expected to be tabled by the end of 2025. Although its core elements and scope are still to be defined, this 28th legal regime would be an important measure in the forthcoming EU tax policy agenda.

Finally, a new proposal for the EU's own resources is expected to be tabled. This is necessary as EU funds are needed for, inter alia, the repayment of the EU's economic recovery fund and debts related to COVID-19.

Council Directives and proposals

The FASTER Directive

The European Commission's proposal for the Faster and Safer Relief of Excess Withholding Taxes Directive (FASTER Directive) was adopted by the Council on 10 December 2024 and entered into force on 30 January 2025. The FASTER Directive aims to make relief processes faster and more efficient and to reduce the risk of fraud and abuse. Thereto, member states should have a quick relief system in place. Member states may choose between either *"relief at source"* system or *"quick refund"* system, which should result in a correct amount being withheld or an accelerated refund of excess withholding tax.

The directive furthermore introduces an EU-wide electronic tax residency certificate for investors, which is aimed at improving the administrative process.

Large EU financial intermediaries facilitating relief systems will be required to join a national register of Certified Financial Intermediaries (CFI). Such CFIs will have to report to competent authorities the information essential to identify investors and their entitlement to reduced withholding tax rates and to detect possible fraud or abuse.

Member States must implement this directive in their national laws by 31 December 2028 and apply these laws as of 1 January 2030.

The VAT in the Digital Age package

Released in 2022, the ViDA package includes VAT measures that will impact all businesses and particularly those carrying out cross-border transactions and platform companies.

The ViDA package focuses on improving VAT efficiency, minimising VAT fraud and reducing foreign VAT registration obligations. It consists of three pillars: (i) digital reporting, (ii) single VAT registration and (iii) VAT treatment of the platform economy.

On 5 November 2024, the Council of the EU reached political agreement on an amended version of the ViDA proposal. The European Parliament was re-consulted on the amended ViDA proposal and subsequently the proposal was put up for formal adoption by the Council. The formal adoption took place on 11 March 2025.

The BEFIT proposal

Released in 2023, the proposal on Business in Europe: Framework for Income Taxation (BEFIT) lays down a common corporate income tax framework for the calculation and subsequent allocation of an aggregated tax base for groups active in the EU, focusing on simplification and harmonisation.

In its current form, the BEFIT proposal contains several advantages such as cross-border loss relief and the absence of withholding tax on intra-BEFIT group interest and royalty payments. However, it also creates a new layer of complex corporate income tax rules. In addition, the interaction of BEFIT with the Pillar Two rules is an area of concern for stakeholders.

Due to the input provided by stakeholders at the beginning of 2024, BEFIT will not be put up for adoption in its current form but, following recent communications of Commissioner Hoekstra, renewed discussions are expected in 2025.

The transfer pricing proposal

Released in 2023, together with the BEFIT proposal, the TP proposal aims to harmonise transfer pricing rules within the EU through the incorporation of the arm's length principle into EU law with reference to the OECD's TP Guidelines.

The TP proposal attracted critical reactions from member states, inter alia addressing the potential creation of a double transfer pricing standard and differences in the definition of associated enterprises between member states. In 2024, discussions started on replacing the TP proposal with a non-binding Joint Transfer Pricing Forum, which will continue in 2025.

The Unshell proposal

Released in 2021, this proposal aims to counter the misuse of EU entities that have no or minimal substance and do not perform an actual economic activity. Such misuse will be addressed by means of introducing tax reporting obligations, information exchange and a possible denial of certain tax benefits.

The final wording of the Unshell proposal is under discussion and there are still divergent views on certain elements such as the substance indicators and the consequences of being *"shell entity"*.

Although still on the European Commission's agenda, an agreement on the Unshell proposal is not expected in the short term.

Domestic Developments

Introduction

In December 2024, the proposal to incorporate part of the OECD Pillar Two Administrative Guidance (AG) in the Minimum Tax Act 2024 as well as rules on the interaction of the Pillar Two rules with the Dutch *"subject-to-tax rules"* in the Dutch Corporate Income Tax Act (CITA) were adopted. Other important changes for multinational groups relate to the new tax classification rules for Dutch and foreign entities applicable as of 1 January 2025.

Below these changes are described in more detail as well as certain other new measures and developments relevant for MNEs.

Dutch implementation of Pillar Two

On 31 December 2023, the Minimum Tax Act 2024 entered into force, in line with the EU Pillar Two Directive and the GloBE rules.

The Netherlands introduced the Income Inclusion Rule and the Qualified Domestic Minimum Top-up Tax (QDMTT) for financial years starting on or after 31 December 2023 and the UTPR for financial years starting on or after 31 December 2024. The act implements the UTPR as an additional levy, instead of the denial of a deduction. Furthermore, the act contains an implementation of the transitional CbCR Safe Harbour and the UTPR Safe Harbour and provides for the QDMTT Safe Harbour.

The law adopted in December 2024 fully incorporates certain administrative guidance as released by the OECD's Inclusive Framework in February 2023 and July 2023, and partially incorporates administrative guidance released in December 2023.

It is currently under review if the remainder of the December 2023 administrative guidance, as well as administrative guidance released in June 2024 and January 2025, require further legislative changes.

Dutch entity classification rules

Prior to 2025, the Dutch tax entity classification rules differed from international standards, causing unintended hybrid mismatches. As of 2025, new classification rules apply which aim to align the current rules with international standards.

Foreign entities
Prior to 2025, the primary classification rule for foreign entities was comparing the foreign entity with its Dutch equivalent (the so-called *"similarity approach"*). In general, if a foreign entity were sufficiently comparable to a Dutch legal form, it was treated in accordance with the rules applicable to that Dutch equivalent. Under the new classification rules, the similarity approach remains the primary classification rule.

The similarity approach is regulated by the Tax Classification Decree published in November 2024, which elaborates on the application of this approach and also contains a non-exhaustive (indicative) list of foreign entities that have already been classified for Dutch tax purposes.

If there is no clear Dutch equivalent for the foreign entity, two secondary classification rules for foreign entities have been introduced as of 1 January 2025:

- The symmetrical approach – foreign entities that are not tax residents of the Netherlands will be classified similarly to the classification in their jurisdiction of residence.
- The fixed approach: foreign entities that are tax resident of the Netherlands will be classified as non-transparent.

Limited partnerships
Until 2025, limited partnerships were classified as transparent for Dutch tax purposes if the admission or replacement of a limited partner required the unanimous consent of all (general and limited) partners (the *"consent requirement"*).

As of 2025, the consent requirement has been abolished. This abolishment will in principle result in Dutch and foreign limited partnerships no longer being treated as non-transparent from a Dutch tax perspective.

Consequently, all (Dutch and foreign) limited partnerships should in principle be classified as tax transparent for Dutch tax purposes, unless they are classified as a non-transparent fund for joint account (*fonds voor gemene rekening* or FGR).

FGRs
As of 2025, an FGR can either be transparent or non-transparent from a Dutch tax perspective. As of 2025, the transparent FGR is called the *"transparent fund"*. Any further reference to FGRs in this article will therefore mean the non-transparent FGR.

The potential reclassification of a transparent limited partnership into an FGR and the relevant criteria under which such reclassification may occur are somewhat in flux. In light of this, in December 2024, the Dutch government published a decree addressing the amended definition of the FGR (the *"Fund Decree"*).

The Fund Decree lays down the cumulative criteria that must be met by a (contractual) entity to be (re)classified as an FGR. An entity is classified as an FGR if the four cumulative criteria – as summarised below – have been met:

- the entity should invest for joint account (ie, it has to be established for collective investments, which implies that an entity with only one participant can generally not be classified as an FGR);
- the entity should have a strategy that is classified as *"normal"* portfolio management

(ie, the strategy cannot be considered to be entrepreneurial by nature);
- the entity should be an *"investment fund"* or *"fund for collective investment in tradeable securities"* within the meaning of Article 1:1 of the Dutch Financial Supervision Act (ie, this criterion excludes certain types of entities, in particular family funds, from being classified as an FGR); and
- the participations in the entity should be embodied by *"tradeable participation certificates"* (which excludes participations that are only transferable to the entity itself by way of redemption).

Developments

It is important to note that the Dutch government is aware of the issues and uncertainties that may have been caused by the possible reclassification of transparent limited partnerships into FGRs and has announced that potential issues regarding the new Dutch entity tax classification rules will be further investigated during 2025. As part of this further investigation, the government opened a public consultation on 11 February 2025, in which stakeholders are requested to provide input on the issues they have encountered and possible solutions to resolve these.

Other tax developments

Tax-free repurchase facility for listed companies remains available

Under the repurchase facility, listed companies can, under conditions and within limitations, repurchase shares without the obligation to withhold Dutch dividend tax.

In December 2023 a heavily debated law was adopted abolishing the tax-free repurchase facility for listed companies as of 1 January 2025.

The new Dutch government acknowledged the adverse effects of this abolishment on the competitive position of Dutch companies and on the Dutch business climate. The measure was subsequently reversed in December 2024, before it actually came into effect, entailing that the facility has remained in place.

Concurrence of the loss settlement rules and the debt waiver exemption

Under Dutch tax law, a waiver of an uncollectible debt is considered a gain. However, an exemption applies to the amount exceeding available tax losses. From 2022, loss relief is restricted to 50% of the current year profit exceeding EUR1 million. Consequently, upon a waiver, tax could be due on half of the amount of the waiver if it exceeded the EUR1 million threshold. This made it more difficult for a loss-making company to restructure, as tax had potentially to be paid on such gains (leading to a cash out for a company in financial distress).

To bring the debt waiver exemption in line with its objectives, the debt waiver exemption has been amended by the new Dutch government, with effect from 1 January 2025. Under the new rules, if available tax losses exceed EUR1 million, the gain resulting from a waiver will be tax exempt to the extent it exceeds the current year loss (along with a corresponding reduction of the tax losses carried forward). This means no tax is due in the case of a debt waiver.

New group concept in the Withholding Tax Act 2021 (WTA)

The Netherlands levies a conditional withholding tax (CWT) on interest, royalties and dividend payments (*"IRD Payments"*) to affiliated entities in low-tax jurisdictions (LTJs) or in jurisdictions that are included on the EU blacklist, to certain hybrid entities and in abusive situations.

Affiliation is based on the presence of a qualifying interest. A qualifying interest is an interest based on which, directly or indirectly, a decisive influence (ie, control) can be exercised on the decision-making process. A qualifying interest may be held independently or as part of a co-operating group that collectively holds a qualifying interest.

For the definition of a co-operating group in the WTA, reference is made to the co-operating group as stipulated in Article 10a of the Dutch Corporate Income Tax Act (CITA). The co-operating group has deliberately not been defined and is interpreted strictly by the Dutch tax authorities in a CITA context. In practice, this created uncertainty for CWT purposes. To avoid overkill and an adverse impact on the Dutch investment climate, the new Dutch government introduced a new group definition for CWT purposes (ie, a qualifying unit), which replaces the co-operating group definition.

A qualifying unit is present in situations where entities act jointly with the main purpose, or one of the main purposes, of avoiding the levy of CWT at the level of one of those entities. The burden of proof regarding the existence of a qualifying unit is with the tax authorities and it is possible to obtain advance tax rulings regarding the presence or absence of a qualifying unit.

Given the welcome introduction of an avoidance test, and the opportunity to obtain certainty in advance regarding this topic, it is expected that only structures that are specifically set-up to avoid CWT will be covered by the new group definition.

Interest deduction limitations

General

Interest expenses are, as a general rule, deductible for Dutch corporate income tax purposes. However, certain deduction limitations may apply. For example, interest deduction may be limited pursuant to the earnings stripping rule or the anti-base erosion rule. A recent development in relation to the earnings stripping rule is summarised below.

Earnings stripping rule

The new Dutch government increased the room to deduct interest expenses under the earnings stripping rule. With effect from 2025, the earnings stripping rule limits the deduction of net interest expenses – ie, the balance of interest costs and interest income (including certain foreign exchange results), for both related and unrelated party loans – to the higher of EUR 1million and 24.5% of a taxpayer's tax EBITDA (previously 20%).

Non-deductible acquisition or sale costs

Costs related to the acquisition or sale of a participation are not deductible for Dutch corporate income tax purposes if the participation exemption applies (*"non-deductible acquisition or sale costs"*). In December 2018, the Supreme Court ruled that costs only qualify as such if there is a direct causal link with the acquisition or sale of a participation, determined by objective standards. Such direct causal link is present if the costs were not incurred without the acquisition or sale of the relevant participation.

In December 2023, the Supreme Court clarified that this direct causal link means that the costs must be objectively useful or necessary for the acquisition or sale. Costs that do not contribute to achieving the acquisition or sale are not considered non-deductible acquisition or sale costs.

For example, farewell bonuses paid by the sell-side to employees of sold participations were ruled not to be non-deductible as they were not aimed at achieving the sale.

On 19 September 2024, the State Secretary of Finance updated the decree on the participation exemption, addressing non-deductible acquisition or sale costs. The positions taken by the State Secretary of Finance include:

- warranty & indemnity insurance premiums being non-deductible, but payouts under such insurance are not taxed; and
- salary costs of employees working on an acquisition or sale transaction may be non-deductible, even if they would have also been incurred without the transaction.

Final Remarks

In 2025 the tax developments at international and EU level remain important for the Netherlands as the government's basic principle in addressing global tax developments is to adhere as much as possible to such international agreements and EU directives.

As far as expected unilateral measures are concerned, the government is currently investigating the introduction of additional measures against dividend stripping. The outcome of this study is expected to be reported to the House of Representatives in the spring of 2025. In addition, the government is evaluating the Dutch taxation of so-called lucrative interests, among which certain carried interest schemes.

NEW ZEALAND

Law and Practice

Contributed by:
Greg Neill, Fred Ward and Young-chan Jung
Russell McVeagh

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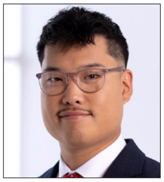
Russell McVeagh is a leading full-service New Zealand law firm and employs approximately 300 staff and partners. The firm is committed to operating on the cutting edge of legal practice, with award-winning lawyers who are internationally recognised for their thought leadership, depth of experience and ability to translate complex legal issues into client success stories. It has particular expertise in banking and finance (including securitisation and financial markets regulation), corporate and commercial (including M&A), tax, competition/antitrust, employment, health and safety, resource management (including energy), litigation, restructuring and insolvency, property and construction, technology and digital, and public law and regulation. The tax team has extensive corporate tax experience and provides advice on a wide variety of issues relating to financing and capital raising, M&A, business establishment and reorganisations, investment products, PPPs and infrastructure investment, employee remuneration packages, customs and excise, transfer pricing, and tax investigations and disputes.

Authors

Greg Neill is a partner in Russell McVeagh's tax group. He is an experienced tax and transactional lawyer, and provides advice on a broad range of New Zealand tax matters for corporations, financial institutions and large private businesses based in New Zealand and offshore. His primary expertise includes M&A, private equity, banking and corporate finance, as well as real estate and construction, private wealth investment and general corporate tax. Greg is a member of the International Fiscal Association, the taxation committee of the New Zealand Financial Services Council and the *"Build to Rent"* Taskforce of the Property Council of New Zealand.

Fred Ward has been a partner with Russell McVeagh since 1995. With more than 30 years' experience with the firm, he offers clients a broad range of taxation services, including advice on cross-border financing structures, M&A and dealing with the Inland Revenue at all levels of the investigation process, including negotiating settlements. Fred's key practice area is taxation, particularly financing transactions, cross-border transactions, M&A and tax dispute work. He is a member of the International Fiscal Association and the taxation committee of the New Zealand Law Society.



Young-chan Jung is a senior solicitor in Russell McVeagh's tax group. He advises on tax matters including financing transactions, M&A, binding ruling applications, restructurings, disputes (including tax litigation) and the tax reform process. He has acted for clients in a range of sectors, including financial institutions, investment funds, telecommunications providers, energy and infrastructure providers, gambling and gaming service providers, high net worth individuals and charities.

Russell McVeagh

Level 30, Vero Centre
48 Shortland Street
PO Box 8
Auckland 1140
New Zealand

Tel: +64 9 367 8000
Fax: +64 9 367 8163
Email: enquiries@russellmcveagh.com
Web: www.russellmcveagh.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Companies are generally the most common business structure in New Zealand. This is due to the simplicity of operation and governance, limited liability for shareholders and the business community's familiarity with companies.

However, the choice of legal entity and funding structure is often based on a combination of commercial and tax-related factors, such as:

- whether limited liability is provided;
- ease of contracting;
- the ability to raise capital;
- the tax preferences of investors; or
- applicable tax rates.

In addition to companies, general partnerships and limited partnerships are often used for co-investment transactions and in certain sectors, such as project-based joint ventures and significant investment in infrastructure assets. Smaller businesses may utilise a sole proprietor model or a company.

Companies

A limited liability company incorporated in New Zealand under the Companies Act 1993 (NZ) (Companies Act) is a legal entity in its own right and has a legal existence separate from that of its shareholders. In general, subject to the company's constitution, a shareholder of a company has liability limited to the amount of that shareholder's capital contribution.

A New Zealand incorporated company is taxed as a separate legal entity from its shareholders at a flat rate of 28%. New Zealand has an imputation system whereby tax paid at the corporate level can be *"imputed"* to shareholders by attaching credits to dividends.

General and Limited Partnerships

Both general partnerships and limited partnerships are commonly adopted business structures in New Zealand. A limited partnership is a separate legal person under New Zealand law, whereas a general partnership is not.

The liability of partners is unlimited for a general partnership, with each partner being jointly liable with the other partners for the debts and obligations of the partnership business.

A limited partnership requires at least one general partner and one limited partner. A limited partnership's general partners have unlimited liability. Each general partner is jointly and severally liable with the limited partnership itself and the other general partners for any unpaid liabilities of the limited partnership.

A limited partner of a limited partnership is not liable for the unpaid liabilities of the limited partnership, provided that the partner does not take part in the management of the limited partnership.

A partnership (general or limited) is not taxed as a separate legal entity. Instead, partnerships are fiscally transparent for New Zealand income tax purposes.

While transparent for income tax purposes, a limited partnership is legally a separate entity from its limited partners. It is therefore often an attractive business or investment vehicle from a commercial perspective, given the dual benefit of limitation of liability for investors and income tax transparency. From a tax perspective, a limited partnership allows investors to attend to their own tax position and provides a favourable option for investors with special tax characteristics (such as non-residents or entities taxed at a rate lower than the 28% company rate). Limited partnerships also facilitate access to tax losses for investors that might otherwise be *"trapped"* in a corporate structure.

It should be noted that partnerships are not transparent for New Zealand goods and services tax (GST) purposes.

Sole Proprietorships

A sole proprietorship is a business operated by an individual in their own legal capacity. As a sole proprietorship is not a separate legal entity, the owner has unlimited liability and is therefore personally liable for all debts of the business. This also means that any income derived by the sole proprietorship will be taxed in the hands of the proprietor in accordance with their marginal individual tax rate.

Look-Through Companies

A look-through company (LTC) is a standard New Zealand company that has elected to be transparent for income tax purposes. Accordingly, while an LTC is a separate legal entity under the Companies Act, for income tax purposes it is treated like a partnership and is fiscally transparent. This enables a small business to trade with limited liability but to have profits and losses taxed directly to the owners.

Income tax transparency means that the company's shareholders must pay tax on the LTC's profits directly, but similarly can offset the LTC's expenses or losses against their other income. Because of this favourable tax treatment, a company can only elect to be an LTC if, amongst other things, it has no more than five shareholders, who must be either natural persons, trustees or other LTCs.

1.2 Transparent Entities

The three types of transparent entities commonly used in New Zealand business are:

- general partnerships;
- limited partnerships; and
- LTCs.

General partnerships are a key type of transparent entity commonly used for certain businesses in New Zealand. The transparent nature allows for income to be taxed in accordance with each partner's own tax profile and avoids the extra layer of tax if (for example) a company was used instead. Partnerships are commonly used by professional services firms and in the agriculture and horticulture industries.

Limited partnerships are frequently used in New Zealand in a commercial context, particularly for co-investment arrangements (including private equity) and for development or infrastructure projects that possess a significant element of risk and are capital intensive. This is primarily because the limited partnership structure provides for the limitation of liability but is fiscally transparent for income tax purposes. This largely enables investors or limited partners to attend to their own tax affairs, having regard to their own particular commercial circumstances.

LTCs are fiscally transparent companies that are designed as a policy matter to reduce the impact of tax on a decision for a small business to incorporate. LTCs are similar to limited partnerships in the sense that liability is limited for owners or investors, and income tax is dealt with on *"flow-through"* basis. However, the LTC rules are targeted more towards closely held companies and are seen as being particularly useful for small start-up businesses, where it is considered likely that the new company will initially make a loss.

1.3 Determining Residence of Incorporated Businesses

Companies

Under the Income Tax Act 2007 (NZ) (Income Tax Act), a company will be deemed to be a New Zealand tax resident if:

- it is incorporated in New Zealand;
- its head office is in New Zealand;
- its head of management is in New Zealand; or
- its directors, in their capacity as directors, exercise control of the company in New Zealand (even if directors' decision-making also occurs outside New Zealand).

Where a company is deemed to be a tax resident in both New Zealand and another country with which New Zealand has a double tax agreement (DTA), the residence of the company will be established in accordance with the relevant DTA. New Zealand's DTAs generally contain a tie-breaker test to make this determination (in most cases being the *"place of effective management"* test). DTAs subject to the OECD Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting (MLI) do not contain a conventional tie-breaker test, with the residence of a dual resident entity instead being determined via mutual agreement between the competing jurisdictions.

General and Limited Partnerships

As partnerships are not separate taxpayers for income tax purposes, a partnership cannot of itself be *"resident"* or *"non-resident"* for New Zealand income tax purposes. Instead, the tax residence of the partners is determinative for ascertaining the New Zealand income tax liabilities of the partners. Each partner is separately assessed and there is no joint partnership assessment (although a joint return is filed for administrative purposes).

Where a partner is an individual, that individual will be deemed to be a New Zealand tax resident if they satisfy the residency tests for an individual (outlined below). Where a partner is a company, tax residency is determined using the residency tests for a company (outlined above).

Certain DTAs to which New Zealand is a party (including DTAs that are subject to the MLI) have provisions that specify when income derived by, or through, a fiscally transparent person may qualify for treaty benefits.

Sole Proprietorships

As income derived from a sole proprietorship is taxed in the hands of the individual, it is the residency status of the individual which is relevant. Generally, an individual will be deemed to be a New Zealand tax resident if they:

- have *"permanent place of abode"* in New Zealand; or
- are personally present in New Zealand for more than 183 days in total in a 12-month period.

Look-Through Companies

LTCs are transparent and akin to partnerships for income tax purposes. This means it is the tax residence of the owners or shareholders which is determinative for the purposes of ascertaining the New Zealand tax liability.

1.4 Tax Rates

Companies

Companies are taxed at a flat rate of 28%. New Zealand does not have variable corporate tax rates for corporates with particular levels of assets or turnover.

New Zealand's imputation credit regime means that income tax paid at the company level may be *"imputed"* to shareholders by attaching credits to dividends. The imputation rules derive from the tax policy that a company is taxed as a proxy for its shareholders. The rules address the double taxation that would otherwise occur when profits earned by a company are taxed and those profits are then subsequently used by the company to pay taxable dividends to shareholders.

General and Limited Partnerships

Partnerships are treated as transparent for income tax purposes, meaning income derived by a partnership flows through to its partners (in proportion to their partnership interests). Therefore, the income tax rate for income derived by a partnership will be determined in accordance with how each partner is taxed in its own right. For this reason, partnership structures are often used where investors have different tax profiles (for example, non-residents not subject to tax under a DTA, or tax-exempt or lower tax entities).

Sole Proprietorships

As income derived from a sole proprietorship is taxed directly to the individual, the income tax rate will depend on the individual's marginal tax rate. Individuals are subject to taxation at progressive marginal tax rates, with the prevailing maximum rate being 39% (for income in excess of NZD180,000).

Look-Through Companies

LTCs are treated akin to partnerships for income tax purposes. This means that the income tax rate for income derived by an LTC will be determined in accordance with how each shareholder is taxed in its own right.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

For companies, New Zealand income tax is levied on taxable income, being a company's net income minus any available tax losses.

Net income is determined by subtracting annual total deductions from annual gross income. Available tax losses may comprise any tax losses of the company carried forward from prior income years or tax losses able to be offset from other companies in the same corporate group. The resulting net amount is the taxable income.

Common with other jurisdictions, this may differ from a taxpayer's accounting or financial reporting profit as adjustments may be required for exempt or excluded income and non-deductible expenses. However, financial reporting standards are relevant for certain rules in the Income Tax Act regarding the recognition of income or expenditure, including New Zealand's financial arrangements rules applicable to debt instruments (amongst other financial arrangements).

In general, income will be allocated to the income year in which the amount is derived. However, specific provisions or timing rules of the Income Tax Act may require the adoption of a particular method for recognising the derivation of income and expenditure.

2.2 Special Incentives for Technology Investments

Research and Development

The Income Tax Act contains rules providing for research and development (R&D) tax credits. The legislative policy is to provide a tax credit as an incentive to a person for performing or contracting for the performance of activities to create new knowledge or new or improved processes, services or goods.

A 15% tax credit in respect of eligible R&D expenditure is available to businesses undertaking eligible R&D activities in New Zealand. The relevant expenditure must have a sufficient connection with the prescribed R&D activity, and must be *"required for"* and *"integral to"* such activity.

A person who is entitled to an R&D tax credit must file an R&D supplementary return for a tax year. Where an R&D tax credit is available, it can be used to satisfy a person's income tax liability.

To the extent they have remaining R&D tax credits after the satisfaction of their income tax liability, a person may be able to obtain a refund of the credit in certain cases, or can otherwise carry the credits forward to a subsequent income year. Where a company is seeking to carry forward R&D tax credits, it must satisfy the 49% shareholder continuity requirements that are essentially equivalent to those restricting the ability to carry forward tax losses. In addition to the shareholder continuity requirement, as is the case with tax losses where a continuity breach occurs, the R&D tax credits may nevertheless be carried forward if there is no major change for a period in the nature of the business activities of the company following the breach.

2.3 Other Special Incentives

New Zealand does not have any other special tax incentives for corporate investment in particular industries or business sectors, nor for particular classes of taxpayers.

2.4 Basic Rules on Loss Relief

Carrying Tax Losses Forward

Under the Income Tax Act, a company may carry forward any unused tax losses to a subsequent income year if certain shareholding continuity tests are satisfied. A tax loss may be carried forward and offset against net income in a subsequent income year if at least 49% of the company's voting interests (or market value interests) are held by the same persons. Market value interests are essentially a person's total market value of shares and share options in a company, and become relevant where substantive control or economic interests in a company may not be fully represented by voting interests.

Despite a breach of this ownership continuity test, a company may still be eligible to carry forward its unused tax losses in circumstances where there has been no major change in the nature of the business activities carried on by the company. This alternative test was introduced in 2020 as part of the government's COVID-19 relief measures. Despite the introduction of this alternative *"business continuity"* test, value is seldom attributed to tax losses in the M&A context where the transaction would result in a breach of the ownership continuity test. This is because of the largely subjective and untested nature of the *"business continuity"* test.

A company's unused tax losses may also be made available to another company in circumstances where a group of persons holds common voting interests (or market value interests) of at least 66% in respect of each company over the applicable *"continuity period"*.

Carry Back of Tax Losses

As part of the COVID-19 relief measures, the government also enacted a temporary loss carry back scheme for the 2020 and 2021 years. However, this is no longer applicable and New Zealand does not have any general rules that allow for the carrying back of income tax losses.

2.5 Imposed Limits on Deduction of Interest

As a general rule, the Income Tax Act allows most companies (other than qualifying companies and LTCs) to deduct interest expenditure regardless of whether it is incurred in deriving assessable income or relates to capital expenditure.

New Zealand has a global interest deductibility test for companies, such that there is no requirement for a nexus with the derivation of gross income. The purpose of this global approach to interest deductibility is that the use of the particular funds borrowed should be irrelevant to the question of deductibility – a deduction is available anyway. Interest deductions for corporates are limited under New Zealand's interest deductibility rules, not by reference to the use of the borrowed funds, but via the detailed thin capitalisation and transfer pricing regimes.

This ability for companies to automatically deduct interest does not, however, extend to interest expenditure that is related to certain mixed-use assets.

The deductibility of interest expenditure that is incurred in relation to residential rental properties was previously limited, but this will be fully restored by April 2025.

2.6 Basic Rules on Consolidated Tax Grouping

Two or more companies that have 100% common ownership may elect into New Zealand's consolidated group regime, under which companies that form a consolidated group are treated as a single entity for tax purposes and are jointly and severally liable for the entire group's tax. If an election is made, it is not mandatory for all companies that are 100% commonly owned to be members of the consolidated group; the consolidated group will comprise only those companies that elect to be members of the group.

Subject to certain requirements, companies within a wholly owned group may also elect to form an imputation group, under which the imputation regime applies to the companies on a group basis. It should be noted that imputation groups may consist of entirely New Zealand companies, entirely Australian companies, or a mixture of both.

There is also a similar regime for New Zealand GST. Two or more companies that have 66% common ownership may also register for GST as a group. The group will be treated as a single entity for GST purposes and must choose one GST-registered member to be its representative.

2.7 Capital Gains Taxation

New Zealand does not have a comprehensive capital gains tax regime. However, there are deeming rules that may apply to treat certain receipts as income that would otherwise conventionally be regarded as capital in nature (including, for example, in relation to various real estate transactions).

One such rule is the so-called *"bright-line test"* applicable to the sale of certain residential property. A gain made in circumstances where a residential property (other than a person's principal residence) is bought and sold within the bright-line period is deemed to be income even if it would otherwise be a capital gain. The bright-line period has recently been reduced to two years (from the previous period of ten years).

For New Zealand tax purposes, any capital gains derived by a company are generally only able to be distributed to shareholders in a tax-free form if the relevant company is liquidated. The risk otherwise is that the distribution is treated as a taxable dividend.

With no general tax on capital receipts, New Zealand also limits the deductibility of capital expenditure. The distinction between capital and revenue expenditure is primarily determined through tests developed under case law.

2.8 Other Taxes Payable by an Incorporated Business

In addition to its income tax regime, New Zealand also imposes a broad-based value-added tax on the supply of all goods and services in New Zealand, referred to as GST, at the rate of 15%. Certain transactions (including exported goods and services and sales of land between GST registered persons) are zero-rated for GST purposes. Supplies of financial services and residential accommodation are treated as exempt supplies and are therefore not subject to GST.

New Zealand does not have stamp duty or any other transaction taxes.

2.9 Incorporated Businesses and Notable Taxes

Although companies in New Zealand will not be subject to any other notable New Zealand taxes (other than income tax and GST), there are certain specific regimes that apply within this framework. These include the employment tax collection regimes (pay as you earn) and the fringe benefit tax that applies in respect of non-cash benefits provided to employees. These regimes require separate registration and impose reporting and withholding or tax payment obligations on employers.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most businesses in New Zealand adopt the form of a company. According to the New Zealand Companies Office, there were more than 733,000 incorporated companies in New Zealand as of 31 December 2024. Companies that meet certain requirements (including having no more than five shareholders) may elect into the LTC rules to enable tax transparency.

3.2 Individual Rates and Corporate Rates

There is a difference in New Zealand between the corporate tax rate (28%) and the top marginal individual tax rate (39%).

Individual professionals are entitled to determine the trading structure of their business, including whether to use a company or to trade as a partnership or in their own name. However, in doing so, such individuals must consider the general anti-avoidance provision found in New Zealand's Income Tax Act (see **7.1 Overarching Anti-Avoidance Provisions**). This is an issue that has been considered by the courts, and case law outlines how New Zealand's general anti-avoidance provision should be interpreted in light of individual professionals structuring their businesses to gain a tax advantage.

If an arrangement to derive income utilising a company structure has tax avoidance as its purpose or effect, it will be considered void as against the Commissioner, who may act to counteract any tax advantage obtained from or under such an arrangement.

New Zealand also has a specific anti-avoidance provision which, subject to certain thresholds, operates to attribute income from personal services to a person in circumstances where an associated entity of that person contracts with a third party to provide services and those services are performed by that person. Essentially, this is designed to ensure that the relevant person cannot interpose a company between themselves and the third party with which they are contracting to reduce their tax liability.

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules in the Income Tax Act that prevent the accumulation of earnings by closely held companies for investment purposes or otherwise.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Receipt of Dividends

New Zealand's Income Tax Act provides that a dividend paid by a New Zealand resident company to an individual is income of that individual, which means that any dividend derived by an individual will be taxed at that individual's marginal tax rate (as discussed in **1.4 Tax Rates**). This tax may be imposed and collected via New Zealand's resident withholding tax rules.

New Zealand has an imputation regime that is designed to eliminate the double taxation of corporate earnings that are subsequently distributed to a company's shareholders. Imputation credits arise when a company pays tax on its income at 28%. The company can then attach up to NZD0.28 of imputation credits to each NZD0.72 of cash dividend it pays to its shareholders, to avoid double taxation. The shareholder can then use these imputation credits to offset their tax liability.

This means that, where a dividend is fully imputed, the company's earnings (being taxed at the company level and then again in the hands of the shareholder) will ultimately be taxed at the shareholder's personal marginal tax rate. A dividend of NZD100 (being NZD72 cash and NZD28 imputation credits) may give rise to an individual tax liability of NZD39, which the individual can satisfy to the extent of NZD28 using the imputation credits.

Gain on Sale of Shares

Shares held by an individual shareholder in a closely held company will generally be held on capital account, which means that the sale of those shares will give rise to a non-taxable capital gain. However, in certain circumstances (for example, where a shareholder is in the business of dealing in shares or acquired the shares for the dominant purpose of disposal), any gains made on the sale of shares may be deemed to be income and taxed accordingly at the shareholder's marginal tax rate.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

New Zealand makes no distinction as to how individuals are taxed on dividends from closely held companies or publicly traded companies. The same can be said regarding gains made on the sale of shares (see **3.4 Sales of Shares by Individuals in Closely Held Corporations**).

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

New Zealand has the following withholding taxes that apply to returns on inbound investment.

Interest

Subject to certain exceptions, interest that is paid to non-residents will generally be subject to withholding tax at 15%, although this may be reduced to 10% under an applicable DTA.

New Zealand does not have a general exemption from interest withholding tax for widely held debt. There is, however, an option for borrowers to reduce the withholding tax rate on interest paid to non-resident lenders to 0% by making certain registrations and paying a levy (known as the approved issuer levy, or AIL). A borrower will generally be eligible for this in respect of interest paid to a lender that is not associated with the borrower. The AIL regime is intended to reduce the burden on New Zealand borrowers of having to *"gross up"* interest paid to non-resident lenders for New Zealand non-resident withholding tax.

The AIL applies at the rate of 2% of the gross amount of interest paid. It is payable by the borrower and is imposed as a levy rather than as a tax. Accordingly, it is unlikely to be creditable against foreign tax payable by the lender on its New Zealand interest income.

Dividends

Dividends paid to non-residents are generally subject to non-resident withholding tax at a rate of 15% (to the extent fully imputed) or 30%, subject to the availability of tax treaty relief. However, the rate of non-resident withholding tax for such dividends may be reduced to 0% where the dividend is fully imputed and where the recipient has a 10% or greater direct voting interest in the payer.

The withholding tax rates for dividends described above are generally capped at 15% in the case of persons resident in a country with which New Zealand has a DTA. Lower dividend withholding tax rates (typically 5% or in some cases 0%) apply under certain of New Zealand's DTAs, including those with Australia, Canada, China, Hong Kong, Japan, Mexico, Samoa, Singapore, Turkey, the United States and Vietnam. The lower rates are available for dividends paid to a shareholder that is a company meeting relevant minimum ownership requirements and certain other criteria.

Royalties

For royalties paid to non-residents, the rate of withholding tax imposed under domestic law is also 15%. Again, however, this rate may be reduced to 10% under an applicable DTA. In some of New Zealand's more recently negotiated DTAs, the rate in respect of royalties may be further reduced to 5%.

4.2 Primary Tax Treaty Countries

The framework of New Zealand's DTAs generally follows that of the OECD Model Tax Convention.

New Zealand currently has 41 DTAs in force, covering almost all of its major trading partners (including but not limited to Australia, China, Hong Kong, the United States and the United Kingdom). These bilateral tax treaties seek to reduce tax impediments to cross-border trade and investment, and to assist tax administration. New Zealand is also in negotiations with certain other jurisdictions to implement DTAs that will further broaden New Zealand's DTA network.

New Zealand is party to a variety of tax information exchange agreements to facilitate the exchange of tax-related information with countries where no DTA is applicable.

The ratification of the OECD MLI also strengthens New Zealand's position when it comes to international taxation, by modifying New Zealand's existing tax treaties.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The OECD MLI entered into force in New Zealand on 1 October 2018 and introduces an anti-abuse rule called the *"principal purpose test"* into many of New Zealand's DTAs. This test is found in Article 7 of the MLI and acts to deny the benefits of a DTA where one of the principal purposes of using a treaty country entity by a non-treaty country resident is to obtain the benefits of the tax treaty.

4.4 Transfer Pricing Issues

The most significant transfer pricing issues for inbound investors operating through a local corporation are generally the pricing around the inbound sale of goods and interest costs on related party debt. According to New Zealand's Inland Revenue, the most common multinational business form encountered in New Zealand is foreign-owned wholesale distributors or those that purchase and on-sell goods without significant transformation.

4.5 Related-Party Limited Risk Distribution Arrangements

While no transfer pricing dispute has yet progressed through the courts in New Zealand, there have been instances where Inland Revenue has challenged the use of related-party limited risk distribution arrangements for the local sale of goods or provision of services.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

New Zealand adopted changes to its transfer pricing regime in 2018 to better align with the OECD's transfer pricing guidelines. These amendments included the adoption of restricted transfer pricing in relation to inbound debt.

4.7 International Transfer Pricing Disputes

While no transfer pricing dispute has progressed through the New Zealand courts, it is an area of increasing interest to Inland Revenue, and transfer pricing matters are actively investigated and challenged. This is due to the material risk to the New Zealand revenue base and due, in particular, to the monetary amounts that are often involved in cross-border transactions between related parties.

The mutual agreement procedure (MAP) will generally be utilised as part of a transfer pricing dispute with Inland Revenue, and transfer pricing matters are typically resolved under the MAP. This is a key reason why no transfer pricing dispute has yet progressed to the courts.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

A taxpayer may be party to two or more cross-border arrangements regarded as involving non-arm's length pricing, and one of those arrangements may be adjusted as part of a transfer pricing dispute (whether pursuant to a settlement or otherwise). In those circumstances, the taxpayer may be permitted a compensating adjustment in relation to the other cross-border arrangements.

In broad terms, where the consideration under a transfer pricing arrangement is adjusted, a taxpayer may be entitled to relief in the form of a compensating adjustment in relation to *"compensating arrangement"* where:

- the same parties are involved in the transfer pricing arrangement and the relevant compensating arrangement;
- the transfer pricing arrangement and the compensating arrangement involve the same type of goods, services, money, other intangible property or anything else, or there is a link between the pricing under the two arrangements; and
- the adjustment under the transfer pricing arrangement takes place in the same income year or in the year immediately before or after that income year.

For the purposes of calculating the taxpayer's income tax liability, the actual amount either paid or received by the taxpayer under the compensating arrangement is able to be substituted with an arm's length amount.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

A non-resident company may have a taxable presence in New Zealand by carrying on business in New Zealand either through a fixed establishment (or *"branch"*) or by incorporating a local subsidiary.

If operating through a New Zealand branch, a non-resident company will only be subject to New Zealand income tax on any income that is deemed to have a New Zealand source.

Conversely, a New Zealand incorporated subsidiary of a non-resident company will be considered a New Zealand tax resident and will therefore be subject to New Zealand income tax on its worldwide income.

5.3 Capital Gains of Non-Residents

Unlike many other OECD countries, New Zealand has no comprehensive capital gains tax regime. However, the definition or concept of income for New Zealand tax purposes does include profits and gains from certain transactions that would conventionally be regarded as capital in nature (see **2.7 Capital Gains Taxation**). This treatment is consistent for both residents and non-residents.

Any gain derived from the sale of shares in a New Zealand company by a non-resident would be taxed under New Zealand law only where the gain is regarded as income (and not a capital gain) that is sourced in New Zealand. In any event, DTA relief may be available depending on the jurisdiction of residence of the non-resident and the nature of the shares being sold.

5.4 Change of Control Provisions

The indirect change of control of a New Zealand company should not of itself trigger an income tax charge or liability for duties but may affect that company's ability to carry forward tax losses and imputation credits. The carry forward of tax losses and imputation credits has a shareholder continuity requirement of 49% and 66% respectively (see **2.4 Basic Rules on Loss Relief**).

While a company's direct shareholding may not change, the voting interests (and market value interests) held by a corporate shareholder are subject to *"look-through"* rule when determining shareholder continuity, and are treated as being held by the shareholders of the corporate shareholder. The effect of the look-through rule is that corporate chains of ownership are traced through to the ultimate shareholders.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

As a general principle, no specific formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services in New Zealand.

5.6 Deductions for Payments by Local Affiliates

There is no standard applied in allowing a deduction for payments by New Zealand companies for management and administrative expenses. This includes local affiliates of multinational groups paying for intra-group services. However, such transactions are subject to the arm's length principle under New Zealand's transfer pricing regime.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing by a foreign-owned New Zealand company is subject to New Zealand's thin capitalisation and transfer pricing regimes. These rules essentially determine the extent to which interest paid on such borrowings may be deductible for New Zealand tax purposes, having regard to the relative amount of New Zealand borrowing (in the case of thin capitalisation) or the pricing of the borrowing (in the case of transfer pricing). It is also necessary to consider New Zealand's hybrid mismatch rules in the context of related-party borrowing and whether a deduction is fully available for interest costs.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Companies resident in New Zealand are subject to New Zealand income tax on their worldwide income. The main exception to that principle is an exemption that applies to dividends received by a New Zealand resident company from a foreign company.

Generally, where a New Zealand resident company derives assessable income from a foreign source in a country that has a DTA with New Zealand, that foreign income should not be subject to foreign income tax (provided that the New Zealand resident company does not have a permanent establishment in that country to which the foreign income is attributable). Interest, dividends and royalties that have a foreign source and that are derived by a New Zealand resident company may be subject to foreign income tax, but this will generally be limited under an applicable DTA.

Where a New Zealand resident company derives assessable income from a foreign source that is subject to foreign income tax, it may be entitled to a foreign tax credit for any foreign income tax paid on that income.

6.2 Non-Deductible Local Expenses

The Income Tax Act provides that a person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income.

6.3 Taxation on Dividends From Foreign Subsidiaries

The general position is that dividends received from foreign companies are treated as exempt income of New Zealand resident companies and are therefore not taxable. This rule is subject to certain exceptions, including where dividends are derived by *"portfolio investment entity"* (essentially a collective investment vehicle).

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangible assets developed by New Zealand companies are able to be used by non-resident subsidiaries without the latter incurring local corporate tax. However, a royalty or other charge would typically be paid by the non-resident subsidiary to the New Zealand-based owner of the asset. The use of the intangible asset may be subject to New Zealand's transfer pricing regime if the consideration provided by the non-resident subsidiary is not in accordance with the arm's length principle.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

New Zealand has a comprehensive controlled foreign company (CFC) regime, under which income may be attributed to New Zealand resident shareholders in respect of their interests in non-local subsidiaries. The CFC rules apply to New Zealand residents holding an income interest of at least 10% in a CFC (essentially being a foreign company controlled by five or fewer persons resident in New Zealand).

Attributed CFC income of a person is taxable income and may arise irrespective of any dividends paid by the non-local subsidiary.

No attribution of income will generally be required if the CFC passes an *"active"* business test. A CFC will pass the active business test and be a non-attributing active CFC if it has attributable income that is less than 5% of its total income. In broad terms, attributable income comprises *"passive"* income, such as rent, royalties, certain dividends and interest. For these purposes, the relevant income amounts are measured using either financial accounting or tax measures of income.

The position is different for non-local branches of New Zealand companies, given that a branch is strictly a part of the same legal entity. No attribution of income therefore occurs under the CFC rules (as there is no separate foreign company controlled by New Zealand residents).

6.6 Rules Related to the Substance of Non-Local Affiliates

The New Zealand CFC rules do not make any distinction based on the substance of the non-local affiliate.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

New Zealand does not have a comprehensive capital gains tax regime. However, the definition or concept of income does include profits and gains from certain transactions that would conventionally be regarded as capital in nature (see **2.7 Capital Gains Taxation**).

Shares held by a New Zealand company in a non-local affiliate would typically be held as a capital asset, as the shares form part of the structure of the corporate group. Any gain derived on a disposal of those shares should accordingly not give rise to a New Zealand income tax liability (as being attributable to the realisation of a capital asset).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Income Tax Act contains a general anti-avoidance provision, which provides that a tax avoidance arrangement will be voided against the Commissioner for income tax purposes. *"tax avoidance arrangement"* is defined as an arrangement that has tax avoidance as its sole purpose or effect, or as one of its purposes or effects if the tax avoidance purpose or effect is not merely incidental.

Pursuant to relevant New Zealand case law in this area, the key question is essentially whether an arrangement, viewed in a commercially and economically realistic way, makes use of a specific legislative provision in a manner that is consistent with Parliament's purpose. If it does, the arrangement will not, by reason of that use, be a tax avoidance arrangement.

The Income Tax Act also empowers the New Zealand Commissioner to counteract any tax advantage that a person obtains from or under such an arrangement by way of reconstruction.

In addition to the general anti-avoidance provision, the Income Tax Act contains a range of specific anti-avoidance provisions that relate to the application of particular provisions in the Act and particular transactions or arrangements.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

New Zealand Inland Revenue does not have a regular or routine audit cycle. Commencement of an audit may arise under several different circumstances, including:

- the review of a particular transaction or return;
- a focus by Inland Revenue on an industry or activity; or
- random selection and initiation of an audit.

However, large enterprises in New Zealand are subject to periodic and ongoing risk assessments by Inland Revenue, which may give rise to an audit.

In recent years, Inland Revenue has taken a notably reduced approach to audit investigations due to resourcing being deployed elsewhere to administer COVID-19 measures and Inland Revenue's own business transformation. However, Inland Revenue has now indicated that audit and investigation activity will likely increase, and the new government has also agreed to increase funding for Inland Revenue to expand its audit capability.

9. BEPS

9.1 Recommended Changes

New Zealand's Inland Revenue is responsible for the development of the BEPS action plan in New Zealand and has generally supported the OECD's initiative of a co-ordinated, global solution to the BEPS problem, the Two-Pillar Solution and the recommended BEPS package of 15 actions.

In terms of BEPS recommended changes that have already been implemented in New Zealand, many were enacted in June 2018 as part of the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, as follows.

- Interest limitation: rules were introduced regarding certain related-party loans between

a non-resident lender and a New Zealand resident borrower. A restricted transfer pricing approach may be required, which looks to credit ratings of borrowers at high risk of BEPS and the typical characteristics of third-party debt.
- Hybrids: comprehensive hybrid mismatch rules were introduced to neutralise the effects of hybrid mismatch arrangements. These rules are based on OECD recommendations, with appropriate modifications to accommodate the New Zealand tax environment.
- Transfer pricing: New Zealand's transfer pricing legislation was amended to align with the 2017 OECD transfer pricing guidelines and to strengthen Inland Revenue's ability to monitor and enforce the new transfer pricing rules.
- Permanent establishment: New Zealand introduced a new anti-avoidance rule for large multinationals (with over EUR750 million of consolidated global turnover) using a corporate structure intended to avoid having a permanent establishment (PE) in New Zealand. This rule operates on a complementary basis to the OECD's widened *"PE"* definition under the MLI.
- Other measures: rules were also introduced in relation to certain administrative matters, such as additional powers for Inland Revenue to request information from large multinational groups for the purposes of a tax investigation of that group.

In addition, country-by-country reporting has been implemented in accordance with OECD recommendations. This applies only to a select number of corporate groups headquartered in New Zealand, and each year Inland Revenue provides those groups with the relevant templates and guidance notes from the OECD.

As discussed in **4.2 Primary Tax Treaty Countries**, New Zealand has signed and ratified the MLI in an effort to prospectively modify its existing DTAs.

More recently, the OECD Pillar Two Global Anti-Base Erosion (GloBE) tax rules have been implemented in New Zealand. The GloBE rules are incorporated into New Zealand law by reference to the OECD Model Rules, commentary and published administrative guidance.

Both the *"Income Inclusion Rule"* (applying when a New Zealand-based multinational has undertaxed income in another country) and the *"Undertaxed Profits Rule"* (UTPR – the back-up rule where multinationals operate in countries that do not implement the GloBE rules) took effect in New Zealand from 1 January 2025. The *"Domestic Income Inclusion Rule"* (DIIR) for in-scope New Zealand-headquartered groups (applying when a New Zealand-based multinational enterprise has undertaxed income in New Zealand) will commence from 1 January 2026. A later date has been deemed acceptable for the DIIR, as the Transitional UTPR Safe Harbour means that a New Zealand-headquartered enterprise should not be subject to another country's UTPR until at least 1 January 2026.

9.2 Government Attitudes

The New Zealand government has generally adopted a positive attitude to the implementation of BEPS and remains committed to ensuring that highly digitalised multinational enterprises that derive material amounts of income from New Zealand are liable for their *"fair share"* of New Zealand tax.

New Zealand continues to work towards the implementation of Pillar Two, but the implementation of Pillar One remains less certain. New

Zealand's Inland Revenue has confirmed that New Zealand will exercise its discretion not to adopt the aspects of Pillar One formerly referred to as *"Amount B"* (being an optional simplified and streamlined transfer pricing approach). As a result, New Zealand's existing transfer pricing rules and current practice will continue to apply notwithstanding the introduction of this approach in other jurisdictions.

"Amount A" of the OECD's Pillar One has yet to be finalised, and New Zealand continues to monitor progress. However, New Zealand introduced a Bill in August 2023 providing for a comprehensive Digital Services Tax (DST) as an alternative to Amount A. This Bill has not progressed any further through the House. The DST was proposed to come into effect on 1 January 2025 at the earliest, with the ability to be deferred for a further five years to allow for further progress to be made at the OECD level. The DST is intended to act as *"backstop"* and will become operative only if satisfactory progress is not made towards implementing the OECD multilateral solution.

In relation to Pillar Two, as noted in **9.1 Recommended Changes**, New Zealand has implemented the Pillar Two initiatives and the OECD GloBE rules.

9.3 Profile of International Tax

International tax measures have a relatively high public profile in New Zealand, given the country's geographical location and dependence on international trade. New Zealand is, and has historically been, a net importer of capital and therefore depends on robust international tax rules in relation to inbound capital investment in particular. The implementation of BEPS recommendations has generally been regarded as being consistent with that sentiment.

9.4 Competitive Tax Policy Objective

Like many other jurisdictions, New Zealand has a desire to ensure that its tax policy is competitive internationally. As noted in **9.3 Profile of International Tax**, New Zealand has a high dependence on inbound capital so it is important that the relevant tax settings are competitive, in order to attract investment and maximise growth. However, at the same time, there is a desire for the New Zealand tax system to be robust and a general view that New Zealand is likely to be better off if it focuses on where it has a competitive advantage rather than introducing specific incentives. In relation to BEPS, the New Zealand government has noted that, while New Zealand is starting from a good position relative to many other OECD countries, taking further steps to address BEPS is an important priority.

9.5 Features of the Competitive Tax System

No key features of the New Zealand tax system have been identified as being at risk or vulnerable as a result of BEPS pressures.

9.6 Proposals for Dealing With Hybrid Instruments

In 2018, New Zealand enacted a comprehensive set of rules regarding hybrid and branch mismatches. These rules incorporate the core aspects of the recommendations in the OECD reports regarding hybrid and branch mismatches of 2015 and 2017, with certain modifications for the New Zealand context.

9.7 Territorial Tax Regime

New Zealand does not have a territorial tax regime whereby tax is paid on New Zealand sourced income only. As a general principle, New Zealand taxes its residents on their worldwide income.

9.8 Controlled Foreign Corporation Proposals

This is not applicable in New Zealand.

9.9 Anti-Avoidance Rules

The implementation of BEPS measures in New Zealand has also meant an increased focus on the use of tax treaties to facilitate tax avoidance. New Zealand has introduced a new anti-avoidance rule for large multinationals using a corporate structure intended to avoid having a permanent establishment in New Zealand. In addition, through the MLI, there has been a focus on *"treaty shopping"* by multinationals and the ability for New Zealand to deny treaty benefits to companies that are using treaties to avoid tax.

9.10 Transfer Pricing Changes

New Zealand has made changes to its transfer pricing rules in response to the OECD BEPS initiatives. Rather than radically changing the rules, the amendments as a result of BEPS are generally seen as strengthening the application of those rules by adopting economic substance and reconstruction provisions (consistent with the OECD's transfer pricing guidelines). As a result, in certain cases the legal form may be disregarded where it does not align with economic substance, and transactions that would not be entered into by parties acting at arm's length can similarly be disregarded or reconstructed.

9.11 Transparency and Country-by-Country Reporting

As an administrative matter, New Zealand's Inland Revenue had an existing practice of requiring New Zealand-headquartered multinationals groups to file *"country-by-country"* report. This applied to groups with annual consolidated group revenue of EUR750 million or more in the previous financial year and for all income years beginning on or after 1 January 2016.

However, as part of the wide-ranging BEPS initiatives introduced in 2018, a specific legislative provision was introduced that requires country-by-country reports to be filed. The codification of this requirement was considered to be useful in the context of the BEPS reforms as it provided an explicit signal to the affected multinationals and other countries of New Zealand's commitment to country-by-country reporting.

9.12 Taxation of Digital Economy Businesses

New Zealand has two GST regimes targeting digital economy businesses operating largely from outside New Zealand in relation to:

- low-value imported goods; and
- cross-border remote services and intangibles.

Collection of GST on Low-Value Imported Goods

In 2019, New Zealand introduced measures to require non-resident suppliers to register and return GST on low-value imported goods that are supplied to New Zealand-resident customers. Low-value goods are physical goods valued at NZD1,000 or less.

To remain consistent with New Zealand's domestic GST regime, non-resident suppliers supplying New Zealand-resident customers with low-value imported goods are only required to register and return GST when the value of these supplies exceeds (or is expected to exceed) NZD60,000 in a 12-month period. In addition, such suppliers are not required to return GST on supplies made to New Zealand GST-registered businesses. It should be noted that suppliers operating through electronic marketplaces can have GST charged on their supplies by the electronic marketplace (despite the supplier itself not reaching the NZD60,000 threshold).

GST on Cross-Border Remote Services and Intangibles

In 2016, New Zealand introduced measures to require certain non-resident suppliers to register and return GST on remote services provided to New Zealand-resident customers. Services where, at the time of the performance of the service, there is no necessary connection between the physical location of the customer and the place where the services are performed will be subject to these rules.

Again, to remain consistent with New Zealand's domestic GST regime, non-resident suppliers supplying New Zealand-resident customers with remote services are only required to register and return GST when the value of these supplies exceeds (or is expected to exceed) NZD60,000 in a 12-month period. Such suppliers are also not required to return GST on supplies made to New Zealand GST-registered businesses.

9.13 Digital Taxation

As noted in **9.2 Government Attitudes**, New Zealand introduced a Bill in August 2023 providing for a comprehensive DST in New Zealand (as an alternative to Amount A under Pillar One). Once in force, the DST would be levied at a rate of 3% on certain revenues derived by large multinationals from specified digital services. Specific revenue thresholds based on global and domestic revenues are proposed to apply.

Although New Zealand's preferred approach is to implement an internationally agreed solution, the introduction of a proposed DST allows New Zealand to quickly take action if the international community cannot make sufficient progress towards a multilateral solution. For this reason, the commencement date of the DST was proposed to be 1 January 2025 at the earliest, with the ability to be deferred for a further five years to allow for further progress to be made at the OECD level. If a multilateral solution at OECD level is reached, the intention is that the DST will be repealed. The Bill has not progressed any further through the House since its introduction.

9.14 Taxation of Offshore IP

New Zealand has not introduced any transfer provisions dealing specifically with the taxation of offshore-based intellectual property. It is legislatively prescribed in New Zealand's transfer pricing rules that those rules are to be applied consistently with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – July 2022. In that sense, the guidance on intangible assets and supply arrangements contained in Chapter VI of the OECD Transfer Pricing Guidelines is incorporated into New Zealand law.

The payment of royalties by New Zealand residents for the use of offshore-owned intellectual property is a current focus of Inland Revenue. Licensing arrangements with offshore-based related parties or associates present a risk to the New Zealand tax base if outbound payments are not priced in accordance with the arm's length principle. The transfer of intellectual property out of New Zealand is also a focus of Inland Revenue, particularly where an intellectual property asset is sold and then licensed back to the original owner.

Trends and Developments

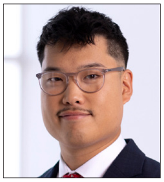
Contributed by:
Greg Neill, Fred Ward and Young-chan Jung
Russell McVeagh

Russell McVeagh is a leading full-service New Zealand law firm and employs approximately 300 staff and partners. The firm is committed to operating on the cutting edge of legal practice, with award-winning lawyers who are internationally recognised for their thought leadership, depth of experience and ability to translate complex legal issues into client success stories. It has particular expertise in banking and finance (including securitisation and financial markets regulation), corporate and commercial (including M&A), tax, competition/antitrust, employment, health and safety, resource management (including energy), litigation, restructuring and insolvency, property and construction, technology and digital, and public law and regulation. The tax team has extensive corporate tax experience and provides advice on a wide variety of issues relating to financing and capital raising, M&A, business establishment and reorganisations, investment products, PPPs and infrastructure investment, employee remuneration packages, customs and excise, transfer pricing, and tax investigations and disputes.

Authors

Greg Neill is a partner in Russell McVeagh's tax group. He is an experienced tax and transactional lawyer, and provides advice on a broad range of New Zealand tax matters for corporations, financial institutions and large private businesses based in New Zealand and offshore. His primary expertise includes M&A, private equity, banking and corporate finance, as well as real estate and construction, private wealth investment and general corporate tax. Greg is a member of the International Fiscal Association, the taxation committee of the New Zealand Financial Services Council and the *"Build to Rent"* Taskforce of the Property Council of New Zealand.

Fred Ward has been a partner with Russell McVeagh since 1995. With more than 30 years' experience with the firm, he offers clients a broad range of taxation services, including advice on cross-border financing structures, M&A and dealing with the Inland Revenue at all levels of the investigation process, including negotiating settlements. Fred's key practice area is taxation, particularly financing transactions, cross-border transactions, M&A and tax dispute work. He is a member of the International Fiscal Association and the taxation committee of the New Zealand Law Society.



Young-chan Jung is a senior solicitor in Russell McVeagh's tax group. He advises on tax matters including financing transactions, M&A, binding ruling applications, restructurings, disputes (including tax litigation) and the tax reform process. He has acted for clients in a range of sectors, including financial institutions, investment funds, telecommunications providers, energy and infrastructure providers, gambling and gaming service providers, high net worth individuals and charities.

Russell McVeagh

Level 30, Vero Centre
48 Shortland Street
PO Box 8
Auckland 1140
New Zealand

Tel: +64 9 367 8000
Fax: +64 9 367 8163
Email: enquiries@russellmcveagh.com
Web: www.russellmcveagh.com

Contributed by: Greg Neill, Fred Ward and Young-chan Jung, **Russell McVeagh**

Corporate Tax in New Zealand: an Introduction

Tax policy as a measure to "rebuild the New Zealand economy"

2024 saw New Zealand's most recently formed coalition government's first full calendar year in office. In what has been labelled by many as an environment of high inflation and rising costs of living, Prime Minister Christopher Luxon's centre-right National Party, along with its coalition partners the New Zealand First Party and ACT Party, have committed to *"rebuilding the New Zealand economy"*, and tax has remained an important topic.

As promised when campaigning for office, the key focus of the National Party was tax relief for the *"squeezed"* middle class through a combination of shifting income tax brackets and use of tax credits. The Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Act 2024 came into effect on 1 April 2024, and a new Bill has since been introduced to give effect to the government's tax commitments. A new Tax and Social Policy Work Programme for Inland Revenue has also been put in place to ensure accountability and transparency in the government's pursuit of fiscal sustainability.

More recently, the New Zealand government has announced a key focus on economic growth, innovation and investment. Relevant measures announced to date include the establishment of *"Invest New Zealand"*, a foreign investment agency aimed at promoting foreign direct investment into New Zealand, and, in relation to tax matters, a consultation regarding New Zealand's foreign investment fund rules relating to the taxation of offshore portfolio equity investments.

Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Act 2024

The Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Act 2024 came into effect on 1 April 2024 and saw a range of changes that set the scene for the new coalition government's attitude towards New Zealand's tax policy.

The Act was the new government's first opportunity to bring in some of the measures it had campaigned on, including:

- restoring interest deductibility for residential investment properties;
- reducing the applicable term of the *"bright-line test"* (a quasi-capital gains tax, being a test which brings gains from the sale of residential property that would otherwise be on capital account within the tax net) from ten years to two years;
- removing depreciation deductions for commercial and industrial buildings; and
- increasing the trustee tax rate from 33% to 39%, to align with the top marginal tax rate for individuals in New Zealand.

Other measures that came into effect in 2024

Outside of the Act, an extension of New Zealand's GST rules also came into effect from 1 April 2024, such that operators of electronic marketplaces are now required to collect and return GST at the standard rate of 15% on supplies of certain *"listed services"* (including ride-sharing and ride-hailing, delivery services for beverages or food or taxable accommodation provided through electronic marketplaces such as Uber and Airbnb) that are performed, provided or received in New Zealand. This is an extension of previous rules that applied to marketplace operators involved in the supply of remote services and low-value imported goods to New Zealand residents.

A new duty was also imposed on offshore online casino operators to ensure that they are being taxed appropriately for services offered in New Zealand, with effect from 1 July 2024. This duty applies in addition to New Zealand's existing GST on remote services regime, to which online casino operators were already subject.

Taxation (Annual Rates for 2024-25, Emergency Response, and Remedial Measures) Bill

Following the enactment of the Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Act 2024, the Taxation (Annual Rates for 2024-25, Emergency Response, and Remedial Measures) Bill was introduced in August 2024. This Bill proposes several measures aimed at delivering the government's key promise to improve New Zealand's economic conditions.

Emergency response measures

The centrepiece of the recent Bill proposes a streamlined way to provide timely tax relief following emergency events. The proposal looks to build certain tax relief measures into primary legislation, any of which could be activated by Order in Council. This would ensure the system is better prepared for emergencies, provide for a more efficient government tax response and give affected taxpayers more certainty at an earlier point in time.

Based on previous emergency events, the generic measures proposed by the Bill that may be activated by Order in Council following the declaration of an emergency event include:

- taxation rollover relief (including for revenue account property, depreciable property and amortisable land improvements);
- income spreading provisions for forced livestock sales;
- capped employer payments and fringe benefits; and
- information sharing for specific events and the ability to remit use of money interest.

Existing definitions of *"emergency"* and the declarations of an emergency under other legislation would be relied upon, rather than creating a new definition specifically for income tax purposes. As such, a definition of *"emergency event"* as an emergency in accordance with the Civil Defence Emergency Management Act 2002 and declared an emergency under that Act would be inserted into tax legislation. This would mean that the tax relief measures proposed in the Bill could be given effect if either a state of national emergency or a state of local emergency is declared under the Civil Defence Emergency Management Act.

Crypto-asset reporting framework

The global market for crypto-assets has grown rapidly in recent years, and this has resulted in the development of new investment products and payment practices. Given the characteristics of the technology that underlies crypto-assets, tax administrators have faced unique challenges from a tax compliance perspective because of the limited visibility over income derived from these crypto-assets compared to income derived from more traditional sources.

The OECD and G20 have led various global tax initiatives over the years, and in 2022 they released model rules for the Crypto-Asset Reporting Framework (CARF). The CARF is a standardised framework that provides for the collection and automatic exchange of information on crypto-assets, and requires *"reporting crypto-asset service providers"* to provide tax authorities with information on crypto-asset transactions in an effort to improve tax transparency over crypto-asset activities.

In May 2024, Inland Revenue released a regulatory impact statement that discussed the CARF and considered other options to improve tax compliance in the crypto-asset space in New Zealand. The options put forward included:

- taking no action;
- implementing the OECD CARF;
- designing and implementing a bespoke set of rules; and
- implementing an annual disclosure regime.

After discussing the advantages and disadvantages of each approach, the preferred approach put forward by the Minister of Revenue was to implement the OECD CARF. As a result of this, the CARF has been included in the Taxation (Annual Rates for 2024-25, Emergency Response, and Remedial Measures) Bill and, if enacted, will be given legislative effect in New Zealand from the 2026/27 tax year.

Like other international information-sharing initiatives that New Zealand has adopted into domestic legislation, the CARF is proposed to be incorporated into New Zealand law by reference to the OECD CARF, rather than full transportation. This means that any changes made to the CARF at the OECD level will also flow through into New Zealand law, unless explicitly blocked by an Order in Council.

Under the CARF, reporting crypto-asset service providers will be required to collect and report information to tax authorities about the activities of crypto-asset users on their platforms, including aggregate level data on all relevant crypto-asset transactions. These service providers must retain records of any information obtained under the CARF for a period of at least seven years to allow Inland Revenue to reassess the crypto-asset users if necessary. Crypto-asset users will also be required to provide information to the service providers if that information is required by the service providers to comply with the CAR. Penalties will be imposed to address non-compliance.

Tax and Social Policy Work Programme

The government's Tax and Social Policy Work Programme released in November 2024 provides further insight into the government's areas of focus in the tax policy area. By looking into a range of policy issues that will simplify tax, reduce compliance costs and address integrity risks, the government aims to *"rebuild the economy"* and *"improve fiscal sustainability"* through the following six strategic workstreams:

- economic growth and productivity;
- integrity in the tax system;
- modernising the tax system;
- strengthening international connections;
- social policy; and
- other agency work.

Each workstream contains a range of items. Some of the proposals in the Work Programme have already been proposed through the Taxation (Annual Rates for 2024-25, Emergency Response, and Remedial Measures) Bill, but there remains a long list of items that still require attention.

New double tax agreements

In pursuit of its desire to strengthen its international connections, New Zealand has continued to take steps to update and broaden its network of double tax agreements (DTAs), and is currently negotiating a number of DTAs and Protocols with new and existing counterparty jurisdictions.

Following on from the recent signing of the DTA with the Slovak Republic and the second protocol to the DTA with Austria, New Zealand is currently negotiating with Croatia, Hungary, Portugal, Slovenia and Iceland in an effort to maximise the benefits of New Zealand's free trade agreement with the European Union and further broaden its international relations through its DTA network. Replacement DTAs with the United Kingdom and Australia are also under negotiation, as well as an updated Protocol with South Korea.

The Second Protocol updating the DTA and First Protocol with Belgium is signed but is not yet in force, alongside tax information agreements with both Bermuda and Saint Kitts and Nevis. These will enter into force once the relevant countries have completed the necessary domestic procedures.

Current FIF proposals for migrants

New Zealand's foreign investment fund (FIF) rules govern the taxation of portfolio equity interests held by New Zealand residents in offshore companies. The rules seek to tax investments of 10% or less in foreign companies, and aim to ensure that there is no New Zealand tax advantage from investing offshore when compared to investing domestically. There is a concern that the FIF rules may currently discourage non-residents who hold material portfolio interests in foreign companies from migrating to New Zealand. This is because, under the FIF rules, those interests may give rise to deemed taxable income on an annual basis, rather than taxing on a realisation basis.

In response to these concerns, New Zealand's Inland Revenue released an officials' issues paper (Issues Paper) outlining a proposal to amend the FIF rules for migrants. The Issues Paper canvasses the three following options for changing the FIF rules, which would be additional to the existing FIF methods so that migrants would not be forced to use them.

- Adjusting the attributable FIF income method: the attributable FIF income method is an existing method for calculating a person's FIF income and can only be chosen by a person with an income interest of 10% or more in a FIF and where sufficient financial information can be supplied to Inland Revenue. Under these rules, no FIF income arises if the company is an active FIF (generally a FIF of which passive income is less than 5% of gross income). The proposed amendments include a relaxation of the FIF rules by removing the 10% threshold required to access this method. This would resolve cashflow and double taxation issues.
- Revenue account method: the proposed revenue account method would seek to tax FIF interests on revenue account. This would mean that only dividends and any capital gains realised on disposal would be taxed.
- Deferral method: the deferral method would also seek to tax FIF income on a realisation basis. Gains would be taxed upon disposal of the FIF interests based on a deemed 5% per annum return over the period the taxpayer has been in New Zealand. This is essentially a retrospective application of the *"fair dividend rate"* (an existing FIF calculation method under which an investor is taxed on 5% of the market value of a FIF interest annually) and deems an annual 5% return on investment, regardless of whether or not the FIF interest was disposed of at a loss.

The Issues Paper also considers the scope of the proposals and whether they would apply exclusively to migrants or whether any changes to the rules should apply more broadly to existing residents. Given the government's desire to promote economic growth and ensure that New Zealand is an attractive destination for investment and skilled migrants, it will be interesting to see how these proposals are progressed.

NIGERIA

Law and Practice

Contributed by:
Theophilus Emuwa, Jibrin Dasun, Perpetua Onyeukwu and Tubosiya Ibama
ÆLEX

Contents

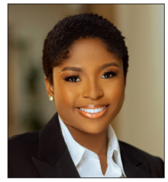
ÆLEX is a full-service commercial and litigation law firm with offices in Nigeria and Ghana. It provides tax advisory and litigation services for a wide range of multinational and local companies across the oil and gas, shipping, aviation, manufacturing, and financial services sectors. The firm has been involved in a number of ground-breaking tax cases in the tax tribunal and courts in Nigeria. ÆLEX has successfully handled tax disputes on behalf of major multinational companies on various upstream oil and gas tax issues, such as the deductibility of expenses, tax incentives, capital and investment allowances, and transfer pricing. ÆLEX was named the Transfer Pricing Firm of the Year (Nigeria) at the 2024 ITR World Tax Awards.

Authors

Theophilus Emuwa is a partner at ÆLEX and head of the firm's taxation practice. He has over three decades of experience and is widely acknowledged as one of Nigeria's leading tax lawyers. He has advised a wide range of multinational and local companies, cutting across the oil and gas, shipping, aviation, and manufacturing sectors on all aspects of the Nigerian tax regime. He was the Pioneer Chair of the Tax Committee of the Nigerian Bar Association's Section on Business Law. He is a fellow of the Chartered Institute of Taxation of Nigeria; the Vice Chair of the Nigerian Branch of the International Fiscal Association; and a member of the Permanent Scientific Committee of the International Fiscal Association. Theophilus is highly recommended by many directories, including Chambers Global.

Jibrin Dasun is a senior associate in the taxation practice at ÆLEX. Jibrin regularly advises both local and foreign clients on Nigerian taxes, including companies income tax, petroleum profits tax, hydrocarbon tax, personal income tax, capital gains tax, customs duties, stamp duties and VAT. He also advises a broad range of clients on the regulatory and exchange control issues that affect inward investment, repatriation of profits and capital. Jibrin is a Chartered Tax Practitioner in Nigeria and an international tax affiliate of the Chartered Institute of Taxation (CIOT) of the United Kingdom. He holds the CIOT's Advanced Diploma in International Taxation. Jibrin is also a member of the International Fiscal Association and the Taxes Committee of the International Bar Association.

Perpetua Onyeukwu is an associate in the tax practice group of ÆLEX. Her practice focuses on corporate and individual taxation, indirect, transactional, and international tax. She regularly advises on the income tax regime for companies and individuals, including withholding tax, capital gains tax, stamp duties, excise duty, VAT and double tax treaties. She also routinely advises on tax compliance, tax-efficient structuring of transactions, tax and exchange control issues impacting inbound and outbound investments by foreign and multinational companies in Nigeria, and tax implications of labour and employment-related issues, including employee stock and option plans and payroll tax. Perpetua is a chartered tax practitioner in Nigeria and a member of the International Fiscal Association, Nigerian Bar Association, and International Bar Association.



Tubosiya Ibama is an associate in the tax practice group of ÆLEX. She regularly advises clients on direct and indirect tax matters impacting inbound and outbound investments. Her expertise spans all aspects of the Nigerian tax system, including corporate and individual taxation, capital gains tax and VAT. She routinely advises multinational enterprises on tax due diligence and audit exercises. In collaboration with a global law firm, she regularly advises a number of multinational companies regarding the tax efficient structuring of their employee compensation plans in Nigeria. She also represents several MNEs and local companies in tax disputes regarding all aspects of the Nigerian tax regime. She is a member of the Nigerian Bar Association, the International Bar Association and the International Fiscal Association.

ÆLEX

4th Floor, Marble House
1 Kingsway Road
P.O. Box 52901
Falomo
Ikoyi, Lagos
Nigeria

Tel: +234 703 413 6930
Fax: +234 1 4617 092
Email: lagos@aelex.com
Web: www.aelex.com

ÆLEX

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Generally, a corporate form is adopted by businesses seeking long-term success, commonly the private limited liability company (ltd) corporate structure. An ltd may have one shareholder but cannot have more than 50 shareholders and must restrict the transfer of its shares. There is also the public limited liability company (plc), which can have any number of shareholders, from two upwards. A plc is the required form for companies listed on the stock exchange.

The ltd and the plc are the commonly required corporate entities in regulated business sectors like banking and finance, insurance, oil and gas, and capital markets. The unlimited liability company is also available, which features unlimited liability for shareholders, but it is rarely used. There is also the limited by guarantee corporate form, which is a non-profit sharing corporate structure used to promote charitable objects. Limited liability partnerships (LLPs) have now been recognised as having separate legal personality from the partners but are not transparent for tax purposes in Nigeria. Regarding their tax treatment, tax arises at the corporate level for all corporate structures, including LLPs.

1.2 Transparent Entities

The following transparent entities are recognised by Nigerian law:

- general partnerships;
- limited partnerships; and
- sole proprietorships.

Many small-scale businesses and petty traders carry on business as partnerships or sole proprietorships.

1.3 Determining Residence of Incorporated Businesses

The tax residence of incorporated businesses is based on the place of incorporation. The income of transparent entities (general partnership, sole proprietorship, and limited partnership) is taxed in the hands of their owners.

Nigerian companies are subject to income tax on their worldwide profits. Therefore, the profits of a Nigerian company are deemed to accrue in Nigeria, regardless of where they actually arise.

A non-resident company is liable to tax on its income derived from Nigeria, that is, income attributable to its Nigerian operations. The profits of a non-resident company are deemed to be derived from Nigeria (and therefore taxable in Nigeria) in the following instances.

- The company has a fixed base of business in Nigeria, and to the extent that the profits are attributable to the fixed base.
- The company does not have this fixed base in Nigeria but habitually operates a trade or business through a person authorised to conclude contracts on its behalf, to the extent that the profits are attributable to the trade or business carried on through that person.
- The company's trade or business activity involves a turnkey project (single contract for surveys, deliveries, construction, or installation), and the profits are attributable to that contract.
- The trade, business, or activity is between the company and another person controlled by it or which has a controlling interest in it and conditions are made or imposed between the

company and that other person in their commercial or financial relations, which the tax authority deems artificial or fictitious, so much of the profits adjusted by the tax authority to reflect an arm's length transaction.
- The company transmits, emits or receives signals, messages and data of any kind in Nigeria by cable, radio, electromagnetic systems, or any other electronic or wireless apparatus, in respect of any activity including electronic commerce, online payment platforms, electronic data storage and online advertisements, to the extent that the company has a significant economic presence (SEP) in Nigeria and profit can be attributed to such activity. Pursuant to the Companies Income Tax (Significant Economic Presence) Order 2020 (the SEP Order), a non-resident company will be deemed to have a SEP in Nigeria where it:
  (a) derives gross turnover or income of more than NGN25 million or its equivalent in other currencies from any or a combination of (i) streaming or downloading services of digital contents to persons in Nigeria, (ii) transmitting data collected on Nigerian users which has been generated from the users' activities on a digital interface (including website or mobile applications), (iii) providing goods or services, directly or indirectly, through a digital platform to Nigeria, or (iv) providing intermediation services through a digital platform linking foreign suppliers with customers in Nigeria;
  (b) uses a Nigerian domain name or registers a website address in Nigeria; or
  (c) has a purposeful and sustained interaction with persons in Nigeria through a digital page or platform customised to target persons in Nigeria, including pricing the products in naira or providing billing or payment options in naira.
- The company receives payments from a person resident in Nigeria, or from a fixed base or an agent of a non-resident company, as compensation for the provision of technical, professional, management or consultancy services, excluding:
  (a) payments by a company to an employee under a contract of employment;
  (b) payments for teaching in, or by, an educational institution; and
  (c) payments *"by a foreign fixed base of a Nigerian company"*.

1.4 Tax Rates

"Small" businesses (ie, those with a turnover of less than NGN25 million) are exempt from CIT, while *"medium-sized"* companies (turnover between NGN25 million and NGN100 million) pay CIT at the rate of 20%, and *"large"* companies (turnover above NGN100 million) pay CIT at the standard rate of 30%.

In addition to the CIT, a hydrocarbon tax (HT) of 15% is payable for operations in onshore and shallow waters pursuant to a Petroleum Prospecting Licence (PPL) and 30% in respect of operations in onshore and shallow waters pursuant to a Petroleum Mining Lease (PML).

Companies that opt not to convert their Oil Prospecting Licence (OPL) or Oil Mining Lease (OML) to PPL or PML, respectively, will continue to be taxed under the Petroleum Profits Tax Act until their OPL or OML expires. The Petroleum Profits Tax (PPT) rates vary between 50% and 85%, depending on the nature of the company's operations. Also, a company that has not commenced the sale of crude oil under a programme of continuous production will enjoy a reduced PPT rate of 65.75% until all pre-production capitalised costs have been fully amortised.

The taxable income of non-corporate businesses and transparent entities is assessed in their owners' hands.

Individual employees are allowed a consolidated relief allowance of 20% of gross income plus either NGN200,000 or 1% of gross income, whichever is higher. The balance of the income after the relief will be taxed in accordance with the graduated tax rates set out below.

- First NGN300,000 – 7%;
- NGN300,001-600,000 – 11%;
- NGN600,001-1,100,000 – 15%;
- NGN1,100,001-1,600,000 – 19%;
- NGN1,600,001-3,200,000 – 21%; and
- NGN3,200,001 and over – 24%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are arrived at by aggregating all trading income and then deducting exempt income, allowable expenses, capital allowance (at annually specified rates) and carried-forward losses. Allowable expenses are limited to expenses that are *"wholly, exclusively, necessarily and reasonably"* incurred in making profits. The test for deductibility does not include reasonableness for petroleum companies who pay PPT. For capital expenditure, deduction is only up to the capital allowance rate for each item.

Profits are taxed on an accrual basis, and tax is paid on a preceding-year basis, except for tax on profits from petroleum operations, which is paid, on a current year basis, in monthly instalments based on projected profits, with a reconciliation made at the end of the tax year to reflect actual profits.

2.2 Special Incentives for Technology Investments

The Nigeria Startup Act provides the following tax incentives to start-ups licenced by the National Information Technology Development Agency:

- 100% capital allowance deduction in respect of expenditure on research and development;
- 20% tax credit for expenditure on research and development, in addition to capital allowance (up to 95% in the first year) instead of depreciation;
- 30% investment tax credit for an investor in a licensed start-up;
- capital gains tax exemption on gains arising from the disposal of the shares of a licensed start-up provided that the shares have been held for a minimum of 24 months; and
- reduced withholding tax rate of 5% on payments to foreign companies that provide technical, consulting, professional, or management services to a licensed start-up, which is the final tax.

There are no special incentives for a patent box.

2.3 Other Special Incentives

Interest on long-term foreign loans with repayment periods above seven years (with a two-year grace period), between five and seven years (with a grace period of not less than 18 months), and between two and four years (with a grace period of not less than 12 months) enjoy 70%, 40%, and 10% tax exemption, respectively.

Venture capital companies that invest in venture capital projects and provide at least 25% of the total project cost enjoy:

- a 50% withholding tax reduction on dividends received from project companies;
- capital allowance on their equity investments in project companies; and
- gains arising from the disposal of such shares held for up to five years, between six and ten years, and between 11 and 15 years enjoy capital gains tax exemption of 100%, 75%, and 25% respectively. There is no exemption for shares held above 15 years.

Oil and Gas Companies

Companies subject to the PPTA that have executed a production sharing contract with the Nigerian National Petroleum Corporation enjoy an investment tax credit (ITC) or an investment tax allowance (ITA) of 50% of their qualifying expenditure. The ITA is deductible from revenue in arriving at taxable profits. The ITC operates as a full tax credit and does not result in a reduction of qualifying capital expenditure for the purposes of calculating capital allowances. Upon conversion to the PIA regime, ITA and ITC no longer apply.

Several incentives have recently been introduced to encourage investment in the oil and gas sector. We have highlighted some of these incentives below:

- Companies with deep offshore leases or future leases awarded after 28 February 2024 can receive a production tax credit if they meet the following conditions:
  - (a) the lease must have an approved Field Development Plan; and
  - (b) the company must commit to irreversibly fund and develop an oil and gas project and engage its construction contractors to start implementation of the project between 28 February 2024 and 1 January 2029.

The production tax credit applies to crude oil production at USD3.00 per barrel or 20% of the fiscal oil price (whichever is lower) for up to 150 million barrels or USD4.50 per barrel or 20% of the fiscal oil price (whichever is lower) for up to 500 million barrels, provided that the total producible reserves do not exceed 400 million barrels of crude oil equivalent.

- A production tax credit also applies at the following rates to gas sold from non-associated gas developments or fields with both crude oil and non-associated gas in deep offshore areas:
  - (a) USD1.00 per thousand cubic feet or 30% of the fiscal gas price (whichever is lower) for up to 5 trillion cubic feet of gas sold, if the HCL content in the field does not exceed 30 barrels per million cubic feet; or
  - (b) USD0.50 per thousand cubic feet or 30% of the fiscal gas price (whichever is lower) for up to 5 trillion cubic feet of gas sold, if the hydrocarbon liquids (HCL) content is between 30 and 100 barrels per million cubic feet.
- Companies undertaking non-associated gas greenfield developments in onshore and shallow water areas, with first gas production on or before 1 January 2029, shall be entitled to a gas tax credit. The credit shall be the lower of either USD1.00 or USD0.50 per thousand cubic feet, or 30% of the fiscal gas price, depending on the volume of HCL content of the gas produced.
- Any other non-associated gas greenfield project in onshore and shallow water areas with first commercial production after 1 January 2029 shall be eligible for gas tax allowance at a rate of USD0.50 per thousand cubic feet or 30% of the fiscal gas price, whichever is

lower, provided that the HCL content does not exceed 100 barrels per million cubic feet.

There are also special incentives available to oil companies to encourage gas utilisation or the development of gas delivery infrastructure. Companies liable to PPT can offset their gas-related capital allowance against their oil production profits. Companies liable to hydrocarbon tax can offset the costs of producing associated gas upstream of the measurement point from their crude oil production profits.

Under the Companies Income Tax Act (CITA), companies engaged in the business of gas utilisation in downstream operations can enjoy either:

- an initial tax-free period of three years, renewable for another two years, and after the tax-free period, an annual allowance of 90% for investment in plant and machinery, and an additional 15% investment allowance; pursuant to the Oil and Gas Companies (Tax, Incentives, Exemption, Remission, ETC) Order, 2024, such companies can enjoy a gas utilisation investment allowance of 25% on qualifying expenditure on plant and equipment incurred on any new and ongoing project in the midstream oil and gas industry after the expiration of the tax-free period; or
- an annual allowance of 90% for investment in plant and machinery and an additional investment allowance of 35%.

The shareholders also enjoy tax-free dividends during the tax-free period where the investment was in foreign currency or imported plant and machinery during the period was not less than 30% of the equity share capital of the company. Companies that enjoy the tax-free period above cannot enjoy any gas utilisation incentives in any other legislation.

Pioneer Industry

A company engaged in *"pioneer industry"* or *"pioneer product"*, as designated by the government of the day, may apply for *"pioneer status"*, which, when granted, entitles it to:

- a three-to-five-year tax holiday;
- relief from withholding tax on dividends paid to its shareholders during the tax holiday; and
- the postponement of the deduction of capital allowance until the end of the tax holiday.

Free Trade Zones

Approved enterprises operating within a free trade zone are exempt from all federal, state, and local government taxes, levies, and rates. However, the enterprises are required to file tax returns with the FIRS.

2.4 Basic Rules on Loss Relief

Loss carry back is not permitted, but all companies can carry tax losses forward indefinitely. Income losses cannot be used to offset capital gains and vice versa.

2.5 Imposed Limits on Deduction of Interest

Existing anti-avoidance provisions allow the tax authority to disallow/reduce the interest charged between related parties where such interest is not reflective of the arm's length principle.

In addition, there are thin capitalisation rules under which the tax-deductibility of interest expense on a foreign-party loan is limited to 30% of EBITDA in any given tax year. Deductible interest expense not fully utilised can be carried forward for a maximum of five years.

2.6 Basic Rules on Consolidated Tax Grouping

Nigerian law does not permit tax grouping; each company within a group is individually taxable in Nigeria. Consequently, losses suffered by one member of a group of companies cannot be utilised to reduce the tax liability of another company within the group but can be carried forward and set off against the future profits of the company that incurred them.

2.7 Capital Gains Taxation

A 10% capital gains tax is payable on chargeable gains arising from the disposal of chargeable assets. All forms of property are chargeable assets under Nigerian law, regardless of where they are located, including foreign currency, securities, digital assets, debts, and incorporeal property generally. For the purposes of computing capital gains tax, losses incurred upon the disposal of a chargeable asset will be deductible against chargeable gains arising from the same class of asset and can be carried forward for a maximum of five years.

Gains arising from the disposal of the following are exempt from capital gains tax:

- private motor vehicles;
- securities issued by the Nigerian government;
- disposal of shares worth less than NGN100 million in a year;
- decorations awarded for valour or gallant conduct;
- life assurance policies;
- chattels sold for NGN1,000 or less;
- assets acquired by way of a gift which are subsequently disposed of by way of gift;
- investment in superannuation funds, statutory provident funds and retirement benefit schemes;
- assets devolving upon death;
- compensation for loss of office up to NGN10 million;
- securities in a unit trust scheme, provided the proceeds are re-invested;
- gains arising from the acquisition of the shares of a company as the result of a merger, takeover, or acquisition, provided that no cash payment is made in respect of the shares acquired;
- gains accruing to local government councils and statutory corporations; and
- gains accruing from the disposal of chargeable assets by ecclesiastical, charitable, or educational institutions of a public character, statutory or registered friendly societies and registered co-operative societies and trade unions, provided that such gains do not arise from the disposal of assets acquired in connection with any trade or business, nor from the disposal of an interest possessed by the corporation in a trade or business carried on by some other person, and are applied purely for the purposes of the organisation, institution or society.

CGT is not payable where the proceeds from the disposal of the shares in a Nigerian company are utilised to acquire shares in the same or other Nigerian companies in the year of the disposal of the shares.

Where the proceeds from the disposal of an asset are used to finance the acquisition of a similar asset, the person making such disposal may apply to be treated as if the transaction has resulted in neither a gain nor a loss. Where the consideration received upon disposal of such asset exceeds the consideration paid for the acquisition of the replacement asset, the amount of that excess will be subject to capital gains tax.

2.8 Other Taxes Payable by an Incorporated Business

VAT is levied on the supply of all goods and services, with a few exceptions, at the rate of 7.5% and is collected by the supplier and remitted to the tax authority. However, oil and gas companies, including oil service companies, ministries, departments and agencies of governments, deposit money banks, and select telecommunications companies must withhold the VAT on the invoices from their suppliers and remit it to the FIRS.

A non-resident company supplying taxable services to a resident is required to charge, collect and remit VAT to the FIRS. Where the non-resident company fails to do so, the FIRS will demand the VAT from the resident. The Finance Act 2023 amended the VAT Act and introduced:

- a VAT anti-avoidance rule empowering the FIRS to make necessary adjustments to counteract the effect of any artificial or fictitious transaction; and
- the requirement for an importer of goods purchased online from a non-resident supplier to provide proof of the registration of the non-resident supplier with the FIRS in order to avoid paying VAT at the port.

A taxpayer can recover VAT incurred in acquiring stock-in-trade or inventory but not VAT incurred on overhead and administration expenses or on capital assets.

Lagos State levies a 5% consumption tax on services by hotels, restaurants and event centres.

Stamp duty is paid on most instruments, including electronic instruments. The rates differ for various instruments and can be as high as 6% of the value of the underlying transaction.

2.9 Incorporated Businesses and Notable Taxes

The following taxes or levies are notable:

- an Information Technology levy of 1% of profit before tax is payable by specified companies with a turnover of NGN100 million and above;
- a levy of 0.005% of the net profit of a company is payable annually to the Nigeria Police Trust Fund;
- an oil and gas company is required to pay 3% of its annual budget to the Niger Delta Development Commission for tackling ecological problems in the Niger Delta, where most of Nigeria's oil is produced;
- an oil and gas company is required to pay 3% of its annual operating expenditure for the preceding financial year to the Host Community Trust Fund established for the benefit of the community hosting the company's operations;
- a NASENI levy of 0.25% of profit before tax of companies engaged in banking, mobile telecommunication, ICT, aviation, maritime, and oil and gas with a turnover of NGN100 million and above; the levy, when paid, is tax-deductible for the company's income tax purposes; and
- a tertiary education tax (TET) under the Tertiary Education Trust Fund (Establishment, etc) Act 2011 is payable by Nigerian companies other than a company with a gross turnover of NGN25 million or less; the TET rate is currently 3%.

Payroll Taxes

An employer is required to:

- contribute 10% of employees' monthly basic salary to be paid into a retirement savings account with an approved Pension Fund Administrator pursuant to the Pension Reform Act, while employees are required to make a corresponding contribution of 8%;
- make a minimum monthly contribution of 1% of its monthly payroll under the Employees' Compensation Act;
- deduct 2.5% of employees' monthly basic salary for remittance to the Federal Mortgage Bank of Nigeria as National Housing Fund contribution within one month after the deduction; and
- contribute 1% of its annual payroll cost to the Industrial Training Fund in compliance with the Industrial Training Fund Act.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses
Closely held local businesses commonly operate in corporate form, using the structure of a private company limited by shares.

3.2 Individual Rates and Corporate Rates
See **1.4 Tax Rates**.

3.3 Accumulating Earnings for Investment Purposes
Where it appears to the FIRS that a Nigerian company controlled by not more than five persons has not distributed profits to its shareholders with a view to reducing the aggregate of the tax chargeable in Nigeria, the FIRS may direct the undistributed profits to be treated as distributed and taxable in the hands of the shareholders in proportion to their shares.

3.4 Sales of Shares by Individuals in Closely Held Corporations
There are no special rules on the taxation of gains on the sale of shares in closely held corporations.

Gains arising from the disposal of shares in a Nigerian company for an aggregate sum of NGN100 million or more in any 12 consecutive months are subject to CGT at 10%. However, if the proceeds are utilised to acquire shares in the same or other Nigerian companies in the year of disposal of the shares, CGT is not payable.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations
There are no special rules on the taxation of dividends from, or gains on, the sale of shares in publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Withholding tax of 10% applies to interest, dividends, royalties and rents. This withholding tax is treated as the final tax when the payment is due to a non-Nigerian company. Where dividends are paid to a Nigerian company, such dividends are treated as franked investment income and are not subject to further tax.

Relief in the form of withholding tax exemptions is available on outbound payments where:

- the payment of dividends is satisfied by an issue of shares of the company paying the dividends;
- dividends are paid by a pioneer company exempted from tax under the Industrial Development (Income Tax Relief) Act; or

- dividends are paid by an enterprise operating within a free zone.

4.2 Primary Tax Treaty Countries

Nigeria has double tax treaties (DTTs) with Belgium, Canada, China, the Czech Republic, France, Italy, the Netherlands, Pakistan, the Philippines, Romania, Singapore, Slovakia, South Africa, Spain, Sweden, and the United Kingdom. Many investors use vehicles set up in the Netherlands and South Africa. Mauritius is increasingly becoming an attractive jurisdiction even though the DTT between Nigeria and Mauritius is yet to come into force.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The FIRS will challenge the use of treaty country entities by non-treaty country residents if it is of the view that the use of the treaty country entity was designed to take advantage of the treaty or abuse its provisions.

4.4 Transfer Pricing Issues

The availability of local comparables is one of the biggest transfer pricing challenges for inbound investors operating through a local corporation; transfer pricing compliance requirements is another. This is because the FIRS has imposed a minimum of NGN10 million as a penalty for each failure to declare relevant group information, to disclose related-party transaction(s) or to maintain contemporaneous transfer pricing documentation, where required.

4.5 Related-Party Limited Risk Distribution Arrangements

The local tax authorities challenge the use of related-party limited risk distribution arrangements for the sale of goods or the provision of services locally if they determine that the arrangement provides a tax advantage and has not been made on arm's length terms.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

OECD Standards

The transfer pricing standards of the OECD and those of the UN apply in Nigeria unless they conflict with the local standards. The local transfer pricing standards conflict with the OECD standards in two major regards:

- in addition to requiring the arm's length test in respect of royalty payments, the Income Tax (Transfer Pricing) Regulations 2018 (TP Regulations) provide that, for the transfer of rights in an intangible amongst connected parties, any amount that exceeds 5% of the EBITDA derived from the commercial activity conducted using the intangible is not tax-deductible; and
- the TP Regulations also provide that, for exports, the related-party price will be the sale price for tax purposes if it is higher than the quoted price. For imports, the quoted price will be the sale price for tax purposes if the related-party price is higher than the quoted price.

4.7 International Transfer Pricing Disputes

There is no published data regarding the use of the Mutual Agreement Procedure (MAP) by Nigeria's competent authorities to resolve international transfer pricing disputes.

The FIRS is open to resolving tax disputes through the MAP process. In 2018, the FIRS issued the Guidelines on MAP in Nigeria to guide Nigerian residents seeking to initiate the MAP process regarding tax disputes, including transfer pricing disputes involving a treaty partner. By the combined provision of these guidelines and the TP Regulations, where a Nigerian resident initiates a MAP in respect of a transfer pricing adjustment made by the tax authorities of a treaty partner, the FIRS will allow a corresponding adjustment where it agrees that the adjustment done by the tax authorities of the treaty partner is consistent with the arm's length principle. If the FIRS does not agree that the adjustment by the tax authorities of the treaty partner is consistent with the arm's length principle, Nigeria's competent authority will initiate the MAP.

However, it is unlikely that Nigeria's competent authority will often resolve international transfer pricing disputes via MAPs initiated by Nigerian residents given Nigeria's status as an import-dependent nation and its low-tax treaty network.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The TP Regulations do not make provisions for compensating adjustments. Therefore, the OECD and UN standards would apply.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Unless granted a special exemption, branch operations by non-local corporations are not permitted in Nigeria. As such, non-local corporations seeking to carry on business in Nigeria must set up a subsidiary for that purpose. There are separate rules for the taxation of local branches of non-local corporations that carry on the business of transport by sea or air and the business of transmission of messages by cable or any form of wireless apparatus.

5.3 Capital Gains of Non-Residents

Capital gains of non-residents from the sale of shares of a local entity for aggregate proceeds of NGN100 million or more in any 12 consecutive months are subject to CGT at 10%. However, if the proceeds are reinvested in shares of Nigerian companies in the year of disposal of the shares, CGT is not payable.

CGT is not payable on gains from the sale of shares of a non-local holding company that directly owns the stock of a local company.

5.4 Change of Control Provisions

There are no change of control provisions that would trigger tax or duty charges for indirect disposals of holdings.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Generally, formulas are not used to determine the taxable income of foreign-owned local affiliates except in the following industries:

- transport (by sea or air); and
- cable undertakings.

Where the data required to apply the formula is not available, the FIRS is entitled to tax on a turnover basis. In practice, 20% of turnover is deemed as profit, which is then taxed at the income tax rate of 30%, resulting in an effective tax of 6% of turnover.

5.6 Deductions for Payments by Local Affiliates

Payments by local affiliates to non-local affiliates are deductible only to the extent that the payments are consistent with the arm's length principle. Also, certain agreements between local affiliates and non-local affiliates are required to be registered with the National Office for Technology Acquisition and Promotion. Failure to register such agreements with NOTAP hinders the local affiliates' ability to remit payments pursuant to the agreements through licensed banks.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing must comply with the arm's length principle. The thin capitalisation rules discussed under **2.5 Imposed Limits on Deduction of Interest** will also apply.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of a local corporation is not exempt from corporate tax, as a Nigerian company is taxed on its worldwide income. However, because dividends, interest, rents and royalties earned abroad and brought into Nigeria through the commercial banks are exempt from tax, the foreign income of a local corporation is effectively exempt from corporate tax.

6.2 Non-Deductible Local Expenses

Expenses that are attributable to foreign income would be deductible to the extent that they were incurred wholly, exclusively, necessarily and reasonably for the purposes of making a company's profits.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends earned from foreign subsidiaries of local corporations would be subject to income tax unless they were brought into Nigeria through any of the commercial banks. Such dividends would enjoy any relief in an applicable double tax treaty where the dividends are not brought into Nigeria through any commercial banks.

6.4 Use of Intangibles by Non-Local Subsidiaries

There are no rules imposing tax on the transfer of intangibles developed by local corporations to non-local subsidiaries for use in their business. However, the FIRS can rely on the general anti-avoidance provisions in the law to attribute a profit to the local corporation if it considers that the terms of the transfer of the intangibles do not reflect the arm's length principle.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Nigeria does not have CFC rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

Rules related to the substance of non-local affiliates do not apply in Nigeria.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Local corporations are not taxed on gains on the sale of shares of non-local affiliates, unless the gains are received in, or brought into, Nigeria.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

There are anti-avoidance provisions in the various tax laws, which empower the tax authorities to make necessary adjustments to counteract any tax reduction that would result from transactions that are considered artificial. The tax authorities may deem any transaction artificial if they find that its terms have not been effected or, if it is a transaction between related parties, or its terms do not reflect the arm's length principle.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no fixed audit cycle, but large corporates are typically audited annually.

9. BEPS

9.1 Recommended Changes

In response to BEPS, Nigeria has refused to agree to the Two-Pillar solution introduced by the OECD. However, Nigeria has signed the following instruments:

- the Multilateral Convention to Implement Tax Treaty-related Measures to Prevent Base Erosion and Profit Shifting;
- the Multilateral Competent Authority Agreement for the Common Reporting Standard; and
- the Multilateral Competent Authority Agreement for the Automatic Exchange of Country-by-Country Reports.

Nigeria has also put the following guidelines in place to give effect to the above instruments:

- the Income Tax (Common Reporting Standard) Regulations, 2019;
- the Income Tax (Country-by-Country Reporting) Regulations, 2018;
- the Guidelines on Country-by-Country Reporting in Nigeria, 2018;
- the Guidelines on the Appropriate Use of Country-by-Country Reports, 2018; and
- the Guidelines on the Mutual Agreement Procedure (MAP) in Nigeria.

9.2 Government Attitudes

The Nigerian government is keen on eliminating BEPS, as shown by its signing, domestication and active enforcement of anti-BEPs instruments. By implementing anti-BEPS measures, Nigeria seeks to eliminate double non-taxation, expand its revenue base and grow its economy.

The tax-to-GDP ratio of Nigeria is amongst the lowest in the world, and the government expects that the BEPS plans will increase revenue from taxation.

9.3 Profile of International Tax

International tax does not have a high public profile in Nigeria.

9.4 Competitive Tax Policy Objective

Despite its low tax-to-GDP ratio, Nigeria has competitive tax policies aimed at increasing foreign and local participation in the economy, including the exemption from all taxes granted to entities operating in the tax-free zones, the five-year income tax holiday granted to entities in several industries, and the tax exemption of all foreign-earned passive income brought into Nigeria through any of the commercial banks. On 8 August 2023, President Bola Tinubu inaugurated the Presidential Fiscal Policy & Tax Reforms Committee (the *"Committee"*) to review and redesign Nigeria's fiscal system with respect to revenue mobilisation, quality of government spending and sustainable debt management. The Committee is expected to identify relevant measures to make Nigeria an attractive destination for investment and facilitate inclusive economic growth. As part of its expected outputs, the Committee has put forward four proposed bills, namely:

- Nigeria Tax Bill, 2024, which repeals certain Acts on taxation and consolidates the statutes relating to taxation;
- Nigeria Tax Administration Bill, 2024, which provides for the assessment, collection of, and accounting for taxes, and prescribes the powers and functions of tax authorities;
- Nigeria Revenue Service (Establishment) Bill, 2024, which establishes the Nigeria Revenue Service, charged with powers of assessment, collection of, and accounting for revenue accruable to the Government of the Federation; and
- Joint Revenue Board (Establishment) Bill, 2024, which establishes the Joint Revenue Board and the Office of the Tax Ombud, for the harmonisation, co-ordination and settlement of disputes arising from tax administration in Nigeria.

It is expected that the proposed bills will be passed sometime in 2025.

9.5 Features of the Competitive Tax System

The lack of anti-fragmentation rules and the lack of CFC rules in the domestic tax legislation are features of the Nigerian tax regime that are vulnerable to the BEPS action plans. See the incentives discussed under **2.3 Other Special Incentives**.

9.6 Proposals for Dealing With Hybrid Instruments

Nigeria does not have domestic legislation to deal with hybrid instruments. However, once Nigeria ratifies the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent BEPS, Article 3 thereof will apply to deal with transparent entities resident in tax treaty countries.

9.7 Territorial Tax Regime

Nigerian companies are taxed on their worldwide income. However, a Nigerian company's foreign-earned dividend, interest, rent and royalty income are exempt from tax if brought into Nigeria through a commercial bank.

9.8 Controlled Foreign Corporation Proposals

There are no proposals to implement CFC rules.

9.9 Anti-Avoidance Rules

Nigeria has anti-avoidance rules in some of its tax treaties and has indicated its intention to adopt the *"principal purpose test"* and the competent authority tiebreaker provisions of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.

9.10 Transfer Pricing Changes

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and the United Nations Practical Manual on Transfer Pricing for Developing Countries, and all future updates, apply in Nigeria unless they conflict with the TP Regulations, in which case the latter will prevail.

9.11 Transparency and Country-by-Country Reporting

Nigeria favours the OECD proposals for transparency and country-by-country reporting and, amongst others, has signed the Convention on Mutual Administrative Assistance in Tax Matters, the Country-by-Country Multilateral Competent Authority Agreement, and the Common Reporting Standards Multilateral Competent Authority Agreement.

9.12 Taxation of Digital Economy Businesses

Foreign companies with a digital presence in Nigeria are subject to CIT; see **1.3 Determining Residence of Incorporated Businesses**.

Payments to non-resident individuals who remotely provide technical, professional, consultancy and management services to Nigerian residents attract a final withholding tax of 10%. For individuals, a final withholding tax of 5% applies.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Withholding tax of 10% (which is the final tax) applies to all offshore royalty payments. There are no special rules for IP owners in a tax haven.

Trends and Developments

Contributed by:
Lolade Ososami, Joseph Eimunjeze, Kelechi Ibe and Itoro Uwemedimo Etim
Udo Udoma & Belo-Osagie

Udo Udoma & Belo-Osagie (UUBO) is a full-service, multi-disciplinary law firm that is focused on facilitating corporate and commercial business throughout Nigeria and across Africa. The firm has an in-depth understanding of the Nigerian business environment and leverages an extensive network of long-term relationships across Africa and beyond, with leading African and global firms and strategic affiliations with leading organisations, to provide multi-jurisdictional legal and transaction advisory services. UUBO has been providing a wide spectrum of clientele with sterling legal support for a period spanning 40 years, leveraging the experience of over 140 professionals, including 14 partners, working across offices in Lagos, Abuja, and Port-Harcourt. The tax team provides specialised guidance in a range of areas, such as general corporate tax, transaction taxes, tax planning and advisory, indirect tax, tax controversy, and transfer pricing.

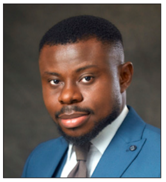
Authors

Lolade Ososami is a partner and a team lead in UUBO's taxation (international and corporate tax), corporate advisory, mining and oil and gas teams. She advises on the tax aspects of diverse commercial transactions in various sectors, including banking and finance, fintech, securities transactions, telecommunications, downstream petroleum operations, solid minerals and foreign investment. Lolade has advised on different transaction structures in these sectors. Lolade is ranked by Chambers Global in the Band 1 category for her extensive tax experience. Lolade is a Fellow of the Chartered Institute of Taxation of Nigeria, a member of the Tax Committee of the International Bar Association, and a member of the International Fiscal Association (IFA).

Joseph Eimunjeze is a partner in UUBO's banking and finance, capital markets, fintech, corporate advisory, and tax teams. His specialisations also include tax advisory, mergers and acquisitions, insolvency and corporate restructuring, foreign investments, and banking regulatory compliance. His corporate advisory experience includes advising local and foreign clients on a diverse range of issues, such as investment structure, corporate taxation, and petroleum taxation. He is ranked by Chambers Global in the banking and finance and fintech practice areas. Joseph is a chartered tax practitioner and an associate member of the Chartered Institute of Taxation of Nigeria.

Contributed by: Lolade Ososami, Joseph Eimunjeze, Kelechi Ibe and Itoro Uwemedimo Etim,
Udo Udoma & Belo-Osagie

Kelechi Ibe is a senior associate in UUBO's tax, mergers and acquisitions and general corporate advisory teams. He routinely advises on transaction taxes, cross-border and local investments, sell- and buy-side due diligence and advisory, corporate mergers and acquisitions, and regulatory compliance. He previously worked with the Deal Advisory, Mergers & Acquisition Tax Unit of KPMG in Nigeria. He is an associate of the Chartered Institute of Taxation of Nigeria (CITN) and a student member of the Association of Chartered Certified Accountants (ACCA).



Itoro Uwemedimo Etim is an associate in UUBO's banking and finance, capital markets, fintech, and tax teams. Itoro has a firm understanding of complex banking, corporate finance, and capital markets, and corporate tax issues. He has strong technical skills and an admirable appreciation of the intersection of law and finance; he deploys this to provide innovative, pragmatic solutions to clients in many areas, including corporate finance, banking, securitisation, derivatives and structured finance, capital markets, and corporate tax. He is involved in the most impactful, high-value, and sophisticated deals and has consistently exceeded clients' expectations in terms of his work product.

Udo Udoma & Belo-Osagie

10th, 12th and 13th Floors
St. Nicholas House
Catholic Mission Street
Lagos
Nigeria

Tel: +234 1 2774920
Email: uubo@uubo.org
Web: www.uubo.org

UDO UDOMA &
BELO-OSAGIE

Contributed by: Lolade Ososami, Joseph Eimunjeze, Kelechi Ibe and Itoro Uwemedimo Etim,
Udo Udoma & Belo-Osagie

Introduction

The Nigerian fiscal landscape has witnessed interesting trends and developments in recent times. One key development is the proposed overhaul of Nigeria's fiscal regime.

In November 2024, President Bola Tinubu, GCFR, presented the federal government's budget proposals themed *"Renewed Hope"* at the joint sessions of the National Assembly, Nigeria's federal legislative arm, in Abuja. The proposed 2025 annual National Budget is pegged at NGN49.74 trillion, representing a 41.9% increase from 2024 with a fiscal deficit of NGN13.39 trillion, signalling the intention of the federal government of Nigeria (FGN) to increase tax revenue to achieve its ambitious spending plans aimed at promoting economic development, maintaining macroeconomic stability and incentivising an investment-friendly economy.

This publication examines pivotal regulatory changes, including adjustments to withholding tax (WHT) rates, enhanced tax registration protocols, and the contentious windfall tax on banks. It further discusses VAT modifications that incentivise renewable energy, tax incentives for oil and gas investments, and the introduction of the first-ever Guidelines for Advance Pricing Agreements (APAs) by the Federal Inland Revenue Service (FIRS). We also consider some key proposals of the Tax Reform Bills, which culminate from the work of the Presidential Committee of Fiscal Policy and Tax Reforms (the *"Committee"*) inaugurated in July 2023.

Below are the highlights of these developments and more.

Key Trends and Developments

Review of the applicable withholding tax rates

In 2024, the Minister of Finance and Coordinating Minister of the Economy (the *"Minister"*) issued the Deduction of Tax at Source (Withholding) Regulations 2024 (the *"Regulations"*) with a commencement date of 30 September 2024. Its implementation began on 1 January 2025 because of the 90-day window for implementation of tax reforms. With the implementation of the Regulations, certain transactions now benefit from either an exemption or a reduced WHT rate. For instance, sales of goods by Nigerian businesses are now subject to WHT at a rate of 2%. This, however, does not apply to goods manufactured or materials supplied directly by the manufacturer or producer, across-the-counter sales and other relevant specific exemptions.

As part of an effort to ease the tax burden on small enterprises in Nigeria, small companies (presently companies with annual turnover below NGN25 million) and unincorporated entities of similar attributes are not required to deduct tax at source under certain circumstances. These circumstances are when: (i) the supplier/recipient has a valid tax identification number (TIN), and (ii) the value of the transaction is NGN2 million or less in the relevant month.

Also, *"across-the-counter"* transactions, telephone charges, internet data, and airline tickets, among others, are now exempt from WHT in Nigeria to help manage cash flow constraints.

Notwithstanding the foregoing, the FGN is positioning to tax the informal sector and previously undertaxed or untaxed sectors, such as lottery winnings and payments to entertainers and sports professionals, by including such payments in the Regulations as being liable to

WHT. These areas, particularly entertainment and sports, have grown significantly in Nigeria, generating considerable economic activity and associated revenue. The government's recent move to impose WHT on transactions in these sectors aims to capture a larger share of the revenue generated by these sectors, which, until now, may have been operating with limited regulatory oversight from a tax perspective.

We published an overview of the Regulations, which can be accessed here.

Increased focus on tax registration

The tax authorities seem to be intensifying their enforcement of tax registration, primarily targeting entities without a TIN for tax administration purposes. As a result, the FIRS' stamp duties portal has been updated to capture a variety of transactions and entities, and accordingly, non-Nigerian counterparties to agreements relating to transactions in Nigeria are required to provide their TIN as a prerequisite for the stamping of their documents in Nigeria.

This development is required to strengthen Nigeria's tax administration, ensuring that businesses, including foreign entities, are properly registered and taxed. It reflects a growing emphasis on transparency and accountability in Nigeria's business environment. By requiring all parties involved in Nigerian business activities to have a TIN, the tax authorities are widening the tax base and reducing informal or unregistered transactions that often evade tax obligations.

Another key area where this trend significantly impacts is the WHT regime. Vendors must now provide a TIN when issuing an invoice, as failure to comply results in a penalty twice the stipulated WHT rate. This penalty is a strong deterrent, encouraging businesses to prioritise their tax registration processes to avoid incurring additional costs.

Proposed windfall tax on Nigerian banks

The Nigerian government proposed a windfall tax on realised profits made by Nigerian banks from foreign exchange transactions due to the devaluation of the Naira. Initially set at 50%, the Senate increased the tax rate to 70%, with the rationale of increasing federal revenue. As of today, there is limited information on the status of the proposed tax, but we know that stakeholders' engagement has been ongoing.

It is worth noting that the proposal has been met with concerns about potential adverse ripple effects. Legal commentators and economists have argued that the windfall tax could reduce banks' net earnings, weaken their capital base, and result in higher service fees and interest rates for customers, as banks may pass the additional tax burden onto their customers.

Value-Added Tax (Modification) Order 2024 (the "Order")

The Minister issued the Order on 1 September 2024. The Order, which amends and expands the Value-Added Tax Exemption List (VAT Exempt List) under Part I and II of the First Schedule to the Value-Added Tax Act (*"VAT Act"*), has an effective date of 1 September 2024 for its implementation but provides for a retrospective commencement date of 1 October 2023 for the provisions relating to automotive gas oil. The Order primarily sets the tone for Nigeria's energy transition strategy.

It reaffirms the FGN's efforts to fast-track Nigeria's energy transition initiatives by providing incentives to promote foreign and local investments in more sustainable energy alternatives. The Order follows the *"Fiscal Incentives for the*

Contributed by: Lolade Ososami, Joseph Eimunjeze, Kelechi Ibe and Itoro Uwemedimo Etim,
Udo Udoma & Belo-Osagie

Presidential Gas for Growth Initiative" (the *"Circular"*) issued by the Federal Ministry of Finance in December 2023, which directed the Federal Inland Revenue Service (FIRS) and the Nigeria Customs Service (NCS) to apply a 0% VAT rate on feed gas for all processed gas, CNG, imported LPG, CNG and LPG equipment component, conversion and installation services as well as equipment and infrastructure (including conversion kits) related to the expansion of CNG and LPG. The Circular raises validity concerns, especially in light of the VAT Act, which requires the Minister to make amendments to the VAT Act through a Gazetted Order. The Order expands on and preserves most of the incentives provided by the Circular and resolves any legal validity challenges that may have arisen.

Some of the items that have been included under the VAT-exempt list include:

- equipment and infrastructure related to the expansion of CNG;
- equipment and infrastructure related to LPG, including conversion kits;
- domestic liquified natural gas (LNG) processing facilities and equipment;
- electric vehicles;
- parts, semi-knock-down units for the assembly of electric vehicles;
- biogas and biofuel equipment and accessories for clean cooking and transportation;
- CNG and LPG conversion and installation services; and
- manufacturing, assembly and sale of electric vehicles.

The Oil and Gas Companies (Tax Incentives, Exemption, Remission, etc.) Order, 2024(*"Gas Incentives Order"*)

On 6 March, 2024, President Bola Ahmed Tinubu signed the Gas Incentives Order, with the objective of specifying incentives applicable to non-associated gas (NAG) and promoting investments in NAG greenfield development. The Gas Incentives Order provides for a Gas Tax Credit (GTC) for NAG greenfield developments in onshore and shallow water locations with first gas production on or before 1 January 2029 at the rate of USD1.00 per thousand cubic feet or 30% of the fiscal gas price (whichever is lower) if hydrocarbon liquids (HCL) content does not exceed 30 barrels per million standard cubic feet (SCF). If HCL exceeds 30 barrels per million SCF but does not exceed 100 barrels per million SCF, a GTC at the rate of USD0.50 per thousand cubic feet or 30% of the fiscal gas price is applicable. For other greenfield NAG projects with first commercial production after 1 January 2029, a gas tax allowance (GTA) is provided at a rate of USD0.50 per thousand SCF or 30% of the fiscal gas price (whichever is lower), provided that HCL content does not exceed 100 barrels per million SCF. The GTC for NAG operations applies for a maximum of ten years, after which it becomes a GTA claimable at the outlined rates.

We published more details about the Gas Incentives Order which can be accessed here.

Guidelines on advance pricing agreements (APAs)

On 27 November 2024, the FIRS issued Nigeria's first-ever Guidelines on Advance Pricing Agreements (the *"APA Guidelines"*) to provide guidance on the procedure and conditions for APAs in Nigeria, as well as the administration of executed APAs to enable taxpayers and the FIRS to determine, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer price of future transactions between taxpayers and related parties that accords with the arm's length principle over a maximum period of three years. The terms agreed upon in an APA may also apply to controlled transactions carried out before the APA comes into force for a rollback period of not more than three years.

The APA Guidelines recognise unilateral, bilateral and multilateral APAs that cover all controlled transactions (including transfers of tangible or intangible property or services) between (i) two or more connected persons; (ii) a permanent establishment, fixed base, or any taxable presence and its head office; or (iii) two permanent establishments, fixed bases, or other taxable presence of the same person.

It sets a threshold for APA applications as (i) the equivalent of USD10 million for each covered controlled transaction (single transaction) for each year or (ii) the equivalent of USD50 million in the case of a group of covered controlled transactions (group of transactions) for each year covered in the APA.

The APA Guidelines were issued further to Regulation 9 of the Income Tax (Transfer Pricing) Regulations 2018, which provides the legal basis for a taxpayer to request an APA and suspends the operation of APAs in Nigeria pending when the FIRS publishes relevant notices and guidelines on APA, as it has now done. Since the FIRS has issued the APA Guidelines, we expect taxpayers to adopt APAs and agree with the FIRS on the price of controlled transactions to avoid any potential disputes between such taxpayers and the FIRS.

The Nigerian Tax Reform Bills

In October 2024, President Bola Ahmed Tinubu proposed four bills to the National Assembly for their consideration. The four bills are the (i) Nigeria Tax Bill; (ii) Nigeria Revenue Service (Establishment) Bill; (iii) Nigeria Tax Administration Bill; and (iv) Joint Revenue Board (Establishment) Bill (together *"the Tax Reform Bills"*). As stated earlier, the Tax Reform Bills are the outcome of the work of the Committee mandated to recommend changes to improve the Nigerian fiscal landscape, streamline and consolidate the tax laws of the nation and promote consistency in the administration and operation of the tax laws.

The key highlights of the Tax Reform Bills include the:

- replacement of the FIRS with the Nigerian Revenue Service and the introduction of an overt collaborative framework between the tax authorities within the federal, state and local governments;
- gradual reduction of the CIT rate from 30% to 27.5% (in the 2025 Year of Assessment (YOA)) and 25% (in the 2026 YOA);
- proposed top-up tax where, in any YOA, the effective tax rate of a company is less than 15%; such a company is expected to recompute and pay the top-up tax, which will make its effective tax rate equal to 15%, and this provision applies to (i) a company that is a constituent entity of a multinational enterprise group, and (ii) any other company with an aggregate turnover of NGN20,000,000,000 and above in the relevant YOA;
- increase to income bands for personal income tax (PIT) purposes and increase in the PIT rates;
- removal of VAT on essential items, and an increase of VAT rates on non-essential commodities from 7.5% to: 10% (in 2025), 12.5% (from 2026 to 2029) and 15% (from 2030 onwards);
- introduction of a controlled foreign company (CFC) rule that targets undistributed profits of

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Udo Udoma & Belo-Osagie

a foreign company controlled by a Nigerian company;
- change of certain previously VAT-exempt items to zero-rate, the implication being that companies providing those goods and services may be eligible for input VAT refunds from the FIRS instead of expensing the input VAT (or VAT on purchases) through their profit and loss accounts;
- taxation of capital gains (as income tax) to apply where the gains are derived from the indirect transfer of ownership of companies or assets in Nigeria and where such a transfer results in a change in the ownership structure of the group membership of any Nigerian company;
- introduction of economic development tax credits as a replacement for the Pioneer Status Incentive, which presently grants a maximum of five years tax holiday;
- apparent exclusion of instruments relating to the transfer of shares in a Nigerian company from the stamp duties exemption list, signalling a clarification that such instruments, including the share purchase agreement and share transfer forms, are liable to stamp duties; and
- clarification that when a business restructuring like a merger occurs, certain tax assets such as unabsorbed losses, unutilised capital allowances, and WHT credits can be acquired and used by the surviving entity post-merger, subject to certain conditions.

Outlook for 2025

Driving growth in renewable energy

With the exemption of the supply of electric vehicles, parts and semi-knock-down units for assembling electric vehicles, biogas and biofuel equipment, accessories for clean cooking and transportation and the manufacturing, assembly and sale of electric vehicles from VAT, we expect increased investment in Nigeria's renewable energy sector. This tax trend reflects a strong commitment to sustainable energy solutions and positions renewable energy businesses to benefit from reduced tax burdens as they contribute to cleaner, more sustainable energy sources in Nigeria.

Increased oil and gas activities

As Nigeria gradually diversifies its economy, oil and gas activities will remain its primary source of revenue. With a budget deficit of over NGN18 trillion, we expect the FGN to encourage more investment in oil and gas activities, including deep offshore areas. The incentives regime, especially for gas production, should see Nigeria attract more investment in the subsector, leading to more revenue for the government and additional tax revenue. We expect global oil prices to reduce from the USD70 per barrel benchmarked by the FGN in its 2025 budget; hence, production volumes will need to increase from the targeted 2 million barrels per day to meet Nigeria's projected revenue for 2025. Nigeria's quota from the Organization of Petroleum Exporting Countries (OPEC) (presently 1.5 million barrels per day) may impede this move.

More multinational companies to be taxed in Nigeria

A combination of Nigeria's Significant Economic Presence (SEP) regime and the proposed minimum top-up tax will see more multinational companies paying taxes in Nigeria, especially given the gradual implementation of Pillar 2 globally. There is also increased transparency and collaboration among competent authorities, which means the exchange of information (much needed for tax administration) will be at an all-time high.

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Udo Udoma & Belo-Osagie

The artificial intelligence (AI) revolution and tax income for Nigeria

The rise of paid AI tools and foreign-owned digital platforms adopted by Nigerian residents (individuals and corporates) presents an emerging tax opportunity. Nigeria could strengthen its taxation of foreign digital services to capture additional revenue. Nigeria already has a regime for taxing foreign companies doing business through digital models in Nigeria (the SEP) and would be looking more closely at driving compliance by these companies.

A clearer taxation regime for solid minerals and other mining activities

With mining activities contributing significantly to revenue, we expect new incentives for local beneficiation, clearer tax regimes and policies to boost sustainable mining practices.

Conclusion

Nigeria's recent tax trends and developments mark a shift towards transparency and global alignment, offering opportunities for growth and innovation while fostering a more favourable business environment. We expect that passing the Tax Reform Bills into law, with the necessary modifications, would introduce significant changes that would modify fiscal obligations, including tax rates, deductions, and reporting requirements.

We understand that the Presidency aims for the Tax Reform Bills to be enacted by Q1 2025, with a commencement date in Q2 or Q3 2025 (after the 90-day window for implementation based on the National Tax Policy). We can see that the National Assembly is under some pressure to pass the proposed Tax Reform Bills into law, as the Tax Reform Bills would play a central role in positioning the FGN strategically to achieve its fiscal objectives.

NORWAY

Law and Practice

Contributed by:
Bernhard Getz-Jeffreys
Ro Sommernes Advokatfirma DA

Contents

Ro Sommernes Advokatfirma DA is a medium-sized commercial law firm located in Oslo with highly respected expertise. The firm provides legal services to Norwegian and international clients. Ro Sommernes' aim is to provide bespoke legal advice by ensuring that it invests resources to understand the client's business and establish a personal relationship, with a particular emphasis on active partner involvement. The firm is solution-oriented and works with its clients to find constructive solutions. Ro Sommernes has cutting-edge expertise in designing tax-optimised incentive schemes for senior executives, including share- and option-based schemes. The firm provides high-quality advice related to structuring, transactions and due diligence processes, as well as advice in other general national and international tax matters. Ro Sommernes' tax law department works closely with the company's other departments to ensure that the client's interests are taken care of. The firm has over 30 lawyers, all working from its offices in Oslo.

Author

Bernhard Getz-Jeffreys specialises in tax law and corporate law, mainly focusing on transaction-related matters, tax structuring, planning and executing transactions and reorganisations, and establishing management investment plans and share incentive programmes for senior executives. He provides advice on all matters related to Norwegian and international taxation and regularly writes articles on tax issues for the *"Norwegian Financial Times"* (Finansavisen). Bernhard is a member of the Norwegian Bar Association and the International Fiscal Association and is also an examiner at the University of Bergen, where he graduated with a Master of Laws in 2015.

Ro Sommernes Advokatfirma DA

Hieronymus Heyerdahls gate 1
0160 Oslo
Norway

Tel: +47 23 00 34 40
Email: mail@rosom.no
Web: www.rosom.no/en

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In Norway, most new companies are established as limited liability companies (*aksjeselskaper* AS) where the shareholders' liability for the company's obligations is restricted to the capital they have contributed. Limited liability companies are recognised as independent legal and tax entities, meaning the company itself is taxed separately from its shareholders.

Norwegian law also provides for other types of companies that are separate legal entities but tax-transparent. Examples include general partnerships (a *nsvarlige selskaper*) and partnerships with pro rata liability (*selskaper med delt ansvar*).

Additionally, Norway recognises hybrid company structures, such as silent partnerships (i *ndre selskaper*) and limited partnerships (*kommandittselskaper*), where the liability varies among the participants. In these cases, at least one owner has unlimited liability for the company's obligations, while others enjoy limited liability. These entities are treated as tax-transparent entities.

Norwegian tax law does not allow for choosing between tax-transparent and tax-opaque entities, as this depends on the corporate body of the relevant entity.

1.2 Transparent Entities

In the consultancy and brokerage industry, it is common to structure businesses as silent partnerships with a limited liability company acting as the principal. To external parties, the business operates as an ordinary limited company. However, profits and losses are allocated between the principal and the silent partners according to the terms of a partnership agreement.

In the private equity sector, funds are typically structured as either limited liability companies or silent partnerships. Silent partnerships offer a distinct advantage for foreign investors, as they are exempt from withholding tax of up to 25% on dividend distributions.

Shipping companies used to be structured as limited partnerships, but the particular tax advantages of such a structure are now history.

1.3 Determining Residence of Incorporated Businesses

The tax residency assessment is a broad assessment dependent on several factors. Firstly, all companies established under Norwegian corporate law are considered tax residents of Norway.

Companies that are not established in Norway under Norwegian corporate law may still be deemed tax-resident in Norway if the company's actual management is exercised in Norway. This is assessed based on:

- where key decisions for the company are made;
- where board meetings and general meetings are held; and
- where the company's day-to-day management is carried out.

If a company is considered tax-resident in more than one country, a tax treaty between Norway and the other country will determine residency. Such treaties often include *"tiebreaker"* rules, which resolve conflicts by considering:

- the location of the company's *"place of effective management"* or management seat; and

- the location of the company's head office and principal operations.

When evaluating actual management and residency, emphasis is placed on the substantive realities of the company's operations, rather than formalities.

For tax-transparent entities such as general partnerships and limited partnerships, the partnership is checked, and the owners are taxed based on their separate residency. However, the shareholders may be partially tax liable in Norway – for business income in Norway – as a consequence of participation in a Norwegian partnership.

1.4 Tax Rates

The Norwegian corporate tax rate is 22% (as of 1 January 2025). This rate applies uniformly to both companies that are independent tax entities and corporate shareholders of tax-transparent entities. Personal shareholders of tax-transparent entities are also subject to a personal bracket tax and liable to pay national insurance contributions.

The effective tax rate on dividend distributions from limited liability companies or tax-transparent entities is 37.84% (as of 1 January 2025).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable profit of a limited liability company is calculated on the basis of the company's accounting profit. Tax adjustments are then made to arrive at the final taxable profit, which is the basis for calculating corporate income tax.

Limited liability companies in Norway are taxed on an accrual principle, meaning that income and expenses are recognised and taxed in the year in which they are earned or incurred, regardless of when the payment is actually made.

For sole proprietorships and workers, income is taxed on a receipt basis.

2.2 Special Incentives for Technology Investments

Norway offers several tax incentives for technology investments, with *SkatteFUNN* (tax deduction for research and development in an innovative business sector) as the central instrument. The arrangement entitles companies to a 19% tax deduction for R&D project costs approved by the Research Council of Norway. The deduction applies to project costs of up to NOK25 million per year.

Option taxation for start-up companies provides special tax benefits when granting stock options to employees.

Private investors can also obtain a tax deduction for investments in technology companies, with a maximum deduction of NOK1 million per year, resulting in a tax reduction of up to NOK220,000.

2.3 Other Special Incentives

Special incentives in Norway for selected industries and companies are as follows.

- Energy and environment:
  (a) CO_2 compensation arrangement – energy-intensive companies receive partial compensation for increased costs because of the EU emissions trading system (ETS); and
  (b) electricity tax reduction – reduced electricity tax for industrial companies and

certain projects considered *"environmentally friendly"*.

- Start-up companies and SMEs:
  - (a) option taxation for start-up companies – lenient tax rules for stock options to employees in small start-up companies; and
  - (b) tax incentives for investments in start-up companies – individual investors receive a tax deduction of up to NOK1 million per year for investments in start-up companies.
- Shipping and maritime industry:
  - (a) taxation of shipping companies – reduced tax for shipping companies that opt for tonnage taxation instead of ordinary corporate tax; and
  - (b) foreign companies using a Norwegian management company are exempt from local income tax under certain conditions.
- Agriculture:
  - (a) tax exemption for the transfer of agricultural property to the next generation, and low net wealth taxation of similar assets.

2.4 Basic Rules on Loss Relief

Losses can be carried forward indefinitely and deducted from net income in future years. Carry back may be available upon the termination of business activities.

Business and capital gains may, as a starting point, be offset against each other, provided that the income is taxable. Losses from personal (business) income can only be offset against other personal (business) income. Income from silent partnerships and limited partnerships may only be carried forward and offset against future income from the same partnership.

2.5 Imposed Limits on Deduction of Interest

In Norway, interest deductions are limited by an interest limitation rule.

The main rule states that net interest expenses exceeding 25% of taxable profit before interest, tax and depreciation cannot be deducted. This applies to both consolidated (group) and unincorporated entities, but with different thresholds:

- for group companies, the restriction applies only if the net interest expense for the Norwegian part of the group exceeds NOK25 million; and
- for non-group companies, the limit is NOK5 million.

For group companies, the rule covers interest on loans from both related and unrelated lenders. However, an equity exemption applies: if the company can demonstrate that its equity ratio (or that of the Norwegian part of the group) is equal to or higher than the equity ratio of the international group, the interest deduction is granted in full, despite the limitations.

For non-group companies, the limitation applies only to interest on loans from related parties.

2.6 Basic Rules on Consolidated Tax Grouping

Each corporate entity is treated as a separate tax entity with individual tax filings and tax obligations. Net income within the group can however be offset against losses in other group companies through *"group contributions"* (*konsernbidrag*).

The requirements for group contributions are as follows:

- companies must belong to the same group (at least 90% ownership);
- both the contributor and recipient must be taxable in Norway, with limited exceptions under European Economic Area (EEA) law;
- contributions are deductible for the donor and taxable for the recipient; and
- the transfer must be genuine and approved by the general meeting.

Additionally, group companies can register jointly for VAT purposes, meaning that several group companies are considered as one entity for (most) VAT purposes and that no VAT applies to transactions between these group companies.

2.7 Capital Gains Taxation

Gains from share sales are generally taxable, while losses are deductible. The gain is calculated as the sales price minus the taxable cost price plus transaction costs. Under the first-in first-out (FIFO) principle, the first shares acquired are sold first.

Norwegian corporations and partnerships are exempt from capital gains tax on the sale of shares or units under the exemption method, which also prevents the deduction of losses. This applies to shares and other shareholdings in Norwegian companies, as well as shareholding in companies domiciled in the EEA, provided they are genuinely established and conduct economic activity there. For companies outside the EEA, the exemption applies if they are not domiciled in a low-tax country and meet specific ownership and holding period requirements.

Norway does not impose withholding tax on capital gains.

2.8 Other Taxes Payable by an Incorporated Business

Input transactions are subject to VAT. However, the sale of ongoing businesses (business transfers) is exempt from VAT.

Real estate transactions are subject to a stamp duty of 2.5% of the gross sales price. Additionally, adjustment obligations for VAT purposes may arise, potentially triggering a requirement to repay previously deducted input VAT.

2.9 Incorporated Businesses and Notable Taxes

The most significant tax item compared to other countries is the Norwegian resource rent tax, which is a special tax levied on income derived from natural resources, including oil production, electricity generation, and the fishing and seafood industries.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most local closely held companies are limited companies with limited liability for shareholders, but some, particularly in the agriculture and consultancy sectors, operate as sole proprietorships.

3.2 Individual Rates and Corporate Rates

Norwegian tax rules are based on the principle of reality over form. This means that taxation takes place based on realities and not formalities. An income shall be allocated to the subject that has earned the income and classified on the basis of the nature of the income and taxed thereafter (as capital gains/business profits, etc).

Furthermore, there are strict limitations on private individuals' access to a company's assets and properties outside the company's ordinary activities. Violations of these rules can be sanctioned under criminal law.

3.3 Accumulating Earnings for Investment Purposes

In Norwegian tax law, there are no specific rules that directly prevent limited companies from accumulating profits. The exemption model is designed to facilitate the reinvestment of profits in new businesses without tax in addition to ordinary profit tax.

For shareholders that participate actively in the business, capital gains may be reclassified to salary income/personal income for tax purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

In Norway, individuals are taxed on dividends and capital gains from the sale of shares according to the shareholder model. The effective tax rate on share gains and dividends is 37.84%, less accumulated shielding of the shares.

The allowance is calculated on a share-by-share basis. The allowance for each share is equal to the cost price of the share multiplied by a predetermined risk-free interest rate, based on the effective rate of interest on treasury bills (*statskasseveksler*) with three months maturity plus 0.5 percentage points, after tax. The allowance is calculated for each calendar year and is allocated solely to shareholders at the expiration of the relevant calendar year. The risk-free interest rate for 2024 was 3.9%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The taxation of dividends and capital gains for individuals investing in publicly traded corporations follows the same principles as for private corporations. Note, however, that different documentation requirements apply to obtain withholding tax relief.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In Norway, a 25% withholding tax applies to dividends paid to foreign shareholders, though it may be reduced under tax treaties. EEA-domiciled companies are exempt if they are genuinely established and operate in the EEA, while non-EEA companies may qualify under specific ownership criteria. Interest and royalties paid to affiliates in low-tax jurisdictions outside the EEA are subject to a 15% withholding tax, while payments to non-low-tax jurisdictions are not taxed. Norwegian tax authorities have increased oversight of cross-border transactions involving these payments.

4.2 Primary Tax Treaty Countries

Norway has established tax treaties with over 90 countries to prevent double taxation and foster international investment. These agreements are largely based on the OECD Model Tax Convention and influence the taxation of investments in Norwegian companies, including shares and debt instruments.

In 2023, Norway Statistics reported that Sweden, the Netherlands, Brazil, the UK and the USA together accounted for 57% of total foreign direct investment in Norway.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Local tax authorities in Norway challenge treaty shopping, where entities in treaty countries are used by residents of non-treaty countries to reduce taxes. Norway addresses this through various measures, including the principal purpose test (PPT) in many modern tax treaties, which denies benefits if the arrangement's primary purpose is tax advantage. Some treaties also include a limitation on benefits (LOB) clause, restricting benefits to entities with genuine economic activity in the treaty country, a common feature of US treaties.

Norway's general anti-avoidance rules (GAAR) further allow authorities to challenge artificial structures created primarily for tax advantages.

4.4 Transfer Pricing Issues

Inbound investors operating through local corporations in Norway face transfer pricing challenges. Transactions between related parties must comply with the arm's length principle, requiring prices and terms to reflect those agreed upon by independent parties in an open market. The tax authorities can adjust taxable income if transactions deviate from this standard.

Strict documentation requirements, specified in the Norwegian Tax Administration Act, enforce compliance:

- Section 8-11 requires contemporaneous documentation of transfer prices for related-party transactions, available for audits; and
- Section 8-12 imposes additional taxes and sanctions for incomplete or missing documentation, with significant financial consequences, including discretionary income adjustments.

Valuing intangible assets such as trade marks, patents and technology remains a complex issue, as Norwegian authorities, in line with OECD guidelines, scrutinise valuations across jurisdictions. Intra-group services must be supported by evidence of necessity, actual delivery and market-based pricing. Similarly, loans between group companies must reflect market interest rates, with adjustments applied for deviations, particularly in cases of thin capitalisation. Notably, transfer pricing rules do not apply to equity transactions.

4.5 Related-Party Limited Risk Distribution Arrangements

Local tax authorities in Norway frequently challenge limited risk-sharing arrangements with related parties due to their potential to shift profits to low-tax jurisdictions. Authorities assess whether these arrangements reflect genuine economic substance by evaluating risk allocation, functional contributions and compliance with the arm's length principle.

Transactions must align with market terms and be properly documented. If the local entity assumes greater risks or functions than agreed, adjustments may be made for tax purposes. Contributions to intangibles or market value may also increase local profit allocation. Authorities can disregard profit-shifting arrangements or adjust profit margins to industry benchmarks.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Norwegian transfer pricing rules align closely with OECD guidelines.

However, Norwegian tax authorities impose strict documentation requirements, often demanding more detailed records than some other OECD countries. Inadequate documentation can result in fees, discretionary adjustments or additional taxes.

The general anti-avoidance rule allows the tax authorities to reclassify transactions designed primarily for tax benefits, reflecting Norway's stringent application of OECD base erosion and profit shifting (BEPS) measures. Additionally, Norwegian authorities closely scrutinise the allocation of profits from intangible assets, ensuring they align with the enterprise's substance and risk distribution.

While the Ministry of Finance is permitted to issue rules that deviate from OECD guidelines, this provision is rarely exercised, as noted in preparatory statements (Ot prp nr 62, 2006–07).

4.7 International Transfer Pricing Disputes

The introduction of country-by-country reporting has given the tax authorities access to more detailed information on the activities of multinational enterprises. In recent years, the Norwegian tax authorities have increased their focus on transfer pricing, especially after the Office of the Auditor General's report revealed a lack of control in this area.

There are no official statistics on the incidence of mutual agreement procedures (MAP) in Norway. With an increased focus on transfer pricing and more controls, it is likely that the number of MAP cases will increase. However, it is important to note that the MAP process can be time-consuming, and taxpayers should therefore consider alternative dispute resolution mechanisms where appropriate. The Swedish Supreme Court recently ruled on a case and ordered the local tax authorities to allow a Swedish group company to make an appropriate adjustment as a result of increased taxable income abroad. As ordinary court proceedings are usually shorter than MAP proceedings, this may lead to a reduction in the use of MAP in the future.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

In Norway, compensating adjustments are permitted to align related-party transactions with the arm's length principle.

Such adjustments may involve both tax and customs authorities. If an adjustment affects the customs value of imported goods, it must be post-declared. Similarly, changes impacting taxable income must be reflected in the company's tax return, ensuring compliance with independent pricing standards.

Adequate transfer pricing documentation is crucial to justify these adjustments. Missing or insufficient documentation can lead to additional taxes and other penalties.

In cross-border disputes, MAP can resolve disagreements between tax authorities, preventing double taxation and ensuring consistent application of the arm's length principle.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches (Norwegian branches of a foreign company; NUF) and subsidiaries of foreign companies are taxed differently in Norway.

Branches (NUF)

A branch is not a separate legal entity, but an extension of the parent company. It is only liable to tax in Norway on income earned in Norway. Branches are subject to ordinary corporate tax of 22%. As the branch is considered a part of the international headquarters, distributions are generally not subject to withholding taxes.

Subsidiaries

A subsidiary is a separate legal entity registered in Norway and is liable to tax on its global income. Subsidiaries also pay 22% corporate tax. Dividends to foreign owners may be subject to withholding tax, at a standard rate of 25%, but this can be reduced through tax treaties.

5.3 Capital Gains of Non-Residents

In Norway, capital gains on the sale of shares are generally taxable. For individuals or companies without tax residence in Norway, specific rules apply. Non-residents are generally not liable to pay tax in Norway on gains from the sale of shares in Norwegian companies unless the shares are linked to a permanent establishment in Norway.

Similarly, gains from the sale of shares in a foreign holding company that directly owns shares in Norwegian companies are also not taxable in Norway for non-residents, unless the foreign company itself has a permanent establishment in Norway.

Norway has entered tax treaties with many countries to prevent double taxation. These agreements often allocate the right to tax capital gains from the sale of shares to the state of the seller's residence, except for gains related to real estate or permanent establishments. As a result, the provisions of a tax treaty between Norway and the investor's country of residence may eliminate or reduce Norwegian tax liability in such cases.

5.4 Change of Control Provisions

Changes in control in Norway can trigger tax or duty charges, depending on the type of transaction and ownership structure. Section 9-3 of the Norwegian Tax Act imposes tax on gains from the sale of shares in Norwegian companies, while withholding tax on dividends may apply.

For indirect holdings higher up in an overseas group, taxation may apply if the shares are connected to real estate or a permanent establishment in Norway. Additionally, the tax authorities may disregard artificial arrangements designed to avoid taxation during such transactions.

Tax treaties between Norway and other countries influence the taxation in these scenarios by determining which jurisdiction is entitled to tax capital gains, particularly when they involve real estate or business establishments.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

A change in control can trigger tax liability, especially when selling shares in a Norwegian company. Gains on the sale of shares in a foreign holding company that owns shares in Norwegian companies may trigger taxation in Norway if the shares are linked to a permanent establishment or real property in Norway.

When selling indirect ownership interests in a foreign group, even when the ownership is higher up in the group, tax liability may still arise if the shares are linked to real property or a permanent establishment in Norway. Tax treaties between Norway and other countries may affect the taxation of such sales and may in some cases reduce or eliminate the tax liability. It is therefore important to consider the specific provisions of relevant tax treaties.

In cases where the transaction is considered artificial to avoid tax, the general anti-avoidance rule can be invoked to nullify the transaction and impose taxation, even in cases involving the transfer of indirect ownership interests.

5.6 Deductions for Payments by Local Affiliates

In Norway, payments from local companies for management and administration costs incurred by a foreign company in the same group may be deductible, provided that the cost is under arms length's terms.

In addition, documentation demonstrating that the payments are necessary to generate taxable income is required. Tax treaties can also affect the right to deduct, especially in international transactions.

This means that payments to be deductible must follow the arm's length principle and be documented as necessary for income service.

5.7 Constraints on Related-Party Borrowing

In the Norwegian context, specific limitations are imposed on loans between related parties, particularly with regard to interest deductions. Interest expenses on loans from related parties may be deductible, contingent upon the fulfilment of certain criteria.

In 2019, novel interest limitation rules were introduced, affecting both intra-group and external loans. In instances where net interest expenses in the Norwegian part of the group exceed NOK25 million in total, the deduction for interest expenses is limited to 25% of the company's taxable EBITDA. To safeguard ordinary loans, a balance sheet-based exemption rule has been implemented. This rule stipulates that interest deduction is not applicable if either the company's equity or the equity in the Norwegian part of the group is greater than or approximately equal to the group's equity.

Additionally, loans from a company to a personal shareholder will in most cases be regarded as a taxable dividend. However, according to the Companies Act and the Accounting Act, this is considered a loan.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

In Norway, foreign income earned by local companies is generally subject to corporate taxation under Section 2-2 of the Norwegian Tax Act. However, certain types of foreign income, such as dividends and gains from the sale of shares in EEA-domiciled subsidiaries, may qualify for tax exemption under the exemption method in Section 2-38, provided the subsidiaries are genuine enterprises meeting specific criteria.

When tax is paid abroad, Norwegian companies can claim a credit deduction under Section 6-40, limited to the Norwegian corporate tax rate of 22%. To prevent tax avoidance, the general anti-avoidance rule enables the tax authorities to deny benefits from artificial structures designed to avoid Norwegian taxation.

Tax treaties also play a critical role, reducing or eliminating withholding tax on dividends, as governed by Section 10-13. For companies controlling foreign entities in low-tax jurisdictions, Section 10-60 introduces controlled foreign corporation (CFC) rules to ensure such income is taxed in Norway (for a further explanation, see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**).

6.2 Non-Deductible Local Expenses

When foreign income is exempt from taxation in Norway, for example through the exemption method, certain local costs related to this income may be treated as non-deductible. This primarily applies to costs that are directly related to the exempt foreign income.

Section 6-1 of the Norwegian Tax Act states that costs must be necessary for taxable income to be deductible. If the costs can be linked to exempt foreign income, they will in principle not be deductible. General operating expenses that are not directly related to exempt income may still be deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries are taxed in Norway according to different rules, depending on whether they are covered by the exemption method or whether they are subject to withholding tax.

Pursuant to the participation exemption, dividends from foreign subsidiaries may be exempt from taxation in Norway through the exemption method, provided that the Norwegian company owns at least 10% of the shares in the foreign company and that the foreign company is a real enterprise with economic activity. This means that dividends received from such subsidiaries are not taxed in Norway.

If the dividend is not covered by the exemption method, it may be subject to withholding tax in the country where the subsidiary is domiciled. The withholding tax may vary, and tax treaties between Norway and the country in question may reduce or eliminate the withholding tax on dividend.

In addition, Section 6-40 of the Norwegian Tax Act allows the company to claim a credit deduction for the foreign withholding tax paid, which can help to avoid double taxation. This deduction may not exceed the Norwegian corporate tax rate, which is 22%.

6.4 Use of Intangibles by Non-Local Subsidiaries

When intangible assets developed by Norwegian companies are transferred to foreign subsidiaries, this may trigger taxation in Norway depending on whether a gain arises from the transfer. Such taxation also occurs if the Norwegian company emigrates for tax purposes (exit taxation).

Capital gains taxation is based on the gain realised on the transfer – ie, the difference between the tax book value and the market value of the asset.

The transfer must also follow the arm's length principle, which requires that the transaction takes place at market prices – ie, prices that would have been agreed between independent parties. It is also necessary to have documentation showing that the terms of the transfer comply with this principle.

Tax treaties can have an impact, especially when intangible assets are transferred to foreign subsidiaries. Such agreements can reduce or eliminate tax on gains, depending on the provisions agreed between Norway and the country in question.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Norwegian companies may be subject to tax on the income of their foreign subsidiaries under CFC rules, as outlined in Section 10-60 of the Norwegian Tax Act. These rules aim to prevent tax avoidance by taxing the income of subsidiaries located in low-tax jurisdictions, regardless of whether the income is distributed as dividends.

CFC rules are triggered when Norwegian companies control foreign entities operating in jurisdictions with significantly lower tax rates. In such cases, the foreign subsidiary's income is taxed in Norway to ensure it cannot be used to shift profits and avoid taxation.

However, these rules do not apply to foreign branches of Norwegian companies, which are taxed under the general provisions for foreign income.

Taxpayers can claim a credit deduction for taxes paid abroad to prevent double taxation, provided they meet the documentation and calculation requirements specified in Section 16-20 of the Norwegian Tax Act.

6.6 Rules Related to the Substance of Non-Local Affiliates

Norwegian tax regulations include provisions that address the substantive requirements for foreign subsidiaries. These provisions are designed to prevent companies from establishing an apparent presence in low-tax countries with no real economic activity, known as *"tax havens"*. A company is considered resident in Norway if it is incorporated under Norwegian company law, or if it is incorporated abroad and has its real management in Norway.

Consequently, a foreign company can be regarded as a Norwegian taxpayer if it has its real management in Norway, regardless of its formal registration location. Companies domiciled in Norway are generally liable for tax payments in Norway. This implies that a foreign company that is considered a Norwegian taxpayer due to its effective management being in Norway will be subject to Norwegian taxation on its global income.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

When a Norwegian (local) company sells shares in a foreign subsidiary, the gain from the sale may in principle be exempt from taxation in Norway pursuant to the participation exemption if the non-local affiliate is genuinely established and performs real activities within the EEA, or, if it is resident outside the EEA, is not resident of a low state jurisdiction and the Norwegian company owns at least 10% of the shares and the votes in the foreign subsidiary, and has done so for a minimum of two years prior to the sale.

If the exemption method does not apply, any capital gains on the sale is taxed at a rate of (currently) 22%.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Norway has implemented several measures to prevent tax avoidance and ensure compliance with tax regulations.

- Section 13-2 of the Norwegian Tax Act authorises tax authorities to disregard transactions that are artificial or primarily designed to achieve tax benefits. This ensures that transactions align with the intended purpose of the law and are based on genuine economic substance.
- Section 8-11 of the Tax Administration Act mandates thorough documentation for related-party transactions. Insufficient or missing documentation may lead to taxable income adjustments and penalties, emphasising the importance of transparency in intra-group dealings.
- Section 10-60 of the Norwegian Tax Act establishes CFC rules (for details, see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**).

Norway also participates in the OECD's BEPS initiative and incorporates measures like the PPT and LOB in tax treaties to combat tax evasion on a global scale.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Norwegian Tax Administration has a system for routine tax audits, but there is no specific statutory interval for such audits. The Norwegian Tax Administration carries out audits based on risk assessments and has procedures and guidelines for this purpose (Tax Administration Act, Ot prp nr 70 (2008–09)). According to the preparatory work for the Tax Administration Act (Ot prp nr 70 (2008–09)), auditing and control must be carried out efficiently and purposefully, adapted to the individual taxpayer's circumstances.

Section 9-1 of the Tax Administration Act gives the tax authorities the right to audit taxpayers' accounts to ensure the accurate calculation and payment of tax and duties. Routine checks are allowed, but audits are mostly based on risk assessment, with higher-risk companies getting priority. Section 8-3 of the Tax Administration Act allows the tax authorities to conduct on-site audits. The Norwegian Tax Administration can visit a company to inspect its documentation, transactions and accounts, and verify its adherence to tax regulations. On-site audits are more frequent for high-risk companies.

The Norwegian Tax Administration employs risk assessment methodologies to identify entities or individuals deemed to be at elevated risk of misreporting or tax evasion. Consequently, certain entities are subjected to regular audits, while others are assessed as lower risk and consequently audited less frequently.

9. BEPS

9.1 Recommended Changes

To address tax evasion and avoidance, Norway has adopted several of the changes recommended in the OECD's BEPS project, including:

- the general anti-avoidance rule, which prevents the abuse of tax treaties by allowing tax authorities to intervene in transactions primarily designed to obtain tax benefits without genuine economic activity (BEPS measure 6).
- the CFC tax rules (for Norwegian-controlled foreign companies; *NOKUS* taxation), leading to Norwegian income tax on the income of foreign companies domiciled in low-tax countries controlled by Norwegian companies or individuals, regardless of distribution (BEPS measure 4);

- implementation of the PPT in a number of tax treaties through the multilateral instrument (MLI), to prevent the abuse of tax treaties in tax planning (BEPS measure 6);
- the introduction of country-by-country reporting to impose upon multinational companies an obligation to report their income in each country of operation, to better assess profit shifting to low-tax countries (BEPS measure 13);
- the introduction of increased documentation requirements for transactions between related parties to avoid artificial pricing for tax avoidance (BEPS measure 13);
- the implementation of the new transfer pricing guidelines and withholding tax on royalties, to prevent profit shifting via the transfer of intangible assets to low-tax countries to avoid taxation (BEPS measure 5); and
- rules to limit deductions for interest, to prevent excessive debt financing being used to reduce tax (BEPS measure 4).

9.2 Government Attitudes

Norway follows the OECD's BEPS guidelines to combat tax evasion and ensure a fair and efficient tax system that prevents multinational companies from exploiting legal loopholes.

As an active participant in the BEPS 2.0 initiative, Norway supports both Pillar One, which reallocates taxing rights to reflect where companies generate value, particularly in the digital economy, and Pillar Two, which establishes a 15% global minimum tax to curb tax competition and secure fair revenue for all nations. Pillar Two is already in force in Norway.

Pillar One will require changes to national legislation and tax treaties. These measures will impact multinational companies operating across jurisdictions, ensuring they contribute fairly to the tax base.

To align with these reforms, updates to the Tax Administration Act and the Norwegian Tax Act will be necessary, reinforcing Norway's commitment to maintaining a sustainable and equitable taxation system.

9.3 Profile of International Tax

In Norway, international tax has sparked public interest, especially after scrutiny of tax evasion and profit shifting.

The government is taking a proactive stance on OECD's BEPS measures, aiming for fair taxation. This commitment is seen in laws like the cut-through rule and CFC taxation. The Norwegian tax administration has adapted its practices to prevent tax avoidance and ensure that multinational companies pay tax in Norway. This adaptation is evident in the preparatory work for the Tax Administration Act (Ot prp nr 70 (2008–09), where international co-operation is emphasised as a key instrument for combatting tax evasion.

9.4 Competitive Tax Policy Objective

Norway's position is to have its tax policy aligned with international standards. The nation strives to strike a balance between international obligations and a competitive tax environment.

Norway has adopted a tax policy to attract investment and combat tax evasion.

Norway has maintained a 22% corporate tax rate and uses tax incentives, like R&D deductions, to encourage competitiveness. The corporate tax rate is subject to ongoing political discussions, and it is anticipated that the tax rate may be increased in the upcoming years.

Norway's tax structure includes a special tax (a rent tax) on income from natural resources, including petroleum extraction, power generation and the fishing and seafood industries. Also, Norway imposes a net wealth tax on individuals resident in Norway, which is considered to be non-competitive and discriminatory against local residents.

9.5 Features of the Competitive Tax System

One of the most vulnerable aspects of the Norwegian tax system is its tax incentives, which are subject to EU state aid scrutiny under the EEA agreement. Incentives like R&D tax deductions and schemes offering advantages to specific industries risk being classified as illegal state aid if they distort competition. This has been a particular concern in Norway, where international companies benefit from such measures. To address potential issues, Norway has carefully modified its tax incentives to comply with EEA regulations and avoid challenges from the European Commission.

In addition to state aid rules, the international tax framework significantly influences Norway's system. International trends and rules (such as the interest deduction limitation rule and country-by-country reporting) ensure that Norway's tax system aligns with global standards while maintaining fairness and transparency.

9.6 Proposals for Dealing With Hybrid Instruments

Norway has already implemented several BEPS measures to address hybrid instruments.

The interest deduction limitation rule limits the possibilities for multinational groups to shift their income to countries with lower tax rates through artificial financing arrangements in Norway.

The participation exemption does not apply to dividends from foreign subsidiaries if such subsidiary may deduct the dividend payment in its jurisdiction.

Section 8-11 of the Tax Administration Act imposes further documentation requirements for transactions with related parties, including those involving hybrid instruments, with the aim of preventing abuse and ensuring tax compliance. These measures align with BEPS recommendations, and further adjustments may be necessary to comply with future guidelines.

9.7 Territorial Tax Regime

Norway does not have a territorial tax system, instead using a global tax system where Norwegian companies are liable for tax on all income, both domestic and foreign.

Interest deduction limitations have been introduced to prevent profit shifting via artificial interest payments, in line with BEPS measure 4.

Stricter interest deduction limitations may affect multinational companies that use group financing arrangements, but are unlikely to have much effect on investors operating within existing structures in Norway.

9.8 Controlled Foreign Corporation Proposals

Norway has a global tax system that addresses CFCs through Section 10-60 of the Norwegian Tax Act.

These regulations tax the income of Norwegian owners of foreign companies in low-tax countries, regardless of distribution. This approach aligns with the BEPS CFC proposals, which aim to prevent profit shifting. Norway aligns with the CFC proposals' overarching principles, but practical challenges may emerge in distinguishing between companies with genuine economic activity and those using artificial tax planning structures. This can impede the effective implementation of the CFC rules.

9.9 Anti-Avoidance Rules

LOB and anti-avoidance rules in double tax treaties (DTC) can have a significant impact on both inbound and outbound investments in Norway. LOB clauses prevent abuse of tax treaties, for example by treaty shopping, and require companies to have real economic activity to enjoy tax benefits.

Norway also has GAAR, granting the tax authorities the right to deny tax benefits if transactions are artificially structured for tax avoidance. These rules apply to both foreign investors seeking tax benefits in Norway and Norwegian investors using tax treaties in other countries.

9.10 Transfer Pricing Changes

BEPS measures have caused big changes to how transfer pricing is done in Norway. More strict rules on documents and reports, especially those derived from BEPS measure 13's country-by-country reporting, led to Section 8-11 of the Tax Administration Act. This section requires companies to document transfer pricing structures to ensure adherence to the arm's length principle.

These changes enhance the tax authorities' capacity to verify that transfer prices accurately reflect real economic activity.

The taxation of profits from intangible assets (IP) has been controversial, and BEPS has introduced measures to ensure that profits from intangible assets are taxed where they are created. Norway has implemented BEPS measures that prevent profits from intangible assets being transferred to low-tax countries through transfer pricing.

9.11 Transparency and Country-by-Country Reporting

Norway supports country-by-country reporting and has implemented the requirements of BEPS measure 13 under Section 8-11 of the Tax Administration Act, imposing on multinational corporations a duty to disclose their financial earnings, taxes paid and economic activities on a country-by-country basis.

9.12 Taxation of Digital Economy Businesses

It is challenging to adapt the tax system to the global digital economy. Norway is committed to ensuring that digital platforms contribute tax revenues in accordance with their economic activities. The nation's future tax policies are to be aligned with globally recognised tax regulations for the digital economy, which may include digital services tax (DTS) schemes.

Norway has introduced new reporting obligations for foreign companies, leading to, for instance, the obligation for companies (such as AirBnB) to report all transactions in Norway to the tax authorities.

Norway has also introduced withholding taxes on royalties paid from Norwegian entities to related non-Norwegian entities resident in low-tax jurisdictions.

In addition, the tax authorities are closely monitoring the tax and VAT obligations of foreign entities with sales in Norway.

9.13 Digital Taxation

Norway endorses international initiatives on the taxation of the digital economy, including the OECD's BEPS measure 1.

It supports a DST to ensure that digital platforms contribute tax in countries where they generate revenue, regardless of a physical presence. The taxation of companies without a physical presence is regulated by Section 2-2 of the Norwegian Tax Act and Section 8-11 of the Tax Administration Act, which are relevant to digital companies. Norway has demonstrated its commitment to global solutions by supporting OECD initiatives and aligning with the EU's digital taxation initiatives.

9.14 Taxation of Offshore IP

Norway does not have a set of regulations for taxing offshore intangible assets, but the usual tax regulations apply to assets used in Norwegian territory.

Income derived from business activities in – or managed from – Norway is taxed in Norway, and withholding tax on royalties, interests and dividends may be imposed. The general anti-avoidance and transfer pricing rules prevent circumvention of the existing rules, and both the general anti-avoidance rule and LOB/PPT rules in the tax treaties prevent the abuse of the treaties, especially by IP owners in tax havens.

Trends and Developments

Contributed by:
Bernhard Getz-Jeffreys
Ro Sommernes Advokatfirma DA

Ro Sommernes Advokatfirma DA provide legal services to Norwegian and international clients. The firm's aim is to provide bespoke legal advice by ensuring that it invests resources to understand the client's business and establish a personal relationship, with a particular emphasis on active partner involvement. Ro Sommernes is solution-oriented and works with its clients to find constructive solutions. The firm has cutting-edge expertise in designing tax-optimised incentive schemes for senior executives, including share- and option-based schemes. Ro Sommernes provides high-quality advice related to structuring, transactions and due diligence processes, as well as advice in other general national and international tax matters. The firm's tax law department works closely with the company's other departments to ensure that the client's interests are taken care of. Ro Sommernes has over 30 lawyers, all working from its offices in Oslo.

Author

Bernhard Getz-Jeffreys specialises in tax law and corporate law, mainly focusing on transaction-related matters, tax structuring, planning and executing transactions and reorganisations, and establishing management investment plans and share incentive programmes for senior executives. He provides advice on all matters related to Norwegian and international taxation and regularly writes articles on tax issues for the *"Norwegian Financial Times"* (Finansavisen). Bernhard is a member of the Norwegian Bar Association and the International Fiscal Association and is also an examiner at the University of Bergen, where he graduated with a Master of Laws in 2015.

Ro Sommernes Advokatfirma DA

Hieronymus Heyerdahls gate 1
0160 Oslo
Norway

Tel: +47 23 00 34 40
Email: mail@rosom.no
Web: www.rosom.no/en

The Norwegian Tax System: Challenges and Possible Future Changes in Perspective

The Norwegian tax system is fundamental to financing the country's welfare state, providing the financial foundation for universally accessible healthcare, education and social services. It has long supported a model of equitable wealth distribution and high living standards.

However, Norway now faces profound economic and social challenges, including an aging population, rapid technological advances and shifting dynamics in the global economy. Norway's Long-term Perspective Report of 2024 (*Perspektivmeldingen*) offers a comprehensive assessment of how the tax system must adapt to sustain the welfare model. The report emphasises the need for proactive reforms to address demographic pressures, enhance economic sustainability, and transform the economy in accordance with a greener and more digital business world. This transition may lead to changes to the rules of taxation.

Current status of the Norwegian tax system

Norway is recognised for its relatively high tax burden, reflecting the country's commitment to a well-funded welfare state. The welfare state guarantees free access to healthcare, education and extensive social services, ensuring a high standard of living and reducing inequality.

The Norwegian tax system is based on several key components.

Income taxes and social security contributions

Personal income taxes in Norway are structured progressively, with tax rates increasing as income rises. This ensures that individuals with higher earnings contribute a larger share of their income, reinforcing the system's emphasis on equity and redistribution.

Employers also play a critical role in funding the welfare state through employer contributions, which are payroll taxes levied on wage payments. These contributions are a considerable source of state revenue, financing essential social welfare programmes such as healthcare, pensions and unemployment benefits. Together, personal income taxes and employer contributions form the backbone of Norway's welfare funding.

Corporate income taxes

A flat corporate income tax is levied upon national and foreign corporations performing business activities in Norway. The corporate income tax rate is subject to international competition and therefore to possible changes. The rate was reduced from 27% to 22% between 2015 and 2019. Simultaneously, the capital gains tax for individuals was increased proportionately to ensure that the combined taxes of corporate and personal capital gains taxes remained intact.

Taxation within the oil and gas industry

Norway's petroleum tax system is a unique and essential part of its framework, targeting oil and gas companies operating on the Norwegian continental shelf. This tax has historically generated significant revenue for the state, making oil and gas a cornerstone of Norway's economic development.

The petroleum tax rate is significantly higher than in many other countries, ensuring that a substantial share of the resource wealth is captured for public benefit. These revenues have been crucial in financing Norway's extensive welfare state and in building the Government Pension Fund Global, a sovereign wealth fund established to safeguard long-term economic stability and prosperity for future generations.

However, as the global energy transition accelerates, Norway faces the challenge of reducing its dependence on petroleum revenues. This requires a dual approach: maintaining petroleum taxes to fund the transition in the short term while simultaneously achieving greener industry and incentivising investments in renewable industries to secure long-term fiscal sustainability.

Resource rent taxes

In recent years, Norway has expanded its use of resource rent taxation (*grunnrenteskatt*) to new industries beyond the traditional petroleum and hydropower sectors. The government has argued that natural resources belong to the public and that businesses extracting significant economic rent from these resources should contribute more to society. This has led to proposals for new resource rent taxes, particularly targeting aquaculture and wind power, sparking intense debate among industry stakeholders and policymakers.

The introduction of a resource rent tax on aquaculture in 2023 marked a significant shift. The tax, set at 25%, applies to larger fish farming operations that utilise public fjords and coastal areas. The government justifies the tax by pointing to the industry's substantial profits and its reliance on shared natural resources. However, the measure has faced strong opposition from industry leaders, who argue that it reduces investment incentives and threatens Norway's global competitiveness in seafood production. Despite these concerns, the tax was implemented, and revenue is now shared between the state and local municipalities.

Similarly, the new resource rent tax on onshore wind power, which was given effect from 1 January 2024, has gained traction. Supporters argue that wind power developers should pay more for access to Norway's natural resources, while opponents warn of reduced investment and slower development of renewable energy as a result of the appliance of an increased tax rate. As Norway continues to balance economic growth with fair resource distribution, the expansion of resource rent taxation remains a politically sensitive and evolving issue. It is, however, clear that resource rent taxation is *"in the wind"*, and as we further tap into the world's resources, the need to impose taxes on the use of the limited resources increases.

Value added tax and duties

A substantial portion of state revenue is derived from the value added tax (VAT), a general consumption tax applied to most goods and services. However, it is inherently regressive, as it affects lower-income groups more heavily than higher-income groups. Despite this, its broad application ensures a steady revenue stream to support public services.

Specific duties further complement the system, targeting goods like alcohol, tobacco and fuel. While these duties primarily generate revenue, they also support broader policy goals. For example, environmental taxes and tolls are explicitly designed to reduce emissions and encourage sustainable practices. Similarly, taxes on alcohol and tobacco can indirectly promote public health by discouraging overconsumption. These measures showcase how taxation can shape societal behaviour while addressing broader challenges like sustainability and health.

Net wealth taxes

Norway further imposes net wealth tax on individuals who are tax resident in Norway. The net wealth tax is progressive. The tax's objective is to reduce inequality and generate tax revenues for the state. It is stated in the State Budget for 2025 that, in 2024, the net wealth tax generated revenues of approximately NOK32 billion, which constituted approximately 1.5% of the state's total revenues from direct and indirect taxes, customs and duties in the same year. Norway's progressive tax structure fosters equity and shared responsibility, ensuring that those with greater financial means contribute more.

The net wealth tax has been a significant subject of political debate in recent years, particularly regarding its impact on business owners and capital flight. Unlike many other countries, Norway maintains a net wealth tax levied on individuals with assets above a certain threshold. Recent governments have adjusted both the tax rate and valuation rules, with an increasing focus on taxing high net worth individuals. These changes have sparked controversy, particularly among business owners who argue that the tax disproportionately affects private sector investment and entrepreneurship.

In 2022 and 2023, the government increased the wealth tax rate for the highest brackets and adjusted the valuation of certain asset classes, including shares in privately held companies. This led to concerns about liquidity challenges, as business owners must pay the tax based on theoretical valuations rather than realised profits. Additionally, stricter rules on asset valuation have resulted in a higher effective tax burden on business owners, which some claim influences business investment opportunities and job creation. The debate intensified as reports emerged of wealthy individuals relocating to countries with more favourable tax regimes, such as Switzerland.

The ongoing discussion around wealth taxation in Norway reflects broader political and economic considerations, balancing the need for state revenue with the maintenance of a competitive business environment. While proponents argue that the tax promotes economic fairness and funds public welfare, critics warn of negative long-term effects on capital formation and economic growth. The government has signalled a willingness to refine the system, but with wealth tax remaining a key political issue, further changes are likely in the coming years.

Challenges that may influence the Norwegian tax system

The Norwegian tax system faces several significant challenges in the coming years. Norway's Long-term Perspective Report of 2024 outlines key factors that may necessitate changes to ensure the system's long-term sustainability and its ability to support the welfare state.

An aging population

One of the most extensive challenges facing the tax system is the aging population. As the number of retirees increases and the working-age population shrinks, the tax base will contract while public expenditures rise. Pension payments and healthcare costs are expected to grow significantly, imposing economic pressure on the welfare system.

Projections indicate that by 2060, dependency ratios will have doubled, putting unprecedented strain on public finances. This demographic shift means that public spending will need to increase to meet the rising demand for healthcare, pensions and other welfare services. However, with fewer individuals in the workforce, tax revenues are likely to decline.

Potential solutions include raising taxes, adjusting the retirement age or creating incentives for greater workforce participation among under-represented groups, such as seniors, women and immigrants through a reduction of taxes for low-income workers. Immigration policies could play a pivotal role in addressing labour shortages while sustaining long-term tax revenues. Additionally, Norway could expand tax credits for childcare expenses to encourage dual-income households, boosting workforce participation.

Increased globalisation and digitalisation

Globalisation and digitalisation present new complexities for tax collection and enforcement. Many multinational companies shift their profits to low-tax jurisdictions, effectively reducing the taxes they pay in countries like Norway. At the same time, digitalisation has given rise to new forms of income generation, such as freelance work, the gig economy and digital platforms, which can be challenging to monitor and tax effectively.

Aligning with global tax standards, such as the OECD's Pillar Two minimum corporate tax rate, will be crucial for ensuring fairness and transparency in tax collection. The Perspective Report for 2024 emphasises the necessity of modernising Norway's tax infrastructure to address challenges in the digital economy. Implementing AI-based compliance measures will allow for real-time monitoring and fraud detection, ensuring tax collection remains robust. These measures align with global trends and aim to enhance transparency while ensuring fairness in tax enforcement.

To address tax avoidance and ensure fair taxation in this evolving landscape, international co-operation is required. In the Perspective Report of 2024, the importance of global agreements and updated tax policies to ensure that both companies and individuals pay taxes where their economic activity occurs is emphasised. Initiatives like the OECD's base erosion and profit shifting (BEPS) framework and digital services taxes in the EU provide valuable blueprints for Norway to strengthen its tax base.

To address these issues, the Ministry of Finance mentions that Norway may expand its collaboration under global frameworks such as the OECD's Inclusive Framework and the EU's digital services tax initiatives, in addition to implementing digital registries to monitor flexible, sporadic jobs and actors' income. Stricter reporting obligations have been introduced in recent years to providers of digital services in Norway.

New tax reforms may also focus on shifting the tax base towards digital and capital income, reflecting broader economic changes driven by automation and in order to allow for lower personal income taxes for low-income workers.

As automation and AI reshape the global economy, reliance on labour income taxation may decline. Norway could explore shifting its tax base towards capital gains, digital revenues and consumption to reflect these broader economic changes and secure fiscal stability in an automated future. Norway could further invest in digital tax platforms that simplify compliance, detect fraud and adapt to emerging economic trends. Such measures would ensure a more robust and equitable tax collection system.

Climate challenges and green taxes

Adapting the tax system to align with green policies is another pressing challenge. Norway has already introduced carbon taxes and other environmental levies to reduce emissions and encourage sustainable practices. However, meeting its climate obligations will require further adjustments.

Future reforms may include increasing taxes on carbon emissions and other environmentally harmful activities to discourage their use. At the same time, mechanisms such as revenue recycling – where proceeds from green taxes are redistributed to vulnerable groups – can ensure fairness. Tax incentives to promote investments in renewable energy, sustainable transportation and circular economy initiatives will also be essential for achieving Norway's climate goals without hindering economic growth.

Expanding beyond carbon taxes, Norway could increase its environmental levies on plastics, single-use items and industrial waste, aligning taxation with global sustainability trends. Investments in renewable energy infrastructure and subsidies for carbon capture and storage (CCS) would strengthen Norway's position as a leader in green technology while addressing climate adaptation needs.

Successful implementation of these tax reforms will depend on public acceptance and trust in the system. Transparent communication about the purpose and benefits of reforms, particularly those involving green taxes or wealth redistribution, will be critical. Engaging with businesses, civil society, and taxpayers will help ensure that reforms are perceived as equitable and necessary.

Potential changes to the tax system

In response to the challenges outlined above, significant adaptations to the Norwegian tax system may be necessary. In the Perspective Report of 2024, the Ministry of Finance highlights several potential pathways for reform, aiming to ensure that the tax system remains effective, equitable and capable of supporting Norway's welfare state in the long term.

Higher taxes to finance the welfare state

One potential solution to address the financial strain posed by an aging population is to raise taxes. This could involve increasing income tax rates for high-income individuals, raising consumption taxes like VAT or introducing new taxes on wealth such as a state real property tax and inheritance tax. These measures could generate additional revenue to maintain public services and welfare programmes.

However, raising taxes comes with risks. Overburdening individuals or businesses could stifle economic growth and competitiveness, particularly in an increasingly globalised world. Any increase in taxation would need to strike a careful balance, ensuring fairness without discouraging investment, innovation or workforce participation. Policymakers may also consider complementary reforms, such as incentivising greater workforce participation or moderating public spending growth, to alleviate the pressure on the tax system.

Better taxation of the digital economy

The rise of digitalisation and globalisation has created significant challenges for traditional tax systems, as international companies increasingly operate across borders while minimising their tax liabilities. To address this, Norway may need to develop new tax rules specifically targeting digital businesses and their economic activities within the country.

One possible solution could involve implementing digital services taxes, designed to capture revenue from global tech companies operating in Norway. Additionally, international co-operation will be essential to prevent tax evasion and ensure fair taxation. Collaborating with organisations such as the OECD to establish global standards for taxing the digital economy could help Norway protect its tax base while fostering a level playing field for businesses.

Green taxation policies

Green taxation will play a central role in reducing greenhouse gas emissions and promoting sustainable economic growth. Policymakers must ensure that these reforms support vulnerable populations while incentivising renewable technologies. Increasing taxes on carbon emissions and other environmentally harmful activities can incentivise individuals and businesses to adopt greener practices, contributing to Norway's climate goals.

In addition to increasing environmental taxes, the tax system could be used to support the development of green technologies and industries. For instance, offering tax incentives for investments in renewable energy, low-emission transportation and circular economy solutions may promote sustainable economic growth. Such taxes should be adapted to ensure that they do not place disproportionate burdens on lower-income households and that taxation fairness is maintained across society.

A potential future tax policy for Norway

To remain effective in an increasingly complex global landscape, the Norwegian tax system needs to evolve to address new challenges while at the same time preserving the core principles of equality and sustainability. A future-oriented tax system must strike a delicate balance: financing rising public expenditures while supporting economic growth and maintaining Norway's global competitiveness.

Although Norway's aging population and rising demand for welfare services will likely lead to the effectivisation of public services and a reduction in public spending, it will also require adjustments to the tax system. While higher taxes could provide the necessary revenue, reforms must be carefully designed to avoid stifling economic growth. A progressive approach, where higher-income earners and wealthier individuals contribute more, can uphold equity and equality. The Conservatives, however, have flagged that the net wealth tax will be reduced or abolished if they come to power in the election in 2025. This will in the short term reduce the equality between the classes of society, but may, in the opinion of the Conservatives, increase investments in Norway and lead to financial growth and an increased tax base in the future.

A new tax reform will most likely include a broadening of the Norwegian tax base and higher corporate income taxes. It will also likely include a minor tax on Norwegian corporations that accrue capital gains from sale of shares and similar equities or dividends from such equities (which are today tax exempt under the participation exemption), to avoid owners of such investment companies potentially becoming *"zero-tax payers"*. Further, there is the potential to increase the taxes of owners of households through new taxes on the ownership and/or use of such houses to replace or complement today's tax exemption for sale of such houses, or potentially a reduction in the deductibility of interest on mortgages. However, the introduction of such rules would be politically damaging to the party introducing them, and is thus not considered likely.

Norway's challenge is also to replace the tax revenues from the oil and gas industry, which in 2024 contributed NOK357 billion to the state budget, accounting for approximately 17% of the state's revenues from taxes and duties. To ensure tax revenues after the oil and gas age, targeted tax incentives for renewable energy, sustainable transportation and green technologies are expected to promote economic growth while fostering environmental innovation.

PARAGUAY

Law and Practice

Contributed by:
Mauro Mascareño, Carlos Vargas and Rodrigo Gómez Sánchez
Mascareño Vargas – Asesores

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PARAGUAY LAW AND PRACTICE

Contributed by: Mauro Mascareño, Carlos Vargas and Rodrigo Gómez Sánchez,
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Mascareño Vargas – Asesores (MVA) is an advisory firm that stands out for its unique business engineering approach, offering comprehensive corporate services. The firm provides seamless, integrated solutions tailored to its clients' diverse needs by combining legal, tax and financial expertise. The mission of MVA is to be the trusted partner of its clients in Paraguay, delivering high-quality advisory services that support business growth across multiple jurisdictions while mitigating risks and identifying strategic opportunities. The firm focuses on developing and expanding its clients' commercial activities by providing strategic corporate law, taxation and financial structuring solutions. The innovative, customised approaches of MVA are designed to meet each client's needs, ensuring full regulatory compliance and helping them achieve their business goals. The firm's extensive experience across various industries sets it apart, allowing it to offer highly relevant and strategic advice. MVA guides its clients through complex legal and financial landscapes, ensuring successful navigation of regulatory challenges.

Authors

Mauro Mascareño is the founding partner and managing director of MVA, with over 15 years of experience in corporate and tax law in Paraguay. He specialises in mergers and acquisitions, project financing and estate planning. He has advised various companies on foreign investment processes and complex transactions in Paraguay, and he has worked on the structuring of technology and M&A projects. He also serves as vice president of the International Fiscal Association of Paraguay (IFA Paraguay) and holds postgraduate degrees from the London School of Economics and Harvard Kennedy School.

Carlos Vargas is a partner at MVA and an expert in national and international tax law. With over 15 years of experience, he specialises in corporate tax advisory, business reorganisations and investment projects, with a strong track record in corporate planning for both local and international companies. He is recognised for his strategic advisory work for tech companies and e-commerce platforms. He also teaches and is an active member of the legal community.

Rodrigo Gómez Sánchez is a partner at MVA with extensive experience in corporate and commercial law, including mergers and acquisitions, financing and emerging market regulations. His focus includes advising technology and infrastructure companies in Paraguay and the Southern Cone. He has represented international clients in complex cross-border transactions and is known for his strategic approach to tax and regulatory compliance and risk management. He is also a board member of the International Fiscal Association of Paraguay (IFA Paraguay).

Mascareño Vargas – Asesores

Capitan Juan Dimas Motta
245 esquina Andrade
001408 Asunción
Paraguay

Tel: +595 981 547 839
Email: mva@mv-a.com.py
Web: www.mv-a.com.py

Contributed by: Mauro Mascareño, Carlos Vargas and Rodrigo Gómez Sánchez,
Mascareño Vargas – Asesores

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Paraguay predominantly adopt a corporate form, as it offers limited liability for owners and a general, clear legal framework. The most common structures are the *Sociedad Anónima* (SA), the *Sociedad de Responsabilidad Limitada* (SRL) and the more recent *Empresa por Acciones Simplificada* (EAS).

Each entity type requires at least two shareholders, except the EAS, which permits single shareholder companies and has a faster incorporation process if standard by-laws are used.

In contrast, SRLs and SAs generally require more formalities to be met and may be better suited to larger or more complex undertakings. The SA is the only vehicle that is eligible to list its shares on the local stock exchange, while an SRL can issue securities (bonds) but not shares. EASs are not allowed to list their shares nor issue securities in the local stock exchange market.

All of these corporate entities are taxed as separate legal entities, subject to Paraguay's corporate income tax or IRE regime, which is typically 10% on net profits. A further distribution tax applies when profits are paid out to shareholders, at varying rates depending on whether the shareholder is a resident or non-resident and whether a double tax treaty is applicable or not. Rates range from 5% to 15%.

This structure allows businesses to clearly separate corporate obligations from those of their owners, aligning with international norms on corporate taxation.

In addition, unlike SAs and SRLs, EASs may pay IRE at a maximum effective rate of 3% of their gross income if their gross income does not exceed approximately USD250,000 per year. This regime is called IRE Simple or Simple.

Finally, the partner of a single-member EAS may not be subject to the dividend and profits tax or IDU. However, the tax administration has not yet approved this interpretation, which informally maintains that the IDU must be paid in this case.

At the time of publication, there is no known official position or administrative or judicial precedent on whether or not IDU is payable in these cases.

1.2 Transparent Entities

Paraguayan law does not commonly provide for transparent or *"pass-through"* entities in the same way that some other jurisdictions do. While unregistered partnerships (*sociedades de hecho*) and civil partnerships (*sociedades simples*) exist, they do not generally benefit from limited liability or advantageous tax treatment as transparent vehicles. Consequently, they are rarely chosen for substantive commercial or investment activities.

Under Law No 6380/19, which came into effect on 1 January 2020, Paraguay introduced the concept of Transparent Legal Entities (*Entidades Jurídicas Transparentes*), which allow certain entities, such as trusts, private services-oriented joint ventures (*consorcios*) and investment funds, to have income and expenses *"passed through"* directly to their partners or beneficiaries.

While this structure theoretically provides a true *"pass-through"* tax regime, it remains uncommon in practice, as many local entrepreneurs and investors are more familiar with standard corporate forms like the SA or the EAS, both of which offer established governance frameworks, limited liability and relative ease of capital-raising.

For investment groups such as private equity and hedge funds, transparent entities are rarely adopted. These sophisticated investors generally prefer the tried and tested corporate vehicles (SAs mainly), citing benefits like robust regulation, potential stock market listing and investor familiarity. Although the transparent entity model could theoretically appeal to certain niche strategies, most market participants still gravitate toward the stability and clarity of traditional corporate forms in Paraguay.

In addition, investment funds have another advantage: practically all the profits obtained by their participants, whether resident or not, are exempt from tax, not because of the transparency regime, but because of a special exemption aimed at promoting the use of these investment instruments and the local stock market, since these funds can only place their shares on Paraguayan stock exchanges.

1.3 Determining Residence of Incorporated Businesses

Under Law No 6380/19, Paraguay generally applies an incorporation test for tax residency, deeming entities incorporated under its laws as tax residents. However, in the context of double taxation treaties, the place of effective management may determine residency if a tie-breaker rule is applied.

Paraguayan tax law treats transparent entities as fiscally neutral, attributing income and deductions directly to their beneficiaries, who are taxed based on their own residency and applicable regulations. While these entities may be considered *"resident"* due to incorporation, taxation occurs at the beneficiary level.

Where a double taxation treaty applies, treaty provisions prevail and residency determinations focus on the beneficiaries rather than the entity. Treaties generally recognise that the income of a transparent entity is taxable in the jurisdiction of its beneficiaries and not the entity itself.

1.4 Tax Rates

Incorporated Businesses

Paraguay applies a 10% IRE to the net profits of resident entities, including SAs, SRLs and EASs.

When distributing profits, these corporations must also withhold the IDU at 8% for Paraguayan-resident shareholders and 15% for non-residents generally.

Under double taxation treaty rules, it is generally 5% for Spanish residents, although there are cases in which it could be 0% and others in which it could be 10%. For Chilean residents, the dividend withholding tax is 10%.

While this additional levy technically applies to distributed profits, the practical effect is that the overall effective tax rate ranges from 14.5% for Spanish residents, 19% for Chilean residents, 23.5% for other non-residents and 17.2% for residents.

Businesses Owned by Individuals Directly

Businesses owned by a resident individual (*empresa unipersonal*) can settle the IRE under the IRE Simple regime. Under this regime, if their annual gross income does not exceed approximately USD250,000, they pay a maximum of 3% on their gross income.

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The maximum of 3% is because the IRE Simple rule is 10% is paid on the actual profit, which is the income for the year minus the deductible expenses, or on a presumed profit of 30%, which the rate of 10% is applied to, whichever results in the lowest tax being paid.

Likewise, the owners of these sole proprietorships who pay IRE through the Simple regime are not subject to IDU for their business' dividends.

If the USD250,000 threshold is surpassed, or the IRE is assessed under the general regimen, businesses owned directly by a sole proprietor have the same regime as an incorporated business. This is a 10% IRE rate on the annual profits and IDU at 8% when distributing the profits.

Businesses Owned Through Transparent Entities

Under Law No 6380/19, an entity recognised as transparent shifts its income and expenses to the partners or shareholders, meaning the entity itself does not pay IRE. Instead, each owner pays tax according to their personal tax status.

In contrast, non-residents may be subject to 15% withholding tax on their portion. However, for tax transparent entities (EJT) with non-resident beneficiaries, such as a trust, a regulation forces them to have the EJT pay IRE as if they were residents and then IDU, therefore eliminating tax transparency.

Investment funds' earnings are generally tax-exempt, except when the fund is a company shareholder. In this case the fund must pay IDU at 8% for the receipt of dividends from local companies.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

General Approach

In Paraguay, IRE is generally assessed on net profits determined by the difference between taxable revenues and deductible costs/expenses. The starting point is typically the company's accounting records, prepared in line with local GAAP or IFRS. Thereafter, specific tax rules require add-backs or exclusions to arrive at the taxable base. Notably, profits are taxed on an accrual basis. Income is recognised when earned and expenses when incurred, regardless of when cash actually changes hands.

Main Adjustments

Certain items may not be fully deductible or may trigger partial limitations. For instance:

- thin capitalisation rule: interest expenses (combined with royalties and technical assistance fees paid to related parties) are only deductible up to 30% of the company's net taxable income before those expenses;
- transfer pricing: transactions with related parties (especially non-resident affiliates) must be at market value (arm's length). Any interest, service fees, or cost allocations above or below that value are adjusted for IRE purposes;
- managerial/director compensation: fees paid to directors or shareholders acting as management may be capped in deductibility (broadly up to 1% of gross revenue, along with certain other expenses);
- depreciation and amortisation: must generally follow statutory lives and methods prescribed by the tax authority rather than purely accounting estimates, therefore, generating a

difference between IFRS rules and tax rules; and
- foreign exchange gains/losses: recognised on an accrual basis as taxable income or deductible expense in the period they arise.

Paraguay imposes a minimum taxation rule on loss relief. While companies may carry forward operating losses for up to five fiscal years, the utilisation of these losses in any given year is capped at 20% of that year's net taxable income (before the losses are offset). Consequently, at least 80% of the current year's net income remains taxable, ensuring a minimum tax base even when significant losses have been incurred in prior periods.

Another relevant point relates to revaluation of fixed assets. Under Paraguayan rules, revaluation gains are not taxed immediately. Instead, they only become taxable upon actual disposal of the asset. This means that any upward adjustment in book value does not trigger a current tax liability, as long as the asset remains on the company's balance sheet.

However, once the asset is disposed of, the realised gain (calculated as the sale price minus depreciated tax cost) is fully included in the tax base, ensuring that the increased asset value is eventually subject to IRE.

This framework ensures that while the primary reference point is the financial statements, Paraguay's IRE rules impose specific limitations and require detailed support for claimed deductions, particularly in related-party settings.

2.2 Special Incentives for Technology Investments

Paraguay does not offer a specific patent box regime or any specialised R&D tax incentives akin to those in other jurisdictions. Consequently, there is no direct preferential treatment for royalties stemming from patents or for in-country R&D expenditures.

However, as the Tax Law is currently written, the assignment of the use of patents, trade marks and rights by a Paraguayan entity that takes place exclusively abroad is not subject to IRE, so it could be understood as a patent box. However, the Law does not conceive it as such.

Therefore, the transfer of rights, trade marks and patents exploited exclusively abroad are not subject to IRE. Nonetheless, when the company pays its shareholders dividends, there will be IDU to pay, according to the applicable rate, depending on the residence of the partners.

However, general investment incentives (not uniquely tech-focused) can apply if a project meets the relevant criteria. For instance, under Law No 60/90, intangible assets such as technology or software may be recognised as eligible investments, potentially benefiting from import tax exemptions or other concessions if approved as part of an overall project.

Additionally, Law No 1064/97 (the Maquila regime) can offer low effective tax rates for industrial processes or tech-enabled manufacturing geared toward export, although it is not limited to R&D activities. These broader mechanisms may help reduce the tax burden for tech-oriented companies, but Paraguay does not currently have a dedicated scheme specifically targeting R&D or patent income.

2.3 Other Special Incentives

Investment Incentives (Law No 60/90)

Under this framework, qualifying investments (including capital goods, certain raw materials and financing structures) may obtain partial or total exemption from import duties, VAT or IVA on locally purchased or imported capital goods, and even the IDU if the project meets specific thresholds (eg, investment of at least USD13 million). The actual benefits granted can vary from project to project and are subject to approval by a Bi-ministerial Resolution.

Maquila Regime (Law No 1064/97)

Companies authorised under the Maquila programme pay a single tax of 1% on the local value added or the value of their monthly export, whichever is higher, provided the output is exported. Additionally, dividends paid abroad are exempt from the IDU, and there is broad relief from national, departmental and municipal taxes for activities within the scope of the Maquila contract. While not targeted exclusively at technology ventures, it can be valuable for tech-enabled manufacturing or service processes oriented towards export markets.

Free Trade Zones (Law No 523/95)

Firms established as *"users"* in a free trade zone pay a 0.5% single tax on export revenue and are generally exempt from other taxes (including the IDU and income taxes) on those export operations. Goods or services entering local markets from a free trade zone become subject to Paraguay's standard tax regime and the user arrangement must be negotiated with the concessionaire who operates the zone.

Financing Structures

Law No 60/90 can exempt interest on foreign loans from withholding taxes (*Impuesto a la Renta de No Residentes*) and IVA when the lender is a recognised financial institution and the project surpasses specified investment thresholds (USD13 million). This relief can significantly reduce overall borrowing costs for large-scale investment or infrastructure projects.

Electric Transport Promotion (Law No 6925/22)

Although not exclusively a tax incentive scheme, Law No 6925/22 promotes the adoption of electric vehicles in both the public and private sectors by offering tax exemptions and streamlined import processes.

Specifically, the Law contemplates reduced or zero import duties, preferential IVA treatment and other potential benefits for manufacturers and importers of electric or hybrid vehicles, their batteries and key components. These measures seek to encourage the development of local electromobility infrastructure, such as charging stations, and foster cleaner, more sustainable transportation.

2.4 Basic Rules on Loss Relief

Carry Forward and No Carry Back

Paraguayan corporate tax legislation allows businesses to carry forward losses for up to five fiscal years but does not permit any carry back of losses to prior periods. In principle, all income, ordinary or capital, falls under the same IRE calculation, so operating losses may offset capital gains (and vice versa), subject to general rules. When claiming losses, taxpayers must maintain thorough documentation to substantiate the amounts and ensure compliance with specific limitations imposed by the tax authority.

80% Minimum Tax Rule

A significant limitation is the so-called minimum taxation rule, which allows losses carried forward to offset only 20% of the net taxable income in each of the five subsequent years. Therefore, at least 80% of the current year's income remains taxable, ensuring some base-line level of taxation even when historical losses are available. Unused losses beyond the five-year period or amounts disallowed by the annual 20% cap generally expire and cannot be claimed thereafter.

However, from a civil and commercial point of view, a company with accumulated losses cannot distribute profits or pay dividends until all the losses have been covered, either by offsetting them against profits, contributions or capital reductions.

2.5 Imposed Limits on Deduction of Interest

Local corporations in Paraguay are subject to a thin capitalisation rule, which limits the deduction of interest (together with royalties and technical assistance fees) paid to related parties to 30% of the entity's net taxable income before those expenses. Any excess is non-deductible in that year.

Additionally, for the interest to be deductible, the lender must be a taxpayer whether of personal income tax, IRE or non-resident income tax.

Transfer pricing rules require interest paid to foreign-related parties to be at arm's length conditions.

For interest payments to non-resident lenders, a withholding tax (*Impuesto a la Renta de No Residentes* or INR) applies at the following rates:

- if the lender is a related-party (ie, controlling or majority-owned affiliate), the nominal rate is 15% of the gross payment (for an effective rate of 15%); and
- where the lender is unrelated, the nominal rate is 15%, but it is calculated on a presumptive base of 30% of the gross payment, resulting in an effective rate of 4.5%.

If a double taxation treaty is in place, a reduced withholding rate may apply, depending on the specific treaty provisions.

For third-party (eg, local commercial banks not related to the borrower), there is generally no numeric debt-to-equity limit beyond ensuring the expense is necessary, duly documented and incurred to generate taxable income.

2.6 Basic Rules on Consolidated Tax Grouping

No Consolidation Permitted

Paraguay does not permit consolidated tax grouping. Each legal entity, whether part of a broader group or not, must file its own separate tax return and compute its liability independently. Consequently, losses incurred by one company cannot be offset against the profits of another group entity.

Utilising Separate Company Losses

Because there is no group relief, businesses often rely on corporate reorganisations (eg, mergers, absorptions and spin-offs) to consolidate operations under a single entity, potentially transferring tax liabilities (including losses or credits). Although these reorganisations may proceed tax-free if certain requirements are met, each restructuring must be planned carefully to comply with applicable civil and tax rules. Otherwise, losses remain isolated at the individual company level.

2.7 Capital Gains Taxation

Capital gains for corporations in Paraguay are taxed under the general IRE regime, at a rate of 10% on net gains. There is no separate capital gains tax or special rate, so any profits realised on the sale of shares (or other capital assets) merge with ordinary income to form part of the taxable base. As a result:

- sale of shares: the net gain is calculated as the difference between selling price and tax basis (eg, the acquisition cost) and taxed at 10%;
- no broad exemptions: unlike individuals, who may benefit from reduced effective rates under specific rules, corporate taxpayers do not enjoy any significant exemptions on the sale of shares;
- IVA: the sale of shares is exempt from IVA, while other assets are generally taxed at 10%, save for real estate which has a 1.5% effective IVA rate; and
- double tax treaties: certain treaties may reduce or eliminate Paraguayan tax on capital gains, but the relief depends on the terms of each specific agreement.

2.8 Other Taxes Payable by an Incorporated Business

Apart from IRE and the IDU, Paraguayan-incorporated businesses may also encounter the following taxes or charges when executing specific transactions.

IVA

Applies at rates of 5% or 10% to most sales of goods and provision of services.

Imports of goods are also subject to IVA, usually at the standard 10% rate.

Certain agricultural products, animals (including poultry), and their primary derivatives qualify for a reduced 5% rate.

Excise Tax (Impuesto Selectivo al Consumo or ISC)

Levied on certain goods (eg, tobacco, alcoholic beverages, fuel and some machinery/equipment) either upon import or at the first local sale of locally produced items.

Rates vary but can be as low as 0.5% to 1% on some capital goods and as high as 50%.

Municipal Taxes

Municipal Trade Tax (*Impuesto a la Patente Comercial* or IPC) is levied on the value of a company's assets located in each municipality, calculated via a fixed amount plus a variable rate (ranging from roughly 0.85% to 0.05%).

Construction tax. If the business erects new facilities or expands existing ones, some municipalities impose a one-time levy based on the declared construction cost.

Real Estate Tax (*Impuesto Inmobiliario*). An annual 1% tax on the fiscal value of real property, payable to the municipality in which the property is located.

Municipal real estate transfer tax. When assigning land or real estate, a municipal tax on the value of the transaction must be paid. The rate is 0.3% of the assigning value if the land is in the capital (Asunción) and 0.2% if it is in any other part of the country, plus, a judicial fee of 0.74% of the assignment value must be paid when registering the deed of assignment before the Public Records.

Customs Duties on Imports

Collected by the customs authority based on the declared (ad valorem) value of imported goods, plus any relevant internal taxes (like IVA and, where applicable, ISC).

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An IRE advance of 0.4% on the customs value of imports typically applies as well, creditable against the year-end corporate tax liability.

While these taxes may not apply to every transaction, they can arise when a business imports capital goods, buys or sells real estate or builds new facilities. Companies should therefore review each contemplated transaction to determine whether additional taxes or municipal levies may apply.

2.9 Incorporated Businesses and Notable Taxes

Beyond the principal levies already mentioned (IRE, IDU, IVA, INR and ISC municipal taxes and import duties), there are no additional relevant taxes.

Paraguay does not impose a net worth tax or stamp duties and there is no financial transaction tax. Additionally, no general export tax exists for goods shipped abroad, although exporters do face compliance measures such as monthly reporting and a mandatory withholding obligation of up to 70% of the supplier's IVA included in certain transactions.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

In Paraguay, most closely held local businesses opt for a corporate form, particularly limited liability vehicles like the SA, SRL and EAS. Even small-scale family enterprises frequently choose these vehicles due to their limited liability, relatively straightforward registration processes and the ability to accommodate multiple or even single shareholders (in the case of the EAS).

Non-corporate forms (eg, sole proprietors) are still used, but the trend is to a corporate form, as the individual business generally lacks limited liability protections.

3.2 Individual Rates and Corporate Rates

In Paraguay, professional services rendered by individuals typically fall under the personal income tax on personal services (IRP-RSP) system, which has a maximum rate of 10%. However, this system allows wide-ranging deductions, including personal and family expenses, not strictly tied to generating taxable income. Consequently, the actual effective rate for many professionals can be equal to or even lower than the effective 17.2% IRE plus dividends tax rates, removing the main incentive to shift income into a corporate form.

Because of this alignment in rates, Paraguay does not impose specific *"personal service corporation"* rules aimed at reclassifying individual income into corporate earnings. Professionals remain free to operate through a corporate form if they wish, but there is no inherent tax advantage in doing so. The law has therefore not found it necessary to implement special anti-avoidance measures in this area.

3.3 Accumulating Earnings for Investment Purposes

No Forced Distribution or Accumulated Earnings Tax

Paraguay does not impose specific rules preventing closely held corporations from accumulating earnings for reinvestment purposes. There is no accumulated earnings tax or similar mechanism penalising undistributed profits. Corporate owners can therefore choose to retain income within the company, deferring the IDU until such time as they decide to distribute dividends.

Standard Corporate Formalities

Under commercial law, most businesses must allocate a small portion of annual profits to a legal reserve (eg, at least 5% of the profits up to 20% of share capital), but that reserve remains within the company and does not equate to a forced dividend to shareholders. Beyond this mandatory reserve, there is no legal requirement for periodic or minimum distributions and no special anti-accumulation provisions apply.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends

Resident individuals

Dividends from a Paraguayan corporation incur the IDU at 8%, withheld at source by the distributing company.

Non-resident individuals

They are subject to the same IDU but at 15%, which is also withheld at source.

A double taxation treaty, if applicable, may reduce or eliminate this tax.

Capital Gains (Sale of Shares)

Resident individuals

Gains on share sales fall under the Personal Income Tax on Capital Gains (IRP-RGC) category at a nominal rate of 8% on the net gain (sale price minus acquisition cost). However, if cost documentation is incomplete or results in a higher taxable gain, the law provides a simplified option that presumes the gain to be 30% of the selling price. This results in an effective maximum tax rate of 2.4% (8% of 30%).

Non-resident individuals

Gains are taxed under INR at a nominal rate of 15%. The basis is calculated as the lesser of:

- the difference between the sale price and the nominal value of the shares; or
- 30% of the sale price.

By multiplying that basis by the 15% nominal rate, the maximum effective rate typically does not exceed 4.5% (15% of 30%). A double taxation treaty, if applicable, may reduce or eliminate this tax.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Publicly listed companies in Paraguay are subject to the same IDU rates. Therefore, dividends paid to residents are generally subject to an 8% withholding tax and those paid to non-residents are subject to a 15% withholding tax. The reduced rates may apply under an applicable double taxation treaty.

Regarding the sale of publicly traded shares, the tax legislation specifically exempts these transactions from capital gains tax if the securities are listed and traded through the local stock exchange.

Therefore, resident individuals generally do not incur personal income tax on capital gains derived from selling publicly traded shares if those sales meet the conditions of the local securities market regulations.

Non-resident individuals are similarly exempt, provided the transaction is fully executed via the local exchange, although they should confirm any additional reporting or documentation requirements.

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4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In Paraguay, dividends paid by local corporations to non-resident shareholders are generally subject to a 15% IDU withholding tax, while resident shareholders are subject to an 8% rate.

Interest paid to non-residents is also subject to a withholding tax known as INR. When the lender is a related-party, the nominal rate is 15% of 100% of the gross payment (an effective rate of 15%).

For unrelated lenders an effective rate of 4.5% is payable. Royalties, licences or technical assistance fees paid to non-residents normally face a 15% nominal rate, with the base often presumed at 15% of 100% for related parties, leading to a 15% effective rate.

Relief may arise from a double taxation treaty, which can reduce or eliminate these withholding tax rates, but in the absence of a treaty, the statutory rates apply. The local tax authority tends to be particularly vigilant regarding cross-border payments for services and intangibles, ensuring that the payer withholds the correct INR and files the necessary documentation.

Overlooked or incorrect withholding tax is likely to trigger audits, penalties and interest charges.

4.2 Primary Tax Treaty Countries

Paraguay maintains a relatively small network of double taxation treaties. Treaties with Chile, Taiwan, Qatar, the UAE, and Uruguay are currently in force, along with a recently enacted and significant treaty with Spain, which took effect in January 2025.

The three major sources of foreign direct investment into Paraguay (namely, the US, Brazil and the Netherlands) do not appear among these jurisdictions. With Spain already ranking among the country's top ten investors, the upcoming double taxation treaty is expected to stimulate further inflows, both from Spain itself and by positioning the country as a hub for capital originating in the EU and other global regions.

Uruguay and Chile are large investors too, according to official data.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Local tax authorities in Paraguay are only starting to scrutinise potential *"treaty shopping"* scenarios and there are few documented precedents.

However, with the recent adoption of an OECD Model Convention with Spain (in force from January 2025), new anti-abuse rules, such as beneficial ownership requirements, have been formally introduced. As a result, while enforcement has been light historically, it is expected that in the future, the tax authority will examine whether treaty-based entities have real economic substance and genuine control of the income, particularly under treaties with explicit anti-abuse provisions more closely.

4.4 Transfer Pricing Issues

The most frequent transfer pricing challenges in Paraguay centre on cross-border transactions involving loans, fees for technical assistance and intangible assets. Although the relevant rules adhere to the arm's length principle, their practical application can be challenging for new inbound investors, especially those engaging in multiple related-party transactions. Additionally, once a local corporation exceeds annual gross revenues of approximately ten billion guaraníes (about USD1.4 million), it must prepare and submit a Transfer Pricing Study (*Estudio Técnico de Precios de Transferencia* or ETPT) detailing the methods used to confirm that intercompany pricing aligns with market conditions.

A common area of scrutiny involves services provided by non-resident related parties, particularly management, consultancy and intellectual property arrangements, where the tax authority may question the actual economic substance or the valuation of intangible benefits. Likewise, interest expenses on related-party financing can become contentious if interest rates deviate from prevailing market benchmarks.

While there is no formal advanced pricing agreement (APA) system, the tax authority has indicated increasing vigilance in auditing these areas, suggesting that robust documentation and careful benchmarking are key to minimising disputes, although the actual control of the operations is yet to be seen in the short to medium term.

4.5 Related-Party Limited Risk Distribution Arrangements

Paraguayan transfer pricing rules do not specifically define limited risk distribution arrangements, but they do require that any related-party transactions reflect an arm's length profit allocation.

In practice, where a local company acts as *"limited risk distributor,"* the tax authority may challenge the arrangement if it suspects that the local margin is artificially low. This scrutiny typically involves ensuring that the local entity's functional profile matches the reduced risks and functions described and that its compensation aligns with independent comparable rates in similar circumstances.

While aggressive challenges are not yet widespread, if the authority believes that local risks and functions are understated or that the local entity should retain more profit, it could adjust the transfer price upward. Proper documentation of functional responsibilities, assets employed and actual risks borne by the local distributor is therefore crucial to defend such a model.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Paraguay's transfer pricing regime is broadly aligned with the OECD arm's length principle but remains less comprehensive in terms of both substance and enforcement mechanisms.

The legislation references the standard OECD methods (comparable uncontrolled price, resale price, cost-plus, transactional net margin and profit split), yet it does not explicitly incorporate the full suite of OECD guidance.

Additionally, Paraguay does not offer an APA system, nor does it have a long-standing track record of audits or judicial precedents interpreting complex transactions.

Consequently, while the formal rules point to OECD benchmarks, actual enforcement is at an early stage and can sometimes yield inconsistent or highly manual review processes when local examiners encounter intricate multinational structures.

In addition, Paraguay applies a method like the *"sixth method"* for commodity transactions, which can extend beyond purely related-party dealings. If commodities such as soy or other grains are exported to purchasers situated in a low-tax or no-tax jurisdiction, the local tax authority may require that the prices be benchmarked against official commodity exchange listings or other internationally recognised indices at the date of shipment.

While this approach primarily addresses transfer pricing concerns among affiliated entities, it can also be triggered for sales to non-related parties if certain conditions are met, reflecting a broader policy to discourage under-invoicing and ensure export prices align with arm's length values.

4.7 International Transfer Pricing Disputes

Bearing in mind that Paraguay adopted transfer pricing rules effectively from 2021, the local tax authorities are gradually setting their focus on cross-border transactions, although Paraguay's transfer pricing regime remains comparatively new and lightly enforced compared to other jurisdictions.

If the authorities obtain fresh data or suspect underreporting, they may initiate or reopen enquiries for prior years, but formal reassessments remain limited, partly because there is still a relatively limited track record of in-depth transfer pricing audits.

Mutual agreement procedures (MAPs) have historically been rare in Paraguay, largely due to the limited scope of its double taxation treaty network. The tax authority has no experience of resolving disputes under MAP mechanisms and, as a result, they tend to rely on domestic administrative or judicial routes when controversies arise. With new treaties (notably with Spain) entering into force and the gradual adoption of OECD-aligned anti-abuse clauses, the prospect of MAPs could become more relevant in the near future, although widespread usage or reliance on MAPs remains speculative at this stage.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

There is no formal, automatic mechanism for compensating adjustments when a transfer pricing claim is settled in Paraguay (to the best of our knowledge, there have been none so far).

Once an adjustment is agreed upon or imposed, the revised taxable base for that period is generally accepted as final.

If it later emerges that an overpayment has occurred as a result of the adjustment, any refund or credit should be determined on a case-by-case basis through a reassessment or mutual agreement with the tax authority.

In other words, while individual cases may result in some corrective measures, Paraguay does not provide a standardised compensation adjustment process for settling transfer pricing disputes.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

In Paraguay, local branches of non-local corporations are taxed in the same way as local subsidiaries. Both are subject to IRE on Paraguay-sourced income at the same nominal rate and the tax calculation, deductions and filing obligations are applied identically.

While a branch is legally an extension of its foreign parent and a subsidiary is a separate legal entity there is no distinction between the two for tax purposes.

5.3 Capital Gains of Non-Residents

Non-resident capital gains from selling shares in local Paraguayan corporations are subject to INR. The taxable base is determined on a presumptive method, calculated as the lesser of either the actual gain (ie, the difference between the sale price and the nominal value of the shares) or 15% of 30% of the sale price, which results in an effective rate that typically does not exceed 4.5%.

When it comes to the sale of shares in a non-local holding company that directly owns stock in a local corporation and when the ultimate beneficial owner of the holding company is a non-resident, the tax treatment becomes more nuanced. In these cases, if the holding company is incorporated abroad, the gain realised by a non-resident may not be considered sourced in Paraguay and therefore may not be subject to Paraguayan tax. However, the determination of the source of the gain is complex and can depend on the specifics of the transaction and the underlying asset structure, particularly when a double taxation treaty applies.

Double taxation treaties may further reduce or eliminate the capital gains tax, but these benefits generally apply to direct investments and may not extend to gains on indirect holdings through non-local entities. The actual tax outcome will depend on the precise treaty provisions and the circumstances surrounding the sale.

5.4 Change of Control Provisions

Paraguay does not include specific change of control provisions in its tax regime that trigger additional tax or duty charges solely based on a change in corporate control.

Disposals of shares by a non-resident of an indirect holding company is not subject to Paraguayan taxes.

However, when an overseas holding company disposes of an indirect interest (ie, a holding much higher up the group structure) in a local corporation, the tax treatment may require a closer examination of the transaction's substance. In these cases, while no additional tax or duty is imposed simply due to the change in control, the tax authority may scrutinise the arrangement to ensure that the disposal reflects a genuine economic transaction and that the tax bases have not been artificially reallocated.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In Paraguay, there is no standard formula mandated by law specifically for determining the income of foreign-owned local affiliates. Instead, taxable income is computed based on the affiliate's actual financial records, adjusted in line with the general tax rules and the arm's length principle.

In practice, the income from sales of goods or services is determined on a case-by-case basis, with necessary adjustments for transfer pricing, thin capitalisation and other relevant factors. Although the tax authority may, in certain instances apply a simplified or safe harbour method, particularly where documentation is incomplete or for smaller taxpayers, these approaches are not broadly established or routinely used for foreign-owned affiliates.

5.6 Deductions for Payments by Local Affiliates

In Paraguay, deductions for payments made by local affiliates for management and administrative expenses incurred by a non-local affiliate are allowed when those payments are determined to be at arm's length.

In practice, this means that the expense must reflect the price that would have been charged by an independent service provider under comparable circumstances. The tax authority requires that these payments are supported by appropriate documentation and comply with the transfer pricing rules. If the amount paid is deemed excessive relative to market rates, the tax authority may adjust or disallow part of the deduction.

5.7 Constraints on Related-Party Borrowing

Foreign-owned local affiliates borrowing from non-local affiliates are subject to the same general constraints as other related-party loans.

In practice, the interest expense on these loans is limited by the thin capitalisation rules, which restrict the deduction to 30% of the affiliate's net taxable income before these expenses.

Additionally, the interest rate on the borrowing must be at arm's length, reflecting prevailing market conditions. If the interest rate deviates from market benchmarks, the tax authority may adjust or disallow the excess deduction.

There are no additional statutory ceilings specific to borrowing from non-local affiliates beyond these general requirements.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Contrary to what most people think say, from 1 January 2020, foreign income of local corporations is not automatically exempt from corporate tax in Paraguay.

In fact, local corporations are subject to tax on their worldwide income, including earnings from foreign sources, with some exceptions. However, in the past, it was the other way around.

However, Paraguay's system incorporates a credit mechanism to avoid double taxation. Essentially, if determined foreign income has already been taxed abroad at a rate equal to or higher than Paraguay's 10% corporate tax rate, that income is effectively exempt from additional Paraguayan tax.

If the foreign tax rate is lower, the corporation must pay Paraguayan tax on the difference, with the foreign tax paid credited against its domestic liability.

This approach ensures that the effective tax rate on foreign income does not exceed the local rate while addressing any undertaxed foreign earnings.

6.2 Non-Deductible Local Expenses

If foreign income is exempt, expenses incurred solely to generate that income are generally not deductible for domestic tax purposes.

Only expenses that directly relate to the production of taxable local income can be deducted in full. For mixed expenses, ie, those that support both exempt foreign income and taxable domestic income, the taxpayer must apportion the costs on a reasonable basis, so that only the portion attributable to domestic income is deductible.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by local corporations from their foreign subsidiaries are generally included in the domestic tax base. However, a participation exemption or foreign tax credit may apply.

In practice, if the dividend income has already been taxed abroad at a rate that is at least equal to Paraguay's 10% corporate tax rate, the local corporation can either be exempt from additional corporate tax on that dividend or claim a credit for the foreign taxes paid. This mechanism is designed to avoid double taxation on the same income.

When these dividends are later distributed to shareholders, they are subject to the IDU at the applicable rate. This is typically 8% for residents and 15% for non-residents unless a double taxation treaty provides for a reduced rate.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by local corporations and subsequently used by non-local subsidiaries are not automatically exempt from local corporate tax.

These transactions must instead comply with Paraguayan transfer pricing rules, meaning that any transfer or licensing of intangibles must be priced at arm's length.

Payments made by the non-local subsidiary, such as royalties or licence fees, are recognised as ordinary income by the local corporation and are subject to the IRE, provided that the rights are used at least partially in Paraguay.

If the transaction is not properly priced, the tax authority may apply transfer pricing adjustments and assign a royalty payment to ensure that the economic benefit derived from the intangible is taxed accordingly.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Paraguay does not operate a controlled foreign corporation regime.

In practice, this means that local corporations are not required to include the income of their foreign subsidiaries in their domestic tax base until that income is repatriated as dividends.

The same principle applies to non-local branches of local corporations. Income earned by a foreign branch is generally not subject to Paraguayan tax until repatriation.

In other words, whether a local corporation operates its business abroad through a subsidiary or a branch, the foreign income remains untaxed in Paraguay until it is brought back, and there is no separate CFC-type rule that distinguishes between these two structures.

6.6 Rules Related to the Substance of Non-Local Affiliates

Paraguay does not have specific statutory provisions that impose explicit substance requirements on non-local affiliates.

However, in practice, the tax authority expects that all intercompany transactions, including those with non-local affiliates, reflect genuine economic activity.

This means that if a non-local affiliate lacks sufficient physical presence, personnel or real decision-making authority, the tax authority may scrutinise the related-party transactions and adjust the pricing to ensure that profits are not artificially shifted.

Essentially, while there is no formal *"substance test"* codified separately, the principle of economic substance is effectively enforced through transfer pricing rules and general anti-avoidance measures when an applicable double taxation treaty includes such provisions. There are otherwise no additional rules.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Local corporations that dispose of shares in non-local affiliates calculate the taxable gain as the difference between the sale price and the tax basis (typically the cost of acquisition).

This gain is then included in the taxable income of the local corporation and taxed at the IRE tax rate of 10%.

There is no separate or preferential rate for these gains and the treatment is analogous to that applied to other general taxable income.

However, under a double taxation treaty, the applicable rules may vary depending on the specific transaction, such as when the subsidiary's assets include real estate, among other factors.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Paraguay's tax legislation does not consolidate all anti-avoidance measures into a single, standalone general anti-avoidance rule (GAAR).

Instead, a series of specific provisions, such as transfer pricing rules and thin capitalisation limits, collectively function as de facto anti-avoidance measures.

The tax authority has the discretion to recharacterise or disregard transactions that appear to be artificial or lack genuine economic rationale, but there have been very few cases in which this provision has been successfully applied.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

In Paraguay, routine corporate tax audits are conducted on a risk-based approach rather than on a fixed, statutory schedule applicable to all taxpayers.

The tax authority reviews a range of corporate taxpayers, typically focusing more frequently on larger entities, those with complex operations or companies with past compliance issues.

The process generally begins with a desk audit of submitted returns and supporting documentation and it can escalate to field audits if discrepancies or high-risk transactions are identified.

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Mascareño Vargas – Asesores

9. BEPS

9.1 Recommended Changes

Paraguay has implemented several measures that reflect BEPS recommendations.

For instance, the country has introduced detailed transfer pricing rules and documentation requirements, including the preparation of a transfer pricing study once certain revenue thresholds are exceeded, and established thin capitalisation limits to restrict excessive interest deductions on related-party loans.

In addition, anti-abuse provisions and substance requirements have been incorporated into the framework to ensure that intercompany transactions reflect genuine economic activity.

These changes, incorporated through recent legislative reforms such as Law No 6380/19, represent significant steps towards aligning the tax system with international standards.

However, while these measures address key areas of BEPS Action 4 and related recommendations, full alignment with the broader BEPS agenda, especially in terms of Pillars One and Two, remains a work in progress.

9.2 Government Attitudes

The Paraguayan government has shown a balanced approach toward BEPS measures. On the one hand, it is committed to modernising its tax system by implementing stronger transfer pricing rules, thin capitalisation limits, and other measures in line with international standards. On the other hand, Paraguay seeks to maintain a competitive environment that continues to attract foreign investment.

Regarding Pillar One, which deals with reallocating taxing rights for large, often digital, multinational enterprises, it is unclear whether significant changes will directly affect Paraguay due to its smaller digital economy and traditional business structure. However, any global changes could still have an indirect impact if large multinational enterprises adjust their business models.

As for Pillar Two, which establishes a global minimum tax, Paraguay's current corporate tax rate of 10% is rather low, compared with other countries.

If a global minimum tax is enforced, Paraguay may need to adjust its tax framework to avoid an effective rate that is higher than its statutory rate. Although there is no firm timeline yet, these international proposals are expected to be incorporated into domestic legislation from 2026 onward, although, it depends on the political agenda of the government.

The most pronounced impact is likely to be seen on multinational groups operating in Paraguay, particularly in sectors such as digital services, multinational enterprises involved in exporting, and finance, where profit shifting has been more common.

9.3 Profile of International Tax

International tax issues have not traditionally been at the forefront of public debate in Paraguay, especially compared to larger economies. However, interest in global tax matters is gradually increasing.

In recent years, legislative reforms and alignment with international standards have increased awareness among policymakers and the business community. This growing profile is influencing the way Paraguay implements BEPS recommendations, particularly in areas like transfer pricing and thin capitalisation.

Although public debate remains relatively muted, there is a clear governmental intent to modernise the tax system without undermining its competitive low-tax environment.

Consequently, while BEPS measures will likely be adopted, their implementation is expected to be gradual and pragmatic, carefully balancing global compliance with the need to attract and retain foreign investment.

9.4 Competitive Tax Policy Objective

Paraguay's government has long maintained a competitive tax policy, exemplified by its low statutory corporate tax rate and investor-friendly environment. At the same time, the global push for BEPS compliance creates pressure to ensure that profits are reported accurately and that the tax base is not eroded by artificial arrangements.

To balance these priorities, the government is expected to implement BEPS recommendations gradually, enhancing transfer pricing documentation, reinforcing thin capitalisation rules and tightening substance requirements, without significantly raising the effective tax rates that have historically attracted investment.

This careful calibration may involve the use of transitional measures or safe harbours for taxpayers, allowing firms to adjust to the new compliance standards without suffering abrupt tax increases. The government's objective is to preserve the integrity of the tax system and prevent profit shifting, while still upholding the competitive advantages of its regime.

Ultimately, by integrating BEPS measures in a pragmatic manner and engaging in ongoing dialogue with international bodies and domestic stakeholders, Paraguay aims to ensure both a fair tax system and an attractive environment for foreign and domestic investment.

9.5 Features of the Competitive Tax System

Paraguay's competitive tax system is built on a low statutory rate (currently 10%), along with preferential regimes such as the IRE Simple regime for smaller companies, which can yield effective rates as low as 3% and various targeted investment incentives. These features are key to attracting foreign investment and stimulating economic growth. However, they could be more vulnerable than other areas of the tax regime if they are perceived as overly generous or if they lead to significant base erosion. Although Paraguay is not bound by EU state aid rules, its tax incentives are still subject to scrutiny by both domestic stakeholders and international investors to ensure fairness and transparency, as well as the controls and constraints that the MERCOSUR legislation established for its members.

To date, there has been little controversy or legal challenge regarding these competitive features, with the tax authorities emphasising compliance and proper documentation. Nonetheless, as global tax standards evolve, particularly under the BEPS agenda and increased international scrutiny, there may be future pressure to recalibrate these incentives to ensure a balanced approach between competitiveness and tax base protection.

9.6 Proposals for Dealing With Hybrid Instruments

At present, Paraguay does not have comprehensive, standalone legislation specifically targeting hybrid instruments.

However, considering increasing global pressure and the ongoing BEPS process, there is growing awareness of the potential for hybrid mismatch arrangements to facilitate tax avoidance. In our view, Paraguay is likely to adopt measures in line with international recommendations, such as denying deductions for payments under hybrid instruments or introducing rules that require a robust economic substance analysis, through amendments to existing tax laws rather than an entirely new regime.

Given Paraguay's competitive tax framework and its commitment to maintaining an attractive investment environment, any changes are expected to be implemented gradually. The government will likely focus on high-risk areas, particularly those involving complex financing structures used by multinational groups. Overall, while hybrid instrument rules are not yet a major feature of the domestic tax landscape, they will probably become more significant in the coming years as Paraguay aligns more closely with global BEPS standards.

9.7 Territorial Tax Regime

Paraguay does not have a fully territorial tax regime for corporations. Resident companies are taxed on their worldwide income, with some exceptions, although foreign tax credits help mitigate double taxation.

Consequently, there are no interest deductibility restrictions specifically tailored to a territorial system under the current framework.

However, in light of global proposals, particularly those emerging from the BEPS process, there may be future changes that introduce tighter limits on interest deductions.

These measures would aim to curb excessive debt financing and prevent profit shifting by related parties, potentially raising the effective cost of borrowing.

If these proposals are implemented, both domestic and foreign investors might need to reassess their financing structures, possibly shifting towards a greater reliance on equity to maintain competitiveness.

9.8 Controlled Foreign Corporation Proposals

Paraguay does not currently apply CFC rules, and we could say such a regime is not a priority given the country's tax structure. Paraguay is not typically a holding jurisdiction for foreign subsidiaries, nor is it a country that faces significant profit shifting concerns, given its competitive tax rates. As a result, policies targeting CFCs are unlikely to be a focus of the tax agenda in the near future.

9.9 Anti-Avoidance Rules

Paraguay's tax framework includes some anti-avoidance measures and many of its modern double tax treaties contain limitation on benefit clauses designed to prevent *"treaty shopping"*.

In practice, these provisions require that taxpayers demonstrate real economic substance and that transactions are carried out on an arm's length basis.

For inbound investors, this means that if their corporate structures or financing arrangements appear to be primarily designed to exploit treaty benefits without genuine commercial activity, the tax authority may deny those benefits, particularly when applying the latest double taxation treaties with Spain, Uruguay, Qatar and the UAE.

Similarly, outbound investors may also face restrictions if their arrangements are seen as contrived for tax purposes. Overall, while these rules add an extra compliance layer, with proper planning and economic substance, their impact on legitimate investment activities can be minimised.

9.10 Transfer Pricing Changes

Paraguay's transfer pricing rules came into effect in 2021 following the enactment of the 2019 legislation. While these regulations incorporate many BEPS recommendations, their implementation is still in an early phase, with both tax authorities and taxpayers undergoing a learning process. So far, no significant changes have been made to the framework, as the focus remains on adaptation and practical application rather than immediate revisions.

9.11 Transparency and Country-by-Country Reporting

While increased transparency, including country-by-country reporting (CbCR), is a key tool in the global fight against profit shifting, Paraguay has not yet implemented a CbCR framework. Currently, the country only requires a local file, which must be submitted alongside a sworn statement. This documentation includes certain information about the multinational group's parent entity, but does not yet extend to a full CbCR requirement.

At the same time, Paraguay is focused on enhancing its transparency standards and strengthening its capacity for information exchange. However, the adoption of CbCR remains a future consideration rather than an immediate priority.

9.12 Taxation of Digital Economy Businesses

Paraguay has implemented a structured system for taxing digital economy businesses, primarily through its IVA framework and INR provisions. This model follows approaches successfully implemented in countries like Uruguay and Chile, ensuring that digital transactions contribute appropriately to tax revenues.

Digital services consumed in Paraguay are subject to IVA at 10% if certain conditions are met, such as indicators like IP address, billing address or bank account details confirming domestic consumption.

For income taxation, the treatment depends on the type of recipient:

- if the foreign service is provided to a local corporation, INR withholding tax of 4.5% applies on the payment; and
- if the service is provided to individual residents, the foreign provider must register with the tax authority and comply with tax obligations. However, this does not require incorporation in Paraguay nor create a permanent establishment. It is simply a compliance mechanism that involves registering and appointing a local representative for tax purposes.

While Paraguay's current framework is effective in taxing digital services, the potential impact of Pillar One remains uncertain as there have been no discussions on its adoption within the country so far.

9.13 Digital Taxation

Instead of introducing a separate digital services tax, Paraguay has chosen to integrate the taxation of digital transactions into its existing tax framework. This approach ensures consistency with broader tax policies while maintaining an attractive investment environment.

Digital services consumed in Paraguay are subject to IVA, determined by factors such as IP address, billing address or bank account details. Additionally, non-resident digital service providers must comply with INR rules.

Paraguay's strategy prioritises compliance through existing tax mechanisms rather than introducing a standalone digital tax, a model that has been tested in other Latin American jurisdictions. This approach reflects the country's commitment to maintaining a competitive tax system while ensuring that digital transactions contribute appropriately to its tax base.

9.14 Taxation of Offshore IP

Paraguay has not introduced a specific regime for taxing offshore intellectual property deployed within the country. Instead, income derived from offshore IP is treated under the general rules of INR.

Under these provisions, payments related to offshore IP are subject to withholding tax at the standard rates applicable to non-resident income.

The nominal withholding rate is typically 15%, although in some cases the effective rate may be lower if a presumptive base (for example, 15% of 30% of the payment) is applied, resulting in an effective rate of around 4.5%, if considered, for instance, a digital service.

These rules also do not differentiate between IP owners based in tax havens and those in countries with which Paraguay has a double taxation treaty.

In cases where a double taxation treaty is in force, its provisions may reduce or even eliminate the withholding tax, depending on the specific terms of the treaty. In the case of the double taxation treaty with Spain, the withholding tax is capped at 5%.

Trends and Developments

Contributed by:
Mauro Mascareño, Carlos Vargas and Rodrigo Gómez Sánchez
Mascareño Vargas – Asesores

Mascareño Vargas – Asesores (MVA) is an advisory firm that stands out for its unique business engineering approach, offering comprehensive corporate services. The firm provides seamless, integrated solutions tailored to its clients' diverse needs by combining legal, tax and financial expertise. The mission of MVA is to be the trusted partner of its clients in Paraguay, delivering high-quality advisory services that support business growth across multiple jurisdictions while mitigating risks and identifying strategic opportunities. The firm focuses on developing and expanding its clients' commercial activities by providing strategic corporate law, taxation and financial structuring solutions. The innovative, customised approaches of MVA are designed to meet each client's needs, ensuring full regulatory compliance and helping them achieve their business goals. The firm's extensive experience across various industries sets it apart, allowing it to offer highly relevant and strategic advice. MVA guides its clients through complex legal and financial landscapes, ensuring successful navigation of regulatory challenges.

Authors

Mauro Mascareño is the founding partner and managing director of MVA, with over 15 years of experience in corporate and tax law in Paraguay. He specialises in mergers and acquisitions, project financing and estate planning. He has advised various companies on foreign investment processes and complex transactions in Paraguay, and he has worked on the structuring of technology and M&A projects. He also serves as vice president of the International Fiscal Association of Paraguay (IFA Paraguay) and holds postgraduate degrees from the London School of Economics and Harvard Kennedy School.

Carlos Vargas is a partner at MVA and an expert in national and international tax law. With over 15 years of experience, he specialises in corporate tax advisory, business reorganisations and investment projects, with a strong track record in corporate planning for both local and international companies. He is recognised for his strategic advisory work for tech companies and e-commerce platforms. He also teaches and is an active member of the legal community.

Contributed by: Mauro Mascareño, Carlos Vargas and Rodrigo Gómez Sánchez,
Mascareño Vargas – Asesores

Rodrigo Gómez Sánchez is a partner at MVA with extensive experience in corporate and commercial law, including mergers and acquisitions, financing and emerging market regulations. His focus includes advising technology and infrastructure companies in Paraguay and the Southern Cone. He has represented international clients in complex cross-border transactions and is known for his strategic approach to tax and regulatory compliance and risk management. He is also a board member of the International Fiscal Association of Paraguay (IFA Paraguay).

Mascareño Vargas – Asesores

Capitan Juan Dimas Motta
245 esquina Andrade
001408 Asunción
Paraguay

Tel: +595 981 547 839
Email: mva@mv-a.com.py
Web: www.mv-a.com.py

Contributed by: Mauro Mascareño, Carlos Vargas and Rodrigo Gómez Sánchez,
Mascareño Vargas – Asesores

The Double Taxation Agreement Between Paraguay and Spain: A Key Framework for Investment Attraction

Introduction

The economic and cultural ties between Paraguay and Spain have historically been strong, with a significant number of Spanish nationals actively participating in business and residency in Paraguay. Beyond investments, the Spanish community has increasingly chosen Paraguay as a destination for work, retirement and entrepreneurial ventures. Spanish businesses play a pivotal role in the country's economic development, while tourism and short-term stays by Spanish citizens continue to grow, further strengthening bilateral relations.

Given this dynamic relationship, a clear and efficient tax framework governing cross-border income flows is essential. The double taxation agreement between Paraguay and Spain (the *"CDI ES-PY"*) establishes well-defined rules for the taxation of income in both jurisdictions, mitigating the risks of double taxation and providing much-needed legal certainty for both investors and individuals. Of particular importance is the fact that the treaty addresses potential conflicts of dual residence, with the aim of ensuring a transparent determination of tax obligations in each country.

The CDI ES-PY not only represents a significant step forward in tax matters for Paraguay but also has the potential to become a strategic way of attracting investment. One of the most notable aspects of this treaty is its major alignment with the Organisation for Economic Co-operation and Development (the *"OECD"*) Model Tax Convention. This represents an interesting approach by Paraguay, which has mixed models incorporating elements of both OECD and UN tax frameworks.

The OECD model favours taxation in the country of residence, as opposed to the UN model, which grants more taxing rights to the source country where the income is generated. This choice could reflect Paraguay's ambition to create a tax environment that is more attractive to foreign investors, particularly by offering lower withholding tax rates and legal certainty. The adoption of these standards introduces higher compliance expectations, requiring enhanced administrative capacity to effectively apply the treaty's provisions.

This agreement raises important questions about the future of existing treaties and the potential for revisions or renegotiations, particularly in cases where most-favoured-nation clauses may be triggered. Could this treaty serve as a benchmark for future agreements? For instance, one might ask whether it will influence a renegotiation of the CDI with Chile, where a revision of conditions is already expected. These are not merely rhetorical questions but crucial issues that could shape Paraguay's tax strategy in the coming years.

Paraguay's experience in international taxation

It is important to recognise that Paraguay's experience in international taxation is still in its early stages compared to other countries in the region. The enactment of Law No 6380/19, which has been in force since 2020, marked a significant step by introducing key international tax provisions, including domestic anti-abuse rules.

Since then, Paraguay has advanced in implementing tax information exchange mechanisms and adopting transfer pricing regulations. Additionally, it has expanded the corporate income tax base by incorporating elements of worldwide taxation, albeit with certain limitations. However, the country's ability to effectively enforce and oversee these rules remains uncertain, as its fiscal control mechanisms are still being developed.

This evolving context is particularly relevant when considering the implementation of the CDI ES-PY. One of the main challenges will be adapting the country's electronic tax administration system, which currently lacks the capacity to efficiently manage differentiated withholding tax rates. Ensuring a smooth and effective application of the treaty will require significant adjustments in tax administration and enforcement capabilities.

Another challenge concerns the international recognition of Paraguay's tax residence certificate. There is ongoing debate about whether its current format aligns with international standards, as the information it provides may not be entirely relevant for the application of double taxation agreements. This ambiguity could create uncertainty for investors seeking to benefit from the CDI ES-PY, potentially complicating the effective application of reduced withholding tax rates.

That said, it is worth acknowledging the notable progress made by Paraguay's Tax Administration in recent years, both in terms of technical capacity and human resources. This growth has been complemented by its strategic participation in international tax forums, both public and private, reflecting a clear commitment to strengthening its institutional framework. Notably, Paraguay has taken an active role in organisations such as the Inter-American Centre of Tax Administrations and the International Fiscal Association. In fact, the upcoming IFA Latin America Regional Congress, to be held in Asunción from 20 to 22 May 2025, underscores the country's increasing engagement in global tax discussions. These efforts contribute to enhancing Paraguay's credibility in the international tax arena and could play a key role in addressing existing challenges.

A favourable agreement for investment

The CDI ES-PY is one of the most beneficial agreements for investors, establishing clear rules to eliminate double taxation and provide fiscal stability. Among its most relevant provisions are:

- tax residence: establishes criteria to resolve conflicts of residence when an individual is considered a resident in both states;
- elimination of double taxation: defines which country has the right to tax specific income, providing predictability for investors. If income is taxable in both jurisdictions, the treaty allows taxpayers to claim a credit for taxes paid abroad, preventing double taxation and fostering a favourable investment environment;
- tax rate limitations: reduce tax rates, creating an attractive investment environment;
- scope of application: limited to income taxes and does not affect wealth taxes or VAT; and
- effective date: applicable from 1 January 2025.

Business profits

The CDI ES-PY establishes that business profits can only be taxed in the country of residence unless a permanent establishment (PE) exists in the other country. This provides a significant incentive for cross-border service provision, as it prevents the application of withholding taxes at the source. This provision enhances the country's competitiveness as a business destination.

In that context, a Spanish consulting firm providing advisory services to a Paraguayan company would not be subject to withholding tax in Paraguay unless it maintains a PE in the country. In contrast, a company from a jurisdiction without a double taxation treaty with Paraguay would face full withholding tax rates, making Paraguay-Spain business ties far more competitive.

Dividends

Paraguay's dividend taxation framework is particularly attractive when analysed in the context of its general tax rates. Without the CDI ES-PY, the dividend and profit tax or IDU imposes a 15% withholding tax on payments to non-resident shareholders or partners. However, under the CDI ES-PY, these rates are significantly reduced. In some cases, they are even lower than the 8% rate applied to local shareholders or residents:

- Spanish pension funds: IDU withholding tax of 0%;
- Spanish companies with more than 50% ownership in a Paraguayan company: IDU withholding tax of 5%; and
- other cases: maximum IDU withholding tax of 10%.

As a result, a Spanish company holding a majority stake in a Paraguayan subsidiary will now benefit from a reduced withholding tax rate of 5%, making Paraguay an even more attractive destination for foreign direct investment. This reduction has a direct impact on cash flow, enabling Spanish companies to reinvest more capital in the Paraguayan market.

Interest

The taxation of interest payments under the CDI ES-PY offers a significantly more favourable framework compared to the general regime. Without the treaty, Paraguay's non-resident income tax or INR applies withholding tax rates ranging from 4.5% to 15%, depending on whether the creditor is a related-party. However, under the CDI ES-PY, these rates are substantially reduced:

- general maximum INR withholding tax: 5%; and
- if the beneficiary is a state entity, pension fund or financial institution in Spain: 0% INR withholding tax.

For example, consider a Spanish bank that grants a loan to a Paraguayan company. Under the general regime, the interest payments could be subject to an INR of up to 4.5%. However, with the CDI ES-PY in place, the withholding tax rate would be capped at 0% if the bank qualifies as *"financial entity"* under the treaty. This significant reduction enhances financing conditions for Paraguayan businesses and strengthens cross-border financial co-operation.

Royalties

Under the treaty, royalties are subject to a maximum INR withholding tax of 5%, applicable to payments for intellectual property rights, trade marks and know-how transfers. Unlike other models, such as the UN model adopted by Paraguay in its treaty with Uruguay. the CDI ES-PY does not include service payments within the definition of royalties. As a result, only payments involving the transfer of specialised knowledge, such as secret formulas or proprietary industrial or commercial know-how, qualify as royalties and are subject to withholding tax.

For comparison, without this CDI ES-PY, the INR would apply an effective withholding tax rate of 15% on royalties paid to non-residents. This reduction to 5% is a significant benefit, especially for industries relying on technology transfers, brand licensing and technical knowledge.

For example, a Spanish company licensing its trade mark for use in Paraguay would have been subject to a 15% withholding tax before the CDI ES-PY. Now, under the agreement, the tax rate is reduced to 5%, significantly lowering the cost of brand licensing and encouraging greater foreign investment in the country.

Additional income rules to consider

Beyond business profits, dividends, interest and royalties, the CDI ES-PY also covers key areas such as capital gains, real estate income, pensions, salaries and anti-abuse measures. These provisions define how the treaty applies and its broader impact as follows:

- real estate income: taxed in the country where the property is situated;
- capital gains: taxed in the country where the property is located if derived from the sale of real estate or shares whose value is primarily based on real estate;
- salaries: as a general rule, taxed in the country of residence. However, if the work is performed in another country and exceeds a threshold (typically 183 days), the source country also gains taxing rights, among others; and
- pensions: generally taxed in the recipient's country of residence, except in special cases.

Anti-abuse provisions

The beneficial ownership and principal purpose test (PPT) clauses in the CDI ES-PY introduce key anti-abuse measures, although their wording does not fully align with the OECD Model Tax Convention. Instead of a limitation on benefits (LOB) clause with strict objective criteria, such as economic substance tests, ownership and control requirements, or a list of qualified entities, the treaty relies on a more flexible beneficial ownership approach, particularly for dividends, interest and royalties, among others. Additionally, the CDI ES-PY explicitly preserves each country's right to apply domestic anti-avoidance rules, including those related to controlled foreign companies (CFCs) and thin capitalisation.

The PPT clause is a broad anti-abuse rule that allows tax authorities to deny treaty benefits if they determine that the principal purpose of a transaction or arrangement was to obtain a tax advantage. While this approach provides flexibility, it also introduces uncertainty, as enforcement relies heavily on interpretation. The lack of clear precedents in Paraguay makes it difficult to predict how tax authorities will assess intent, potentially leading to inconsistent application. This underscores the importance of robust documentation for businesses to demonstrate the commercial rationale behind their transactions and mitigate challenges in enforcement.

The beneficial ownership requirement plays a crucial role in determining access to treaty benefits for dividends, interest and royalties. Under this provision, only the true economic recipient of the income, not an intermediary entity lacking economic substance, can claim reduced withholding tax rates. This measure aims to prevent treaty abuse and ensures that passive income streams are not routed through artificial structures solely for tax advantages.

A major issue surrounding beneficial ownership provisions is their impact on investment-holding companies. Many multinational corporations use intermediary entities in treaty-friendly jurisdictions for efficiency in capital management and legal structuring. The beneficial ownership test could restrict access to treaty benefits for these

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entities unless they can prove that their operations serve a genuine business purpose beyond tax planning. This is especially relevant in industries where cross-border business models depend on optimising tax efficiency while maintaining compliance with international standards.

As Paraguay further integrates into the global tax treaty network, the interpretation and enforcement of these anti-abuse provisions will play a crucial role in shaping investor confidence. Since there are no precedents on how Paraguayan tax authorities will apply the PPT and beneficial ownership clauses, businesses and investors face a degree of legal uncertainty. Clear guidelines and a consistent application of these rules will be key to maximising the CDI ES-PY's benefits while aligning Paraguay with evolving international tax norms.

Impact on Paraguay's tax policy future

The CDI ES-PY introduces significant strategic challenges for Paraguay's international tax policy. Its effective implementation will depend on the strengthening of tax administration, the modernisation of fiscal processes and their alignment with international standards.

Currently, Paraguay's tax administration is prioritising revenue collection through stronger measures against informality and smuggling. A key step in this strategy is the full integration of the newly established National Directorate of Tax Revenue (*Dirección Nacional de Ingresos Tributarios* or DNIT), which consolidates the functions of both internal taxation and customs. This structural reform is expected to enhance oversight, improve efficiency and strengthen tax enforcement, contributing to a more transparent and effective fiscal system.

Additionally, Paraguay has made progress in tax information exchange with other jurisdictions, reinforcing compliance with international standards. The country is also advancing in transfer pricing regulations, crucial in preventing tax base erosion and profit shifting (BEPS). However, despite these advancements, practical implementation remains a challenge, and how these regulatory improvements will interact with the CDI ES-PY is yet to be determined.

Given these ongoing developments, the timeline and priority for fully implementing the CDI ES-PY remain uncertain. Paraguay's current focus appears to be on strengthening domestic tax compliance and regulatory frameworks before fully integrating treaty benefits into its administrative processes. However, as these reforms progress, the CDI ES-PY could become a key instrument in reinforcing Paraguay's role as a regional hub for international investment.

Conclusion

The CDI ES-PY represents a major milestone in Paraguay's ongoing integration into the global tax treaty network, reinforcing its position as an increasingly attractive destination for investment. The treaty's introduction of low and competitive withholding tax rates not only enhances Paraguay's appeal to Spanish investors but also strengthens its role as a gateway for global capital, leveraging Spain's extensive network of international agreements to facilitate cross-border economic activity.

Beyond the treaty itself, Paraguay's macroeconomic stability, low taxation and simple fiscal rules continue to solidify its reputation as a strategic investment hub. Despite ongoing challenges in formalisation, workforce professionalisation and institutional strengthening, the country has made steady progress in improving its business

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environment, financial transparency and regulatory frameworks. This is further evidenced by its investment-grade credit rating and the strong demand for Paraguayan sovereign bonds in international markets, signalling growing investor confidence in its economic prospects.

As Paraguay expands its global footprint, the effective implementation of the CDI ES-PY will be crucial in reinforcing its credibility as a modern, business-friendly jurisdiction. Investors and businesses should closely monitor how Paraguayan tax authorities apply the treaty to ensure compliance and fully leverage its benefits. If properly executed, this agreement will not only enhance Paraguay's competitiveness in the international arena but also serve as a foundation for future tax policy developments, further positioning the country as a regional leader in investment attraction and economic integration.

PHILIPPINES

Law and Practice

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Carina Laforteza, Joanna Marie Joson and Kristina Paola Frias
SyCip Salazar Hernandez & Gatmaitan

Contents

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SyCip Salazar Hernandez & Gatmaitan

SyCip Salazar Hernandez & Gatmaitan has a tax department that comprises 16 partners, two special counsels and 26 associates; 21 of them are lawyers and certified public accountants. The department provides the entire range of tax services, from advising on and structuring the tax aspects of corporate transactions to administrative and judicial litigation in relation to tax refunds and defending clients against assessments for national taxes, local taxes, customs duties and safeguard measures. The department also assists corporate clients in obtaining rulings and in compliance requirements. To a great extent, it draws its work from the extensive client base of the firm. The firm's depth of experience in corporate work – including acquisitions and divestments in various industries, such as power, telecommunications, natural resources, infrastructure, transportation, manufacturing and gaming – sets it apart from other tax advisers.

Authors

Carina Laforteza is a partner and currently head of the tax department at SyCip Salazar Hernandez & Gatmaitan. Carina has extensive tax experience, ranging from tax structuring for corporations and individuals to tax compliance and litigation, as well as tax-related arbitration. She performs corporate work such as M&A and divestments (including transaction structuring) as well as financing work, acting for the lenders or borrowers. Her clients include major players in the aviation, manufacturing, advertising, banking, mass media, telecommunications and money remittance industries. Carina has been a professorial lecturer in taxation at the University of the Philippines since 2009. She is also a certified public accountant.

Joanna Marie Joson is a partner at SyCip Salazar Hernandez & Gatmaitan whose tax-related work includes rendering tax advice in connection with deals involving acquisitions, investments and divestments, and corporate reorganisations, as well as applications of foreign residents availing of preferential tax treatment under tax treaties. She has also handled requests for confirmation of tax exemption, refund applications, responses to assessment notices and appeals against adverse rulings issued by the tax authority. Joanna has an LLM degree in Taxation from New York University.

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Kristina Paola Frias is a senior associate at SyCip Salazar Hernandez & Gatmaitan. Kristina has advised international and local clients on the tax and legal aspects of corporate acquisitions and divestments, investment structuring, construction-related projects, financing and other commercial transactions. She has assisted clients in tax compliance, tax assessment and tax refund cases before administrative agencies and the courts. She has been involved in conducting legal due diligence for corporate acquisitions and financing projects, establishing corporate vehicles, drafting and reviewing transaction documents and corporate housekeeping. Kristina is also a certified public accountant and has taught at the University of the Philippines.

SyCip Salazar Hernandez & Gatmaitan

SyCipLaw Center
105 Paseo de Roxas
Makati City 1226
Metro Manila
Philippines

Tel: +632 8982 3500
Fax: +632 8848 2030
Email: sshg@syciplaw.com
Web: www.syciplaw.com

Contributed by: Carina Laforteza, Joanna Marie Joson and Kristina Paola Frias,
SyCip Salazar Hernandez & Gatmaitan

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Business organisations in the Philippines are generally formed as incorporated entities or corporations, although business firms may also be organised as partnerships or sole proprietorships.

Corporations

Corporations are either formed under the Revised Corporation Code of the Philippines (RCC) or created under special law.

Corporations formed or organised under the RCC may be stock or non-stock corporations. Stock corporations are those with capital stock divided into shares and authorised to distribute to the shareholders dividends on the basis of the shares held. All other corporations are non-stock corporations. Under the RCC, corporations may be organised with a sole shareholder (a *"one-person corporation"*).

Corporations have the powers provided under the RCC, and may exercise such other powers as may be essential or necessary to carry out the business purposes stated in their articles of incorporation. Corporations may exist perpetually.

Corporations are taxed as separate legal entities. For income tax purposes, entities that are not corporations as defined under the RCC – such as joint-stock companies, joint accounts, associations, insurance companies or partnerships – are treated as corporations. However, general professional partnerships (GPPs) and joint ventures or consortiums formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations pursuant to an operating or consortium agreement under a service contract with the Philippine government are not taxed as separate corporations, and the income tax is imposed on the partners and/or consortium members.

The corporate income tax rate is 25% while the minimum corporate income tax (MCIT) is 2%. A lower corporate income tax of 20% is provided for:

- domestic corporations with net taxable income not exceeding PHP5 million and with total assets not exceeding PHP100 million, excluding land on which the corporation's office, plant and equipment are situated during the taxable year for which the tax is imposed; and
- domestic corporations and resident foreign corporations that are registered business enterprises (RBEs) under the enhanced deductions regime (EDR) based on taxable income derived from their registered activities.

When corporations declare dividends to their shareholders, or profits to their partners in the case of partnerships that are considered corporations, these dividends and profits are again taxed at the shareholder – or partner – level. Individual shareholders and partners are generally subject to a 10% final tax on dividends. Dividends declared by a domestic corporation to another domestic corporation or to a resident foreign corporation are not subject to income tax.

Sole Proprietorships

Sole proprietorships, on the other hand, have no separate juridical personality. Proprietors are taxed as individuals, and the income tax rates range from 0% to 35%.

1.2 Transparent Entities

The transparent entities commonly used in the Philippines – GPPs and unincorporated joint ventures or consortiums – are exempt from income tax. The income tax is imposed on their partners or consortium members.

GPPs are formed by persons for the sole purpose of exercising their common profession, while non-taxable unincorporated joint ventures or consortiums are those formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations pursuant to an operating or consortium agreement under a service contract with the Philippine government.

1.3 Determining Residence of Incorporated Businesses

The incorporation test is used in determining the residence of incorporated businesses for Philippine taxation purposes.

A corporation organised under Philippine laws is a domestic corporation, while a corporation organised under the laws of a foreign country is a foreign corporation. A foreign corporation doing business in the Philippines (for example, through a branch) is considered a resident foreign corporation. A non-resident foreign corporation refers to a foreign corporation not engaged in trade or business within the Philippines.

For income tax purposes, domestic corporations are taxed on their worldwide income; foreign corporations are taxed only on their Philippine-sourced income.

Income tax of domestic and resident foreign corporations is based on their taxable income, or gross income less allowable deductions, while non-resident foreign corporations are taxed on their gross income, without deductions.

The residence of transparent entities is generally not material since they are exempt from income tax. However, the determination of the residence of the individuals or corporations composing the transparent entity is relevant, as they are the ones directly subject to income tax.

1.4 Tax Rates

Corporations are generally subject to the following taxes:

- 25% (or 20%) corporate income tax based on taxable income or 2% MCIT based on gross income, whichever is higher. The MCIT is imposed from the fourth taxable year following the year the corporation commenced its business operations. The taxpayer may ask the Commissioner of Internal Revenue (CIR) to suspend the MCIT under certain circumstances. Any excess MCIT over the regular corporate income tax (RCIT) may be carried forward and credited against the RCIT for the three immediately succeeding taxable years;
- 12% value added tax (VAT) or 3% percentage tax for non-VAT-registered corporations; and
- local taxes, the rates of which vary depending on the type and location of the business.

Transparent entities (ie, GPPs and certain types of unincorporated joint ventures or consortiums) are exempt from income tax but are generally subject to the following taxes:

- 12% VAT or 3% percentage tax for non-VAT-registered entities; and

- local taxes, the rates of which vary depending on the type and location of the business.

Individuals engaged directly in business or through transparent entities are generally subject to the following taxes:

- 0%–35% graduated income tax. Purely self-employed individuals and/or professionals whose gross sales or gross receipts and other non-operating income do not exceed the VAT threshold (currently at PHP3 million) have the option to avail themselves of an 8% tax on gross sales or gross receipts and other non-operating income in excess of PHP250,000 in lieu of the graduated income tax rates and the 3% percentage tax;
- 12% VAT or 3% percentage tax for non-VAT-registered individuals; and
- local taxes, the rates of which vary depending on the type and location of the business.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable income is defined as gross income less deductions allowed under the Philippine Tax Code or other special laws.

Taxable income is not entirely based on accounting profits. Certain items are income for accounting purposes but are not taxable under the Tax Code. Certain deductions are allowable for accounting purposes but not under the Tax Code, and vice versa.

For instance, accounting income should be adjusted to exclude from taxable income any income that has been subject to final tax, and to add back expenses that are not deductible under tax laws (eg, provisions for bad debts since, under the Tax Code, bad debts must be written off to be deductible).

Taxable income is generally calculated in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, but if no such method of accounting has been so employed, or if such method does not clearly reflect the income, the calculation will be made in accordance with such method as, in the opinion of the CIR, clearly reflects the income. In the Philippines, the accounting method is generally based on the Philippine Financial Reporting Standards (PFRS), but in case of a conflict between the PFRS and tax law and regulations, the latter shall prevail for purposes of income taxation.

2.2 Special Incentives for Technology Investments

Income earned by an alien or a foreign corporation from the use of intellectual property in the Philippines is considered as Philippine-sourced income and is subject to Philippine income tax. Income earned by a resident citizen or a domestic corporation from the use of intellectual property within or outside the Philippines will be subject to Philippine income tax.

Businesses conducting research and development (R&D) activities may be granted fiscal incentives such as the income tax holiday (ITH) for a certain period. Under the 2020 Investment Priorities Plan, which was integrated into the 2022 Strategic Investment Priority Plan of the Philippines, *"innovation drivers"* such as R&D activities have been identified as preferred activities for investment subject to incentives. Innovation drivers also cover the commercialisation of new and emerging technologies, uncommercialised patents on products and services, and products of locally undertaken R&D activities, such as agricultural biotechnology tools, photonics and nanotechnology, and natural health products.

A taxpayer may treat R&D expenditures, which are paid or incurred during the taxable year in connection with the taxpayer's business as ordinary and necessary expenses, as deductible expenses during the taxable year when they were paid or incurred.

However, subject to relevant rules and regulations, the taxpayer may opt to treat as deferred expenses R&D expenditures that are:

- paid or incurred by the taxpayer in connection with their business;
- not treated as deductible expenses; and
- chargeable to capital account but not chargeable to property subject to depreciation or depletion.

Such deferred expenses shall be amortised over a period of not less than 60 months, as may be elected by the taxpayer beginning with the month in which the taxpayer first realises benefits from such expenditures.

Under the Corporate Recovery and Tax Incentives for Enterprises Act (the *"CREATE Law"*), RBEs under the EDR may avail themselves of a 100% additional deduction on R&D expenditures incurred in the taxable year.

2.3 Other Special Incentives

The CREATE Law sets out the fiscal incentives for entities engaged in preferred activities and registered with the Board of Investments, and for business enterprises that are located within designated economic zones (*"ecozones"*) or former military bases that were converted into ecozones or freeport zones. The tax regime under the CREATE Law was expanded under Republic Act No. 12066 (the *"CREATE MORE Law"*) to make the Philippines more attractive to foreign and local investors by providing enhanced tax incentives.

Under the CREATE MORE Law, a uniform set of incentives may be granted to qualified enterprises whose activities are listed in the strategic investment priority plan, among other conditions. The fiscal incentives that may be granted to qualified registered enterprises under the law are:

- for projects or activities approved by investment promotion agencies (IPAs), an ITH of four to seven years followed by a special corporate income tax (SCIT) of 5% on gross income earned in lieu of all national and local taxes or an EDR for ten years, or SCIT or EDR for a maximum period of 14 to 17 years, depending on location and industry priorities;
- for projects or activities approved by the Fiscal Incentives Review Board (FIRB), an ITH of four to seven years followed by SCIT of 5% on gross income earned in lieu of all national and local taxes or EDR for 20 years, or SCIT or EDR for a maximum period of 24 to 27 years, depending on location and industry priorities;
- duty exemption on the importation of capital equipment, raw materials, spare parts or accessories, including goods used for administrative purposes, of the registered project or activity;
- VAT exemption on importation and VAT zero-rating on local purchases; and
- RBE Local Tax at the rate of not more than 2% of an RBE's gross income earned during the ITH and EDR in lieu of all local taxes and

local fees and charges imposed by the local government unit.

The RBE may forgo the ITH in exchange for availing SCIT or EDR at the commencement of its operations.

Additionally, under the CREATE MORE Law, RBEs may apply for extension of availment of incentives for five or ten years, for the same registered project or activity under certain conditions and subject to performance review by the IPA or FIRB, as applicable. ITH will not be granted to RBEs that applied for extension of availment of incentives for the same project or activity.

The FIRB is tasked to grant appropriate tax incentives to registered projects or activities upon the recommendation of the relevant IPA. The grant of tax incentives to registered projects or activities with investment capital of PHP15 billion and below is delegated by FIRB to the concerned IPAs to the extent of their approved registered project or activity under the strategic investment priority plan. The FIRB is authorised under the CREATE MORE Law to adjust the threshold amount of PHP15 billion.

The President is also given the power to modify the mix, period or manner of availing incentives, or to craft the appropriate support package for a highly desirable project or specific industrial activity, in the interest of national economic development or upon recommendation of the FIRB, provided that the grant of an ITH shall not exceed ten years and, thereafter, an SCIT rate of 5% or an EDR may be granted. Alternatively, the SCIT or EDR may be immediately granted at the start of commercial operations. However, the cumulative period of incentive availment for incentives granted by the President shall not exceed 40 years.

There are other special laws that provide fiscal incentives to certain sectors or undertakings such as co-operatives and renewable energy developers.

2.4 Basic Rules on Loss Relief

The Philippine Tax Code provides that the net operating loss (NOL) of an enterprise (ie, the excess of allowable deductions over the gross income) for any taxable year immediately preceding the current taxable year, which had not been previously offset as deduction from gross income, may be carried over as a deduction from gross income for the next three consecutive taxable years immediately following the year of such loss. However, any net loss incurred in a taxable year when the taxpayer was exempt from income tax is not allowed as a deduction. Additionally, a net operating loss carry-over (NOLCO) shall be allowed only if there has been no substantial change in the ownership of the business in that:

- not less than 75% in the nominal value of outstanding issued shares, if the business is in the name of a corporation, is held by or on behalf of the same persons; or
- not less than 75% of the paid-up capital of the corporation, if the business is in the name of a corporation, is held by or on behalf of the same persons, where such substantial change resulted from the taxpayer's merger, consolidation or business combination with another person, and not through a sale by a shareholder.

Ordinary loss is deductible against ordinary gain and capital gain, while capital loss is deductible only against capital gain.

Individual taxpayers sustaining a net capital loss in any taxable year are also allowed to deduct such loss against capital gain in the succeeding taxable year but only in an amount not exceeding net income in the said taxable year.

Under the CREATE MORE Law, RBEs granted tax incentives are entitled to an enhanced NOLCO, which means that the net operating loss of a registered activity during the first three years from the start of commercial operations that had not been offset as deduction from gross income may be carried over as deduction from gross income within the next five consecutive taxable years immediately following the last year of the ITH entitlement period of the project.

2.5 Imposed Limits on Deduction of Interest

Interest paid or incurred by a taxpayer within a taxable year on indebtedness in connection with their business is generally allowed as a deduction from their gross income, but such allowable deduction for interest expense shall be reduced by 20% of the interest income of the taxpayer subject to final tax. An example of interest income subject to final tax is interest income from peso bank accounts, which is subject to 20% final tax.

No deduction is allowed in respect of interest:

- if, within the taxable year, an individual taxpayer reporting income on the cash basis incurs an indebtedness on which an interest is paid in advance through discount or otherwise;
- if both the taxpayer and the person to whom the payment has been made or is to be made are related parties, as specified under the Philippine Tax Code; or
- if the indebtedness is incurred to finance petroleum exploration.

The taxpayer may opt to treat interest incurred to acquire property used in business as a deduction or as a capital expenditure.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping is not permitted under Philippine law. Losses incurred by one company in a group may not be utilised by another company.

Nonetheless, when a taxpayer merges, consolidates or combines with another person, that taxpayer's NOL may be transferred or assigned to the surviving or new corporation or entity if the shareholders of the transferor/assignor gain control of 75% or more in nominal value of the outstanding issued shares or paid-up capital of the transferee/assignee (if the surviving entity is a corporation) or 75% or more interest in the business of the transferee/assignee (if the transferee/assignee is not a corporation).

Additionally, in a merger, the NOLCO shall be allowed as a deduction from gross income of the surviving entity if the taxpayer that sustained and accumulated the NOL is the surviving entity.

2.7 Capital Gains Taxation

Net capital gains realised by domestic corporations and foreign corporations on the sale or exchange of shares in a domestic corporation not traded on the Philippine stock exchange are subject to a final tax of 15%.

The sale of shares listed and traded on the Philippine stock exchange is subject to a stock transaction tax of 0.6% based on the gross selling price or gross value in money of the shares sold.

If the corporation is a non-resident foreign corporation, it may avail itself of tax treaty relief on capital gains derived from the alienation of property in the Philippines.

2.8 Other Taxes Payable by an Incorporated Business

A corporation that, in the course of trade or business, sells, barters, exchanges, leases goods or properties, or renders services (including digital services consumed in the Philippines), is subject to VAT at the rate of 12% on the sale of goods or service, barter or exchange. The importation of goods is likewise subject to VAT. VAT-registered corporations are required to file VAT returns and pay VAT within 25 days following the close of each taxable quarter.

Depending on the transaction, corporations may be subject to documentary stamp tax (DST), which is a tax on documents, instruments, loan agreements and papers, and upon acceptances, assignments, sales and transfers of obligations, rights or properties.

Certain goods manufactured or produced (eg, distilled spirits, tobacco products, mineral products, petroleum products, sweetened beverages) in the Philippines for domestic sale or consumption or for any other disposition, or that are imported, are subject to excise tax. Cosmetic surgery services performed in the Philippines are also subject to excise tax. Excise taxes are imposed in addition to VAT, and VAT is calculated on the gross selling price or gross receipt plus the excise tax.

2.9 Incorporated Businesses and Notable Taxes

Certain income payments are subject to final or creditable withholding taxes. Incorporated businesses (ie, domestic corporations) may be constituted as withholding agents when they make payments that are subject to final or creditable withholding tax. Under the Ease of Paying Taxes Act (*"EOPT Law"*), the obligation to withhold tax arises at the time the income becomes payable.

Passive income that is subject to final withholding tax (FWT) is no longer included in the calculation of taxable income. The following types of passive income earned by incorporated businesses are subject to the following FWT:

- 20% final tax on interest on currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements, and royalties derived from Philippine sources; and
- 15% final tax on interest income from a depository bank under the expanded foreign currency deposit system.

The sale, exchange or disposition of lands and/or buildings that are not actually used in the business of a corporation and are treated as capital assets is subject to 6% capital gains tax (CGT) based on the gross selling price or fair market value of the property, whichever is higher.

The sale of shares of stock in a domestic corporation that are held as capital assets is subject to a separate tax – CGT or stock transaction tax.

Incorporated businesses (ie, employers) are also required to pay a 35% fringe benefits tax on the grossed-up monetary value of fringe benefits furnished or granted to their employees, except rank-and-file employees, unless the fringe benefit is required by the nature of, or necessary to, the trade or business of the employer, or the fringe benefit is for the convenience or advantage of the employer.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Following the general way business is done in the Philippines, closely held businesses would usually operate in corporate form.

Under the RCC, *"close"* corporation is one whose articles of incorporation provide that:

- all the corporation's issued stock of all classes, exclusive of treasury shares, is held of record by not more than 20 persons;
- all the issued stock of all classes is subject to specified restrictions on transfer; and
- the corporation is not listed on any stock exchange or has not made any public offering of its stocks of any class.

The concept of a one-person corporation was introduced in the RCC.

3.2 Individual Rates and Corporate Rates

As a rule, corporate practice of a profession is not permitted under Philippine law. According to the Philippine Supreme Court, this rule hinges on the idea that *"the ethics of any profession are based on individual responsibility, personal accountability and independence, which are all lost where one verily acts as a mere agent, or alter ego, of unlicensed persons or corporations"*.

3.3 Accumulating Earnings for Investment Purposes

There is no tax on improperly accumulated taxable income, but the RCC prohibits stock corporations from retaining surplus profits in excess of 100% of their paid-in capital stock, subject to certain exceptions.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Cash and property dividends received by citizens or resident aliens from their shares in domestic corporations (including closely held corporations) are subject to a final tax of 10%, while those received by non-resident aliens engaged in trade or business in the Philippines and non-resident aliens not engaged in trade or business in the Philippines are subject to a final tax of 20% and 25%, respectively.

Stock dividends are not subject to income tax if the number of shares received is in proportion to the existing shareholding of the stockholder. However, the issuance of shares through the declaration of a stock dividend is subject to DST at the rate of PHP2 for every PHP200 of the par value of the shares sold.

Net capital gains realised by individuals on the sale or exchange of shares in domestic corporations (including closely held corporations) not traded on the Philippine Stock Exchange are subject to a final tax of 15%. The sale of shares in domestic corporations outside the stock exchange is subject to DST at the rate of PHP1.50 for every PHP200 of the par value of the shares issued.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Cash and property dividends received by individuals (citizens and resident aliens) from their shares in publicly traded corporations are subject to a final tax of 10%, while those received by non-resident aliens engaged in trade or business in the Philippines and non-resident aliens not engaged in trade or business in the Philippines are subject to a final tax of 20% and 25%, respectively.

Stock dividends declared by publicly traded corporations are likewise not subject to income tax if the number of shares received is in proportion to the existing shareholding of the stockholder. However, the issuance of shares through the declaration of a stock dividend is subject to DST at the rate of PHP2 for every PHP200 of the par value of the shares issued.

The sale of shares listed and traded on the Philippine stock exchange is subject to a stock transaction tax of 0.6% based on the gross selling price or gross value in money of the shares of stock sold.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest, dividends and royalties earned by non-resident aliens not doing business in the Philippines are subject to FWT of 25%.

Interest and royalties earned by non-resident foreign corporations are subject to FWT of 25%.

Interest on foreign loans received by non-resident foreign corporations is subject to FWT of 20%.

Dividends earned by non-resident foreign corporations are generally subject to FWT of 25%. This rate is reduced to 15% if the country of domicile of the non-resident foreign corporation allows a credit against the tax due from the non-resident foreign corporation taxes deemed to have been paid in the Philippines equivalent to 10%, which represents the difference between the RCIT rate of 25% and the 15% tax rate on dividends. This is referred to as tax sparing credit.

4.2 Primary Tax Treaty Countries

The Philippines is a party to tax treaties with 44 countries. There is no public data available showing which tax treaty countries are primarily used by investors to make investments in Philippine corporate stock or debt.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Bureau of Internal Revenue (BIR) requires the submission of documents to ascertain whether an entity applying for tax treaty relief is entitled to the preferential tax rates under an applicable tax treaty.

Before the payment of the income, the non-resident deriving income from Philippine sources (eg, interest, dividends, royalties) must submit a prescribed application form for treaty purposes, a tax residency certificate duly issued by the foreign tax authority, and the relevant provision of the applicable tax treaty to the payor of the income or the withholding agent in order to avail itself of the preferential treaty rates for these incomes. The withholding agent may apply the preferential tax treaty rates upon submission of the required documents by the non-resident, subject to the filing of a request for confirmation with the BIR on the propriety of the withholding tax rate applied on the income. Failure to provide the required documents may result in the imposition of withholding tax using the regular rates prescribed under the Philippine Tax Code. If the regular rate under the Tax Code was applied on the income instead of the preferential treaty rates, the non-resident income recipient may file a tax treaty relief application and a claim for refund with the BIR to prove its entitlement to the treaty benefit.

4.4 Transfer Pricing Issues

Based on the BIR's transfer pricing guidelines, intra-firm or interrelated transactions account for a substantial portion of the transfer of goods and services in the Philippines, but the revenue collection from related-party groups continues to decrease. The BIR has attributed this to the fact that related companies are more interested in their net income as a whole rather than as separate entities. Accordingly, the transfer pricing regulations prescribed the guidelines in determining the appropriate revenues and taxable income of the parties in controlled transactions by providing the methods for establishing an arm's length price. The regulations also require taxpayers to maintain or keep documents necessary for the taxpayer to prove that efforts were exerted to determine the arm's length price or standard in measuring transactions among associated enterprises.

To provide a framework and guide for transfer pricing examinations by the BIR, the BIR issued transfer pricing audit guidelines, which are applicable to controlled transactions between related/associated parties where at least one party is subject to tax in the Philippines and to transactions between a permanent establishment and its head office or other related branches.

The BIR also issued regulations to ensure that proper disclosures of a related-party transaction are made and that these transactions are conducted at arm's length. The BIR amended these regulations to streamline the procedure for submission of the disclosure form, transfer pricing documentation and other supporting documents by providing safe harbours and materiality thresholds.

4.5 Related-Party Limited Risk Distribution Arrangements

The transfer pricing regulations recognise that an appraisal of the risk is important in determining arm's length prices or margins. Only those risks that are economically significant in determining the value of transactions or margins of entities will be identified and used in the comparability analysis to be conducted in applying the arm's length principle.

Under the audit guidelines, the BIR must conduct a functional, asset and risk analysis to determine the nature of the taxpayer's business. Functional analysis is performed to obtain accurate identification on the characteristics of the taxpayer's business as well as its counterparts, and, consequently, the level of the risks borne and the remuneration or profit (which must be proportional to the risks borne) can be predicted.

However, this firm has not yet seen, and is not aware, whether the BIR has already applied these audit guidelines and specifically challenged the use of related-party limited risk distribution arrangements.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

While the Philippines was not yet a member of the OECD when the BIR issued transfer pricing regulations, the said regulations are largely based on the OECD Transfer Pricing Guidelines (the *"OECD Guidelines"*).

4.7 International Transfer Pricing Disputes

International transfer pricing disputes are not prevalent in the Philippines. However, the BIR has recognised transfer pricing issues in prior issuances, and it has recently issued guidelines and procedures for requesting mutual agreement procedure (MAP) assistance in the Philippines. While the typical recourse of a taxpayer affected by double taxation or inaccurate application of treaty provisions is to file an administrative or judicial appeal, with the MAP guidelines, the taxpayer is given the option to resolve disputes through the MAP process. Resolution of a MAP case may take an average of 24 months. The time to complete the MAP case will depend on the complexity of the issue and the co-operation of the taxpayer and competent authorities.

While specific guidelines have not yet been released, the BIR has signified that taxpayers may avail themselves of advance pricing arrangements (APAs) to reduce the risk of transfer pricing examination and double taxation. An APA may be unilateral, which is an agreement between the taxpayer and the BIR, or bilateral or multilateral, which is an agreement involving the Philippines and one or more of its treaty partners. If a taxpayer does not choose to enter into an APA, it may still invoke the Article on MAPs in Philippine tax treaties to resolve double taxation issues. Given that the MAP regulations are fairly new, there is no data yet on MAP cases.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The Philippine Tax Code authorises the CIR to distribute, apportion or allocate gross income or deductions between or among two or more organisations, trades or businesses, whether or not incorporated and organised in the Philippines, owned or controlled directly or indirectly by the same interests, if necessary, in order to prevent evasion of taxes or clearly reflect the income of any such organisation, trade or business.

Thus, transfer pricing adjustments made by the BIR are to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent tax evasion in such transactions.

Under the transfer pricing audit guidelines, upon finding that the price or rate is not at arm's length, the BIR will propose adjustments by imputing the arm's length margin (eg, the discrepancy between the price or profit of the affiliated transactions and the arm's length price or profit). The primary adjustments may also lead to secondary adjustments.

The BIR will discuss its findings with the taxpayer, and the latter may contest the facts and issues identified. Thereafter, the regular tax audit process and remedies (eg, protest, administrative and judicial appeal) will be applicable.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

The term *"non-local corporation"* used here shall refer to a foreign corporation, defined under the Philippine Tax Code as a corporation not created or organised in the Philippines or under its laws.

Local branches of non-local corporations are taxed differently from local subsidiaries of such non-local corporations. Local branches of non-local corporations are subject to income tax only on their Philippine-sourced income, while local subsidiaries of non-local corporations are considered domestic corporations and subject to income tax on their worldwide income.

With respect to their taxable income (Philippine-sourced or worldwide, as applicable), local branches and local subsidiaries of non-local corporations are subject to the same tax rates:

- 25% corporate income tax based on taxable income; or
- 2% MCIT based on gross income.

Regional operating headquarters of non-local corporations are now subject to RCIT.

However, the local branch's remittance of branch profits to the foreign head office is subject to branch profit remittance tax of 15%, while remittance of dividends by the local subsidiary to the foreign head office is subject to FWT of 25%, subject to the tax sparing credit and tax treaty.

5.3 Capital Gains of Non-Residents

Net capital gains from the sale of stock in local corporations are always subject to Philippine income tax, except if there is an applicable tax treaty that grants CGT exemption.

Net capital gains of non-resident individuals and non-resident foreign corporations arising from the sale of stock in local corporations not traded on the local stock exchange are subject to CGT of 15%.

The gain from the sale of shares of a non-local holding company will be considered income from sources outside the Philippines and will not be subject to Philippine income tax unless the seller is a resident Philippine citizen or a domestic corporation.

Treaties eliminate CGT under certain conditions. For instance, there are tax treaties that exempt the net capital gains arising from the sale of shares in a local corporation from CGT if the assets of the local corporation do not consist principally of real property.

5.4 Change of Control Provisions

In general, there is no change of control provision that by itself would trigger tax and duty charges unless the change in control arises from the disposition of shares in a domestic corporation. However, change of control may affect the deductibility of certain expenses, such as NOLCO, which is deductible from gross income only if there has been no substantial change in the ownership of a business or enterprise.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The BIR's Revenue Audit Memorandum Order No. 1-95, which contains the audit guidelines and procedures for the proper determination of the income tax liability of Philippine branches and liaison offices of multinational enterprises selling goods or providing services, prescribes a formula whereby a portion of the income derived from Philippine sources by the foreign entity is attributed and taxed to the branch or liaison office.

5.6 Deductions for Payments by Local Affiliates

There is no specific standard applied in allowing a deduction for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. As a rule, an expense may be allowed as a deduction from the gross income of the local affiliate if the same is an ordinary and necessary expense paid or incurred during the taxable year in carrying on, or that is directly attributable to, the development, management, operation and/or conduct of the trade or business of the local affiliate. The transfer pricing guidelines issued by the BIR also require that the payment should be consistent with the arm's length principle. In the case of payment to a non-local affiliate, the payor must withhold any applicable withholding taxes and remit the same to the BIR.

5.7 Constraints on Related-Party Borrowing

In addition to the usual requirements of deductibility of interest expense, the interest agreed upon by and between affiliates should be in accordance with the arm's length principle adopted by the BIR, and the necessary withholding taxes withheld and paid to the BIR.

In determining whether the interest payment transactions are at arm's length, the BIR, under the transfer pricing audit guidelines, will look into various factors, such as the nature and purpose of the debt, the market conditions at the time the loan is extended, the amount of principal and period of the loan, the security offered and guarantees, and the amount of debt already held by the borrower.

Additionally, no interest expense deduction is allowed if both the taxpayer and the person to whom the interest is paid or payable are related parties as specified under the Philippine Tax Code.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The term *"local corporation"* used here shall refer to a domestic corporation, defined under the Philippine Tax Code as a corporation created or organised in the Philippines or under its laws.

Foreign income of local corporations is not exempt from corporate tax as they are taxed on worldwide income.

Philippine-sourced income and foreign-sourced income together constitute the local corporation's gross income. The local corporation pays the higher of RCIT of 25% (or 20%) based on gross income less the allowable deductions provided under the Tax Code, or MCIT of 2% based on gross income.

6.2 Non-Deductible Local Expenses

Foreign-sourced income is not exempt from Philippine income tax. Hence, local expenses attributable to such foreign-sourced income are deductible, subject to the rules on allowable deductions provided in the Philippine Tax Code.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by local corporations from foreign subsidiaries are generally included in the local corporations' gross income, which, after taking into account the allowable deductions provided under the Philippine Tax Code, is subject to an RCIT rate of 25% (or 20%), or MCIT of 2%. However, dividends from foreign subsidiaries may be exempt from tax provided the following conditions are met:

- dividends actually received or remitted into the Philippines are reinvested in the business operations of the domestic corporation in the Philippines within the next taxable year from the time the foreign-sourced dividends are received;
- dividends received are used to fund the working capital requirements, capital expenditures, dividend payments, investment in domestic subsidiaries and infrastructure projects of the domestic corporation; and
- domestic corporation holds directly at least 20% of the outstanding shares of the foreign corporation and has held the shareholding for at least two years at the time of dividend distribution.

If any of the conditions is not satisfied, the dividends shall be considered as taxable income of the local corporation in the year of actual receipt or remittance, subject to surcharges, interest and penalties, as may be applicable.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by local corporations may not be used by their non-local subsidiaries in their business without the former incurring local corporate tax. Local corporations should enter into a sale or licensing agreement with non-local subsidiaries pursuant to which the local corporations should receive compensation in accordance with the arm's length principle. Any income derived by the local corporation should be included in its gross income, and after subtracting the allowable deductions, the taxable income shall be subject to RCIT of 25% (or 20%).

If local corporations do not recognise income for the use of their intangibles by non-local subsidiaries, transfer pricing issues may arise.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

There are no controlled foreign corporation (CFC) rules in the Philippines. As a rule, Philippine tax law does not tax a local parent company on the CFC's taxable income unless the CFC distributes dividends to the parent company.

6.6 Rules Related to the Substance of Non-Local Affiliates

Following the concept of separate legal personality and piercing the veil of a corporate entity, a non-local affiliate will be considered a resident of the Philippines if circumstances show that the affiliate is just an extension of the juridical personality of the local corporation. However, this is largely a fact-driven exercise.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

The gain realised by local corporations on the sale of shares in non-local affiliates is included in the local corporations' gross income, which is subject to RCIT of 25% (or 20%) after taking into account the allowable deductions provided under the Philippine Tax Code, or to MCIT of 2%.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Philippines' anti-avoidance rules are based on jurisprudence. The Supreme Court makes a distinction between tax avoidance and tax evasion. Tax avoidance is recognised as a tax-saving device using means sanctioned by law. Nonetheless, the Supreme Court has ruled that a transaction that is prompted more by the mitigation of tax liabilities than for legitimate business purposes constitutes tax evasion, which is subject to both criminal and civil penalties.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

In general, all taxpayers are considered possible candidates for audit, but certain transactions or taxpayers are considered mandatory or priority audit cases by the BIR. The mandatory audit cases include claims for tax refund/credit on erroneous/double payment of taxes, regardless of amount or requests for tax clearance of taxpayers undergoing corporate reorganisations.

Priority audit cases include cases electronically selected on risk-based criteria, VAT cases or those approved by the CIR.

If a taxpayer is subject to an audit, the BIR will issue a letter of authority to examine the taxpayer's books, accounts and other records for a specific taxable year. The taxpayer has the opportunity to contest the BIR's findings through administrative or judicial process. The BIR has three years from the prescribed date for filing or actual filing of the taxpayer's income tax return, whichever is later, to assess deficiency taxes, except in cases of non-filing, false returns or fraudulent returns with intent to evade tax, where the BIR has a right to assess within ten years from discovery.

9. BEPS

9.1 Recommended Changes

The recommended changes under the BEPS Action Plan have not yet been incorporated in local tax laws and regulations.

Nonetheless, the Philippines has transfer pricing regulations implementing the authority of the CIR to allocate income or deductions between two or more organisations owned or controlled directly or indirectly by the same interests. It also includes the requirement for taxpayers to keep adequate documentation that will demonstrate the taxpayer's compliance with the *"arm's length"* principle. The transfer pricing regulations state that additional regulations relating to the application of the APA process will be issued, but these have yet to be released.

9.2 Government Attitudes

The Philippines joined the OECD/G20 Inclusive Framework on BEPS on 8 November 2023. The Philippine government committed to participate in the Two-Pillar Solution of BEPS.

The Philippine government has yet to announce specific plans on implementing Pillars One and Two of BEPS.

9.3 Profile of International Tax

Traditionally, international tax does not have a very high public profile in the Philippines, although there is now more awareness of it due to the number of foreign investors in the Philippines and increasing outward investments of Philippine companies. Transfer pricing concerns arising from related-party transactions of local subsidiaries with their foreign parent companies or affiliates continue to drive the discourse on developing more comprehensive guidelines for the implementation and enforcement of regulations on transfer pricing. The 2013 transfer pricing guidelines allow taxpayers to enter into APAs with the BIR, but separate guidelines on APAs are not yet in place.

In August 2019, the BIR issued transfer pricing audit guidelines prescribing standardised audit procedures and techniques in auditing taxpayers with related-party or intra-group transactions. While these guidelines serve as an internal manual for BIR examiners in the conduct of their tax audit, the guidelines contain the application of the arm's length principle in specific common transfer pricing issues (eg, intra-group services, intangible assets), transfer pricing methods and factors that the taxpayer may find valuable in its preparation of transfer pricing documentation. In 2020, the BIR issued regulations setting out the guidelines, procedure and the required forms for the proper disclosure of related-party transactions that were intended to improve the BIR's transfer pricing risk assessment and audit functions.

9.4 Competitive Tax Policy Objective

Currently, the Philippines has a competitive tax policy and grants generous fiscal and non-fiscal incentives to inward investments. The CREATE Law reduced the corporate income tax rate and rationalised tax incentives to make the incentive system performance-based, targeted, time-bound and transparent. Following the membership of the Philippines in the OECD/G20 Inclusive Framework on BEPS on 8 November 2023, several tax laws have been enacted.

On 22 January 2024, the EOPT Law, which simplified tax compliance requirements to modernise the Philippines' tax administration, took effect.

Republic Act No. 12023, which subjects digital services rendered by resident and non-resident digital service providers to 12% VAT, took effect on 18 October 2024.

Shortly thereafter, the CREATE MORE Law, which enhanced the tax regime under the CREATE Law, became effective on 28 November 2024.

9.5 Features of the Competitive Tax System

Tax leakages under the Philippine tax system may be attributed to transfer pricing and tax avoidance cases. In this regard, the actions recommended by BEPS may have a more significant impact on transfer pricing provisions and tax avoidance rules, especially if applied to transactions between related parties where the local affiliate enjoys income tax incentives (eg, enterprises located at ecozones and freeport zones).

The Philippine government has issued transfer pricing guidelines, although it appears that the BIR has not strictly implemented the rules. The incentives under the CREATE Law and the CREATE MORE Law were designed to be performance-based and time-bound. Hence, enterprises intending to avail themselves of the incentives after the lapse of the incentive period, including any extension granted under the CREATE MORE Law, must register new activities that are listed under the government's strategic investment priorities plan.

9.6 Proposals for Dealing With Hybrid Instruments

The Philippines has not adopted hybrid mismatch rules in response to BEPS. The fourth proposed tax reform package provides for a unified income tax rate for passive income such as interest, dividends and capital gains.

Generally, the current policy of the Philippine government is to develop a capital market by providing an efficient regulatory framework and, in terms of taxation, harmonising taxes on capital transactions to become simpler, fairer and more efficient.

9.7 Territorial Tax Regime

The Philippines has primarily a territorial tax regime, although resident citizens and domestic corporations are taxed on worldwide income. Consistent with territoriality, non-residents are taxed only on Philippine-source income. Interest income is considered Philippine-sourced if it arises from loans extended to residents.

The Philippines applies a tax arbitrage rule on deductible interest that reduces the allowable deduction for interest expenses by 20% of the interest income subject to final tax. This is intended to bridge the gap between the ordinary corporate income tax rate of 25% and the final tax rate on interest income, which is generally 20%.

Also, interest expense deduction will not be allowed if the interest payment is between two corporations, more than 50% of the stock of which is owned directly or indirectly by or for the same individual, if either one of the corporations is a personal holding company. A personal holding company is one that meets the stock ownership and gross income requirements under the tax regulations. Under the stock ownership requirement, more than 50% in value of the personal holding company's outstanding stock must be owned, directly or indirectly, by not more than five individuals. Under the gross income requirement, 70% or more of the gross income of the corporation must be classified as personal holding company income.

9.8 Controlled Foreign Corporation Proposals

Considering that the Philippines has joined the OECD/G20 Inclusive Framework on BEPS, the Philippines will have to participate in the implementation of the BEPS package of 15 measures, which includes the reduction of incentives to prevent taxpayers from shifting income to low-tax rate jurisdictions. Philippine tax laws providing for fiscal incentives have been amended, but it is worth noting that sweeper CFC rules may not necessarily achieve the purpose of preventing the shifting of income to lower tax jurisdictions since there may be other reasons for locating offshore subsidiaries in low-tax-rate jurisdictions.

9.9 Anti-Avoidance Rules

The Philippines' general anti-avoidance rules are largely based on principles arising from Supreme Court decisions, which made a distinction between tax avoidance and tax evasion. Tax avoidance is *"the tax-saving device within the means sanctioned by law. This method should be used by the taxpayer in good faith and at arm's length."* What the law clearly prohibits is tax evasion, which is considered the wilful attempt, in any manner, to evade or defeat any tax imposed under the Philippine Tax Code. The Supreme Court nonetheless considers transactions that are prompted more by the mitigation of tax liabilities than for legitimate business purposes as entered into for tax evasion purposes.

The Philippines' tax treaties with certain countries have taken into account double taxation convention limitation of benefits.

9.10 Transfer Pricing Changes

The current transfer pricing regulations require taxpayers to keep adequate documentation to show that transfer prices are consistent with the arm's length principle, but such documents are not required to be submitted with tax returns, unless the tax authority requires or requests the taxpayer to do so.

The taxation of profits from intellectual property is not currently a particularly controversial issue in the Philippines. The Philippines' transfer pricing regulations apply to two major categories of intangible properties or assets: manufacturing intangibles and marketing intangibles.

Manufacturing intangibles are generally created through R&D activities, which are risky and entail expenses.

Marketing intangibles include trade marks or trade names that help increase the marketing of goods and services and have important promotional value for the products.

To determine arm's length transactions, the existence of intangible assets must be considered as it necessarily entails a higher profitability level than the average for the industry. Thus, the owner will necessarily require, and should be compensated with, more than a mere return to recover the costs incurred for the development of such intangible assets.

The Philippines also imposes FWT on the gross income earned by non-resident foreign corporations from Philippine sources. Gross income includes income derived from rents or royalties, which are considered to be Philippine-sourced if the income arises from property located in the Philippines or from any interest in such property, or the use of, or the right or privilege to use in the Philippines, any intellectual property. If the intellectual property is owned by a domestic corporation, royalties earned on such intellectual property from sources outside the Philippines will form part of its gross income for purposes of calculating taxable income.

9.11 Transparency and Country-by-Country Reporting

The Exchange of Information on Tax Matters Act of 2009 provides for the Philippines' compliance with, or commitment to, the internationally agreed tax standards required for the exchange of tax information with its tax treaty partners to help combat international tax evasion and avoidance. Under the law, information received by the foreign tax authority from the BIR pursuant to an international convention or agreement on tax matters is considered absolutely confidential, and disclosure of such information shall be limited to the assessment or collection, enforcement or prosecution of the taxes covered under such international convention or agreement.

9.12 Taxation of Digital Economy Businesses

On 2 October 2024, Republic Act No. 12023 was enacted, subjecting digital services delivered by non-resident digital service providers to 12% VAT, as long as the services are consumed in the Philippines. Non-resident digital service providers are required to register as VAT taxpayers with the BIR if their gross sales for the past 12 months exceed, or if they have reasonable grounds to believe that their gross sales for the next 12 months will exceed, PHP3 million.

9.13 Digital Taxation

Republic Act No. 12023 has been enacted, providing that digital services delivered by digital service providers, whether resident or non-resident, shall be subject to 12% VAT, as long as the services are consumed in the Philippines.

Under the law, resident and non-resident digital service providers are required to assess, collect and remit the VAT on the digital services consumed in the Philippines, subject to provisions on withholding.

For non-resident digital service providers, VAT-registered consumers shall be responsible for withholding and remitting to the BIR the VAT due on their purchase of digital services consumed in the Philippines. However, if the consumers are not VAT-registered, the non-resident digital service providers shall be liable for the remittance of VAT on the said digital services.

Educational services and the services of banks and non-bank financial intermediaries, even if provided online, remain exempt from VAT.

9.14 Taxation of Offshore IP

Revenues earned by offshore companies from licensing IP in the Philippines are subject to FWT of 25% (royalty withholding tax regime). The FWT is withheld and remitted to the BIR by the local income payors.

IP owners that are residents in countries that have tax treaties with the Philippines may avail themselves of a preferential tax rate on royalties derived from the licensing of IP in the Philippines.

POLAND

Trends and Developments

Contributed by:
Maciej Kacymirow, Marek Kozaczuk, Mateusz Rogulski and Anna Lewandowska
Greenberg Traurig

Greenberg Traurig is a global, multi-practice law firm with more than 2,750 attorneys serving clients from 49 offices in the USA, Latin America, Europe, Asia and the Middle East. The Warsaw office of Greenberg Traurig provides legal services to clients in Central Europe and beyond, and consists of approximately 100 lawyers. Team members are regularly recognised as leaders in numerous practice areas. Chambers Global and Chambers Europe consistently rank them among the top tiers for the areas of corporate/M&A, capital markets, real estate, private equity, tax, banking and finance, project finance, energy, dispute resolution, restructuring and competition/antitrust.

Authors

Maciej Kacymirow is a local partner and head of the tax practice in Greenberg Traurig's Warsaw office. Maciej advises leading private equity firms, multinational corporations and public companies on sophisticated tax matters, corporate law and complex business transactions. Applying his deep knowledge of Polish and multi-jurisdictional tax regulations, Maciej provides proactive guidance on assessing and optimising tax liabilities associated with cross-border restructurings, mergers and acquisitions, joint ventures and capital market activities. Maciej is a tax adviser and member of the National Chamber of Tax Advisers, and an attorney-at-law and member of the Warsaw Bar Association of Attorneys-at-Law.

Marek Kozaczuk is of counsel at GT Warsaw Office, a tax adviser and attorney-at-law admitted to practice in Poland. With over 25 years of experience in tax advisory, Marek specialises in preventing and resolving tax disputes, representing clients before tax, customs and social insurance authorities, administrative courts, the Supreme Administrative Court, the Supreme Court and the Constitutional Tribunal. He has handled over 1,000 cases. His expertise includes tax risk assessment, dispute prevention, tax litigation, tax refund claims, criminal tax defence (including board members' liability), transactional tax advisory (mergers, demergers and transformation) and tax advisory for IT companies.

Contributed by: Maciej Kacymirow, Marek Kozaczuk, Mateusz Rogulski and Anna Lewandowska, **Greenberg Traurig**

Mateusz Rogulski is a senior associate in the tax practice in Greenberg Traurig's Warsaw office. He advises corporations, investment funds and individuals on complex tax and corporate issues, focusing on real estate, energy transactions and ongoing business activity. With extensive experience in corporate reorganisations, M&A, cross-border structures, due diligence and capital market transactions, Mateusz is valued for his financial insight, proactivity and creative approach. His clear communication of complex issues makes him a trusted partner in resolving tax challenges and delivering tailored solutions. Mateusz is an advocate and a member of the Warsaw Bar Association.

Anna Lewandowska is an associate in the tax practice at Greenberg Traurig's Warsaw office, where she focuses on tax matters. Her experience includes providing tax consultancy on personal income tax, social security system and cross-border tax issues. Anna provides legal opinions on topics such as 50% tax-deductible expenses and the risk of classifying B2B contracts as employment relationships. She also advises on the implementation of incentive programmes and related tax matters. Anna is currently a trainee at the Warsaw Bar Association.

Greenberg Traurig

Varso Tower
ul. Chmielna 69
00-801 Warsaw
Poland

Tel: +48 22 690 6100
Fax: +48 22 690 6222
Email: wawoffice@gtlaw.com
Web: www.gtlaw.com/en/locations/warsaw

Contributed by: Maciej Kacymirow, Marek Kozaczuk, Mateusz Rogulski and Anna Lewandowska,
Greenberg Traurig

Introduction

Poland's corporate tax landscape is undergoing significant changes, driven by both global initiatives and domestic reforms. Multinational corporations operating in Poland face a tax environment that is evolving to align with international standards while also embracing digitalisation and tightening enforcement on certain tax practices. These trends are shaping how large businesses plan and comply with taxes in Poland. In this article, we provide an overview of the key developments in Polish corporate taxation, explain their significance for companies (especially multinationals), and highlight what businesses should be doing to adapt. The discussion covers the implementation of the global minimum tax (Pillar Two), ongoing controversies in the withholding tax regime, the rollout of mandatory e-invoicing (KSeF), other recent notable tax changes, as well as important court rulings that are influencing tax practice in Poland.

Key Issues

Implementation of Pillar Two – global minimum tax

Poland is moving forward with implementing Pillar Two, the OECD's global minimum tax framework. This is a part of an international effort to ensure large multinational groups pay at least a 15% effective tax rate in every jurisdiction. Poland's adoption of these rules is happening via a new law (often referred to as the *"GloBE Act"* in Poland) separate from the standard Corporate Income Tax (CIT) Act. The legislation is based on the EU Directive on global minimum tax, which Poland – like all EU members – is required to transpose.

Under the rules effective from 1 January 2025, companies that are part of multinational or large domestic groups with consolidated annual revenues above EUR750 million will need to calculate their effective tax rate in Poland and possibly pay a top-up tax if that rate falls below 15%. The Pillar Two system introduces three main mechanisms to achieve this minimum taxation:

- an Income Inclusion Rule (IIR), which allows a parent company to top-up tax on profits of low-taxed subsidiaries;
- an Undertaxed Profits Rule (UTPR), which is a backstop to tax profits that were not caught by the IIR; and
- a Qualified Domestic Minimum Top-Up Tax (QDMTT), which allows Poland to collect the additional tax on low-taxed income of Polish entities itself.

Poland's implementation has some unique aspects. Although the law formally applies from 2025, it provides an option for earlier adoption for the 2024 tax year. In practice, this means a Polish subsidiary of a multinational group can opt into the system for 2024, allowing the Polish tax authority to collect any top-up tax for that year. This optional 2024 QDMTT is designed as a safe harbour – if the Polish entity pays the minimum top-up tax for 2024, then the group's parent company or companies in other countries will not have to apply the Pillar Two rules on that Polish income. This strategy could be beneficial for multinational groups, as it keeps the taxation (and cash outflow) in Poland rather than, say, having the parent company's country impose the tax on Polish profits.

Pillar Two will significantly impact large businesses, requiring detailed calculations of their effective tax rate (ETR) in each jurisdiction, including Poland. If the Polish ETR falls below 15%, companies may face an additional tax charge. This will require gathering extensive financial data and potentially adjusting tax planning. The complex Polish GloBE Act demands upgrades to reporting systems and training for tax teams.

In terms of tax planning strategies, Pillar Two limits traditional tax optimisation but allows strategies on where the top-up tax is paid. In Poland, a low-taxed operation could pay a small top-up domestically to avoid a larger one abroad. Businesses should reassess tax incentives, as some may trigger a top-up tax. The Polish government is considering replacing some incentives with grants or Pillar Two qualifying subsidies, and the alignment of the *"Polish Investment Zone"* a government-backed instrument to support new investment throughout Poland (which replaced the older, geographically limited special economic zones) – with Pillar Two is still under discussion.

Controversies around the Polish withholding tax regime

Poland's withholding tax (WHT) system has been a source of complexity and controversy for multinational businesses in recent years. WHT is the tax withheld at source on certain payments to foreign entities, such as dividends, interest and royalties. While many countries have WHT, Poland introduced an unusually stringent mechanism known as *"pay and refund"* that has posed challenges for taxpayers and investors.

Under changes first enacted in 2019, Poland shifted from a straightforward relief-at-source system (where treaty exemptions or reductions could be applied directly when making a payment) to a pay-and-refund mechanism for large payments. After several delays, these rules finally entered into force on 1 January 2022. The core idea is that if annual payments to a single foreign recipient (being the payer's affiliate) exceed PLN2 million (approximately EUR430,000), the Polish payer in principle must withhold tax at the full domestic rate (20% for interest/royalties, 19% for dividends) even if an exemption or treaty reduction could apply. The foreign recipient can then claim a refund of the overpaid tax from the Polish tax authorities, a process which occurs after the fact.

This system quickly became controversial. From a business perspective, it creates cash flow problems and administrative burdens. Companies making cross-border payments can end up withholding millions of zlotys, which their foreign affiliates must then reclaim. The refund process in Poland has been described as lengthy and costly. Indeed, in many cases it can take well over a year to receive a refund, and although the tax authorities claim that the process is becoming more efficient, it is still a serious burden.

Another contentious aspect of the WHT regime is the understanding of the concept of the *"beneficial owner"* and anti-abuse rules tied to WHT reliefs. Polish tax authorities have been aggressive in requiring that the foreign recipient not only meet formal treaty or EU Directive conditions (such as holding a certain percentage of shares for a certain period), but also that the recipient is the true beneficial owner of the income and is not just inserted into the structure to obtain a tax benefit. At the same time, the interpretation of *"beneficial owner"* by the tax administration has been uncertain. For example, the law explicitly requires beneficial ownership for interest and royalties (due to the EU Interest-Royalties Directive implementation), but not for EU dividend payments under the EU Parent-Subsidiary Directive (PSD). Some tax officials and lower courts contended that even EU dividends should meet a beneficial owner test or could be denied if the funds ultimately go to a tax haven investor. This created confusion for legitimate group structures and investment funds. Differing approaches by the courts (discussed in the 'Key Cases' section below) have only partially resolved this issue.

Poland's Ministry of Finance has recognised the difficulties and introduced some ameliorations. Firstly, a Polish withholding agent (payer) can submit a special statement declaring that all conditions for WHT relief are met, which then allows the reduced rate or exemption to be applied without the need to withhold above the PLN2 million threshold. Additionally, Poland introduced the possibility to obtain a binding WHT opinion from the tax authorities – essentially an advance ruling that confirms the recipient's eligibility for relief – which, if granted, allows the payer to avoid the pay-and-refund mechanism for those payments for a specified period (generally 36 months). These options, however, come with their own challenges: the due diligence needed to confidently file the declaration is substantial (with potential penalties for mistakes), and obtaining a WHT opinion can be slow and involves a fee.

Many companies report that the refund procedure, when it is needed, is still slow. In fact, a recent CJEU ruling highlighted that Poland's practice of not paying interest on delayed WHT refunds was against EU law, suggesting systemic delays. Furthermore, determining beneficial ownership and substance has effectively shifted the burden onto Polish companies to investigate their foreign affiliates – they must gather documentation to prove that the recipient of a payment is not a mere conduit. For multinational groups, this often means proving that a finance or holding company abroad has its own business substance and decision-making, which can be a grey area.

Another ongoing challenge is navigating the frequent changes and guidance in this area. The Polish Ministry of Finance issued second draft guidance on the application of the WHT rules in late 2023, with a particular focus on the beneficial ownership test, but it is not legally binding and the Ministry is still working on revised guidance that is expected to be issued in the first half of 2025. In the meantime, in November 2024, the Ministry of Finance issued two general tax rulings clarifying the conditions under which taxpayers may apply the PSD and the Interest-Royalties Directive exemptions in Poland. The rulings emphasise that a recipient of dividends, interest or royalties should be subject to corporate tax on a worldwide basis (without an overall exemption) in its home country to qualify for relief. Interestingly, the PSD-focused ruling allows that a company's inability to pay tax in a given year due to losses does not itself undermine the exemption, whereas the second ruling dealing with interest and royalties interprets *"lack of overall tax liability"* more strictly if a special tax regime effectively zeroes out the CIT burden on those categories of income.

While the above-mentioned rulings provide some guidance on applying the EU Directives, some uncertainties remain on when exactly a recipient is deemed to *"benefit from an exemption"* that would disqualify it from WHT relief. At the same time, taxpayers are expected to keep abreast of evolving interpretations and court decisions. All of this uncertainty increases the tax risk for companies – a small misstep in paperwork could result in the Polish tax office denying a treaty benefit and imposing the full tax, plus interest and penalties.

Given these challenges, large businesses have developed some risk mitigation strategies regarding WHT in Poland. Companies are investing in robust documentation, obtaining certificates of tax residence, representations about

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beneficial ownership and other documentation confirming the business substance of recipients in order to have them on file. Some are applying for WHT clearance opinions when significant or recurring payments are at stake, despite the cost and length of the process, so as to have certainty. Lastly, businesses are closely following court cases and considering litigating disputes, because the tax authorities' stance has at times been successfully challenged in court. In summary, Poland's WHT regime, while intended to prevent abuse, has created compliance headaches. Companies must be diligent and may need to seek professional advice to navigate this minefield of rules and ensure that cross-border payments are handled optimally under Polish law.

Mandatory e-invoicing (KSeF)

Another major development in Poland is the drive toward full e-invoicing for businesses. The National e-Invoicing System, known by its Polish abbreviation KSeF (*Krajowy System e-Faktur*), is a platform for issuing and reporting invoices in a structured electronic format.

Large companies with annual revenue over PLN200 million (approximately EUR46 million) will have to use KSeF from 1 February 2026, and by 1 April 2026 the e-invoicing obligation will extend to all businesses in Poland. This phased rollout gives companies additional lead time to prepare throughout 2025.

KSeF implementation, though not yet mandatory, demands substantial effort. Companies must integrate systems for XML invoice issuance, adapt processes and train staff. At the same time, it is expected that KSeF will benefit both businesses and the government. For the government, it improves VAT compliance and reduces fraud with real-time transaction data, potentially lowering audit frequency. For businesses, electronic invoices streamline processes, reduce errors and could lead to faster VAT refunds. The standardised format simplifies record-keeping and reduces data entry mistakes. In summary, the planned mandatory e-invoicing in Poland represents a significant step toward digital tax administration.

Other Important Developments

Beyond the headline issues of Pillar Two, WHT and e-invoicing, Poland has recently introduced a number of other corporate tax changes that large businesses should note. Many of these changes aim to either tighten the tax system or provide new compliance tools and incentives. Below is a summary of significant developments:

- **Return of the minimum income tax:** The Polish minimum income tax, which targets companies with operational losses or low-profit margins (below 2%), has been reintroduced for the 2024 financial year (to be reported in 2025). Affected companies must calculate a 10% tax on 1.5% of revenue, with certain exclusions such as start-ups and one-time events. This tax aims to curb aggressive tax planning but could also impact businesses facing financial difficulties.
- **Enhanced holding company regime:** Poland has improved its holding company regime, making it more attractive for international groups. From 2023, the participation exemption on capital gains was liberalised, and the holding period for shares was extended to two years. Furthermore, dividends received by a qualifying holding company are now 100% exempt (up from 95%). These changes position Poland as an attractive location for regional holding hubs, offering tax exemptions on both dividends and capital gains from subsidiaries.

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- **Digital reporting – JPK_CIT:** Starting in 2025, large businesses (those with revenues over EUR50 million and tax capital groups) must submit their corporate income tax returns electronically in a standardised format. Smaller businesses will follow in subsequent years.
- **Real estate tax changes:** As of early 2025, Poland has broadened the scope of real estate taxation by modifying the definitions of *"buildings"* and *"structures"*. Companies with substantial industrial operations should review their asset lists to identify newly taxable items, as this change may have led to a significant increase in property tax bills.
- **Transfer pricing simplifications:** In 2023, Poland simplified its transfer pricing documentation rules, repealing the requirement to investigate indirect transactions with entities in *"tax havens"*. The threshold for documentation of direct transactions with such entities was raised, reducing the frequency of triggering onerous transfer pricing documentation solely based on a counterparty's tax residence.
- **Thin capitalisation rule update:** Poland clarified its interest deductibility (thin cap) rules. The 2023 amendment to Poland's thin capitalisation rules clarified that interest expenses are deductible up to PLN3 million, regardless of the 30% of EBITDA limit. This provides more certainty for companies with lower EBITDA, while larger companies will continue to rely on the 30% cap.
- **Other tax incentives and changes:** Poland continued to refine various tax incentives, such as adjustments to the Estonian CIT system and improvements to R&D and IP Box reliefs. Poland also introduced VAT groups, allowing related companies to simplify their VAT settlements.

In summary, the period of the last two years brought a mix of tightening and taxpayer-friendly adjustments in Polish corporate tax environment. Large businesses should review these developments carefully to ensure they are leveraging any new benefits and are compliant with new obligations.

Key Cases

Recent court decisions, both from the CJEU and from Polish administrative courts, have had a notable impact on corporate tax matters in Poland. These rulings provide clarity in some areas and highlight risks in others. Below are some of the most impactful cases:

- **CJEU – Interest on Withholding Tax Refunds (Case C-322/22):** In a landmark judgment on 8 June 2023, the CJEU ruled Polish tax law incompatible with EU law regarding interest on WHT refunds. Poland had denied interest if refund claims were filed more than 30 days after tax payment – an issue affecting foreign investors, particularly non-EU entities. The CJEU found this practice unlawful, confirming that taxpayers are entitled to interest on wrongfully collected WHT. This ruling allows affected companies to claim interest compensation and pressures Poland to improve refund processing. A legislative fix or faster refunds may follow to align with EU law.
- **Polish Supreme Administrative Court – Beneficial Owner of Dividends (Cases II FSK 1277/22 & 1281/22):** On 8 February 2023, Poland's Supreme Administrative Court (NSA) issued important judgments regarding the WHT exemption for EU dividends. The court determined that the beneficial owner criterion does not apply to WHT exemptions for EU dividends under the PSD. Despite challenges from tax authorities concerning conduit-like recipients, the court ruled that Polish law

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does not require beneficial ownership for dividends, unlike for interest and royalties. These conclusions were confirmed in a more recent verdict of the NSA dated 9 October 2024 (Case II FSK 78/22).

- **CJEU – Subsidiary tax liability of the management board members (case C-277/24):** On 27 February 2025, the CJEU ruled that Polish regulations on the liability of board members for the tax obligations of companies are partially incompatible with EU law. The Polish rules do not allow former board members to challenge tax rulings against the company, even though they are financially responsible for the company's liabilities. The CJEU ruled that although the exclusion of former board members from the proceedings against the company was in line with EU law, they should have the opportunity to challenge the findings of the tax decision in the proceedings against them. The CJEU ruling gives board members the right to challenge a company's tax rulings, paving the way for the reopening of closed cases and the recovery of money.
- **CJEU – CIT exemption for foreign investment funds managed internally (case C-18/23):** On 27 February 2025, the CJEU ruled that the external management requirement as a condition for CIT exemption is incompatible with EU rules (under Article 63(1) of the Treaty on the Functioning of the EU) because it restricts the free movement of capital. According to the CJEU, foreign investment funds that are internally managed are therefore also exempt. The CJEU ruling means that Poland should bring its regulations into line with EU law, and until they are changed, the tax authorities should not apply the disputed condition. In practice, foreign investment funds that have so far paid CIT in Poland only because they were managed internally will have grounds to claim its refund with interest.
- **Other notable decisions:** Polish courts have been active on other tax fronts as well. For example, administrative courts have deliberated on the application of general anti-avoidance rules (GAAR) in corporate restructurings, on transfer pricing adjustments and on VAT issues affecting corporations. One area to highlight is the *"look-through"* approach in WHT: in some cases, authorities tried to look through multiple layers of transactions (for instance, if a dividend went from Poland to an EU holding, and then to a non-EU ultimate owner) and deny relief. While the NSA's dividend decisions mentioned above reject a broad look-through for dividends, there have also been cases dealing with interest or royalty payments. Polish courts often refer to the precedent of the CJEU's Danish cases (2019) on beneficial ownership and abuse, striking a balance between combating abuse and respecting the letter of the law. Additionally, the CJEU had other decisions indirectly relevant to Poland – for instance, cases on the VAT side, such as those concerning Polish VAT compliance measures, and Poland's retail sales tax was cleared of EU state aid objections in 2021, which allowed that tax to be implemented.

From a big-picture view, the trend in court verdicts seems to be an increased scrutiny of Poland's aggressive anti-avoidance measures, with courts occasionally pushing back to protect taxpayer rights (as seen in the WHT refund interest case and the dividend cases). At the same time, courts also uphold anti-abuse principles when truly sham structures are identified. For businesses, these rulings underscore the importance of staying informed about jurisprudence. Many companies operating in Poland are actively monitoring court developments or even engaging in litigation to obtain clarity on ambiguous tax issues.

Conclusion

Poland's corporate tax regime is in a phase of dynamic change, influenced by global tax reforms, EU Directives and domestic policy priorities. For large businesses operating in Poland, the key takeaway is that proactivity and adaptation are essential.

For businesses, the key takeaways are: plan ahead, invest in compliance (especially IT systems and knowledgeable personnel) and utilise the available tax planning opportunities that remain (such as the holding company regime or various reliefs) in a responsible manner. Engaging with tax advisers and perhaps the tax authorities (for rulings or clarification) can be prudent given the pace of change. Poland remains an attractive market with a generally stable general 19% CIT rate (and preferential 9% rate for the so-called small taxpayers) and incentives for investment, but the framework around that CIT is becoming more complex. By understanding the trends and developments outlined above, companies can better navigate the Polish tax environment and turn compliance into a strategic advantage, minimising surprises and ensuring smooth operations in 2025 and beyond.

PORTUGAL

Law and Practice

Contributed by:
Samuel Fernandes de Almeida, Joana Lobato Heitor and Bárbara Miragaia
MFA Legal

Contents

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MFA Legal is a new player in the Portuguese market, a boutique firm focused on tax, white-collar crime, compliance and risk management, combining the unique experience of a very senior team with a strong track record in tax advice and litigation, economic criminal law and compliance. MFA's tax team has more than two decades of experience, providing advice to large business groups, multinationals, SMEs, HNWIs and family businesses based in Portugal and African Portuguese-speaking countries. The firm represents clients in the energy, financial and insurance, telecoms, distribution and health sectors. Recognising the complex nature of the business environment, MFA prioritises understanding each client's unique needs. By combining the insights of its senior team with a commitment to innovation and excellence, the firm crafts effective tax strategies that deliver significant value. MFA has a strong track record in litigation, representing clients in more than 200 complex tax cases, including at the CJEU.

Authors

Samuel Fernandes de Almeida is the managing partner of MFA Legal and a renowned tax practitioner specialising in tax litigation and tax arbitration. He has been an arbitrator at the Administrative Arbitration Centre (CAAD) since its creation and is an appointed expert of Tribute Foundation in Portugal. Samuel also has extensive experience in providing tax advice to large multinationals on highly complex projects, particularly in the energy, telecommunications, infrastructure, distribution, banking and insurance sectors. His practice includes tax advice on structuring investments in Portugal, Angola, Mozambique and Cabo Verde, restructuring, transfer pricing and international tax. In addition, Samuel advises family businesses and HNWIs on wealth and estate planning.

Joana Lobato Heitor is a tax partner at MFA Legal specialising in tax litigation and arbitration, international tax planning and corporate reorganisations, with a special focus on the telecommunications, insurance, and energy sectors. In the area of tax litigation, Joana has represented large national and international clients in more than 200 tax cases before the Tax Administration, tax courts, arbitration courts, and the Court of Justice of the European Union. She provides advice to large Portuguese companies in tax inspection procedures, tax fraud investigations and tax proceedings. Joana also provides tax advice in a wide range of jurisdictions, particularly in Portuguese-speaking African countries.

Bárbara Miragaia is a senior associate at MFA Legal with extensive experience in tax litigation and monitoring tax inspections, representing a significant number of national and multinational companies. Bárbara also provides tax advice on direct and indirect taxes, particularly to companies in the energy, telecommunications, distribution, banking and insurance sectors. She also has international experience, with a special focus on tax planning, corporate reorganisations, double taxation, and import and export customs procedures, in jurisdictions such as Angola, Mozambique and Cabo Verde, where she has had the opportunity to monitor the implementation and development of major projects.

MFA Legal

Avenida da Liberdade
212, SL Direito
Lisbon

Tel: +351 211372676
Email: geral@mfalegal.pt
Web: www.mfalegal.pt

Contributed by: Samuel Fernandes de Almeida, Joana Lobato Heitor and Bárbara Miragaia, **MFA Legal**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Corporate entities are generally subject to corporate income tax (CIT) and taxed separately from their shareholders.

The most common corporate forms of business vehicles are private limited liability companies (*sociedades por quotas*) and joint stock companies (*sociedades anónimas*). Private limited liability companies can be incorporated with a minimum of two quota holders, but this requirement can be reduced to a single quota holder, in which case the company is known as an individual limited liability company (*sociedade unipessoal por quotas*). As a rule, there is no minimum share capital requirement, except for joint stock companies, which must have a minimum of at least five shareholders and a minimum share capital of EUR50,000.

There is also a special legal regime for pure holding companies (*sociedade gestora de participações sociais*), which can assume the form of private limited liability companies, individual limited liability companies or joint stock companies. Joint stock companies are required to have their annual accounts certified by a chartered accountant. These are all limited liability companies, and a shareholder's liability is limited to the share capital contributed by the shareholder (for joint stock companies) or the company's share capital (for private limited liability companies).

1.2 Transparent Entities

Certain entities are deemed fiscally transparent, such as:

- civil partnerships;
- professional civil firms (eg, lawyers, architects); and
- corporations engaged in passive management of assets for the benefit of a family group or when said entities have fewer than five shareholders.

Complementary business groupings and European economic interest groupings, treated as residents, are also tax transparent. However, investment funds are liable to CIT, although subject to a special tax regime set out in the Tax Incentive Statute.

Despite transparent entities being exempt from CIT, their annual taxable income is assessed under CIT provisions and the net profit is attributable to their shareholders, irrespective of any dividend distribution.

1.3 Determining Residence of Incorporated Businesses

A company is deemed tax resident when its head office (legal seat) or effective place of management is located in Portugal. There is no legal definition of the concept of effective place of management; instead, the criteria set forth under international tax law (eg, OECD Commentaries and EU Directives) and settled case law, etc, are commonly used.

Tax transparent entities, despite being deemed resident for tax purposes, are not eligible for benefits under double tax treaties (DTTs). The Portuguese tax authorities have clarified that shareholders of tax transparent entities cannot claim treaty relief under DTTs entered into by Portugal.

1.4 Tax Rates

As of 1 January 2025, the standard corporate income tax rate on the mainland is 20% (as opposed to the previous 21%). This rate is applicable to corporations that carry out a commercial activity and branches of permanent establishments (PEs) of non-resident entities (other corporations that do not carry out a commercial activity, such as foundations, and civil partnerships without legal personality are subject to CIT on their global income assessed as per the rules set forth for each category of income for personal income tax (PIT) purposes).

Micro and small to medium-sized enterprises (SMEs) benefit from a reduced 16% tax rate on taxable income up to EUR50,000. A further reduced 12.5% rate was introduced in 2024 for start-ups and mid-cap entities, also up to EUR50,000 of taxable income. Any income exceeding this amount is subject to the standard 20% rate.

Entities with head offices and places of effective management in the Autonomous Regions of Madeira or the Azores benefit from a 30% reduction of the general CIT rate (which results in a rate of 14% for year 2025). Some specific territorial areas in the Autonomous Regions may benefit from an additional reduction of this rate to 8.75%.

Non-resident entities without a PE are generally subject to a final 25% withholding.

A municipal surcharge (*derrama municipal*) of up to 1.5% of taxable income (to be approved on an annual basis by each municipality) may be applicable.

A state surcharge (*derrama estadual*) is applicable to corporations with a taxable income exceeding EUR1.5 million, as follows:

- Taxable profits higher than EUR1.5 million and up to EUR7.5 million are subject to a 3% surcharge.
- Taxable profits higher than EUR7.5 million and up to EUR35 million are subject to a 5% surcharge.
- Taxable profits in excess of EUR35 million are subject to a surcharge of 9%.

Autonomous taxation may also apply to certain costs and expenses, eg, car usage, travel expenses, amounts paid to entities domiciled in blacklisted jurisdictions, and non-documented expenses (among other costs subject to specific requirements), at rates that vary from 5% to 70%. Tax transparent entities are not subject to CIT but may be subject to autonomous taxation. Individual shareholders of tax transparent entities are liable to PIT at progressive rates up to 48%. A 2.5% and 5% solidarity surcharge applies to taxable income above EUR80,000 and EUR250,000, respectively.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

A resident company is subject to tax on its worldwide income assessed on its taxable income, which is based on the profit and loss accounts made under the applicable accounting framework, adjusted according to the rules set forth in the CIT code. Eligible tax losses from previous years may be carried forward and tax benefits may be deducted from the taxable income.

The tax adjustments mainly refer to non-deductible accounting costs or non-taxable accounting profits.

Non-resident entities with a PE in Portugal are subject to tax on the profit attributable to that PE. For non-resident entities without a PE, the taxable base is calculated on the net sum of the different categories considered separately for PIT purposes.

An optional regime is available to exclude from taxation the profits and losses of a foreign PE of an entity deemed tax resident in Portugal. The regime is not applicable to the profit allocated to the foreign PE up to the amount of the losses attributable to that PE that have been considered by the Portuguese head office in the previous 12 tax years. The optional regime must cover all PEs located in a given jurisdiction and must be maintained for a minimum three-year period.

CIT is also applicable to Portugal-source income attributable to a PE of a non-resident company in Portugal. Special withholding tax (WHT) rates apply to income generated in Portugal that is attributable to non-residents without a PE in Portugal.

2.2 Special Incentives for Technology Investments

SIFIDE II

For resident companies and PEs of non-resident companies, a tax credit for qualifying research and development (R&D) expenses (*Sistema de Incentivos Fiscais à Investigação e Desenvolvimento* – SIFIDE II) is available from 1 January 2014 until 31 December 2025, as follows:

- a base rate credit, corresponding to 32.5% of the R&D expenses incurred in a given year; and
- an incremental credit, equal to 50% of the difference between the R&D expenses incurred during that period and the average of the previous two, capped at EUR1.5 million.

To be eligible for this R&D tax credit, the qualifying investor must comply with certain substantive and formal conditions. Also, the SIFIDE benefit cannot be combined with any other similar tax benefit. Expenses that, due to an insufficient taxable basis, cannot be deducted in a given tax year can be carried forward for 12 years.

Patent Box

The Portuguese patent box regime provides an 85% exemption on the gross income derived from the assignment or temporary use of patents and industrial models or designs, copyrights, and indemnities deriving from the infringement of such IP rights, provided certain requirements are met (eg, the IP rights derive from R&D activities developed internally or contracted and the IP rights must be allocated to a commercial, industrial or agricultural activity). A limitation is applicable through the ratio between the eligible expenses and the total expenses incurred in developing or using the IP rights. The regime is in line with BEPS Action 5, and transactions with associated companies are excluded, including entities resident in a blacklisted territory.

Deductibility of IP Rights Costs

The CIT Code allows for the deductibility of costs associated with the acquisition of IP rights. These include trademarks, licences, production processes, and other similar rights acquired for consideration and without a predetermined life cycle. The costs can be deducted over a 20-year period using a straight-line method.

2.3 Other Special Incentives

Special Tax Incentives Regime

A set of tax benefits focused on the development of investment projects in strategic economic sectors is set out in the Portuguese Investment Tax Code.

These tax benefits may be separated into two regimes.

Contractual tax regime

This regime applies to investments with qualifying expenses of EUR3 million or more, materialised before 31 December 2027, and spanning up to ten years. This regime offers a range of benefits, including:

- a tax credit between 10% and 25% of the project's qualifying expenses, to be deducted from the CIT tax assessment (subject to certain limits);
- during the investment period, an exemption from or reduction in municipal real estate tax and municipal real estate transfer tax; and
- an exemption from or reduction in stamp duty owed on transactions or contracts required to complete the investment project.

Investment support tax regime (RFAI)

This applies to investments carried out in certain regions, provided certain conditions are met, and includes the following benefits:

- a CIT deduction of up to 30% of the qualifying expenses up to EUR15 million and of 10% of the qualifying expenses that exceed EUR15 million;
- during the investment period, an exemption from or reduction in municipal real estate tax and municipal real estate transfer tax; and
- an exemption from stamp duty on the purchase of buildings related to the relevant investment.

Both regimes require the fulfilment of certain requirements and cannot be combined with similar tax incentives.

Incentive for Capitalisation of Companies (ICE)

Companies can benefit from a tax incentive for increasing their capital (equity). This incentive allows a deduction against their taxable profit. The deduction is calculated as a percentage of the net increase in their eligible equity. The percentage used is the average 12-month Euribor rate, plus a 2 percentage point spread, applicable to all companies. An additional deduction is applied in the years 2025 and 2026. The increased deduction of 50% is valid for the year 2025.

There is a cap on the total deduction amount, namely the higher of the following:

- EUR4 million; or
- 30% of the tax EBITDA (earnings before interest, taxes, depreciation and amortisation, adjusted for tax purposes, as defined in Article 67 of the CIT Code).

Any excess can be carried forward for five years. In the event of the net increase in eligible equity being negative, the result is zero, and no deduction shall be applicable.

Wage Increase Incentive (*"Incentivo Fiscal à Valorização Salarial"*)

Companies increasing at least in 4.7% employees' average annual base wage, in comparison with the previous year, benefit from a 200% deduction on the costs associated with the increase of such wages for purposes of assessment of taxable profit, up to an annual maximum of five times the National Minimum Wage per worker (the monthly National Minimum Wage is set at EUR870 for the year 2025).

2.4 Basic Rules on Loss Relief

Carry-back of losses is not allowed. From 2023, losses can be carried forward without any time limit, although they are capped at 65% of taxable income.

Carry-forward is not applicable in case of a change of more than 50% of the share capital or the voting rights of a company, except for operations that have been carried out for sound business purposes, and the above limitation does not apply.

Further, no limitation applies if:

- there is a change from direct to indirect ownership (and vice versa);
- the special tax neutrality regime is applicable to the transaction;
- the change of ownership occurs upon the death of the previous shareholder;
- the acquirer has held, directly or indirectly, 20% of the share capital or the majority of voting rights, since at least the beginning of the tax year in which the tax losses were incurred; or
- the acquirer is an employee or a board member of the acquired company, provided that such person has held that position since at least the beginning of the tax year in which the tax losses were incurred.

2.5 Imposed Limits on Deduction of Interest

An interest barrier rule applies to net financing expenses up to the higher of the following:

- EUR1 million; or
- 30% of the tax EBITDA.

The above limitation is also applicable to PEs of non-resident entities, while entities subject to the supervision of the Portuguese Central Bank and the Portuguese Insurance and Pension Fund Supervisory Authority are excluded.

Net financing expenses exceeding the above thresholds (not deductible) in a certain fiscal year may be carried forward and deducted in the following five tax years provided that, when computing the net financing expenses of that year, the aforementioned limits are not exceeded.

Net financing expenses consist of, inter alia, any amounts due in connection with financing payments, including interest on overdraft facilities, short-term loans, bonds, and financial expenses related to financial leases.

For entities that have adhered to the special regime of group taxation, the net financing expenses may be assessed for the whole group considering the sum of the tax EBITDA of all members, provided that the option is kept for a minimum three-year period. Special rules apply for pre-group and post-group tax years.

2.6 Basic Rules on Consolidated Tax Grouping

Tax grouping is permitted and allows group companies to offset the tax losses incurred by one company against profits of other companies. Tax grouping is available provided that the parent company holds, directly or indirectly, at least 75% of the share capital and more than 50% of the voting rights. For each accounting period covered by the grouping regime, the group's taxable profit is calculated by the dominant company and corresponds to the sum of the taxable income and tax losses recorded in the individual tax returns of each member of the group.

Tax losses prior to the beginning of the tax grouping can be carried forward and offset against the company's taxable income where such loss was accounted for. The regime is also available to a dominant company with a registered seat in an EU or EEA country provided certain requirements are met and a resident company is appointed as representative of the tax group.

Upon termination of the regime, or whenever the grouping ceases to apply to one particular entity, tax losses obtained within the group cannot be offset against individual taxable income of the companies.

2.7 Capital Gains Taxation

Capital gains and losses are treated as business income in Portugal and assessed on the difference between the sales proceeds, net of related costs, and the acquisition value, net of impairment depreciation, adjusted by the inflation index (for assets owned for a minimum two-year period). The positive net difference is included in the yearly taxable income, and a 50% reinvestment regime for tangible fixed assets, and intangible and biological assets held for at least one year, may be available.

A participation exemption regime is available for capital gains deriving from the disposal of shares, provided that the following requirements are met:

- the parent company holds, directly or indirectly, at least 10% of the share capital or voting rights of its subsidiary;
- the shares have been held continuously for a minimum holding period of at least 12 months;
- the shareholder is not deemed a transparent entity;
- the subsidiary is not resident in a blacklisted jurisdiction;
- the subsidiary is subject to, and not exempt from, an income tax listed in the EU Parent-Subsidiary Directive or an income tax rate not lower than 60% of the Portuguese CIT rate (ie, 12%, given the standard rate of 20%); and
- the non-resident entity is not part of an artificial arrangement whose main purpose is to obtain a tax advantage.

Capital gains and losses covered by the participation exemption regime are excluded from the annual taxable income of the Portuguese entity.

The above regime is not applicable to corporations more than 50% of whose assets consist of real estate located in Portugal, except if they are allocated to an agricultural, industrial or commercial activity.

2.8 Other Taxes Payable by an Incorporated Business

Property tax is a municipal property tax on the tax value (TV) of urban and rural properties located in Portuguese territory. Property tax is payable by the real estate owner, the usufructuary, or the holder of the surface right of a real estate unit with reference as of 31 December of the year to which it pertains. Rates vary from 0.3% to 0.45% of the TV for urban properties, while a 7.5% rate applies to properties owned by entities located in blacklisted jurisdictions.

Additional property tax is payable by individuals and corporations, as well as by structures or collective undertakings and undivided inheritances, that are owners, usufructuaries, or holders of surface rights of urban properties. Additional property tax is not applicable to properties registered for commercial or industrial activities.

The taxable basis corresponds to the sum of the TV of all the urban properties held by each taxpayer, reported as of 1 January each year, and the applicable rates vary from 0.4% for corporations, to 0.7% for individuals and undivided inheritances, to 7.5% for urban properties owned by entities located in blacklisted jurisdictions.

Transfer property tax is a municipal tax levied on the onerous transfer of real estate located in Portuguese territory. The tax is payable by the acquirer and is calculated on the higher of the TV or the agreed price. In the event of the acquisition of at least 75% of a Portuguese company's shares, where more than 50% of that company's assets are either directly or indirectly derived from real estate located in Portugal, the transfer property tax becomes applicable. However, this is contingent on the real estate not being allocated to a commercial activity. Additionally, the acquisition of at least 75% of the units of closed-ended real estate investment funds triggers the transfer property tax, with rates of 6.5% or 10% for transactions involving acquirers located in a blacklisted jurisdiction.

Stamp duty is applicable to a wide variety of acts, transactions and documents, provided they are deemed to have occurred or are signed in Portuguese territory (eg, loans, leases, securities, transfers of a going concern, etc), and provided they are not subject to VAT. Rates are based on a percentage and specified in the Stamp Duty Schedule.

2.9 Incorporated Businesses and Notable Taxes

VAT is due on the supply of services, sale of goods and importation into Portuguese customs territory at a standard 23% rate. Reduced rates may apply to certain essential goods and services.

Customs duties on importation and excise duties are also applicable to certain products such as oil and energy products, alcohol and alcoholic beverages, tobacco and vehicles.

Also, employers are required to make monthly social security contributions at the standard rate of 23.75% on the monthly gross remuneration paid to their employees.

Social security contributions are deductible for CIT purposes. A carbon tax due by the user in the amount of EUR2 applies to air, sea and river travel.

There are also certain sector-specific contributions, namely in the financial, energy, telecoms and pharmaceutical sectors.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses mostly operate under a corporate form.

3.2 Individual Rates and Corporate Rates

As mentioned in **1.2 Transparent Entities**, professional firms are mandatorily subject to the tax transparency regime. Taxable income is assessed under the rules set forth in the CIT

Code, while net income is attributed to the shareholders, at the progressive PIT rates.

Outside the scope of listed professional activities, nothing prevents an individual investor from incorporating an individual limited liability company (*sociedade unipessoal por quotas*), subject to 20% CIT on the net profit, while the subsequent distribution of dividends shall be taxed at the autonomous rate of 28% for PIT purposes (with the option to aggregate the dividends to other categories of income and subject to the progressive PIT rates).

3.3 Accumulating Earnings for Investment Purposes

There are no rules to prevent the accumulation of earnings, and until 2023, a tax incentive was in place applicable to micro and small to medium-sized enterprises granting a CIT deduction of 10% of the retained and reinvested earnings (up to a maximum of EUR5 million per year) used to acquire qualifying assets.

Retained earnings may fall within the scope of the CFC rules if the closely held corporation is resident in a blacklisted jurisdiction (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**).

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends are generally subject to a final 28% withholding tax. Dividends paid by non-resident entities to resident individuals are also subject to a flat rate of 28% (a tax credit to avoid or reduce international double taxation is usually available). A higher 35% rate may apply to dividends received from blacklisted jurisdictions.

If the resident shareholder opts to aggregate dividends with their annual taxable income, for dividends from resident entities and companies resident within the EU or EEA, a 50% relief is available and the dividends shall be subject to the progressive PIT rates up to 48% (plus surtax, if applicable).

As to capital gains, the annual positive difference between capital gains and losses on the disposal of shares is subject to a special tax rate of 28%, unless the taxable person opts to aggregate the net gains on his or her annual taxable income, subject to the personal income progressive rates up to 48% (plus solidarity surtax, if applicable).

Capital gains from the sale of shares in micro and small to medium-sized enterprises resident in Portugal and within the EU/EEA benefit from a 50% tax relief, resulting in an effective tax rate of 14%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The same tax treatment applies as set out in previous sections.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Dividends, interest and royalties paid to non-resident companies are subject to a 25% CIT withholding, while a higher 35% rate applies to payments made to undisclosed third parties or if the beneficiary is resident in a blacklisted jurisdiction.

Under the participation exemption regime, an exemption is available on the distribution of dividends, provided the following requirements are met:

- the parent company holds, directly or directly, at least 10% of the capital or voting rights of the other company;
- the shares have been held continuously for at least 12 months;
- the shareholder is not a transparent entity;
- the entity that distributes dividends is not resident in a blacklisted jurisdiction; and
- it is subject to, and not exempt from, an income tax listed in the EU Parent-Subsidiary Directive or an income tax rate not lower than 60% of the Portuguese CIT rate.

The exemption under the participation exemption regime is also available to dividends paid to a PE in another EU or EEA country. Dividends from non-qualifying participations will be subject to tax, but a tax credit may be available.

Interest and royalties may also benefit from a withholding exemption under the EU Interest and Royalties Directive, provided that the following requirements are met:

- an equity stake of at least 25% is directly held by one of the companies or a third entity holds the same equity interest in the share capital of both entities for a minimum holding period of two years;
- the entity that receives the interest and/or royalties must be the effective beneficial owner;
- both the paying entity and the receiving entity must be deemed resident within the EU; and
- both entities must be subject to, and not exempt from, an income tax listed in the EU Interest and Royalties Directive and adopt one of the legal forms listed in the Directive.

The above exemptions applicable to dividends, interest and royalties are not available in case of an arrangement or series of arrangements whose purpose is to obtain a tax advantage that defeats the purpose of eliminating double taxation, and such arrangement or series of arrangements is not regarded as genuine. An arrangement or series of arrangements, if it is not carried out for valid economic reasons and has no economic substance, shall not be regarded as genuine.

4.2 Primary Tax Treaty Countries

Portugal has entered into 79 DTTs, while the treaty with Kenya has not yet entered into force. According to the information publicly available, the primary tax treaty countries utilised by investors are the Netherlands, Spain, Luxembourg, the UK, France, Brazil, Belgium, Germany, Ireland, Switzerland, the USA and Italy.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Portuguese tax authorities have been increasing their focus on tackling cross-border abusive practices and preventing treaty shopping practices. According to the 202 *"Fight Against Fraud and Tax and Customs Evasion Report"* released by the Portuguese government in July 2024, the focus has been on identifying and curtailing abusive tax planning and treaty shopping. This includes scrutinising the actual place of effective management, adherence to substance requirements, identification of the ultimate beneficial owner of income, and utilising mechanisms such as information exchange, derogation of bank secrecy, and applying limitations on treaty benefits. The report includes specific recommendations to define a strategy to control tax benefits for investment and to improve the mechanisms for controlling tax fraud risk linked to real estate leases. Regarding major taxpayers, the following were defined as key areas under audit:

- Capital losses on the transfer of equity instruments of entities subject to a clearly more favourable tax regime
- The unlawful use of the benefits of Council Directive 2003/49/EC of 3 June 2003, and/or DTTs
- Transfer pricing regime
- CFC rules
- GAAR

4.4 Transfer Pricing Issues

The main transfer pricing issues relate to management and licensing fees and intra-group arrangements. The Portuguese tax authorities have already ruled out that intra-group service agreements should be covered by advance pricing agreements (APAs) in a tax ruling issued in the end of year 2023.

4.5 Related-Party Limited Risk Distribution Arrangements

Risk distribution arrangements are increasingly subject to scrutiny and also covered by APAs.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The OECD guidelines are generally enforced as Portugal follows the OECD standards.

4.7 International Transfer Pricing Disputes

Specific transfer pricing tax audits are relatively uncommon, although transfer pricing documentation is frequently requested and scrutinised by the Portuguese tax authorities.

According to OECD data (cf *"2023 Mutual Agreement Procedure Statistics"*), most mutual agreement procedures (MAPs) ended with an agreement fully eliminating double taxation. Most transfer pricing MAPs are with Spain, Italy, Germany, Belgium and the UK.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Correlative adjustments are mandatory under Portuguese tax legislation whenever a transfer pricing adjustment is made to the taxable profit of the related party.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Local branches are taxed similarly to subsidiaries of non-resident corporations. A few specific rules on the taxation of PEs of foreign entities must be considered, namely:

- Income remitted by a branch to its head office is not subject to withholding tax.
- As a general rule and following certain criteria, general administrative expenses incurred by the head office may be allocated to the branch.
- There may be certain restrictions concerning the deductibility of certain expenses (such as interest and royalties) charged by the head office to the branch.

5.3 Capital Gains of Non-Residents

Capital gains obtained by non-resident entities on the disposal of equity stakes held in Portuguese companies may be exempt from tax in Portugal, provided that none of the following circumstances is the case:

- More than 25% of the non-resident company is owned, directly or indirectly, by Portuguese tax residents.
- The non-resident company is domiciled in a blacklisted jurisdiction.
- The capital gains derive from the direct or indirect disposal of shares in a resident company, where more than 50% of the company's assets consist of real estate located in Portugal.

Should the exemption not apply, capital gains obtained by non-resident entities are subject to CIT at a 25% rate. Indirect disposal of Portuguese equity stakes may be subject to tax provided that more than 50% of the value of the shares derives from immovable property located in Portugal and is allocated to a commercial activity during the 365 days preceding the sale.

5.4 Change of Control Provisions

The Portuguese tax legislation establishes certain change to control provisions, notably:

- a limitation on the carry-forward of tax losses in case of a change of ownership of 50% or more of the target company's stock or the majority of the voting rights;
- impact on the composition of a tax group; or
- forfeiture of unused deductions under the interest barrier rule upon a change of ownership of 50% or more of the equity stake or voting rights.

Outside the scope of these specific anti-abuse provisions, changes of control do not trigger any adverse tax consequences.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Locally owned companies and foreign-owned local affiliates are subject to the same rules for the purposes of the assessment of the respective taxable income.

5.6 Deductions for Payments by Local Affiliates

Payments made by local affiliates to non-resident affiliates related to management and administrative expenses are generally deductible provided they are directly linked to the corporate purpose and the company's commercial activity and are properly documented. These transactions need to be completed in line with the arm's length principle and additional limitations apply to affiliates resident in blacklisted jurisdictions, as the taxpayer has the burden of proof to evidence that the transaction is material and carried out for sound business purposes.

5.7 Constraints on Related-Party Borrowing

Intra-group borrowing needs to comply with transfer pricing regulations and with the ultimate beneficial owner requirement under the EU Interest and Royalties Directive, and a higher 35% withholding tax applies to interest paid to affiliates located in a blacklisted jurisdiction. Additionally, the interest rate on shareholder loans is capped at the 12-month Euribor rate plus a 2 percentage point spread (6 percentage points for SMEs).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Resident entities are subject to CIT on their worldwide income, which is assessed on the yearly net accounting profits as amended for tax purposes.

Portugal adopts, as a rule, the credit method, and therefore international double taxation relief is achieved through a credit deduction to be offset against foreign-sourced income included in the company's taxable basis. The tax credit, assessed on a country basis, corresponds to the lower of the following amounts:

- the income tax paid abroad; or
- the CIT portion assessed before the deduction, corresponding to the net income that may be taxed in the source country.

Whenever a DTT is applicable, the tax credit may not exceed the tax that should have been paid abroad according to the terms set out under the DTT. Any excess credit that has not been offset may be carried forward for a five-year period.

The exemption method is applicable for dividends, capital gains deriving from the disposal of shares obtained by non-resident shareholders and profits of outbound PEs.

6.2 Non-Deductible Local Expenses

The symmetric refusal of deduction of local expenses is applicable to taxpayers that have elected the exemption method for foreign PEs' profits.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends received by a corporate shareholder shall be included in the taxable base and subject to CIT.

If the participation exemption regime applies, inbound dividends obtained by resident companies may be excluded from CIT, provided the following conditions are met:

- The Portuguese shareholding company holds at least 10% of the share capital or voting rights of the distributing entity.
- The participation has been continuously held in the year prior to the distribution of the dividends (or, if held for a shorter period, is held long enough to complete the one-year period).
- The Portuguese shareholding company is not subject to a tax transparency regime.
- The distributing entity is subject to and not exempt from CIT, or any of the corporate income taxes referred to in the EU Parent-Subsidiary Directive, or a tax of a similar nature with a rate not lower than 60% of the Portuguese CIT rate (ie, 12%); this condition is not applicable if the permanent establishment is deemed incorporated for valid economic reasons in accordance with the definition laid down for CFC purposes.
- The distributing entity is not a resident in a blacklisted jurisdiction.

Where the participation exemption is not applicable, the double taxation may be waived by means of a tax credit.

Following a legislative authorisation approved in July 2024, it was expected that the participation exemption threshold would be reduced from 10% to 5%; however, the alteration was rejected by the Portuguese Parliament.

6.4 Use of Intangibles by Non-Local Subsidiaries

When transferring, assigning or using intangibles developed by resident entities for the benefit of non-resident subsidiaries, the arm's length principle must be adhered to, and the resulting income must be included in the taxable basis. The patent box regime may apply, as described in **2.2 Special Incentives for Technology Investments**.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Portuguese CFC rules are aligned with the Anti-Tax Avoidance EU Directive.

Profits or income derived by an entity resident in a blacklisted jurisdiction, or in a jurisdiction where it is subject to an effective taxation below 50% of the taxation that would have been applied if such entity were resident for tax purposes in Portugal, are allocated to the Portuguese taxpayer, provided it holds, directly or indirectly, at least 25% of the share capital, voting rights, or rights on income or assets of that entity.

CFC rules do not apply if the CFC is resident in another EU or EEA member state, provided that the CFC engages in genuine business or commercial activities for sound business reasons, with its own personnel and premises.

Any income tax paid in the state of residence of the CFC may be offset against the tax due in Portugal, although any unused tax credit cannot be carried forward to subsequent tax years.

6.6 Rules Related to the Substance of Non-Local Affiliates

Besides CFC rules mentioned in previous sections and the effective place of management provision, there are no specific rules addressing substance requirements of non-local affiliates.

The expected approval and implementation of the ATAD 3 Directive will introduce within the EU a harmonised set of substance tests.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains obtained by local companies on the sale of non-resident affiliates may be excluded from CIT under the participation exemption regime, as described in **2.7 Capital Gains Taxation**.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Portuguese GAAR provision disregards, for taxation purposes, artificial arrangements that are not grounded in valid economic reasons, are abusive in form or substance and whose main purpose is to obtain a tax advantage that otherwise would not be achieved, in whole or part, without the use of such artificial or fraudulent means. In these cases, the Portuguese tax authorities shall deem such artificial or fraudulent arrangements ineffective for tax purposes and, as a result, the income from said arrangements will be taxed in accordance with the rules applicable to the equivalent taxable events that would have been chosen if the tax advantage had not been pursued. The above regime is also extended to the paying entity, whenever such entity should have been aware of the artificial series of arrangements that triggered the application of the GAAR provision. This follows a special procedure under the Tax Procedural Code.

Besides the GAAR, Portugal has several specific anti-abuse provisions, notably on payments made to entities in blacklisted jurisdictions, higher withholding and tax rates, tax losses, change of control provisions, denial of application of tax neutrality regimes, CFC rules, and refusal to deduct certain expenses, just to name a few.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Tax audits need to be initiated within the four-year statute of limitations. Despite not being subject to routine audit cycles, large taxpayers, as defined by Ministerial Order, are monitored by a special tax unit and subject to regular tax audits.

The Portuguese tax authorities annually approve a National Plan of Activities of the Tax Inspection (*Plano Nacional de Atividades da Inspeção Tributária*, or PNAIT). This plan sets the priorities for tax inspections each year, identifying specific sectors, actions and targets.

9. BEPS

9.1 Recommended Changes

Portugal has already implemented a number of changes in line with BEPS recommendations, namely:

- implementation of VAT on B2C digital services (under BEPS Action 1);
- anti-hybrid rules (under BEPS Action 2);
- CFC rules (under BEPS Action 3);
- earnings-stripping rules to limit interest deductibility (under BEPS Action 4);
- revised patent box regime (under BEPS Action 5);
- anti-treaty shopping provisions (under BEPS Action 6);
- obligation to disclose aggressive tax planning schemes (under BEPS Action 12);
- mandatory country-by-country reporting (under BEPS Action 13);
- signature of the Multilateral Instrument – MLI, in force since June 2020 (under BEPS Action 15); and
- introduction of global minimum tax (under BEPS 2.0 – Pillar 2).

9.2 Government Attitudes

The Portuguese government has been consistently adopting and implementing the OECD BEPS Action Plan and BEPS 2.0 into domestic law, with the purpose of enhancing transparency and preventing aggressive tax planning.

In November 2024, Law 41/2024 of 8 November transposed Council Directive (EU) 2022/2523 of 14 December 2022 into domestic legislation, ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups, reinforcing the efforts to tackle aggressive tax planning. Law 41/2024 ensures the application of a global minimum tax when the effective tax rate of a covered group, in any of its jurisdictions, is lower than 15%.

Portugal exercised the option to implement the undertaxed profits rule (UTPR) in the form of a complementary tax, rather than a disallowance of deductions for income tax purposes.

The global minimum tax includes three key elements:

- an income inclusion rule (IIR), according to which the parent entities of large-scale multinational or domestic groups must pay a complementary tax in relation to group entities resident in low-tax jurisdictions;
- a UTPR, which requires Portuguese entities of large-scale multinational groups to pay a portion of any complementary tax not assessed under the IIR; and
- the Portuguese complementary national qualified tax (ICNQ-PT), which sets a supplementary tax on Portuguese low-tax entities, requiring the 15% to be paid in Portugal

(rather than at the level of the parent entity through the IIR or other entities through the UTPR).

The legislation includes the option for a safe harbour based on country-by country reporting for tax years beginning on or before 31 December 2026 and ending on or before 30 June 2028.

There are specific fines for companies that do not fulfil their obligations to submit the relevant tax returns. Failure to submit a tax return or late submission may trigger penalties ranging from EUR5,000 to EUR100,000, plus 5% for each day of delay. Errors or omissions may trigger penalties ranging from EUR500 to EUR23,500. Penalties may be waived in the first year of application of the new rules (tax years beginning on or before 31 December 2026 and ending on or before 30 June 2028) provided that certain conditions are met.

In July 2024, the government approved a package of 60 measures to boost the Portuguese economy, including some measures on tax issues, such as: (i) gradually reducing the corporate income tax to 15%; (ii) creating a VAT group regime; (iii) reviewing the fiscal deductibility regime for goodwill; (iv) expanding access to the participation exemption regime; and (v) providing tax deductions for capital gains and dividends earned by individuals in the capitalisation of companies.

In January 2025, the government approved a set of 30 measures intended to simplify some tax rules and regimes. Regarding corporate tax, we would highlight the following: (i) simplification of the Annual Accounting Return (IES); (ii) pre-filling of the Model 22 declaration form with the tax losses generated in previous years; and (iii) harmonisation of deadlines for compliance with reporting obligations, among other improvements on the tax authorities' website.

9.3 Profile of International Tax

Over the last decade, Portugal has concluded a tax reform in 2014, reshaped the tax regime applicable to collective undertakings, refreshed its transfer pricing regulations and continued to enter into DTTs (currently 79 in total), and has in place 12 exchange of information agreements. The DTTs and investment agreements with African Portuguese-speaking countries are also a key element of Portuguese international tax policy.

9.4 Competitive Tax Policy Objective

Please see **9.3 Profile of International Tax**. Despite the European Commission's decision to recover unlawful tax benefits granted in the years 2014-2017, the State Budget for 2025 extended the Madeira Free Trade Zone scheme to new entities licensing until 31 December 2026. It is expected that the preferential tax scheme – which provides a reduced corporate tax rate of 5% – will stay in force until the end of 2028.

There is increasing focus on attracting new investments in technology and innovation, with the SIFIDE incentives, the patent box and the new legal framework approved for start-ups and mid-cap companies.

Although more modest than expected, the State Budget for 2025 brought in a 1% reduction in the statutory CIT rate and introduced changes to some incentives already in force (such as the Incentive for Capitalisation of Companies).

9.5 Features of the Competitive Tax System

Portugal has several tax incentives in force, some of them specifically designed to attract investment to certain zones of the country. As a member of the EU, Portugal is subject to several restrictions when granting tax benefits.

A recent example is the Madeira Free Trade Zone case, where the European Commission has challenged the benefits offered under European state aid restrictions legislation, with significant repercussions for several companies, both national and international.

9.6 Proposals for Dealing With Hybrid Instruments

Anti-hybrid mismatch arrangement rules were implemented in Portugal by means of Law 24/2020 of 6 July 2020, which transposed into national legislation the European Anti-Tax Avoidance Directive ATAD I, as amended by ATAD II. These rules were introduced into the CIT Code and came into force in January 2022.

9.7 Territorial Tax Regime

Portugal does not have a territorial tax regime as resident companies are subject to CIT on their worldwide income. However, a global participation exemption regime applies in Portugal to dividends obtained by Portuguese entities (inbound) and capital gains, provided some requirements are met (see **2.7 Capital Gains Taxation** and **4.1 Withholding Taxes**).

9.8 Controlled Foreign Corporation Proposals

Portugal does not have a territorial tax system; however, it has adopted CFC rules in line with BEPS Action 3 (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**).

9.9 Anti-Avoidance Rules

Portugal has included *"limitation on benefits"* clauses in some DTTs, in line with the commitments taken within the OECD's BEPS recommendations, particularly Action 6. This framework is further strengthened through the MLI, ensuring all new DDTs adopt the Principal Purpose Test.

Also, over the years, the Portuguese tax authorities have become more aware of abusive treaty shopping practices and have intensified scrutiny of abusive arrangements.

9.10 Transfer Pricing Changes

The transfer pricing regulations were amended in November 2021 to accommodate the 2017 OECD Transfer Pricing Guidelines. The previous regulations were already consistently enforced by the courts and the Portuguese tax authorities in line with OECD standards. Transfer pricing controversy in Portugal is still relatively nascent, particularly in areas related to IP rights.

9.11 Transparency and Country-by-Country Reporting

Portugal has adopted several measures to promote a tax transparent legal environment, notably through the adoption of exchange of information mechanisms and mandatory disclosure rules. Decree-Law No 73/2023 has recently transposed the EU Public Country-by-Country Reporting Directive into national legislation, enacting new reporting obligations for multinational enterprises carrying out activities in Portugal. Since June 2024, companies meeting certain criteria have to publicly disclose information related to the activity carried out, income obtained and effective tax paid. The reporting obligations apply, firstly, to multinational enterprises with a consolidated revenue of EUR750 million or more over the last two financial years.

The effectiveness of these regulations is yet to be assessed. A key consideration will be finding a balanced approach that promotes co-operation, transparency and public scrutiny, while also avoiding imposing excessive administrative and reporting burdens on corporations.

9.12 Taxation of Digital Economy Businesses

Law No 36/2023 of 26 July 2023 transposed EU Directive 2021/514 (DAC 7) into national legislation. Under this legal framework, digital platform operators are required to provide information to the Portuguese tax authorities regarding transactions carried out by their customers. Sellers of goods with fewer than 30 transactions and an aggregate turnover below EUR2,000 per reporting period are excluded from these obligations. The first reporting obligation was due by 31 January 2024. Failure to disclose mandatory information may result in fines ranging from EUR500 to EUR22,500.

9.13 Digital Taxation

Please refer to **9.1 Recommended Changes** and **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Domestic tax law does not set out any specific provisions to deal with the taxation of income from offshore intellectual property, other than the higher 35% withholding tax for payments made to entities resident in blacklisted jurisdictions.

SINGAPORE

Law and Practice

Contributed by:
Yang Shi Yong
Drew & Napier LLC

Contents

Drew & Napier LLC is one of the largest law firms in Singapore and has been providing exceptional legal service and representation to discerning clients since 1889. The firm is consistently ranked in the top tier by major international publications and the calibre of its work is acknowledged internationally at the highest levels of government and industry. Drew & Napier's tax and private client services practice is the broadest full spectrum tax law advisory team in Singapore, encompassing tax litigation, corporate tax advisory, enterprise tax risk management, and private wealth planning, presenting clients with a comprehensive and seamless service. In 2020, Drew & Napier also united with some of the most influential leading law firms in South-East Asia to form a network of blue-chip law firms – Drew Network Asia (DNA), which operates as *"a firm of firms"* with international perspective and strong local expertise.

Author

Yang Shi Yong is a director in Drew & Napier's tax and private client services practice. Shi Yong advises on a wide spectrum of tax law including corporate and personal income tax, goods and services tax, property tax, stamp duties, and customs and excise duties, with particular specialisation in Singapore enterprise tax risk management, tax audits, and tax investigation matters. He possesses a wealth of experience in advisory on all tax types, including customs and excise duties, well-rounded knowledge of Singapore tax law and strong management skills. He is regularly engaged on contentious and complex tax audit and investigation matters.

Drew & Napier LLC

10 Collyer Quay
#10-01 Ocean Financial Centre
Singapore
049315

Tel: +65 6535 0733
Fax: +65 6535 4906
Email: mail@drewnapier.com
Web: www.drewnapier.com

DREW & NAPIER

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Business vehicles are chosen based on commercial needs. The types of vehicles include sole proprietorships, partnerships, companies and variable capital companies.

Key Features of Sole Proprietorships

In a sole proprietorship, the business is owned by an individual. The sole proprietorship is not a separate legal entity, and the owner has unlimited liability. For income tax purposes, income derived from the sole proprietorship will be taxed in the hands of the owner.

Key Features of Partnerships

There are three types of partnerships: general partnership, limited liability partnership and limited partnership. A general partnership requires between two and twenty partners. A limited liability partnership requires at least two partners, with no upper limit on the number of partners. A limited partnership requires at least one general partner and one limited partner, with no upper limit on the number of partners.

A general partnership and limited partnership are not separate legal entities from their partners while a limited liability partnership is. Partners in a general partnership and general partners in a limited partnership have unlimited liability. In contrast, partners in a limited liability partnership and limited partners in a limited partnership have limited liability.

For income tax purposes, partnerships are tax transparent. Income derived from partnerships is taxed in the hands of the partners.

Key Features of Companies

A company is a separate legal entity. There are three types of companies: private company, exempt private company and public company.

A private company has a maximum of 50 shareholders and has a constitution restricting the right to transfer its shares. An exempt private company is a private company which has a maximum of 20 individual shareholders and no corporate shareholders. A public company is a company that is not a private company and can have more than 50 shareholders.

For income tax purposes, these three types of companies are taxed as separate legal entities.

Key Features of Variable Capital Companies

A variable capital company (VCC) is a new corporate entity tailored for investment funds. With this, Singapore fund managers can domicile funds locally to enjoy cost economies and reduced compliance hurdles. A variable capital company can be either a standalone fund or an umbrella fund with many sub-funds. The latter creates cost savings because the sub-funds can share a common board of directors and engage the same service providers.

Unlike companies, variable capital companies can vary their share capital without investors' approval. This gives investors the flexibility to exit their investments in the funds when they wish to do so. Additionally, unlike companies which must pay dividends out of profits, variable capital companies can pay dividends out of capital. This allows investment funds to fulfil their dividend payment schedules.

For income tax purposes, a variable capital company is treated as a company incorporated or registered under any law in force in Singapore or elsewhere. For goods and services tax (GST) purposes, each sub-fund of an umbrella VCC is treated as a separate person that is required to assess its GST registration lability based on the value of its taxable supplies. Taxable supplies made by the first-mentioned sub-fund to another sub-fund of the same VCC is taken to be a supply made by one person to another person. For stamp duty purposes, each sub-fund of an umbrella VCC is also treated as a separate legal entity.

1.2 Transparent Entities

Limited partnerships and limited liability partnerships are commonly used by professional services firms and in fund structures. For example, private equity funds may use partnerships as part of a master-feeder fund structure to qualify for a tax incentive under Section 13U of the Income Tax Act 1947 (the *"Act"*).

1.3 Determining Residence of Incorporated Businesses

Companies

A company is a Singapore tax resident if its control and management is exercised in Singapore in the preceding calendar year. The concept of control and management is not defined in the Act but is generally taken to refer to the location where the board of directors' powers of control and management are exercised. This is a question of fact to be determined by the circumstances of each case.

Tax Transparent Entities

Tax transparent entities, such as partnerships, do not have a separate identity for income tax purposes. Instead, one has to determine the partners' tax residency.

An individual partner is a Singapore tax resident if, in the preceding calendar year, they reside (except for reasonable temporary absences) in Singapore, or they are physically present or exercise employment in Singapore for at least 183 days. Foreigners are considered Singapore tax residents under two administrative concessions:

- they stay or work in Singapore continuously for three consecutive years; or
- they work in Singapore for at least 183 days for a period straddling two calendar years (subject to other conditions).

A corporate partner's tax residency is determined in the same manner as a company.

1.4 Tax Rates

Companies

The corporate tax rate is 17%. Companies may be exempt from tax on certain types of income. They may also be taxed at a concessionary rate on qualifying income under the various tax incentives.

Tax Transparent Entities

The tax rate for tax transparent entitles, such as a partnership, will depend on the profile of the partner.

An individual partner who is a Singapore tax resident is taxed progressively, with the top marginal tax rate at 24%. An individual partner who is not a Singapore tax resident will be taxed at a flat rate of 24% on their trade income.

A corporate partner's tax rate is the same as that of a company.

Sole Proprietorship

The tax rate of a sole proprietor is the same as that of an individual partner.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Singapore taxes income based on source and receipt. The source basis applies to income, such as gains and profits from trade, employment and interest, which accrues in or is derived from Singapore. The receipt basis applies to income received in Singapore from outside Singapore, such as when it is remitted into Singapore.

Taxable profits are calculated based on accounting profits after making tax adjustments. The usual tax adjustments include the adding back of non-deductible expenses, non-taxable receipts, and current and brought-forward capital allowances, losses and approved donations.

2.2 Special Incentives for Technology Investments

In addition to the usual tax deduction for R&D expenses, various additional deductions may be available (subject to conditions) for intellectual property and R&D expenses, including:

- an additional deduction of 300% on up to SGD400,000 of qualifying intellectual property registration costs (excluding government grants or subsidies) incurred in the basis period until the year of assessment 2028;
- an additional deduction of 300% on up to SGD400,000 of expenses (excluding government grants or subsidies) to license from another person of any qualifying intellectual property rights (excluding trade marks and software user rights) until the year of assessment 2028; and
- an additional deduction of 300% on up to SGD400,000 of staff costs and consumables for in-house R&D conducted wholly in Singapore, and another additional deduction of 150% on the balance of qualifying expenses in excess of SGD400,000 until the year of assessment 2028.

In lieu of the tax deductions for R&D, eligible businesses may instead opt to convert up to SGD100,000 of the total qualifying expenditure for each year of assessment into cash at a conversion rate of 20%. The non-taxable cash payout is capped at SGD20,000 per year of assessment until year of assessment 2028.

2.3 Other Special Incentives

There are various tax incentives available for different industries, including those explained below.

- The financial sector incentive (FSI) scheme, which applies to licensed financial institutions such as banks and fund managers. The FSI scheme was extended to 31 December 2028 and provides for concessionary tax rates of 10% and 13.5% for new and renewal awards approved on or after 1 January 2024. The applicable rate depends on the applicable FSI scheme relevant to the qualifying FSI activity.
- The global trader programme (GTP) scheme, which applies to companies engaged in the business of international trading of commodities or commodities derivatives, or of brokering international trades in commodities, or both. The GTP scheme provides for concessionary tax rates of 5% 10% or 15% (for awards approved on or after 17 February 2024) on prescribed qualifying transactions.
- The finance and treasury centre (FTC) scheme, which applies to companies providing treasury, investment or financial services in Singapore. The FTC scheme provides for a concessionary tax rate of 8% or 10% on

income derived from qualifying FTC services to approved network companies and qualifying FTC activities carried out by the financial and treasury centre company for its own account with funds obtained from qualifying sources.

2.4 Basic Rules on Loss Relief

Carry Forward

Any unabsorbed losses can be carried forward indefinitely to be deducted against the statutory income in the following year of assessment, subject to the fulfilment of the shareholding test, where at least 50% of the total number of issued shares of the company must be held by the same persons on:

- the last day (ie, 31 December) of the year in which the loss was incurred; and
- the first day (ie, 1 January) of the year of assessment in which such loss would be deducted.

A company may apply for the shareholding test to be waived if there were genuine commercial reasons for the substantial change in shareholders, and this was not undertaken merely to obtain a tax advantage.

Carry Back

Current year unutilised losses of up to SGD100,000 can be carried back for one year of assessment immediately preceding the year of assessment in which the losses were incurred. To carry back losses, an irrevocable election must be made by the time the income tax return is lodged. This is subject to the fulfilment of the same shareholding test on:

- the first day (ie, 1 January) of the year in which the loss was incurred; and
- the last day (ie, 31 December) of the year of assessment in which the loss would be deducted.

To carry back current year unutilised losses, the company must also continue to carry on the same trade or business for which the losses were incurred.

Offset of Income Losses Against Capital Gain

Where a capital gain on the sale of a foreign asset is taxable in Singapore, losses incurred by the seller entity from the sale or disposal of any other foreign asset can be deducted from such gains. This applies where had such other sale or disposal resulted in capital gains and all of those gains had been received in Singapore, they would have been chargeable to tax in Singapore. Certain other exceptions also apply.

2.5 Imposed Limits on Deduction of Interest

Interest expenses are generally deductible if they are incurred wholly and exclusively in the production of income. Interest expenses from non-income producing assets will not be deductible. As an administrative concession, the Singapore tax authorities do not require taxpayers to identify the interest expense incurred from income-producing assets. Instead, taxpayers may use the total asset method to attribute common interest expenses to their assets. Under the total asset method, the proportion of common interest expenses that is attributable to income producing assets is deductible. In contrast, the proportion of common interest expenses that is attributable to non-income producing assets is not deductible.

Singapore does not impose thin capitalisation rules. However, the interest rates of the loans between related parties must either be at arm's length or an indicative margin published by the Singapore tax authorities.

The arm's length interest rate is the interest rate which would be imposed if the parties were not related parties and were dealing independently with each other under similar circumstances at the time the indebtedness arose.

2.6 Basic Rules on Consolidated Tax Grouping

There is no consolidated tax grouping in Singapore.

However, subject to meeting certain qualifying conditions, a Singapore-incorporated company may make an irrevocable election to transfer its unutilised current year capital allowances/losses/approved donations under the group relief system to be deducted against the assessable income of another Singapore-incorporated company from the same group.

The transferor and transferee companies are members of the same group if one holds 75% of the other, or a third Singapore company holds 75% in each of the companies. Further, the holder must be entitled to at least 75% of:

- any residual profits of the other company available for distribution to that company's equity holders; and
- any residual assets of the other company available for distribution to that company's equity holders on a winding up.

2.7 Capital Gains Taxation

Capital gains from the sale or disposal of foreign assets that occur on or after 1 January 2024 are taxable in Singapore where such proceeds are received in Singapore. Such gains are only taxable if the selling/disposing entity does not have adequate economic substance in Singapore or the gains were derived from the disposal of foreign intellectual property rights. This applies to sellers that are members of corporate groups that are not all incorporated, registered or established in a single jurisdiction, or if any entity in that group has a place of business in more than one jurisdiction. Capital gains from the sale of assets situated in Singapore would not be taxable. Other exemptions may apply.

In ascertaining whether gains from a transaction are revenue or capital in nature, the Comptroller may examine the characteristics of the transaction according to certain factors known as the *"badges of trade"*. These include:

- the taxpayer's motive;
- the financing method;
- the frequency of similar transactions;
- the duration of ownership; and
- the reasons for the realisation.

Whether a transaction is revenue or capital in nature is a question of fact – the badges of trade should be considered holistically, and no single factor is determinative.

2.8 Other Taxes Payable by an Incorporated Business

An incorporated business may be liable to pay other taxes on a transaction. These include:

- GST of 9% on:
  - (a) any supply (except an exempt supply) of goods or services made in Singapore by GST-registered persons in the course or furtherance of their business;
  - (b) any business-to-business (ie, supplies made to GST-registered persons) supplies of imported services under the reverse charge regime; and

(c) any business-to-consumer (ie, supplies made to non-GST registered persons) supplies of imported services under the overseas vendor registration regime;

- stamp duty on agreements for the sale of shares, and the purchase or disposal of immovable properties; and
- additional conveyance duty for the purchase or disposal of shares in property-holding entities owning primarily prescribed immovable properties.

2.9 Incorporated Businesses and Notable Taxes

In addition to the taxes that an incorporated business may pay on a transaction (see **2.8 Other Taxes Payable by an Incorporated Business**), it may also be subject to property tax. Property tax is imposed on the owners of properties based on the annual value of the properties. The "*annual value*" of a building is defined in the statute as "*the gross amount at which the same can reasonably be expected to be let from year to year, the landlord paying the expenses of repair, insurance, maintenance or upkeep and all taxes (other than goods and services tax).*"

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

According to statistics collated by the Accounting and Corporate Regulatory Authority, as at November 2024, there are about 440,486 local and foreign companies in Singapore compared to about 141,867 sole proprietorships and partnerships. While there is no further breakdown available of whether most closely held local businesses operate in corporate or non-corporate form, the data suggests the former.

3.2 Individual Rates and Corporate Rates

Individual professionals have the prerogative to determine their business structure. This is subject to the anti-avoidance provision under the Act. Where the arrangement to earn income by setting up a company is carried out for bona fide commercial reasons and does not have as one of its main purposes the avoidance or reduction of tax, the anti-avoidance provision is unlikely to apply. Otherwise, the Comptroller can disregard or vary the arrangement and make any appropriate adjustment to counteract any tax advantage obtained.

3.3 Accumulating Earnings for Investment Purposes

There are no rules preventing closely held corporations from accumulating earnings for investment purposes in Singapore.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends

Individuals are exempted from tax on dividends paid by any Singapore tax resident company.

Gains on the Sale of Shares

If the gains on the sale of shares arose from the carrying on of a trade, such gains will be considered revenue in nature and will be taxable. Conversely, if the gains are capital in nature, this will not be taxable unless, subject to certain exemptions, it is the sale of a foreign share, and the gains are received in Singapore by an entity of a relevant group.

Where employees derive any gains from a right to acquire shares by reason of their employment, such gains will be taxable at the time of the exercise and are computed based on the open market price, less any amount paid for the shares. Where there is a restriction on the sale of the shares, the gains will be taxable when the restriction ceases to apply, and are computed based on the open market price, less any amount paid for the shares.

For a foreign employee who ceases employment before the right to acquire shares is exercised, or before the restriction on sale has lifted, the gains will be deemed income derived by the foreign employee one month before the later of:

- the date employment ceases; or
- the date the right is granted.

The gains will be computed based on the open market price of the shares on that date, less the amount paid for the shares.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends

Individuals are exempted from tax on dividends paid by any Singapore tax resident company.

Gains on the Sale of Shares

The tax treatment on the gains on the sale of shares in publicly traded corporations is similar to that outlined in **3.4 Sale of Shares by Individuals in Closely Held Corporations.** However, the gains on the sale of shares acquired by reason of employment will be calculated based on:

- for non-treasury shares, the open market price at the last transaction on the date on which the shares are first listed on the Singapore Exchange after the acquisition of the shares by the person, less the amount paid for such shares; and
- for treasury shares, the open market price at the last transaction on the date an appropriate entry is made in the Depository Register by the Central Depository (Pte) Ltd to effect the acquisition of the treasury shares by the person, less the amount paid for such shares.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest

Subject to certain exceptions, interest and other payments in connection with a loan or indebtedness which are paid to a non-Singapore tax resident will generally be subject to withholding tax of 15%.

Dividends

There is no withholding tax for dividends paid to a non-Singapore tax resident.

Royalties

Royalties which are paid to a non-Singapore tax resident will generally be subject to withholding tax of 10%.

4.2 Primary Tax Treaty Countries

Singapore has signed agreements for the avoidance of double taxation (DTAs), including limited DTAs, with more than 100 countries. The DTAs generally provide for the avoidance of double taxation and reduced rates of taxation on interest, royalties, etc. The primary DTA countries that foreign investors would use will depend on the country to which the transaction relates.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Singapore signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the *"Multilateral Convention"*) in 2017. The Multilateral Convention implements DTA measures proposed as part of the BEPS Project. As a signatory, Singapore has updated a significant number of its DTAs to include, amongst others, an anti-treaty shopping provision and a principal purpose test provision.

Under the principal purpose test provision, DTA benefits will be denied in abusive cases. Where one of the principal purposes of using treaty country entities by non-treaty country residents is to obtain treaty benefits for artificial arrangements or structures without commercial purpose, this will fail the principal purpose test.

4.4 Transfer Pricing Issues

Inbound investors should bear in mind that local transfer pricing rules (which are largely aligned with the OECD Transfer Pricing Guidelines (the *"OECD Guidelines"*)) will apply if they choose to operate through local corporations, including:

- maintaining contemporaneous transfer pricing documentation (subject to certain conditions and exemptions);
- submitting a Form for Reporting Related-Party Transactions as part of the corporate income tax return if the value of related party transactions disclosed in the financial statements for a financial period exceeds SGD15 million; and
- filing a country-by-country (CbC) report if the local corporation is a Singapore-headquartered multinational enterprise (subject to other conditions).

4.5 Related-Party Limited Risk Distribution Arrangements

Where the use of related-party, limited risk distribution arrangements is at arm's length, the Comptroller is unlikely to make an adjustment to increase the amount of income that is accrued in Singapore, or to reduce the amount of deduction allowed. An arrangement is at arm's length if the same terms and conditions would have been made if the contracting parties are unrelated and dealing independently with one another in similar circumstances.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The transfer pricing rules and administrative guidelines in Singapore are generally aligned with the OECD Guidelines.

4.7 International Transfer Pricing Disputes

Domestic Transfer Pricing Issues

The Comptroller may raise transfer pricing queries when assessing the taxpayers' corporate income tax or conducting a transfer pricing audit. Taxpayers will be selected for a transfer pricing audit based on risk indicators such as the value of related-party transactions, and the performance of a business over time. In making transfer pricing queries, the Comptroller can use *"new"* information received to re-open earlier years. Except in cases of fraud, the statutory time limit to re-open earlier years is four years after the expiry of that year of assessment. Taxpayers should bear in mind that a surcharge of 5% will be imposed where transfer pricing adjustments are made by the Comptroller, regardless of whether any additional tax is payable on the adjustments.

International Transfer Pricing Dispute

Where there is an international transfer pricing dispute, a Singapore tax resident taxpayer can resolve the issue either by taking legal remedies in the country where the transfer pricing adjustment is made, or by making a Mutual Agreement Procedure (MAP) application under the relevant tax treaty. There is a general increase in the number of transfer pricing disputes resolved through

MAPs. The Comptroller endeavours to resolve a MAP case within 24 months after receiving a complete application.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The Comptroller may make a transfer pricing adjustment to increase the profits of taxpayers who do not comply with the arm's length principle and have understated their profits. Where a transfer pricing adjustment has been made, a surcharge of 5% on the transfer pricing adjustment will also be payable. Subject to certain conditions, the Comptroller may wholly or partly remit any surcharge payable.

Compensating adjustments may be made when transfer pricing claims are settled through MAPs.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Both local branches and local subsidiaries of non-local corporations will be subject to Singapore tax on their income that is accrued in, derived in or received in Singapore. The same corporate tax rate of 17% will apply to both. However, a local branch will only be taxed on the profits attributable to its permanent establishment in Singapore.

5.3 Capital Gains of Non-Residents

The capital gains on the sale of shares in local corporations are not taxable in Singapore. However, the capital gains on the sale of shares in a non-local holding company are taxable if the sale occurs on or after 1 January 2024, and the gains are received in Singapore from outside Singapore by an entity of *"relevant group"*. A group is *"relevant group"* if either the entities of the group are not all incorporated, registered or established in a single jurisdiction, or any entity of the group has a place of business in more than one jurisdiction. This tax treatment is subject to certain exceptions, and it applies regardless of whether such non-local holding company owns the shares of a local corporation.

5.4 Change of Control Provisions

For corporate income tax purposes, Singapore does not have any change of control provisions.

However, it is likely that the shareholding test in relation to loss relief (refer to **2.4 Basic Rules on Loss Relief**) and the 75% shareholding requirement in relation to group relief (refer to **2.6 Basic Rules on Consolidated Tax Grouping**) will not be satisfied upon a change of control. A change of control event may also have additional conveyance duty implications where the company in question is a property holding entity for stamp duty purposes.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No mandatory formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services. The usual transfer pricing principles apply.

5.6 Deductions for Payments by Local Affiliates

Deduction is generally allowed if the expense is revenue in nature, and is incurred wholly and exclusively in the production of income. Local affiliates will not be able to claim a tax deduction on management and administrative expenses incurred by a non-local affiliate.

5.7 Constraints on Related-Party Borrowing

For cross-border loans, the interest rate of a related-party loan has to be based on the arm's length principle. The arm's length principle is the interest rate that would be charged if unrelated parties were dealing independently with one another in comparable circumstances.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Foreign income derived from outside Singapore is taxable if it is:

- remitted to, transmitted or brought into Singapore;
- used to repay any debt incurred for a Singapore trade or business; and
- used to purchase any movable property which is brought into Singapore.

Nonetheless, subject to meeting certain conditions, foreign-sourced dividends, foreign branch profits and foreign-sourced service income are tax exempt. Further, where the foreign income is taxed in both the foreign jurisdiction and Singapore, tax reduction or exemption may be available under the relevant DTAs.

6.2 Non-Deductible Local Expenses

There are generally no deductions allowed against foreign exempt income.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends from foreign subsidiaries of Singapore tax-resident corporations are tax exempt where they fulfil the following conditions:

- the dividends are subject to tax of a similar character to income tax or qualified domestic minimum top-up tax (but disregarding any excluded top-up tax) under the law of the jurisdiction in which the foreign subsidiaries are incorporated;
- at the time the dividends are received in Singapore by the Singapore tax-resident corporation, the highest rate of the aforementioned tax (but disregarding any excluded top-up tax or qualified domestic minimum top-up tax) on any gains or any profits from any trade or business carried on by any company in the aforementioned foreign jurisdiction is not less than 15%; and
- the Comptroller is satisfied that the tax exemption would be beneficial to the Singapore tax-resident corporation.

The Minister for Finance also retains the discretion to grant tax exemptions on foreign-sourced income on a case-by-case basis.

6.4 Use of Intangibles by Non-Local Subsidiaries

Although the Act does not define *"royalties"*, the Economic Expansion Incentives (Relief from Income Tax) Act 1967 (which is to be construed as one with the Act) defines *"royalties or technical assistance fees"* to include any consideration for the use of, or the right to use, copyright, scientific works, patents, designs, plans, secret processes, formulae, trade marks, licences or other like property or rights.

If the royalties are accrued in or derived from Singapore, they will be subject to Singapore corporate tax even if the intangibles were used by non-local subsidiaries. The Act also deems royalties to be derived from Singapore if such payments are borne by a Singapore tax resident or Singapore permanent establishment, or are deductible against any income sourced in Singapore.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Singapore does not implement any controlled foreign corporation (CFC) rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

Singapore does not have any rules relating to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Revenue gains on the sale of shares in non-local affiliates will be taxable. Capital gains will also be taxable in certain circumstances – refer to **5.3 Capital Gains of Non-Residents**. Whether the gains are revenue or capital in nature depends on the facts and circumstances of each case. The *"badges of trade"* test may also be applied – refer to **2.7 Capital Gains Taxation**.

However, the Act provides certainty on the exemption of tax on gains arising from the disposal of ordinary shares in the non-local affiliate. The conditions are:

- the disposal happened between 1 June 2012 and 31 December 2027 (both dates inclusive); and
- the divesting local corporation legally and beneficially owned at least 20% of the non-local affiliate for a continuous period of at least 24 months immediately before the disposal.

This tax exemption does not apply to certain situations such as where a non-local affiliate is not listed and:

- is in the business of trading immovable properties;
- principally carries on the activity of holding immovable properties; or
- has undertaken property development (except where the immovable property is used by the non-local affiliate to carry on its trade or business, and the non-local affiliate did not undertake any property development for at least 60 consecutive months before the disposal of shares).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

There are general anti-avoidance provisions in most of Singapore's tax legislation including the Act, the Goods and Services Tax Act 1993 and the Stamp Duties Act 1929. Generally, the anti-avoidance provision applies to any arrangement where the purpose or effect of such arrangement is:

- to alter the incidence of any tax that is payable or would have been payable by any person;
- to relieve any person from any liability to pay tax or to make a return; or
- to reduce or avoid any liability imposed or which would have been imposed on any person.

The Comptroller has the power to disregard or vary the arrangement and make any appropriate adjustment to counteract any tax advantage obtained or obtainable by that person under the arrangement.

However, the anti-avoidance provision does not apply where an arrangement is carried out for bona fide commercial reasons and does not have as one of its main purposes the avoidance or reduction of tax.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Comptroller conducts routine audits according to compliance risk and by randomly selecting taxpayers according to industry sectors. The industries or areas of concern may be announced beforehand and letters highlighting common mistakes made by taxpayers in that industry may be issued to facilitate self-reviews prior to audits. Taxpayers are advised to keep up to date on their correspondence with the Comptroller and, where given the opportunity to before an audit commences, review their tax affairs conscientiously. In-person visits to business premises may also be made. A taxpayer's case may be referred for further investigation where the results of their audit are unsatisfactory to the authorities or disclose wilful intent to evade taxes, at which stage, a raid will be conducted.

9. BEPS

9.1 Recommended Changes

Singapore is a BEPS Associate and has implemented the following four minimum standards: countering harmful tax practices (Action 5), preventing treaty abuse (Action 6), transfer pricing documentation and CbC reporting (Action 13), and enhancing dispute resolution mechanisms (Action 14).

9.2 Government Attitudes

The Singapore government is generally supportive of the BEPS Project and has agreed to give effect to both Pillars One and Two. The implementation date of Pillar One remains unclear whereas Pillar Two has been enacted through the Multinational Enterprise (Minimum Tax) Act 2024 (the *"MTT Act"*). The MTT Act implements two components of Pillar Two: the Income Inclusion Rule (also referred to as the Multinational Enterprise Top-up Tax (MTT) in the MTT Act), and the Domestic Top-up Tax (DTT). The implementation of the Undertaxed Profits Rule, another component of Pillar Two, will be considered at a later stage.

With effect from 1 January 2025, MTT and DTT of 15% will apply to multinational enterprise (MNE) groups with annual revenue of EUR750 million or more in the consolidated financial statements of the ultimate parent entity in at least two of the four financial years immediately preceding the financial year in question. More specifically, MTT will apply a Singapore parent entity's ownership interest in its relevant entities outside Singapore and its stateless entities but not to its ownership interest in its Singapore-based entities. The DTT will apply to the Singapore profits of applicable MNE groups, which excludes wholly domestic groups where all members of the group are located in Singapore. There are a number of exclusions and safe harbours which may apply.

9.3 Profile of International Tax

Singapore places importance on international tax and has implemented the four minimum standards as a BEPS Associate, namely:

- countering harmful tax practices;
- preventing treaty abuse;
- transfer pricing documentation and CbC reporting; and
- enhancing dispute resolution.

Singapore has also implemented the MTT and DTT from Pillar Two under the MTT Act.

9.4 Competitive Tax Policy Objective

The Singapore government is cognisant of the challenges of remaining attractive to foreign investors in light of the BEPS Project. It remains committed to strengthening Singapore's non-tax-related competitive edge, including the country's political stability, the ease of doing business locally, and high corporate governance standards.

In particular, to enhance Singapore's attractiveness in the post-BEPS world, Singapore has implemented the Refundable Investment Credit (RIC) programme. Under the RIC Programme, a company incorporated in Singapore or a branch of a foreign company registered in Singapore has up to 31 December 2029 to apply for approval to be given RIC. RIC is awarded at a rate of 10%, 30% or 50% on qualifying expenditures incurred to carry out qualifying activities during the qualifying period of up to ten years. RIC can be used to offset a company's income tax or any penalty, surcharge or interest related to income tax. Unutilised credits may be carried forward or paid to the company as a cash refund.

RIC supports six types of qualifying activities which are:

- investing in new productive capacity;
- expanding or establishing the scope of activities in digital services, professional services and supply chain management;
- expanding or establishing headquarters activities or centres of excellence;
- carrying out R&D and innovation activities;
- implementing solutions with decarbonisation objectives; and
- setting up or expanding activities by commodity trading firms.

9.5 Features of the Competitive Tax System

Singapore has extensive tax incentive schemes to attract foreign investors to its shores. With the introduction of the BEPS Project, it remains to be seen whether Singapore will remove any of its tax incentive schemes. However, there are several notable changes to certain tax incentives in the 2024 Singapore Budget. For example, an additional concessionary tax rate tier of 15%, which is in line with the global minimum effective tax rate of 15% under Pillar Two, will be introduced under the Development and Expansion Incentive (DEI) and Intellectual Property Development Incentive (IDI). Under the DEI scheme, companies engaged in high value-added services or activities and manufacturing in Singapore are encouraged to conduct economic activities in Singapore through the provision of a concessionary tax rate of 5%, 10% or 15 % on qualifying income in excess of the average income from qualifying activities. Similarly, under the IDI scheme, companies are encouraged to use and commercialise intellectual property rights arising from research and development in Singapore through the concessionary tax rate of 5%, 10% or 15% applicable on qualifying intellectual property income.

In addition, Singapore does not tax the net wealth of individuals because of the practical difficulties in estimating wealth accurately, and because many forms of wealth are mobile. Nonetheless, Singapore taxes wealth in other ways, including through a property tax and stamp duties. The main manner of taxing wealth is through a property tax, and the annual value bands for owner-occupier residential property have been adjusted upwards following the 2024 Singapore Budget.

9.6 Proposals for Dealing With Hybrid Instruments

Singapore does not have any legislation for dealing with hybrid instruments. Nonetheless, the Singapore tax authorities had, in 2019, published an updated guide on the income tax treatment of hybrid instruments.

Since Singapore is a BEPS Associate committed to implementing the four minimum standards, it is unlikely that BEPS Action 2 – neutralising the effects of hybrid mismatch arrangements – will be implemented in Singapore.

9.7 Territorial Tax Regime

BEPS Action 4 on limitation on interest deductions seeks to address BEPS risks arising from scenarios such as groups placing debts in high tax countries, or using intragroup loans to generate excessive interest deductions. One recommendation was to restrict an entity's interest deductions to a fixed percentage (10%–30%) of its earnings before interest, taxes, depreciation and amortisation (*"fixed ratio rule"*).

Singapore has a territorial tax regime. As a BEPS Associate, Singapore does not have any interest deductibility restrictions under BEPS Action 4. In Singapore, interest is generally deductible if it is wholly and exclusively incurred in the production of income. As such, interest from non-income producing assets will not be deductible. While interest above the fixed ratio rule remains deductible in Singapore, BEPS risks are mitigated because Singapore is a low tax country. Additionally, any intragroup loans must be at arm's length, otherwise the Comptroller may reduce the amount of deduction allowed.

9.8 Controlled Foreign Corporation Proposals

Singapore does not have any CFC rules.

9.9 Anti-Avoidance Rules

Singapore's DTAs have either a limitation on relief provision or a principal purpose test provision.

Limitation on Relief

The limitation on relief provision restricts the DTA benefits a Singapore resident may receive in relation to foreign-sourced income received in Singapore. As such, Singapore investors have to repatriate profits from their foreign investments, regardless of the commercial reasons.

Principal Purpose Test

The principal purpose test is to deny DTA benefits where one of the principal purposes of an arrangement is to obtain the said treaty benefits in a way that does not cohere with the relevant DTA's purpose. As such, if the arrangement relates to a core commercial activity and its form is not artificial, it is unlikely that this will be an abusive case where the provision will apply.

9.10 Transfer Pricing Changes

Impact of Transfer Pricing Changes Introduced by BEPS

The Singapore tax authorities have published their own Transfer Pricing Guidelines (the *"TP Guidelines"*), which was prepared by taking guidance from the OECD Guidelines. The TP Guidelines generally adhere to the main principles set out in the OECD Guidelines. Accordingly, the transfer pricing changes introduced by

BEPS do not significantly change Singapore's tax regime.

Taxation of Profits from Intellectual Property

The taxation of profits from intellectual property is generally straightforward – royalties accruing in or derived from Singapore are taxable. Practical difficulties in ascertaining whether the royalties are sourced in Singapore are alleviated by the Act, which deems royalties that are borne by a Singapore tax resident or a permanent establishment in Singapore (except in respect of any business carried on outside Singapore through a permanent establishment outside Singapore), or which are deductible against any income accruing in or derived from Singapore, to be derived from Singapore. The valuation of intellectual property rights, however, remains an area of contention.

9.11 Transparency and Country-by-Country Reporting

The provisions for transparency and CbC reporting have to balance the interests of taxpayers with that of the government. For example, MNEs may face higher compliance costs to prepare a CbC report. They may also have to disclose sensitive commercial information (eg, relating to research and development or intellectual property) even though such information is disclosed confidentially to tax authorities. On the other hand, the additional data from CbC reports provide governments with a better overview of the entire group, which allows them to better assess transfer pricing risks.

In determining the right balance between the interests of the different stakeholders, any provisions for transparency and CbC reporting must contribute to the BEPS project's policy goal of taxing profits in jurisdictions where the corresponding economic activities are performed and where value is created.

9.12 Taxation of Digital Economy Businesses

Singapore has recently introduced two methods to charge GST on profits generated by the digital economy businesses operating largely from outside Singapore:

- the reverse charge mechanism; and
- the overseas vendor registration regime.

Reverse Charge Mechanism

The reverse charge mechanism applies to:

- GST-registered persons who:
  - (a) obtain services from overseas suppliers; or
  - (b) import low value goods, including from electronic marketplaces; and
  - (c) are not entitled to claim full input tax credit, or belong to a GST group that is not entitled to do so; or
- non-GST registered persons who:
  - (a) obtained services from overseas suppliers and imported low value goods (including from electronic marketplaces) in excess of SGD1 million in a 12-month period; and
  - (b) are not entitled to claim full input tax credit even if they are GST-registered.

Under the reverse charge mechanism, GST-registered persons generally have to account for GST on imported services from overseas suppliers or on imported low value goods, as if the former is the supplier. Similarly, non-GST registered persons will have to be GST-registered and account for GST on their imported services and low value goods as if they are a GST-registered supplier.

Overseas Vendor Registration Regime

The overseas vendor registration regime applies to any overseas supplier and operator of an electronic marketplace that, under certain conditions:

- has a global revenue exceeding SGD1 million; and
- makes supplies of remote services and/or low value goods exceeding SGD100,000 to Singapore customers.

Under the overseas vendor registration regime, the overseas supplier and operator have to register and account for GST on supplies of remote services and/or low value goods to non-GST registered customers in Singapore.

Remote services refer to services where, at the time of the performance of the service, there is no necessary connection between the physical location of the recipient and the place of physical performance. This may be digital or non-digital services. Low value goods are goods that at the point of sale:

- are not dutiable goods;
- are dutiable goods for which payment of the customs duty or excise duty is waived;
- are not exempt from GST;
- are located outside Singapore and are to be delivered to Singapore via air or post; and
- have a value not exceeding SGD400.

9.13 Digital Taxation

Other than the GST on the digital economy business, Singapore has not introduced any other digital taxation rules or laws on income taxation. The tax authorities have provided certain guidelines on the tax treatment of transactions involving digital tokens.

9.14 Taxation of Offshore IP

Subject to certain exceptions, withholding tax of 10% will be imposed if royalties are paid for the use of offshore intellectual property to a non-Singapore tax resident. Such withholding tax is applicable if the payment:

- is borne by a Singapore tax-resident person or a person with a Singapore permanent establishment; or
- is deductible against any Singapore-sourced income.

The withholding tax rate may be reduced, or the royalty payments exempted from tax under the relevant DTA. The Act does not impose differing tax treatments on owners of IP in tax havens as long as any related-party arrangements for the use of intellectual property (if any) are at arm's length and do not constitute an abuse of the DTAs.

Trends and Developments

Contributed by:
Lee Woon Shiu and Catherine Cheung Kuan Swan
DBS Private Bank

DBS Private Bank is the third-largest private bank in Asia and provides bespoke, comprehensive solutions to wealth clients all over the world. It has a presence in 19 markets globally, and it is recognised for providing not only wealth management services but also for connecting its clients to opportunities in Asia through its dual booking centres in Singapore and Hong Kong. As one of Singapore's leading family office practices, DBS Private Bank offers a comprehensive suite of bespoke wealth management solutions, which includes investment advisory, portfolio management, trust, liquidity, estate planning, and family office solutions. In 2023, it launched the DBS Multi Family Office Foundry Variable Capital Company, the first bank-backed multi-family office leveraging Singapore's VCC structure, as an attractive alternative for affluent families to manage their wealth without having to establish their own single-family office.

Authors

Lee Woon Shiu is DBS Group head of wealth planning, family office and insurance solutions. He has more than 25 years of experience in advisory, client development and professional training in family office, trusts, high-net worth life insurance and estate planning in Asia Pacific. Woon Shiu attended Yale University and the National University of Singapore where he was a Law Society of Singapore Book Prize Winner. A dual-qualified lawyer of UK and Singapore, with a STEP certification, Woon Shiu is also adjunct associate professor at the Nanyang Technological University where he regularly lectures on wealth structuring and estate succession. He is also a Board Member of the DBS Foundation.

Catherine Cheung Kuan Swan is the head of DBS Private Bank's wealth planning solutions hub. She provides advice, training and transactional support on a wide spectrum of legal, regulatory and tax issues for bespoke structuring, product and trustee guides. Prior to crossing into wealth management, Catherine was a practising lawyer for six years in Singapore and Hong Kong. She has over 20 years of experience with key roles in trust, wealth planning advisory, legal, compliance and fiduciary functions. A triple-qualified lawyer of Singapore, Hong Kong and the UK, Catherine is also a barrister (Middle Temple Inns of Courts, England & Wales). She is also a qualified trust and estate practitioner (TEP) and holds an LLM in commercial and corporate law from King's College London.

Contributed by: Lee Woon Shiu and Catherine Cheung Kuan Swan, **DBS Private Bank**

DBS Private Bank

12 Marina Boulevard
Level 6
DBS Asia Central
Marina Bay Financial Centre Tower 3
Singapore
018982

Tel: +65 9021 5130
Email: catherineks@dbs.com
Web: www.dbs.com.sg

Overview of Singapore's Corporate Tax System

Singapore, having a relatively simple and competitive corporate tax system, offers one of the world's most business-friendly tax environments, with various incentives and tax benefits to promote economic growth and innovation. This is a crucial consideration for business operation or expansion, as well as the establishment or relocation of family offices.

Corporate tax rate

The standard corporate tax rate in Singapore is 17% but certain exemptions and concessions for specific industries and qualifying companies are available to potentially lower effective tax rates.

Territorial tax system

Only income accrued or sourced in Singapore is subject to tax. Income earned from overseas operations is generally not taxed unless remitted or deemed remitted to Singapore. However, individuals receiving foreign-sourced income in Singapore are not taxed.

Single-tier corporate tax system

Generally, varying withholding taxes are imposed on payments (eg, interest, royalties, technical and management fees) made to non-residents. No withholding tax applies to dividends paid to offshore entities.

Dividends distributed by a Singapore tax resident company to its shareholders are not taxed and there is no withholding tax on dividends.

Capital gains tax

There is no capital gains tax in Singapore.

Under the new Section 10L of the Singapore Income Tax Act (1947 ITA), gains arising from the sale or disposal of foreign assets by an entity of a relevant group on or after 1 January 2024 and which are received in Singapore, will be taxable in Singapore in certain circumstances even if such gains would otherwise be capital in nature under ordinary income tax principles.

Section 10L only applies to *"relevant group"* ie, one with entities established in more than one jurisdiction or if any entity of the group has a place of business in more than one jurisdiction. It does not apply to an entity which only has business operations in Singapore or entities with economic substance whose operations are managed and performed by adequate human resources based in Singapore.

Tax incentives

Singapore actively promotes business growth through various tax incentives, including tax exemptions, deductions, and grants. These incentives often target specific industries or activities deemed strategically important to the nation's economy.

Global Traders Programme (GTP)

The GTP is designed to encourage international trading companies to choose Singapore as a base for their global trading activities. GTP qualified companies, which must utilise Singapore's financial services and hire local Singaporeans to work in their companies, enjoy a concessionary corporate rate of 5% or 10% for a renewable five-year period on qualifying trading income, including offshore trading income.

Finance and Treasury Centre (FTC) incentive

The FTC incentive encourages companies with an established international business and operation to use Singapore as a base for conducting treasury management activities. Approved FTCs will enjoy a range of benefits, including a concessionary tax rate of 8% or 10% on qualifying income and a withholding tax exemption.

International Headquarter (IHQ) award

The IHQ award is an incentive aimed to encourage companies to set up or expand global or regional headquarters activities in Singapore, such as those for managing, co-ordinating and controlling business activities for a group of companies. The award provides a tax concessionary rate of 5%, 10% or 15% on an entity's qualifying income.

Corporate tax residency

The tax obligations of an entity will depend on its residency status, which is determined by considering certain factors such as the location of its incorporation, management and control.

Tax treaties

Singapore has signed double tax treaties with about 100 countries. These agreements help mitigate double taxation on income earned in multiple jurisdictions and grant exemption or reduction on some taxes.

Trends and Developments

Vibrant and growing family office sector

Singapore, a leading financial services hub renowned for its open and well-regulated economy, has over the past few years attracted many high-net worth families to establish their family offices in the city-state.

Wealthy families set up a family office to consolidate and manage family assets, which may be held by investment vehicles that form part of a broader wealth planning structure.

By the end of 2024, the number of single family offices (SFOs) awarded the tax incentives by the Monetary Authority of Singapore (MAS) has exceeded 2,000, which is a significant growth from just 400 in 2020.

An SFO is one that provides services to members of the same family. SFOs are becoming an increasingly important part of the wealth planning landscape.

An SFO, either licensed to provide fund management services or exempt from licensing, is considered a fund manager for the purposes of Singapore's fund tax incentives.

Tax incentive schemes applicable to SFO-based structures

Enhanced-tier fund tax incentives (S13U), resident fund scheme (S13O) and offshore fund exemption scheme (S13D)

S13U and S13O under the 1947 ITA have been the two most commonly used tax incentive schemes in SFO-based structures set-up in Singapore.

Both these MAS-awarded incentives, though with differing criteria, in principle provide an exemption from Singapore tax on specified income arising from funds managed by a fund manager in Singapore investing in designated investments such as stocks, shares, bonds, treasury bills, bills of exchange and exchange-traded funds.

The exemption does not apply to income or gains from Singapore's real estate and certain other financial assets which confer an indirect ownership interest in Singapore real estate.

The S13D provides a tax exemption on income of an offshore fund managed by a Singapore-based fund manager. This self-administered scheme not requiring MAS approval, has no economic requirements. The only new requirement introduced for both SFO and non-SFO 13D funds is that the manager of the fund entity must have at least one full-time investment professional.

Updates to the tax incentive schemes for SFOs

Like most tax incentives, S13D, S13O and S13U had a sunset date – scheduled to lapse after 31 December 2024 – but this has been extended till 31 December 2029.

To ensure Singapore attracts high-quality wealthy families amidst the burgeoning number of family offices, MAS has tightened the qualifying criteria under these schemes through a number of amendments.

For SFO-based structures to qualify for either scheme, they must meet stringent economic requirements such as, among others, employing a minimum number of local investment professionals, minimum fund size, local spending requirements, eligible donations to local charities and capital deployment requirements such as grants to blended finance structures with substantial involvement of financial institutions in Singapore.

From 1 October 2024 onwards, all new family office tax incentive application submissions for S13O and S13U must be accompanied by a comprehensive screening report issued by a MAS-approved screening service provider.

Philanthropy tax incentive scheme (PTIS)

To encourage SFOs using Singapore as a base for their overseas giving, MAS introduced the PTIS, which, having gone live on 1 January 2024, allows qualifying donors in Singapore to claim a 100% tax deduction, capped at 40% of the donor's statutory income, for overseas donations made through qualifying local intermediaries. PTIS awards, which may be granted from 1 January 2024 to 31 December 2028, once approved, will be valid for five years from the date of approval.

Commonly used corporate structures

Companies and partnerships

With increased global awareness and a focus on tax transparency and governance, standalone investment holding companies (regardless of jurisdiction of incorporation) managed and controlled in Singapore may no longer be as popular as before, particularly due to the risk of being subject to Singapore corporate tax on trading gains and certain income.

Singapore companies and trusts have become a popular choice as part of more sophisticated SFO structures. Other frequently used structures include limited liability companies (LLCs), partnerships, variable capital companies (VCCs) and hybrid structures.

Trusts

With the rise of family offices and the inclusion of trusts within wider bespoke structures to serve as an integral component of holistic family management strategies, trusts have become a powerful wealth and asset management tool for wealthy families. Trusts are also prevalent in structures for asset protection and effective tax solutions.

Singapore, with its trust law based on English trust law, recognises trusts and because of its well-defined and regulated legal framework, Singapore trusts are still very attractive to wealthy international families despite having a perpetuity period of 100 years as compared to that under Jersey or the BVI law, where the trust is permitted to exist for a longer time-period.

Unlike in previous decades, where trusts mostly held bankable assets and insurance policies, now trusts are often seen holding a diversified class of assets ranging from bankable assets, real estate, and shares in privately operated businesses and substantial listed company shares to art pieces and digital assets. Such developments have also propelled the growth of private trust companies.

I) Trust incentive schemes

S13F (for foreign trusts) and S13N (for locally administered trusts) are the two tax incentives most frequently utilised in trust structuring for wealthy individuals in Singapore.

Both schemes, as well as S13L (for philanthropic purpose trusts), were refined and amended with their lifetimes extended to 31 December 2027.

A Singapore foreign trust is one in which no settlor or beneficiary may be a citizen or resident of Singapore (individuals or companies). Under S13F, such a trust (which must be administered by a Singapore licensed trust company and with underlying companies not incorporated in Singapore) is exempt from tax on income derived from designated investments.

A Singapore locally administered trust (LAT) |is one administered by a Singapore licensed trust company. Under S13N, such a trust and its holding company shall be exempt from tax on all relevant income (as defined in S13 of the 1947 ITA).

A LAT requires:

- every settlor to be an individual;
- every beneficiary to be an individual, a charitable institution, a trust, or a body of persons established for charitable purposes only; and
- at least one of the beneficiaries to not be a settlor of the trust.

II) Using a trust to purchase properties

Increasingly, cash-rich parents are purchasing homes (full payment in cash is required) for their minor children using a trust structure to give an advanced inheritance of residential property to their children during their lifetimes instead of waiting to transfer these upon their demise. This can be driven by inheritance and succession planning or other legitimate tax arrangements.

III) Additional buyer's stamp duty (ABSD) for trusts

With effect from 27 April 2023, ABSD of 65% applies to any transfer of residential property into a living trust. This ABSD is to be paid upfront (ie, within 14 days of executing the sale and purchase agreement or exercising the option to purchase). Banks are not able to extend a loan for the purchase of property using a trust structure and no CPF monies (income saved in Singapore's compulsory savings and pension plan: the Central Provident Fund) can be used for such purchase.

The trustee may apply to the Inland Revenue Authority of Singapore (IRAS) for a refund via which the remission of the ABSD may be provided if certain conditions are fulfilled – eg, all beneficial owners are identifiable or beneficial ownership has been vested in the beneficiary(ies) – the trust cannot be revoked, varied or made subject to any subsequent conditions.

The imposition of the ABSD means that an additional hefty 65% of the purchase price is to be paid upfront. However, as it is possible to apply to IRAS for a refund of the ABSD, purchasing property using a trust structure is likely to continue to be attractive for ultra-wealthy individuals.

Variable capital companies

VCCs are a new form of corporate structure designed for wealth management funds and have been widely adopted. The VCC, which must be managed by a permissible fund manager, can be set up as a standalone fund or an umbrella fund with two or more sub-funds, each holding a portfolio of assets and liabilities segregated from the other sub-funds. A permissible fund manager can be a licensed or registered fund management company, or certain entities exempted under the Securities and Futures Act 2001 in Singapore.

With a unique blend of flexibility, efficiency and regulatory oversight, VCCs can be used for all types of investment funds, serving as an attractive option for fund managers seeking to establish or re-domicile their funds in Singapore. Since the launch of the VCC framework in 2020, more than 1000 VCCs have been incorporated or re-domiciled in Singapore by regulated fund managers based here.

A VCC can be used as a multi-family office (MFO) to manage assets and provide services to members of different families.

It serves as an alternative option for families who may want to start small or are not ready to set up their own SFO or who are unable to meet the requirements for SFOs to enjoy tax exemptions.

Under an umbrella VCC structure, wealthy families can choose from various investment strategies to customise their sub-fund, allowing them to diversify their investment risks and maintain a level of privacy for their investments in a legalised manner. In certain circumstances, the VCC can be a viable option for tax savings, mitigating tax exposure and tax deferral purposes.

The oversight of VCCs (all of which must be managed by a permissible fund manager) falls under the purview of the Accounting and Corporate Regulatory Authority (ACRA), which administers the VCC Act and related regulations. MAS oversees the VCCs' anti-money laundering and counter-financing of terrorism obligations.

Charitable structures

Singapore is poised to become a regional philanthropic hub and this is evident in the government's introduction of the PTIS which is designed to encourage SFOs established in Singapore to grow and expand on their philanthropic giving and activities from Singapore.

Singapore's long-standing charity regime has historically been focussed on encouraging doing good in Singapore since only donations that exclusively benefit the Singapore community will get a tax deduction. Donations to foreign charities will not qualify for any tax deduction.

The PTIS changes this stance by allowing qualifying donors in Singapore (those nominated by the related SFOs) to claim 100% tax deduction for eligible overseas donations made through qualifying local intermediaries. Only SFOs that are managing funds held through at least one S13O/S13U fund can qualify to apply for the PTIS.

More wealthy families are expressing interest in being a force for good in society and prioritising sustainable investment for their portfolios.

Non-profit organisations in Singapore typically take the legal form of (i) a company limited by guarantee (CLG), (ii) a society or (iii) a charitable trust. CLG is the most common of these three structures.

CLGs and societies may be registered as charities to benefit from the associated income tax exemptions. A CLG is also often established to own a foreign-law-governed purpose trust within an SFO-based structure.

According to the Commissioner of Charities' guidelines, only certain organisations with charitable purposes can have the word *"foundation"* in their names, thus the foundations (which are not the civil law type) set up in Singapore tend to be charitable structures.

Charitable trusts are becoming a popular structure among wealthy families for the purpose of charity. As charitable trusts do not have independent legal personality, the trustees are the ones that bear all legal liabilities.

Transfer pricing changes

The new guidelines on transfer pricing released by IRAS on 14 June 2024 require arm's length interest for domestic, related-party loans entered into from 1 January 2025 onwards.

Unlike previously, new shareholders', directors' and/or related-party loans (entered into from 1 January 2025 onwards) can no longer be interest free. This change impacts funding and loan arrangements between related parties with the SFO-based structure.

New top-up taxes in Singapore

Singapore is a member of the OECD/G20's Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and was among the more than 135 jurisdictions that joined a multilateral consensus reached on 8 October 2021.

The consensus was to reform international taxation rules and ensure that relevant multinational enterprises (MNEs) pay a fair share of tax wherever they operate. A two-pillar solution (commonly known as BEPS 2.0) under the consensus seeks to address the tax challenges arising from the digitalisation of the economy.

As such, starting 1 January 2025, Singapore has implemented two new top-up taxes from the BEPS 2.0 Global Anti-Base Erosion (GloBE) rules: the Domestic Top-up Tax (DTT) and the Income Inclusion Rule (IRR). These aim to ensure that relevant MNEs operating in more than one jurisdiction pay a minimum level of tax on the income arising in each jurisdiction where they operate.

Relevant MNEs are groups with annual group revenue of at least EUR750 million (SGD1.1 billion). A minimum effective tax rate of 15% will be imposed on the relevant MNE group's excess profits in a jurisdiction.

The DTT applies to relevant MNE groups in respect of the profits of their group entities operating in Singapore and will be payable if the group's effective tax rate in Singapore is below 15%.

The IIR applies to relevant MNE groups that are parented in Singapore in respect of the profits of their group entities that are operating outside Singapore. If the effective tax rate of the MNE group's entities in any foreign jurisdiction is below 15%, the tax will be imposed to top up the rate to 15%.

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SOUTH KOREA

Law and Practice

Contributed by:
Young Joon Chun, Kyu Dong Kim, Yong Whan Choi and Hyeon Jeong
Yulchon LLC

Contents

Yulchon LLC is a full-service international law firm headquartered in Seoul. It employs nearly 740 professionals, including 64 who are licensed in jurisdictions outside of Korea. Yulchon advises on a wide range of specialised practice areas, including corporate and finance, antitrust, tax, real estate and construction, dispute resolution, intellectual property, and labour and employment. The firm's perspective is international and its reach is global.

Authors

Young Joon Chun heads the tax group at Yulchon LLC and has more than 24 years' tax experience. Before joining Yulchon, he served as a judge at Seoul Southern and Central District Courts. He has been considered one of the best Korean tax lawyers and tax litigators for many years.

Kyu Dong Kim co-heads Yulchon LLC's international tax team and has more than 25 years' tax experience. Before joining Yulchon, he worked at PricewaterhouseCoopers LLP London from 2005 to 2008, and at Samil PricewaterhouseCoopers from 2008 to 2011. He has deep experience in all cross-border tax matters, with a particular focus on ICT clients and structuring overseas fund investments into Korea and overseas investments of Korean companies. He is an active member of the Korean branch of the International Fiscal Association and a member of two investment committees of the National Pension Fund.

Yong Whan Choi co-heads Yulchon LLC's international tax team. He has more than 16 years' tax experience, focusing particularly on transfer pricing, permanent establishment, beneficial ownership and royalty issues involving ICT, global semiconductor and automotive clients. Before joining Yulchon, he served for three years as a government attorney representing the Korea National Tax Service in tax litigation.

Hyeon Jeong is a tax partner within Yulchon LLC's tax group, with more than 12 years' tax experience. He provides tax advisory services to multinational corporations across various industries, drawing upon his broad expertise in Korean tax law, foreign investment incentives, cross-border tax matters and Pillar 2 GloBE Rules. He is a member of the Korean cash grant evaluation committee and regularly participates in cash grant evaluation meetings for foreign investments.

Contributed by: Young Joon Chun, Kyu Dong Kim, Yong Whan Choi and Hyeon Jeong, **Yulchon LLC**

Yulchon LLC

Parnas Tower
38th Floor
521 Teheran-ro
Gangnam-gu
Seoul 06164
Korea

Tel: +82 2 528 5200
Fax: +82 2 528 5228
Email: mail@yulchon.com
Web: www.yulchon.com

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Under the Korean Commercial Code (KCC), the following types of legal entities are recognised in Korea.

- *Jusik Hoesa* – a corporation incorporated by one or more promoters, with each shareholder's liability limited to the amount of contributed capital. This is the type of entity most commonly used in Korea.
- *Yuhan Hoesa* – a corporation incorporated by one or more members, with each member's liability limited to the amount of contributed capital.
- *Yuhan Chaegim Hoesa* – a corporation incorporated by one or more members, with each member's liability limited to the amount of contributed capital. A *Yuhan Chaegim Hoesa* provides more flexibility and self-control than a *Yuhan Hoesa*.
- *Hapmyeong Hoesa* – a corporation incorporated jointly by more than two members who are responsible for corporate obligations if the assets of the corporation are not sufficient to fully satisfy such obligations.
- *Hapja Hoesa* – a corporation composed of one or more partners with unlimited liability and one or more partners with limited liability.

All of the above entities are generally taxed as separate legal entities. However, *Hapmyeong Hoesa* and *Hapja Hoesa* can elect to be treated as transparent for Korean tax purposes, thereby becoming subject to the Korean partnership tax regime.

1.2 Transparent Entities

In Korea, entities that are not a corporation and have an agreed method of distributing profits between members (ie, association, foundation, *Johap* under the Korean Civil Code, and *Hapja Johap* or *Ikmyeong Johap* under the KCC) are tax-transparent entities. A *Johap* is similar to a partnership in concept. Trusts formed by a contractual arrangement are generally treated as tax-transparent entities.

In addition, *Hapmyeong Hoesa* and *Hapja Hoesa* – which are incorporated entities – may choose to be treated as partnerships that are transparent for tax purposes. Under Korean tax law, partnerships are exempt from tax at the partnership level, but each partner is subject to tax on earned income distributed from the partnership.

1.3 Determining Residence of Incorporated Businesses

According to the Korean Corporate Income Tax Law, a corporation that has its head office or principal office in Korea is a resident corporation. A corporation with a place of effective management in Korea is also treated as a resident corporation.

The place of effective management refers to the place where the key management and commercial decisions that are necessary for the conduct of the entity's business are made in substance. The determination of the place of effective management is based on all relevant facts and circumstances.

1.4 Tax Rates

The applicable corporate income tax (CIT) rates are as follows:

- taxable income under KRW200 million – 9% (rate including local income tax: 9.9%);
- taxable income of KRW200 million to KRW20 billion – 19% (20.9%);
- taxable income of KRW20 billion to KRW300 billion – 21% (23.1%); and
- taxable income over KRW300 billion – 24% (26.4%).

In addition, the income of businesses owned by individuals directly (sole proprietorships) is taxed at the owner's personal income tax (PIT) rates, as follows:

- taxable income under KRW14 million: 6% (rate including local income tax: 6.6%);
- taxable income of KRW14 million to KRW50 million – 15% (16.5%);
- taxable income of KRW50 million to KRW88 million – 24% (26.4%);
- taxable income of KRW88 million to KRW150 million – 35% (38.5%);
- taxable income of KRW150 million to KRW300 million – 38% (41.8%);
- taxable income of KRW300 million to KRW500 million – 40% (44%);
- taxable income of KRW500 million to KRW1 billion – 42% (46.2%); and
- taxable income over KRW1 billion – 45% (49.5%).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

In determining taxable income for CIT purposes, expenses (including interest expenses, depreciation and general administrative expenses, such as rental expenses) that are reasonably connected with a company's business can be deducted from the company's taxable income.

Taxable income is based on the accounting profits, and adjustments are made for tax purposes, as required by the Korean Corporate Income Tax Law.

2.2 Special Incentives for Technology Investments

The Special Tax Treatment Control Law provides various tax incentives to stimulate R&D activities. Tax credits are available for qualifying R&D expenditures used for research and workforce development. In addition, until the end of 2026, a 50% CIT credit is provided for income resulting from the transfer of patents and eligible technology by SMEs. Until the end of 2027, a 10% tax credit (up to the value of acquired technology) is also provided to qualifying domestic companies acquiring technology-innovative SMEs until the end of 2027.

2.3 Other Special Incentives

In accordance with the BEPS initiatives, most of the direct tax incentives and benefits previously available for foreign direct investment were abolished by the Korean government under the 2019 tax reform. However, the existing local tax and indirect tax incentives are maintained for qualifying foreign investors. Foreign investors are entitled to an exemption from acquisition tax and property tax on property acquired and owned for up to 15 years, and to an exemption from customs duties, VAT and individual consumption tax on imported capital goods.

2.4 Basic Rules on Loss Relief

Under Korean tax law, tax losses can be carried forward for 15 years, although annual utilisation is capped at 80% of annual taxable income (with an exception granted for SMEs and distressed companies).

2.5 Imposed Limits on Deduction of Interest

Interest expense deductions are subject to the following limitations:

- the thin capitalisation rule – interest exceeding the 2:1 (debt to equity) threshold will not be deductible and will be treated as a dividend; and
- the 30% interest limitation rule – if the ratio of net interest paid to a foreign related party by a Korean company to adjusted net income (ie, earnings before interest, taxes, depreciation and amortisation) exceeds 30%, the excess interest will not be deductible.

2.6 Basic Rules on Consolidated Tax Grouping

Before 2024, consolidation was available for a domestic parent company and its directly or indirectly wholly-owned domestic subsidiaries. For fiscal years commencing on or after 1 January 2024, the shareholding requirement is eased to 90%. A taxpayer may elect the consolidated tax filing regime upon approval from the tax authority, but such election cannot be revoked for five years.

2.7 Capital Gains Taxation

Capital gains are generally taxed at the same CIT rate as ordinary taxable income. However, capital gains from the sale of non-business purpose real estate are subject to additional capital gains tax of 10%, which can rise to as much as 40% for certain properties.

2.8 Other Taxes Payable by an Incorporated Business

Value-added tax (VAT) is imposed on the supply of goods and services. The applicable VAT rate is generally 10%, but zero-rated VAT is available for exported goods and services rendered outside Korea and for certain services provided to a non-resident in a foreign currency. If a company carries on a VAT-able business in Korea, it must register its business under the VAT Act, file a quarterly VAT return and pay all VAT collected from its customers during the relevant quarter, minus any VAT credit to which it is entitled (input VAT).

Customs duties are generally imposed on imported goods. Importation means the delivery of goods into Korea to be consumed or used in Korea.

Acquisition tax is imposed on the purchase price of real estate, motor vehicles, construction equipment, golf memberships, etc. The acquisition tax rate varies depending on the type of assets, ranging from 0.96% to 4.6%.

Where an investor acquires shares in a company and becomes a controlling shareholder of such company (ie, the investor and its related parties collectively own, in the aggregate, more than 50% of the shares of the company) as a result of the share acquisition, such investor is deemed to have acquired the real estate, etc, held by the company and is generally subject to deemed acquisition tax of 2.2% (including surtax).

Securities transaction tax is imposed on the transfer of shares. The securities transaction tax rate for publicly traded shares is 0.15%, and the tax rate for unlisted shares is 0.35%.

A special excise tax is levied on the production or trading of certain luxury items, alcohol and tobacco. In addition, property tax (a local tax) is charged on the statutory value of land, buildings, houses, vessels and aircraft, while comprehensive real estate holding tax (a national tax) is charged on the aggregate published value of land, buildings and houses exceeding a certain threshold.

2.9 Incorporated Businesses and Notable Taxes

Accumulated earnings tax (AET) is applicable to Korean corporations that are designated as large conglomerates under the Monopoly Regulation and Fair Trade Act. The AET imposes additional income tax at the rate of 22% (inclusive of local income tax) on corporate earnings that are not utilised for prescribed purposes (eg, designated investments, employee salaries, employee welfare funds). The AET regime remains in effect until the fiscal year including 31 December 2025.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

The majority of closely held businesses, such as convenience stores and hair salons, operate in non-corporate form, but most businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

In general, CIT rates are lower than PIT rates. However, many individual professionals and businesses choose not to incorporate, so as to avoid subjecting earnings already taxed at the corporate level to double taxation when dividends are paid.

3.3 Accumulating Earnings for Investment Purposes

See **2.9 Incorporate Businesses and Notable Taxes**.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends paid to an individual shareholder are subject to a withholding tax of 15.4% (inclusive of local income tax). However, if an individual shareholder's total financial income (interest income + dividends) exceeds KRW20 million per year, the excess is taxed at regular PIT rates.

Capital gains arising from the sale of shares in an unlisted SME are subject to 11% capital gains tax (22% for unlisted non-SME shares), inclusive of local income tax. Individual shareholders who have a substantial ownership interest and realise capital gains from the sale of shares in an unlisted company are subject to 22% capital gains tax for taxable income up to KRW300 million and 27.5% for taxable income over KRW300 million (a 33% flat rate applies to unlisted non-SME shares held by major shareholders for less than one year before their sale).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends paid from a publicly traded corporation to an individual shareholder are taxed in the same manner as those paid from an unlisted company to an individual shareholder.

Capital gains arising from the sale of listed shares are not subject to tax when sold by a minority shareholder through the securities market. However, when the sale takes place over the counter, the capital gains are subject to a 22% tax (11% in the case of listed shares in an SME), inclusive of local income tax. When the total stake of a shareholder in a listed company, together with any related parties (majority shareholder), exceeds 1% of the total shares, or if the total market value of the stock held by the shareholder is KRW1 billion or more, such shareholder will be taxed on the capital gain at 22% for taxable income up to KRW300 million and at 27.5% for taxable income over KRW300 million, regardless of whether the shares were sold through the securities market or over the counter (a 33% flat rate applies to non-SME shares held for less than one year before their sale).

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In general, interest, dividends and royalties paid to a non-resident company or individual are subject to 22% withholding tax (inclusive of local tax). The rate may be reduced under applicable tax treaties.

The Korean tax authority takes a conservative position in relation to the application of reduced treaty rates, which can differ depending on the beneficial owner of the Korean source income.

In addition, it is worth noting that the Korean tax authority is determined to collect withholding tax on royalties paid to US companies. In respect of royalty withholding tax for US companies, the Korean Supreme Court has held in various cases that royalties received by a US resident for the use of a patent that is not registered in Korea is not Korean source income under the Korea-US Tax Treaty, and therefore should not be subject to income tax in Korea. Even though the Korea-US Tax Treaty generally overrides the domestic tax laws, the Korean tax authority has made considerable efforts to impose withholding tax on such royalties through tax law amendment. After the most recent tax law amendment relating to royalties, it needs to be closely monitored whether the Korean courts will continue to hold that royalties received by a US company for the use of a patent that is not registered in Korea should not be taxed in Korea, or if they will change their position.

4.2 Primary Tax Treaty Countries

As of December 2024, Korea has concluded double tax agreements with 99 countries. Foreign investors have primarily used the Netherlands, Belgium and Ireland to make investments into Korea through intermediate holding companies.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The Korean tax authority tends to challenge the use of treaty countries by non-treaty country residents by aggressively applying the substance-over-form principle to argue that entities established in favourable treaty countries are not the beneficial owners of the relevant Korean source income. *"beneficial owner"* is a person who bears legal or economic risk related to Korean source income and who, in substance, holds ownership rights over such income, including disposal rights.

4.4 Transfer Pricing Issues

The Korean tax authority closely monitors companies whose profitability suddenly drops or whose profits fluctuate over a number of years. The Korean tax authority is likely to scrutinise companies that have had significant business restructuring, as well as those paying substantial royalties or management service fees to foreign companies and companies with financial transactions with overseas related parties.

4.5 Related-Party Limited Risk Distribution Arrangements

The Korean tax authority challenges the use of limited risk distribution arrangements from a transfer pricing (TP) perspective.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Korea is a member of the OECD and generally follows the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). However, the OECD Guidelines do not have the force of law, while the Law for the Co-ordination of International Tax Affairs (which governs TP) does. Accordingly, the Korean tax authority might not accept a taxpayer's arguments if they are based solely on the OECD Guidelines.

4.7 International Transfer Pricing Disputes

The Korean tax authority actively challenges taxpayers' TP policy. If the tax authority obtains new TP information for a particular year, and that information affects not only the TP issues for that particular year but also those for previous years, it is common for the tax authority to expand the scope of its TP review to fiscal years for which the statute of limitations has not yet expired.

Mutual agreement procedures (MAPs) can resolve international TP disputes between Korea and countries that have concluded a tax treaty with Korea. The National Tax Service (NTS), which is in charge of the Korean MAP process, negotiates MAP cases with the other competent authorities (CAs). According to MAP statistics released by the OECD, as of 1 January 2023 there were 120 open MAP cases relating to Korean TP, and 33 cases that closed during 2023. 43 new MAP cases commenced during 2023, and 131 open MAP cases remained as of 31 December 2023. As shown by the increasing number of MAP cases, there has been a gradual increase in the number of taxpayers resolving their TP issues through MAP. It typically takes two to three years from the date the initial application is accepted to complete the MAP process.

The Korean government acknowledges that MAP is an effective dispute resolution process for double taxation issues, and is generally open to the use of the MAP process.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Taxpayers can resort to a MAP under the relevant tax treaty in order to resolve double taxation arising from a TP adjustment. A MAP can generally be requested within three years of the date when the taxpayer becomes aware of the adjustment.

A MAP is often initiated in the jurisdiction that is expected to claim a tax refund. Competent authority (CA) negotiations will commence on the date the relevant CA sends a letter to the other CA accepting the request for a MAP. The CAs will then discuss issues through the exchange of position papers and via CA meetings throughout the year.

If the MAP is concluded, the initial TP adjustment should be reduced or cancelled based on the MAP agreement. Compensating adjustments are allowed.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

In general, Korean branches of foreign corporations are taxed in the same manner as Korean subsidiaries of foreign corporations, with a few notable differences. While dividends paid by a Korean subsidiary to a foreign parent are subject to withholding tax, earnings remitted by a Korean branch to its overseas head office are subject to branch profits tax only when the Korean branch is required to pay branch profits tax under the relevant tax treaty. A Korean branch is allowed to deduct head office expenses allocated to it, whereas a management service agreement would be required to charge similar costs to a subsidiary. In addition, while a Korean subsidiary could qualify for tax benefits under the Foreign Investment Promotion Act and the Special Tax Treatment Control Law, a Korean branch is not eligible for such benefits.

5.3 Capital Gains of Non-Residents

Capital gains derived by non-residents on the sale of shares in Korean corporations are either exempt from Korean tax under an applicable tax treaty or subject to withholding tax at 11% (including local income tax) of the sale proceeds or 22% (including local income tax) of the capital gains, whichever is lower. The purchaser is obliged to withold and pay the tax.

Capital gains arising from the sale of listed shares are not subject to capital gains tax to the extent the non-resident shareholder did not hold 25% or more of the total outstanding shares at any time during the year when the sale took place or in the preceding five years.

5.4 Change of Control Provisions

Since Korea does not have an indirect capital gains tax, gains arising from the sale of shares of a foreign company that directly or indirectly owns shares of a Korean company are not subject to tax (indirect share transfer). However, the Korean tax authority may attempt to impose tax on gains arising from an indirect share transfer by applying the substance-over-form principle.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No special formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services; the OECD Guidelines would apply.

5.6 Deductions for Payments by Local Affiliates

The Korean tax authority often challenges the deductibility of management service fees. In order to deduct the fees, the following conditions must be satisfied (under the Law for the Co-ordination of International Tax Affairs):

- an agreement should be entered into by the service provider prior to the provision of the service;
- the domestic company should benefit from the service provided by its foreign related party through additional profit or reduced expenses;
- the provision of the service should be verified through supporting documentation; and
- no related party should be performing the same type of service as the one received by the domestic company, and no third party should be providing the same type of service as the one received by the domestic company to a related party of the domestic company; however, an exception applies to cases where the same type of service is temporarily received due to a reasonable cause, such as business restructuring or streamlining management decision processes.

5.7 Constraints on Related-Party Borrowing

Where a Korean company borrows from its foreign controlling shareholder and the debt-to-equity ratio exceeds 2:1, interest exceeding such threshold will not be deductible and will be treated as a dividend (thin capitalisation rule).

Also, in line with the OECD's recommendation on the limitation of interest expense deductions, Korea introduced a new rule that treats interest deductions as non-deductible to the extent net interest paid to foreign related parties exceeds 30% of adjusted net income (for this purpose, adjusted net income equals earnings before interest, taxes, depreciation and amortisation). Net interest expense refers to the total amount of interest paid on funds borrowed by a Korean company from all foreign related parties minus the total amount of interest income received by the Korean company from foreign related parties. If the resulting value is negative, the net interest expense will be deemed to be zero.

In addition, loans from foreign affiliates should be at arm's length. Currently, the default interest rate (deemed arm's length interest rate) for loans from a foreign affiliate to a Korean company is the market interest rate for the relevant currency (such as the Secured Overnight Financing Rate for US dollars and the Euro Short-Term Rate for euros) plus a 1.5% spread, and the default interest rate for loans from a Korean company to its foreign affiliate is 4.6%. If a separate TP analysis is conducted, the arm's length rate can be determined based on such analysis.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

As Korean companies are taxed on their worldwide income, their foreign source income is also subject to tax in Korea. However, taxes imposed by foreign governments on foreign income are creditable up to the amount of income tax to be paid in Korea. Any excess foreign tax credit can be carried forward ten years.

6.2 Non-Deductible Local Expenses

This question is not applicable in South Korea.

6.3 Taxation on Dividends From Foreign Subsidiaries

The Korean government introduced a participation exemption for dividends from foreign subsidiaries through the 2022 tax law amendment. Under the participation exemption rule, if a Korean company receives dividends from a foreign subsidiary, a dividend received deduction applies to 95% of the dividends and only the remaining 5% of such dividends are treated as taxable income, to the extent the Korean company has directly held at least 10% of the shares in the foreign subsidiary for at least six months as of the dividend date. However, this does not apply to dividends received from CFCs and hybrid financial products, which are subject to the foreign tax credit system instead.

6.4 Use of Intangibles by Non-Local Subsidiaries

Intangibles developed by Korean corporations can be used by or transferred to foreign affiliates. However, arm's length consideration should be received for the transfer, and such consideration would be included in taxable income for CIT purposes.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Korea has CFC rules designed to prevent Korean corporations avoiding tax on income retained by foreign subsidiaries. The CFC rules apply when a Korean corporation directly or indirectly owns at least 10% of the shares of a company established in a low-tax jurisdiction. For this purpose, a country is considered to be a low-tax jurisdiction if the foreign subsidiary has an average effective income tax rate of 16.8% or less for the past three years. When applicable, Korea's CFC regime deems the CFC to have paid a dividend to the Korean parent equal to the earnings of the foreign subsidiary. This dividend is included in the parent corporation's taxable income.

A foreign corporation that is incorporated in a low-tax jurisdiction and actively engages in business is not subject to the CFC rules. Furthermore, the CFC rules do not apply to a foreign branch of a Korean corporation.

6.6 Rules Related to the Substance of Non-Local Affiliates

Under Korean tax law, the substance-over-form principle applies to both domestic and foreign corporations, and there is no rule relating to substance that applies solely to foreign affiliates. The Korean tax authority tends to use this principle to disregard the immediate foreign recipient of the Korean source income and attribute such income directly to the parent company.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains arising from the sale of shares in a foreign affiliate are taxed as ordinary income to the Korean shareholder. Foreign taxes paid by the Korean shareholder on such capital gains are allowed as a credit (up to the amount of Korean income taxes paid).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

Korean tax law contains substance-over-form rules, which are used by the Korean tax authority to recharacterise transactions and look-through entities residing in favourable tax jurisdictions that are not deemed to be the beneficial owner of the Korean source income.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The NTS conducts periodic and non-periodic audits. Periodic audits typically take place every four or five years and are usually completed within two months, unless extended. Advance notice should be provided 20 days prior to the commencement of a periodic audit.

Non-periodic audits do not require prior notice and can be conducted at any time. According to the NTS, taxpayers are selected for non-periodic audits in the following circumstances:

- where the taxpayer fails to fulfil its tax compliance obligations under the relevant tax law;
- where the taxpayer is suspected of entering into false transactions, such as transactions without valid documentation or disguised/fictitious transactions;
- where detailed information on the taxpayer's tax evasion is reported; or
- where the NTS has evidence of omissions or errors in the tax return.

Upon completion of a tax audit, written notice of the audit results is provided. In the event of any objections, the taxpayer can request a Review of Adequacy of Tax Imposition (RATI) within 30 days of the receipt of such notice (before the final tax assessment is issued).

9. BEPS

9.1 Recommended Changes

Korea has adopted most of the 15 BEPS action plans recommended by the OECD through amending relevant domestic laws and treaties, as follows:

- BEPS Action 1 (digital economy) – in 2015, Korea introduced a new provision in the VAT Law that imposes VAT on applications provided in offshore open markets, and in 2019 it expanded the scope of the extraterritorial VAT regime for electronically supplied services;
- BEPS Action 2 (hybrid mismatch arrangements) – the Korean government introduced rules to neutralise the effect of hybrid mismatch arrangements in 2018;
- BEPS Action 3 (CFC rules) – Korea expanded the scope of CFCs in 2017;
- BEPS Action 4 (interest deductions) – Korea introduced a new interest deduction limitation rule in 2018;
- BEPS Action 5 (harmful tax practices) – in 2019, the Korean government abolished the CIT exemption previously available to foreign-invested companies;
- BEPS Action 6 (treaty abuse) – Korea adopted relevant provisions when entering into or amending tax treaties, and participated in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI);
- BEPS Action 7 (permanent establishment status) – Korea broadened its definition of permanent establishments in 2019;
- BEPS Actions 8 to 10 (transfer pricing) – in 2019, Korea amended TP rules relating to the substance-over-form principle and intangibles;
- BEPS Action 11 (BEPS data analysis) and BEPS Action 12 (disclosure of aggressive tax planning) – the Korean government is considering legislative changes;
- BEPS Action 13 (transfer pricing documentation) – in 2016 and 2017, Korea revised the Korean TP regulations to require certain multinational companies that engage in cross-border related-party transactions to file a Master

File, a Local File and a Country-by-Country (CbC) Report;
- BEPS Action 14 (dispute resolution) – in 2017, Korea allowed non-residents and foreign companies that do not have a place of business in Korea to request a MAP in Korea; and
- BEPS Action 15 (MLI) – Korea signed the MLI in 2017, which took effect in September 2020.

9.2 Government Attitudes

The Korean government has implemented a tax reform to boost economic growth through adopting the OECD BEPS measures. For instance, in alignment with the OECD recommendations, Korea strengthened anti-avoidance measures on BEPS Action 7 to prevent abusive business structures that might erode Korea's tax base.

Korea announced a tax law amendment proposal in July 2022, which included the introduction of Pillar Two provisions that are generally in line with the OECD Guidelines. The National Assembly approved the tax law amendment proposal in December 2022, and the Pillar Two provisions become effective for fiscal years commencing on or after 1 January 2024. In addition, the Korean government issued a Presidential Decree on 29 December 2023, and a draft Ministerial Order on 27 February 2024. The Korean Pillar Two legislation is generally consistent with the OECD Model Rules, Commentary and Administrative Guidance.

Pillar One is likely to affect only two or three Korean multinational enterprises, given the higher profitability threshold, but Pillar Two is expected to affect many Korean multinational enterprises that satisfy the EUR750 million revenue threshold.

9.3 Profile of International Tax

Since the launch of the OECD's BEPS Project, the Korean government has increased efforts to comply with the BEPS standards. In addition, many non-governmental organisations have raised concerns over various schemes used by multinational companies to avoid paying taxes in Korea even when substantial revenue is realised in Korea.

9.4 Competitive Tax Policy Objective

Korea previously had tax incentives aimed at attracting foreign direct investment. However, in December 2017 the EU concluded that it was unfair that these tax incentives applied only to foreign investors, and placed Korea on its blacklist of non-co-operative jurisdictions. Korea revised its tax law to eliminate the disputed preferential tax exemptions, reflecting the Korean government's efforts to comply with BEPS standards.

9.5 Features of the Competitive Tax System

Korea has relatively high CIT rates compared to other OECD countries. However, in 2023, CIT rates for all tax brackets were reduced by 1.1% (inclusive of local income tax). In addition, the government expanded the scale of employment-related tax support by introducing an integrated employment tax credit system and unifying the employment-related tax support system, and also expanded the tax incentives for investment in national strategic technology (semiconductor/battery/vaccine) facilities.

Other incentives are still provided to eligible foreign direct investments, such as cash grants or exemptions from acquisition tax, property tax and customs duties, as explained in **2.3 Other Special Incentives**.

9.6 Proposals for Dealing With Hybrid Instruments

Korea introduced a BEPS-driven rule that limits interest deductions for hybrid financial instruments. This rule has been effective since 1 January 2018, and applies to interest on cross-border hybrid financial instruments between Korean corporations (or Korean branches of foreign corporations) and foreign related parties.

9.7 Territorial Tax Regime

Korea has a worldwide tax regime rather than a territorial tax regime. However, as explained in **6.3 Taxation on Dividends From Foreign Subsidiaries**, Korea introduced a participation exemption for dividends paid by qualified foreign subsidiaries to Korean companies.

9.8 Controlled Foreign Corporation Proposals

This question is not applicable in South Korea.

9.9 Anti-Avoidance Rules

The Korean tax authority handles treaty abuse by applying domestic anti-avoidance rules, such as the substance-over-form principle. Korea has also adopted the LOB (Limitation of Benefits) and PPT (Principal Purpose Test) provisions, which are aimed at ensuring a minimum level of protection against treaty shopping; therefore, additional scrutiny of cross-border tax planning arrangements is expected.

9.10 Transfer Pricing Changes

The 2019 tax reform introduced a new rule for determining arm's length pricing in cross-border transactions involving intangibles, which also addresses appropriate remuneration for functions performed (ie, the development, enhancement, maintenance, protection and exploitation of intangibles). The comparable uncontrolled price (CUP) method, the profit split method and the valuation method (discounted future cash flows) became effective on 12 February 2019 and take precedence over other TP methods; companies performing functions and assuming relevant risks regarding the development, enhancement, maintenance, protection and exploitation of intangibles should receive appropriate remuneration for the contributions they have made.

In light of this tax reform, additional scrutiny is expected on the transfer pricing of intangible assets.

9.11 Transparency and Country-by-Country Reporting

According to the OECD's CbC Reporting Compilation of Peer Review Reports (Phase 1), Korea has indicated that measures are in place to ensure the appropriate use of information in all six areas identified in the OECD Guidance on the appropriate use of information contained in CbC Reports. In other words, Korea uses CbC Reports to assess high-level transfer pricing risks and other BEPS-related risks.

As of February 2025, Korea exchanges CbC Reports with 108 countries. Korea does not make information received from other jurisdictions available to the public. Since CbC Reports provide substantial information to the tax authority that could be used to assess whether companies have BEPS-related issues, these reports may trigger aggressive tax audits and tax assessments.

9.12 Taxation of Digital Economy Businesses

Korea has already amended the VAT Law by introducing an extraterritorial VAT regime for electronically supplied services. Under this regime, a foreign entrepreneur who supplies certain electronic services in Korea bears the obligation to report and pay VAT. For this purpose, *"electronic services"* includes the supply of electronic goods, such as:

- game/audio/video files or software;
- advertising posting services;
- cloud computing services;
- intermediary services enabling the lease/use/consumption of commodities or facilities in Korea; and
- the supply of goods or services in Korea.

9.13 Digital Taxation

According to the Ministry of Economy and Finance, the Korean government has proactively adopted OECD BEPS recommendations and will follow the OECD's long-term plan on digital taxation. With respect to whether Korea will adopt an interim unilateral measure like the UK's digital services tax, the Korean government clearly indicated that a prudent approach should be taken by analysing any impact on related industries and tax revenue.

As discussed in **9.2 Government Attitudes**, the Korean tax law provisions relating to Pillar Two became effective for fiscal years commencing on or after 1 January 2024, but the implementation of the UTPR (Undertaxed Payment Rule) was deferred to 1 January 2025.

9.14 Taxation of Offshore IP

Korea has not introduced any general provisions dealing with the taxation of offshore IP that is deployed in Korea. However, where a tax treaty that Korea has concluded determines the source of royalties based on the location of the use of such royalties, certain IP (eg, patents) that is registered outside Korea but deployed in Korea can be subject to Korean tax.

Trends and Developments

Contributed by:
Je Heum Baik, Hyowon Lee, Jung Yeol Lee and Seo Youn Cho
Shin & Kim

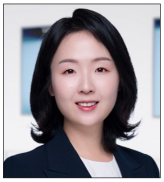
Shin & Kim advises on a wide range of tax areas including corporate tax, VAT, and local tax. The team offers comprehensive tax and legal services for corporate mergers and acquisitions, based on a combination of its expertise in legal, tax, and accounting matters. The firm's tax group consists of Korean attorneys, Korean accountants, foreign licensed attorneys and accountants. In addition, the team also incorporates individuals with valuable experience at the tax division of the Supreme Court as well as former members of the National Tax Service, the tax tribunal and also the Ministry of Public Administration and Security which deals with local taxes. Such a combination of professionals exemplifies the strength and breadth of the insights and services the team can provide.

Authors

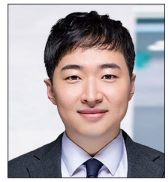
Je Heum Baik heads Shin & Kim's tax practice. He has been practicing over 25 years and is known for his success in large tax cases, the largest one involving KRW1.7 trillion. Mr Baik is committed to educating the next generation of lawyers and is an adjunct professor at various prestigious institutions, including Seoul National University. Most recently, Mr Baik was the chairman of the International Fiscal Association Korea.

Jung Yeol Lee is a partner at Shin & Kim, handling overall tax affairs including customs, tax consulting and appeals. Mr Lee has successfully handled tax/customs appeals, tax/customs investigations, foreign exchange reviews, and tax consulting services for domestic and international companies.

Contributed by: Je Heum Baik, Hyowon Lee, Jung Yeol Lee and Seo Youn Cho, **Shin & Kim**



Hyowon Lee is a senior foreign attorney at Shin and Kim, specialising in US and international taxation, with a focus on cross-border disputes and regulatory compliance. Prior to joining Shin & Kim, Ms Lee worked at the Internal Revenue Service, Office of Chief Counsel, where she worked on guidance projects and private letter rulings. She also spent six years at major international law firms in Washington, DC, advising multinational corporations on international tax issues. Ms Lee combines her legal expertise with a background in business administration and statistics to deliver complex analysis.



Seo Youn Cho is a Korean attorney and accountant at Shin & Kim who primarily concentrates on tax litigation for major companies in Korea. Mr Cho also passed the CFA Level II exam before starting his practice as an attorney. Prior to joining Shin & Kim, Mr Cho worked at the Big Four accounting firms in South Korea, specifically PwC Samil accounting firm and EY Hanyoung accounting firm.

Shin & Kim LLC

23F, D-Tower (D2)
17 Jongno 3-gil
Jongno-gu
Seoul 03155
Korea

Tel: +82 2 316 7283
Fax: +82 2 756 6226
Email: sjchoi@shinkim.com
Web: www.shinkim.com

SHIN & KIM
법무법인(유) 세종

Korea's Implementation of the Global Anti-Base Erosion Tax and Tax Enforcement Trends

Global Anti-Base Erosion Tax

Introduction

South Korea has solidified its position as a global leader in adopting the OECD's Pillar Two Global Anti-Base Erosion (GloBE) rules, becoming the first country to codify these regulations into domestic law through the Adjustment of International Taxes Act (AITA) in December 2022. The framework, effective from 1 January 2024, mandates a 15% minimum effective tax rate (ETR) for multinational enterprises (MNEs) operating across jurisdictions, countering profit shifting and tax avoidance. Subsequent amendments in 2023–25 reflect evolving OECD administrative guidance and address domestic challenges, positioning Korea as a benchmark for early adopters. This analysis examines Korea's legislative trajectory, technical implementation mechanics, and strategic implications for businesses.

Legislative evolution and key amendments

Phase 1: The 2022 AITA framework

The 2022 AITA introduced two core mechanisms to enforce the 15% global minimum tax:

- Income Inclusion Rule (IIR): Requires Korean parent entities to pay *"top-up tax"* if subsidiaries in low-tax jurisdictions report an ETR below 15%.
- Under-Taxed Payments Rule (UTPR): Acts as a backstop, allowing Korea to claim residual taxes if other jurisdictions fail to enforce the IIR.

Initially, both rules were set to take effect on 1 January 2024. However, revisions in 2023–24 refined their implementation timelines and scope.

The AITA aligned closely with the OECD's December 2021 Model Rules but left critical details to subsequent presidential decrees and enforcement guidelines.

Phase 2: The 2023 Amendments and Enforcement Decree

In July 2023, Korea proposed amendments to align its framework with evolving OECD guidelines and global practices, and operationalised technical details. Key changes included:

- UTPR Postponement: Implementation postponed to 1 January 2025, harmonising with timelines in the EU, Japan, and other jurisdictions.
- Permanent Establishment (PE) Expansion: Broadened the definition of PE to include treaty-based classifications if the source state taxes income attributable to the PE.
- Transitional Penalty Relief: Introduced a 50% reduction in late-payment penalties for filings before 30 June 2028, easing transitional burdens.
- QDMTT Safe Harbor: Qualified Domestic Minimum Top-Up Taxes (QDMTT) could reduce GloBE liabilities, pending presidential decree specifics.
- Exclusions: Sovereign wealth funds and insurance investment entities exempted from certain parent entity definitions.
- CFC Pushdown Limitation: Deferred passive income definitions to future guidance.

Phase 3: The 2024 tax amendments

Enacted in December 2023, these amendments introduced critical safe harbors and technical clarifications, incorporating OECD guidelines:

- Transitional Safe Harbor: Exempts MNEs from the IIR in jurisdictions with a nominal corpo-

rate tax rate ≥20% for fiscal years ending before 31 December 2026.
- Simplified ETR Calculation: Allows MNEs to avoid top-up taxes if preliminary calculations demonstrate an ETR ≥15%.
- Consolidated Revenue Standardisation: Aligned revenue definitions with OECD guidelines to prevent discrepancies arising from financial reporting practices.
  (a) GloBE-Specific Book Values: Deferred tax adjustments based on GloBE-defined asset values, not local GAAP/IFRS.
  (b) Tangible Asset Leases: Lease receivables classified as *"tangible asset cost recovery"* items eligible for deferred tax exclusions.
- Joint Venture Clarifications: Treated joint ventures and subsidiaries as separate entities for safe harbor assessments.

Phase 4: The 2025 tax amendment

Published in January 2025, the decree clarified ambiguities in the AITA and the OECD model rules.

Deferred Tax Adjustments:

- GloBE-Specific Values: Requires deferred tax adjustments based on GloBE-defined book values rather than GAAP/IFRS.
- Tangible Asset Leases: Costs classified as lease receivables qualify for deferred tax liability exclusions if linked to tangible asset recovery.

Dividend Deduction System:

- Two-Step Adjustment:
  (a) Reduce covered taxes by the ratio of GloBE income deductions.
  (b) Deduct the adjustment amount from GloBE income.
- Redistributed Dividends: Treats redistributed profits as deductible from the parent entity's GloBE income.

Fiscally Transparent Entities and Fixed Establishments:

- Exclusion of PE Income: Income attributable to permanent establishments of fiscally transparent entities (eg, partnerships) is excluded from GloBE calculations.
- Ownership Thresholds: Applies pro-rata exclusions based on ownership stakes in joint ventures.

Technical mechanics of Korea's GloBE rules

The GloBE Rules apply to MNEs with annual consolidated revenue of at least EUR750 million in two of the four preceding fiscal years, operating across multiple jurisdictions. This includes subsidiaries that might be excluded from consolidated financial statements due to immateriality, such as held-for-sale assets, and entities with significant financial discrepancies exceeding EUR75 million when reconciled to IFRS standards.

The core of the GloBE Rules is the top-up tax calculation, which aims to ensure each jurisdiction's ETR reaches the minimum 15%. This calculation uses jurisdictional blending, meaning ETRs are determined at the jurisdictional level rather than for individual entities. The adjusted net income for this calculation includes additions like net tax expenses and intra-group financing costs, while deducting items such as dividends redistributed to parent entities.

For compliance, MNEs must submit a GloBE Information Return, with the first submission due in June 2026 for the 2024 fiscal year. This return requires detailed information including taxpayer identification, ownership structures, jurisdictional ETRs, covered taxes, and top-up tax liabilities. The rules accept various accounting standards, including those from 18 different jurisdictions such as Japan's J-GAAP, China's CAS, and Singapore's SFRS, providing some flexibility for MNEs operating across different accounting regimes.

Implications and challenges

The implementation of the GloBE Rules in South Korea presents significant implications for Korean MNEs. The US Inflation Reduction Act (IRA) tax credits may lower the ETRs of US subsidiaries, potentially triggering top-up taxes in Korea. However, the OECD has yet to provide guidance on whether IRA credits qualify as *"covered taxes"* under GloBE, creating uncertainty.

Additionally, compliance costs are expected to rise, with large MNEs facing annual expenses of USD5-10 million for jurisdictional ETR tracking and GloBE return preparation. This includes reconciling differences between IFRS and GloBE-defined book values for deferred tax adjustments. To manage these challenges, Korean MNEs must closely monitor OECD guidance and implement robust compliance systems.

The implementation of the UTPR also presents risks. While Korea's UTPR is set to take effect in 2025, actual tax collection will not begin until 2026, coinciding with timelines in the EU and Japan. This staggered implementation across jurisdictions, coupled with a lack of comprehensive multilateral agreements, raises concerns about potential double taxation as different countries may make conflicting claims.

Certain industries face specific pressures under the new regime. Korean semiconductor manufacturers with fabrication plants in the USA will be subject to increased scrutiny due to the interactions between the IRA and GloBE rules. In the automotive sector, companies will need to carefully reassess the ETRs of their European subsidiaries in light of UTPR backstops.

To navigate these challenges, MNEs should consider several strategic recommendations. Implementing robust ETR monitoring systems is crucial, including the deployment of real-time tax rate tracking tools across jurisdictions and the integration of GloBE adjustments into Enterprise Resource Planning systems for automated reporting. Vigilant monitoring of OECD guidance is also essential, particularly regarding pending clarifications on IRA credits, digital services taxes, and sectoral carve-outs. Engaging with the OECD's Inclusive Framework can help companies anticipate regulatory shifts.

Cross-border co-ordination will be vital, with Korean parent entities needing to align with EU and Japanese subsidiaries on safe harbor eligibility. Negotiating advance pricing agreements can help mitigate transfer pricing disputes.

Scenario planning is another key strategy, involving modeling the impacts of nominal tax rate changes, such as potential US corporate tax hikes, on transitional safe harbors and stress-testing GloBE liabilities under various macroeconomic conditions.

In the global context, Korea's approach to GloBE implementation differs in some respects from that of the EU and Japan. Korea's 2025 UTPR start aligns with the EU but precedes Japan's 2026 timeline. Additionally, Korea's 20% nominal tax rate threshold for IIR exemptions is more stringent than the EU's 15 *"substance-based carve-out."* There are also divergences in the treatment of QDMTT, with Korea's safe harbor details still pending presidential decree, in contrast to the EU's predefined profit-based thresholds. Japan's delayed QDMTT adoption until 2027 creates temporary gaps for MNEs with Japanese subsidiaries.

South Korea's implementation of the GloBE rules demonstrates a proactive yet adaptive approach, balancing OECD alignment with domestic industry needs. The legislative amendments from 2022 to 2025, including transitional safe harbors, deferred tax adjustments, and UTPR postponement, show responsiveness to evolving global standards. However, challenges remain, particularly regarding the unresolved treatment of IRA credits, UTPR co-ordination gaps, and rising compliance costs.

For businesses to succeed in this new tax landscape, they must focus on three key pillars:

- investing in GloBE-compliant tax tracking technology;
- fostering cross-jurisdictional collaboration to prevent double taxation; and
- engaging proactively with policymakers to shape emerging OECD guidelines.

As the OECD continues to refine its technical specifications, Korea's experience provides valuable insights for other jurisdictions implementing Pillar Two. MNEs must view GloBE not just as a compliance issue, but as a strategic imperative that will reshape global tax landscapes for years to come.

Tax Enforcement Trends

Introduction

South Korea's National Tax Service (NTS) has intensified its focus on cross-border transactions and digital economy taxation, deploying advanced audit techniques while reinterpreting traditional tax concepts. This evolution reflects Korea's broader strategy to align its tax base with modern business models while maintaining aggressive enforcement against perceived profit shifting. The following analysis explores key trends shaping corporate tax audits, offering insights into evolving compliance risks and strategic considerations for businesses operating in Korea.

Permanent establishments (PEs) for digital platforms

The NTS has aggressively reinterpreted the concept of permanent establishments since the 2018 Corporate Tax Act (CTA) amendment, which incorporated OECD BEPS Action 7 recommendations. Under revised Article 5 of the CTA, a PE now includes digitally integrated operations where multiple locations perform complementary functions, even without a traditional fixed place of business.

Even before the amendment to the CTA, the taxing authority in Korea levied taxes on major global digital platforms in Korea for fiscal years prior to 2019. For example, in one such case, the NTS imposed taxes on a foreign corporation by indicating that a foreign corporation was acting as a distributor for the region even though it did not have a permanent establishment in Korea. The global digital platform company had five locations in Korea, and NTS argued that these locations combined constituted a permanent establishment of the foreign corporation because they were carrying out essential and important parts of the foreign corporation's business. Even if a physical permanent establishment is not recognised, NTS argued that a deemed permanent establishment should be recognised because some of these locations exercised the right to conclude contracts and bind the foreign corporation.

Based on such arguments and issues raised during the tax audit, the taxpayer took this case to the tax tribunal, which found in favour of the NTS. Thus, the taxpayer has launched legal action against the NTS indicating that the basis of taxation is improper and there is no basis for permanent establishment in Korea. Even if the NTS is not successful in the current legal proceedings, due to the amendment to the definition of permanent establishment in 2019, we foresee this issue to be raised during tax audits of other global digital platform companies. To date, there are several cases, each at different levels of the legal proceeding or tax audit, which is an indication that this issue will be raised persistently by the NTS. As there is no Supreme Court precedent on this matter, global digital platform companies should be on guard and ready to defend their positions in case of a tax audit by the NTS of said issue.

Foreign patent royalties

The taxation of patents not registered in Korea remains a contentious issue. The debate has evolved through several key Supreme Court (SC) rulings and legislative reforms:

- 2007 SC Ruling: Applied the territorial principle, stating that patent rights are only effective where registered. Royalties received by a US taxpayer from a Korean corporation for patents registered only in the USA were not considered domestic-source income under the US-Korea tax treaty.
- 2008 CTA Amendment: The NTS amended Article 93 of CTA to classify the *"use"* of overseas-registered patents in Korea for manufacturing and sales as domestic-source income, even if not registered in Korea.
- 2014 SC Ruling: Reaffirmed the 2007 decision, holding that royalties received by a US taxpayer for overseas-registered patents licensed to a Korean corporation did not constitute domestic-source income under the US-Korea tax treaty.
- 2019 AITA Amendment: Article 28 of the AITA was amended to remove the concept of tax treaties taking precedence over domestic law in classifying domestic-sourced income.
- 2022 SC Ruling: Took a narrower approach, holding that a patent holder's exclusive rights are effective only in the country of registration. This allows the NTS to withhold taxes on royalty income from unregistered rights (eg, know-how, copyright) used in Korea, while maintaining that unregistered patent rights benefit from the US-Korea tax treaty.

Despite these SC rulings, the NTS has persisted in levying taxes on royalty income in Korea. At the tax tribunal level, cases are often ruled in favour of the NTS based on domestic law prescribing such income as domestic-sourced.

On 12 August 2024, the NTS issued an authoritative interpretation stating that lump-sum payments received by US corporations without a domestic place of business for patent rights transferred to Korean corporations constitute domestic-source royalty income. This interpretation considers the future cash flows of the patent rights and reaffirms the NTS's position on taxing royalties from unregistered patent rights as domestic-source income.

Looking Forward

The cases that have reached the SC thus far predate the 2008 amendments to CTA and AITA. Currently, several cases are pending in administrative and high courts regarding withholding tax on royalty income from foreign patents. The most recent SC decision has clarified what constitutes a foreign-registered patent, but the NTS is likely to continue arguing that payments for know-how, non-public information, or copyrights constitute domestic-source income.

Given this ongoing debate, it is crucial for companies entering licensing agreements to clearly distinguish and specify the nature of royalty payments. This distinction should clarify whether payments are for foreign patent rights or for the use of know-how and other non-public information, as this categorisation can significantly impact tax treatment in Korea.

SPAIN

Law and Practice

Contributed by:
Raúl Salas, Elena Ferrer-Sama and Cristina Cavero
RocaJunyent

Contents

RocaJunyent was established in 1996 and is one of the most prominent Spanish law firms. It has offices in Madrid, Barcelona and Gerona, as well as associated offices in Palma de Mallorca, Lérida, Tarragona, Málaga, Seville, Bilbao, Badajoz, Burgos and Valladolid. The firm offers advice in all areas of law, especially those related to commercial, banking and financial, procedural and tax law. RocaJunyent is the only Spanish member of the international network TerraLex. Taxes are levied on all kinds of entities and in many situations, which is why RocaJunyent's tax department is prepared to respond to all kinds of problems – from large companies and their complex structures/operations to individual wealth/inheritance issues. The firm's services include business taxation, tax wealth management, M&A, transactions taxation, transfer pricing and tax litigation.

Authors

Raúl Salas is a tax partner at RocaJunyent, where he leads the tax practice in the Madrid office. With more than 30 years' experience, he has participated in some of the most important M&A and real estate operations in the Spanish and European markets. Raúl has acted as the lead adviser for several major international groups when litigating with Spanish tax authorities and with the tax authorities in other European countries. Besides M&A, his areas of specialisation include tax advice for financial institutions and energy and infrastructure companies. Raúl has also published numerous articles in financial newspapers and specialised journals, and has appeared as a guest speaker at seminars and courses on tax issues.

Elena Ferrer-Sama is the director of the tax department at the Madrid office of RocaJunyent. She has more than 20 years' experience in general tax planning and advice – for multinational group companies, in particular – and has an extensive knowledge of direct taxation, especially in the business reorganisation and tax inspection areas. Elena has a law degree from the Complutense University of Madrid (UCM) and a master's degree in Business Tax Advice from the Instituto de Empresa. She has published several specialised articles and collaborated in a number of publications on tax matters, and has taken part in many tax seminars and courses.

Cristina Cavero is a senior associate at the tax department of RocaJunyent. She holds a degree in Law and Business Administration from the Pontifical University of Comillas and a master's degree in Tax Advice from IE Law School. Cristina provides recurrent tax advice to legal entities and individuals, both residents and non-residents, on direct and indirect taxation matters. Additionally, she advises companies and individuals on tax planning and tax auditing.

RocaJunyent

José Abascal Street, 56
6th Floor
28003
Madrid
Spain

Tel: +34 619 015 251
Fax: +34 917 81 97 64
Email: r.salas@rocajunyent.com
Web: www.rocajunyent.com/en/firm

RocaJunyent

Contributed by: Raúl Salas, Elena Ferrer-Sama and Cristina Cavero, **RocaJunyent**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Spain are generally developed as corporate entities, of which the most common forms are:

- joint stock companies (*sociedades anónimas*, or SA), requiring a minimum share capital of EUR60,000; and
- limited liability companies (*sociedades limitadas*, or SL), requiring a minimum share capital of EUR3,000.

The responsibility of the shareholders is limited in both cases.

From a tax perspective, corporations – including other types of commercial companies (not just the SA or SL) – are usually subject to corporate income tax (CIT) regulations, which are levied on all legal entities resident in Spain. Certain entities can be exempt from CIT. This exemption applies mainly to public entities and to certain income from non-profit organisations.

CIT rules are also applicable to non-corporations, such as partnerships or lying heritages, provided that they have a business purpose. In the event that they do not have a business purpose, their income will be allocated (transparently) to their partners or co-proprietors. This is also the case for economic interest groupings, where profits or losses are taxed at the level of their co-proprietors.

1.2 Transparent Entities

The most common types of transparent entities that are taxed under the income allocation regime (*regimen de atribución de rentas*) are civil partnerships without legal status or without commercial object.

The income allocation regime applies to the following entities.

- Communities of property.
- Lying heritages.
- Civil partnerships – although since 1 January 2016, the system only applies to:
  - (a) civil partnerships without legal status; and
  - (b) civil partnerships with legal status that do not have a commercial object (ie, those engaged in agricultural activities, livestock activities, forestry activities, mining activities, and those of a professional nature subject to the law on professional societies).
- Any entity that, not having legal status, constitutes an economic unit or separate assets liable to taxation.
- Entities established abroad whose legal nature is identical or similar to that of entities attached to the income allocation regime constituted in accordance with Spanish law.

Moreover, the Spanish CIT Act provides for other special fiscal transparency regimes that are commonly adopted in particular business sectors.

Temporary Business Association

Under Spanish law, a Temporary Business Association (*Unión Temporal de Empresas*, or UTE) is a system of collaboration between companies for the purpose of carrying out a specific project or service for a specified or unspecified period of time.

The purpose of a UTE is business collaboration in order to achieve a result that, owing to its importance or volume, would be difficult to achieve by just one of the companies alone. In practice, UTEs are frequently used for the execution of public infrastructure project works (such as roads, a recycling plant, etc) in which each company member of the UTE is specialised in a specific part of the project. Though form of association is very common for engineering and construction projects, it can be used in other sectors as well.

Economic Interest Grouping

The aim of an Economic Interest Grouping (*Agrupación de Interés Económico*, or AIE) is to allow companies to join forces where they have common interests, while continuing to preserve their ultimate independence.

The AIe, is a trading company whose sole purpose is to carry out an economic activity ancillary to that carried out by its members, without aiming to obtain any profit, who may be:

- natural or legal persons engaged in business, agricultural or craft activities;
- non-profit entities engaged in research; or
- those exercising liberal professions.

It enables certain companies to carry out commercial activities that would be impossible to carry out on their own, such as market research, centralised purchasing, sales, information management or administrative services.

The AIe, has its own legal personality and commercial character. However, it may not hold shares in companies that are members of the AIe, – nor may it directly or indirectly manage or control the activities of its members or third parties.

This type of entity is used to transfer tax credits to investors in relation to R&D, movies and musical productions.

1.3 Determining Residence of Incorporated Businesses

There are three tests for determining whether a company is resident for tax purposes in Spain:

- whether the company was incorporated under Spanish law;
- whether the registered office of the company is located in Spanish territory; or
- whether the place of effective management (ie, direction and control of the company's activity) is located in Spanish territory.

If any of the foregoing requirements is met, the company can be considered resident in Spain.

Under certain conditions, Spanish tax authorities can assume that an entity located in a tax haven – or in a country with no taxation – is a tax resident in Spain. In order for this assumption to be applicable, the main assets and rights of the entity must be (directly or indirectly) located in Spain or else its main activity must be carried out in Spain.

In the case of transparent entities (such as partnerships), taxation would depend on the partner's residency. Spanish-resident partners are liable to pay tax in Spain on their share of the worldwide profits of the partnership. Non-resident partners are only liable to pay tax on profits that accrue in Spain.

1.4 Tax Rates

The standard CIT tax rate is 25% and applies to most companies, although there are other specific rates for small entities with a net turnover for the immediately preceding period of between

EUR1 million and EUR10 million. Special tax rates apply to certain activities – for example, banking, mining, and oil and gas are subject to a 30% tax rate. Non-profit entities are subject to a 10% tax rate, whereas investment funds and undertakings for collective investment in transferable securities (UCITS) are taxed at 1%.

As of 2023, entities with a turnover of more than EUR20 million during the prior 12-month tax period cannot apply tax credits to reduce current-year tax below 15% (ie, minimum tax of 15% of the tax base). In addition, as detailed in **9. BEPS**, the transposition of Council Directive 2022/2523 (with effect as of 2024) has implemented a complementary tax to guarantee a global minimum level of taxation for multinational groups that have annual income of EUR750 million or above in the consolidated financial statements of their ultimate parent entity in at least two of the four immediately preceding tax years.

There is a special 15% rate for newly created companies, which is applicable to the first tax period in which profit is obtained as well as the following period.

However, partnerships are transparent for corporate tax purposes, so that profits and losses are taxed at the partners' level in proportion to their partnership interests.

The income of individuals who own a business (or who are partners in a transparent partnership carrying out business) – whether generated by themselves or through the partnership – could be taxed at a maximum tax rate ranging from 45.5% to 54%, depending on the autonomous community of residence.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable profit is a company's gross income for the tax period, minus certain deductions. It is determined by the annual financial statements prepared in accordance with Spanish generally accepted accounting principles (SGAAP) that mostly follow International Financial Reporting Standards (IFRS), as adjusted for certain statutory tax provisions. The tax authorities are legally authorised to modify accounting reports in order to determine taxable profit if they consider that the accounting reports have not been calculated according to the SGAAP.

All necessary expenses and costs connected to producing income may be deducted from gross income in order to arrive at a taxable income determination. Additionally, the Spanish CIT Law provides for certain items that are never deductible (permanent differences, such as penalties) or that are deductible in a different year (timing differences, such as differences between accounting depreciation and tax depreciation).

2.2 Special Incentives for Technology Investments

There is currently a patent box system in Spain. In this respect, a reduction of the tax base can be applied to the income obtained by entities from the transfer of the right to use or exploit certain assets (eg, patents, utility models, registered advanced software, and complementary certificates for the protection of medicines, phytosanitary products and legally protected designs) that have been generated by the entity's R&D and technological innovation activities. This reduction can amount to a maximum of 60% of the income and can also be applied to capital gains generated from the transfer of the above-mentioned assets to third parties. In the event that the transaction is carried out between related parties, the partial exemption will not apply.

Furthermore, a tax credit is available for R&D activities. The tax credit for carrying out R&D activities will be 25% of the R&D expenses incurred in the tax year and, if these expenses are higher than the average of those incurred for the same concept in the two previous tax years, the deduction will be up to 42% of these expenses. In addition, the companies may apply a tax credit of 17% of the amount of the personnel costs for qualified researchers assigned exclusively to R&D activities. There is also a tax credit of 8% on investments in fixed assets used exclusively for these activities. However, the tax credit for technological innovation activities will be 12% of the expenses incurred in the tax year related to this concept.

2.3 Other Special Incentives

Spain has several tax incentives for the production and financing of movies and TV series that are totally or partially shot in Spain. The incentive could amount to EUR20 million (EUR10 million in the case of TV series).

The tax credit provided for these activities will be 40% of the total cost of production, as well as the costs of obtaining copies and the costs of advertising and promotion to be borne by the producer of the movie, – provided that more than 50% of the cost of production corresponds to expenses incurred in Spanish territory.

2.4 Basic Rules on Loss Relief

Tax losses may be carried forward indefinitely, although any deduction is limited to 70% of the positive taxable income before the application of the tax benefit for the capitalisation reserve and other specific items. Tax losses of at least EUR1 million can always be offset without limitation.

Additionally, as of 2023, offsetting of current-year tax losses obtained by a company in a tax group against tax profits of other entities in the group cannot exceed 50% of such losses.

As of 2024, the following applies for companies' turnovers being reached in the 12 months prior to the commencement of the taxable period:

- EUR20 million – the offsetting of tax losses would have not exceeded 50% of the yearly taxable income before the capitalisation reserve and tax losses were offset; and
- EUR60 million – the offsetting of tax losses would have not exceeded 25% of the yearly taxable income before the capitalisation reserve and tax losses were offset.

As a final remark, the CIT Law provides anti-avoidance rules to prevent tax losses being utilised when there is a change in control.

2.5 Imposed Limits on Deduction of Interest

As a general anti-avoidance rule, interest paid to a group entity incurred in order to acquire shares (when the seller is another group entity) or to increase equity interests in other group members is wholly non-deductible – ie, tainted financial expenses – unless the operation might pass a business-purpose test.

The remaining net finance cost (ie, the net amount of financial income and cost, excluding the above-mentioned tainted financial expenses) is deductible up to an amount equal to 30% of the operating profit. The definition of operating profit in accounting is similar to EBITDA, minus the effect of:

- the amortisation of fixed assets;
- the subsidies for non-financial fixed assets and others; and
- the depreciation for impairment of fixed assets, as well as the gains or losses derived from the transfer of fixed assets.

The resulting amount should be increased with dividends derived from entities when the stake represents at least 5% of their share capital. This rule will not apply to dividends from subsidiaries that have been acquired from other companies of the group, with group debts generating the tainted non-deductible financial expenses referred to previously.

From the EBITDA should be excluded any income, costs or profit that are not part of the taxable income. According to Spanish tax authorities' criteria, this exclusion rule will not apply to timing differences – hence, timing differences will be considered in the EBITDA calculation in spite of the fact they might not be part of the taxable income.

A net financial cost greater than 30% of the operating profit could be carried forward and deducted in the following tax years (with no term limitation), within the same limit of 30% of the annual operating profit. Conversely, if the net financial cost is below 30% of operating profit (eg, capacity excess), such excess of capacity may be carried forward to deduct more financial cost in the following five years.

The aforementioned limitation (30% of the operating profit) does not apply when:

- the net financial cost does not exceed EUR1 million; or
- the borrower is either an insurance or financial entity.

In the case of entities belonging to a tax unit or tax consolidation group, all these calculations (net financial cost, operating profit, etc) would be referred to the whole tax group.

2.6 Basic Rules on Consolidated Tax Grouping

The Spanish CIT Law allows Spanish tax-resident companies and Spanish permanent establishments (PEs) belonging to a Spanish or multinational group to be taxed as a single group and, therefore, to apply a special tax-consolidation regime for CIT purposes.

In order to apply this regime, the main requirements are as follows:

- the Spanish companies should be owned – directly or indirectly – by the same parent company (either resident or non-resident);
- the parent company (either resident or non-resident) of the tax group must hold a direct or indirect minimum holding of 75% (70% for quoted companies) and the majority of voting rights in the Spanish companies must belong to the group;
- the above-mentioned participation should be maintained throughout the whole taxable period; and
- the parent company cannot be tax-resident in a tax haven.

The tax consolidation regime follows a number of basic rules. The taxable income results from the sum of all the taxable incomes of each Spanish tax-resident company in the tax group, adjusted as outlined in the following points.

- Participation exemption (ie, dividends and capital gains) is not affected by the tax consolidation tax grouping.

- Current tax losses of any of the companies in the tax group can be offset against any company's current tax profits – but, for 2023 and 2024, only up to 50% of such losses.
- Tax profits (other than intra-group dividends) generated from intra-group transactions are deferred and are only included in the consolidated taxable income when:
  (a) they are carried out with third parties;
  (b) one of the intra-group companies that is part of the transaction ceases to form part of the group; and
  (c) the consolidation regime is no longer applied.
- Specific limitations apply concerning the offsetting of tax losses or the application of tax credits generated by the group companies before they formed part of the tax group or joined the group.
- No withholding applies on payments made at intra-group level.

2.7 Capital Gains Taxation

Capital gains are normally classed as ordinary income taxable at the standard CIT rate (generally 25%) during the tax period in which they arise.

However, a 95% participation exemption currently applies to capital gains arising from the transfer of shares (either of resident or foreign entities) when:

- at least a 5% participation is held for an interrupted period of at least one year;
- the transferred entity is an operating entity; and
- certain other requirements are met.

In the case of a foreign subsidiary, an additional condition must be met. In order for the exemption to apply, the foreign subsidiary should have been effectively subject to (and not exempt from) a tax similar to CIT at a nominal rate of at least 10% in each and every year of holding the stake. This requirement is understood to be met when a tax treaty is applicable and includes an exchange-of-information clause.

Capital losses from shares that could benefit from the participation exemption are not tax-allowed, unless they come from liquidation (subject to certain conditions).

2.8 Other Taxes Payable by an Incorporated Business

Depending on the nature of the operations carried out by the business, the following taxes may be payable by an incorporated business on a transaction.

Value Added Tax (VAT)

Spanish VAT regulation implements the EU Directives on VAT. In Spain, VAT is levied on:

- the supply of goods and services provided by entrepreneurs and professionals;
- intra-community acquisitions; and
- the importation of goods into Spain.

The concept of entrepreneurs and professionals encompasses a large number of assumptions, but basically refers to those persons (physical or legal) who carry out business or professional activities – ie, activities that involve the commissioning of material and/or human means of production on their own behalf to intervene in the production or distribution of goods or services.

The Spanish territory in which the tax applies is the Iberian Peninsula and the Balearic Islands. In the Canary Islands, Ceuta and Melilla, other indirect taxes are applied – respectively, the Canaries General Indirect Tax (*Impuesto Gen-*

eral Indirecto de Canarias, or IGIC) and the Tax on Production, Services and Imports (*Impuesto sobre la Producción, los Servicios y la Importación*, or IPSI). The IGIC operates in a similar way to VAT, albeit with some differences when it comes to exemptions. Conversely, the IPSI is a basic sales tax.

There are three different rates of VAT:

- 21% (general rate applied to regular deliveries of goods and services);
- 10% (reduced rate applied to basic needs); and
- 4% (super-reduced rate applied to basic needs other than those classified in the reduced rate).

The ordinary rate of the IGIC is 7%. The other rates are 0%, 3%, 9.5%, 15% and 20%.

Property Transfer Tax

Property Transfer Tax (*Transmisiones Patrimoniales Onerosas*, or TPO) applies to the transfer of goods and rights when the transferor is a private individual. It also applies to real estate transfers and real estate leases when the seller is an entrepreneur but the transfer is either exempt from or beyond the scope of VAT.

The transfer of shares is exempt from both VAT and TPO. However, when the transfer is aimed at dissimulating the transfer of real estate owned by the company, the actual taxation of a transfer of real estate is applied.

TPO tax rates are as follows:

- 6% for the transfer of real estate (as well as for the establishment and transfer of rights in rem over the real estate);
- 4% in the case of the transfer of movable property and livestock; and
- 1% in the case of establishment of rights in rem of guarantee, pensions, bonds or loans.

The aforementioned rates may change from one region to another, as regional authorities have competence to increase those tax rates.

The Tax on Certain Digital Services

The Tax on Certain Digital Services (known as the *"Google tax"*) is an indirect tax that applies to the provision of certain digital services involving users located in Spain. This tax applies to companies with a worldwide turnover of more than EUR750 million and to Spanish income of more than EUR3 million.

The tax rate amounts to 3% of income resulting from rendering digital services as defined in the law. The taxable persons are the companies that provide digital services as defined in the law and that exceed the above-mentioned thresholds.

The Tax on Financial Transactions

The Tax on Financial Transactions (TFT) is an indirect tax that applies to the acquisition of shares in traded Spanish companies when they have a market capitalisation above EUR1 billion on December 1st of the year prior to the acquisition.

There are numerous cases of exemption, including for:

- acquisition of shares issued in the primary market;
- acquisition of shares acquired as a result of the execution of a takeover bid;
- acquisition of shares derived from transactions between entities of the same group;

- acquisition of shares carried out within an operation to which the Special Regime for Mergers applies (Chapter VII, Title VII of the CIT Law);
- acquisitions of treasury stock; and
- acquisitions in execution of a stock option plan by employees.

The tax rate amounts to 0.2% of the consideration paid exclusively for the shares, not including the expenses related to the transaction. The liable person is the intermediary acting in the operation, while the taxable person is the acquirer.

Stamp Tax

Stamp tax (document duties and registration fees) is levied on notarial instruments and records documenting transactions that need to be registered in public registries. The tax rates range from 0.5% to 1.5% of the operation value.

The Tax on the Increase in the Value of Urban Land

The Tax on the Increase in the Value of Urban Land is a local tax applied by local councils. This tax applies when urban real estate is transferred and when there is a gain for the transferor.

Tax on Non-Reusable Plastic Packaging

A new tax on non-reusable packaging entered into force in Spain. This tax is due on imports and intra-community acquisitions, for an amount of EUR0.45 per kilogram of non-recycled plastic in non-reusable packaging.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are also subject to the following notable taxes.

The Tax on Economic Activities

The Tax on Economic Activities (*Impuesto sobre las Actividades Económicas*, or IAE) is a direct tax. The IAE's taxable event is the mere exercise – on Spanish territory – of business, professional or artistic activities.

The Local Property Tax

The Local Property Tax (*Impuesto sobre Bienes Inmuebles*, or IBI) is a direct municipal tax on the value of real estate. It is periodic, real and mandatory in all councils. The rate of taxation will vary depending on the city council, ranging from 0.3% to 1.1% of the cadastral value.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form in order to be taxable by the CIT and to legally separate liabilities between the company and its holders.

3.2 Individual Rates and Corporate Rates

In order to prevent individual professionals from carrying out very personal activities through companies to avoid the application of personal income tax rates, the Spanish tax authorities use the rules for piercing the corporate veil and qualify transactions to ensure that they are actually carried out by individuals and not by the company.

3.3 Accumulating Earnings for Investment Purposes

There is no specific rule in Spain to prevent corporations from accumulating earnings for investment purposes. In fact, to encourage entities to increase their own funds, Spanish CIT provides a tax incentive for the capitalisation reserve. This tax relief is aimed at companies increasing their own funds, which entails a lower distribution of dividends to shareholders in exchange for lower taxation.

Entities that are taxed under the general tax rate can apply a special reduction to their positive taxable base in an amount equal to 20% of the increase in their net equity. The following conditions must be met in order to apply this reduction:

- there must be an increase in the entity's net equity that must be maintained during a three-year period; and
- a reserve for the amount of the reduction must be booked separately in the account balance and should be recorded as a restricted reserve for at least a period of three years.

However, this reduction cannot exceed 20% (25% for very small companies) of the entity's positive taxable base prior to certain adjustments. Excess over the aforementioned limit can be carried forward for application in the following two years.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends paid by closely held corporations are taxed as income from movable capital for Personal Income Tax (PIT) purposes.

Conversely, the sale of shares may produce a capital gain for the individual. This capital gain is calculated as the difference between the transfer value and the acquisition value. The transfer value will be the higher of these two values:

- the value of the net worth corresponding to the transferred securities resulting from the balance sheet corresponding to the last fiscal year closed prior to the date of accrual of the PIT; or
- the result of capitalising at the rate of 20% the average of the results of the three fiscal years closed prior to the date of accrual of the PIT.

Both dividends and capital gains form part of the savings base of the PIT, which is taxed on the basis of a tax-rate scale of between 19% and 30%, depending on the amount of the savings base (from EUR0 to more than EUR300,000).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are taxed on dividends and capital gains from the sale of shares in publicly traded corporations on the same basis as that previously explained regarding closely held corporations in **3.1 Closely Held Local Businesses**. The only difference concerns the calculation of the capital gain. In the case of publicly traded corporations, this is determined by the difference between the transfer value and the acquisition value – ie, the transfer value would be the list value at the time of the transfer.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

If no double-tax treaty applies, or a limit of taxation is not envisaged in the relevant double-tax treaty, payments made by a Spanish taxpayer to a non-resident entity will be subject to withholding tax in Spain at the following general rates:

- 19% on dividends and interest; and

- 19% on royalties paid to residents in the EU, Iceland and Norway (and 24% in all other cases).

For the application of a reduced rate or one of the exemptions described here, the taxpayer must be in possession of a tax-residence certificate issued by the tax authorities of the country of the recipient.

Domestic Law Exclusions or Exemptions

Dividends

According to the domestic law, dividends paid by a subsidiary to its EU parent company are exempt from withholdings when:

- the parent company holds at least a minimum of 5% in the Spanish subsidiary and the interest in the Spanish subsidiary has been held for at least one year before the dividend distribution (or will be held, up to completing the one-year period);
- both the entity paying the dividends and the beneficial owner are subject to and not exempt from one of the corporate taxes mentioned in Article 2(c) of the Council Directive 2011/96/EU of 30 June 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states (the *"Parent-Subsidiary Directive"*)
- the payment is not the consequence of the liquidation of the subsidiary; and
- both the entity paying the dividends and the beneficial owner have one of the legal forms listed in the Annexes to the Parent-Subsidiary Directive.

This exemption will not be applicable where the majority of voting rights of the receiving entity is directly or indirectly owned by non-residents in the EU, unless it is proven that the incorporation of the receiving entity is based on valid economic reasons and sound business reasons.

Interest

Interest paid to an EU resident is exempt from withholding. This exemption does not apply when the recipient is tax-resident in a tax haven.

Royalties

Royalties paid in an EU member state are exempt from withholding when the following requirements are met.

- Both the entity paying royalties and the beneficial owner have one of the legal forms listed in the Annexes to Council Directive 2003/49/EC of 3 June 2003.
- Both the entity paying royalties and the beneficial owner are subject to and not exempt from one of the corporate taxes mentioned in Article 3(a)(iii) to Council Directive 2003/49/EC of 3 June 2003.
- Both entities are resident in the EU and neither of them is resident in a third country with a double-taxation agreement (DTA). In addition, both entities must be associated companies – ie, one has a direct minimum holding of 25% in the capital of the other or else a third company has a direct minimum holding of 25% in the capital of both entities. This holding should be held for a minimum holding period of one year, which could be completed after the payment. The entity that receives those royalties should receive them for its own benefit and not as an intermediary (eg, an agent, trustee or authorised signatory) for some other person. If the recipient is a PE, the received royalties should effectively be connected with the PE's activity and should be a taxable income for the PE.

This exemption on royalties will not apply if the majority of voting rights of the receiving entity are directly or indirectly owned by a non-resident in the EU – unless it is proven that the receiving entity was incorporated on the basis of valid economic reasons and sound business reasons.

4.2 Primary Tax Treaty Countries

Currently, Spain has entered into double-taxation treaties with more than 90 countries – the main aim of which is to eliminate double taxation and provide for reduced rates of withholding taxes of dividends, interests and royalties. Double-taxation treaties concluded by Spain are generally compliant with the provisions set forth by the OECD.

Owing to the favourable taxation of EU corporations, most foreign investors invest via EU member states. Luxembourg and the Netherlands are the primary tax-treaty countries used by foreign investors for making investments.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The use of treaty-country entities by non-treaty country residents may be challenged by the Spanish Tax Agency, based on the argument that the recipient is not the beneficial owner of the relevant income. This approach is supported both by the OECD Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting (the *"Multilateral Instrument"*, or MLI) and the jurisprudence of the ECJ.

The General Guidelines of the 2024 Annual Tax and Customs Control Plan approved by the Spanish Tax Agency establishes as a priority area of attention the verification of the correct declaration of the withholdings applied to dividends, interest and royalties paid to non-residents. Likewise, whether the recipient of this income is the beneficial owner will be checked, in order to verify that there is no abuse of the EU Regulations aimed at facilitating free movement of capital within the territory of the EU.

4.4 Transfer Pricing Issues

In line with the SGAPP, the CIT Act clearly specifies that controlled transactions carried out by related parties must be valued on an arm's length basis. In this sense, the burden of proof falls on the taxpayer, who must provide documentation to prove to the tax authority that the values applied in the transactions with related parties comply with the principle of valuation at fair market value or on an arm's length basis.

In recent years, the Tax Control Plan published by the tax authorities has included transfer pricing as one of the essential points for attention in the review of multinational groups – especially operations carried out with high-value intangibles, intra-group services, corporate restructurings and intra-group financing operations.

In Spain, tax authorities usually check transfer pricing during the normal course of CIT tax audits, rather than conduct specific transfer pricing audits. These CIT tax audits are mainly oriented towards understanding the role of the Spanish companies under scrutiny in the group's value chain in order to check the consistency of the transfer pricing methods applied and the results of the benchmark analysis. These audits are also designed to detect and regularise the PEs of non-resident entities – an issue that may arise in certain operating structures of multinational groups, such as contracts for the provision of marketing, agencies, commissionaires and similar services. Therefore, the review of transfer pricing policies covers not only the quantification of operations but also the structure of the operations (and their different tax effects).

4.5 Related-Party Limited Risk Distribution Arrangements

Spanish authorities challenge the use of related-party limited risk distribution arrangements – especially when there has been a change to the transfer pricing model and when, consequently, the Spanish entity has reduced its taxable base.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

One significant point on which the Spanish transfer pricing regulations differ from the OECD Guidelines for Multinational Enterprises (the *"OECD Guidelines"*) is their broader parameters for related or associated parties. This requires the preparation of documentation and the application of transfer pricing principles to operations that would not be regarded as related operations in other countries.

4.7 International Transfer Pricing Disputes

The use of mutual agreement procedures (MAPs) in Spain has increased in past years. International transfer pricing disputes are, in some cases, resolved through a MAP. According to the statistics published by the OECD at the end of 2023, 174 transfer pricing MAPs were concluded during 2023.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

If a transfer pricing adjustment is made by the tax authorities, they are obliged to execute the relevant bilateral adjustment to the counterparty in the transaction – if it is a Spanish company.

Whenever a MAP is filed, any domestic transfer pricing claim is suspended (in exchange for a warranty covering tax and interests) until its final resolution. If the solution offered at the end of the MAP procedure is accepted, the claim will be withdrawn. Otherwise, if the MAP resolution is not accepted, the domestic transfer pricing claim can be successfully continued until its final resolution.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

There are no significant differences between the taxation of local branches (PEs) and local subsidiaries of non-local corporations. However, the following items in the tax regime applicable to a local branch of a foreign corporation should be considered:

- application of the rules for related-parties' transactions to operations carried out by the PE with the head office;
- deductibility of the management and general administrative expenses charged by the head office to the PE if these are included in the accounting statements of the PE and charged on a regular basis in accordance with rational principles; and
- payments made to the head office for royalties, interest, commissions and technical assistance services – or for the use or transfer of goods or rights – are generally not deductible.

5.3 Capital Gains of Non-Residents

Non-residents' capital gains on the sale of stock in local corporations are normally considered as ordinary income, taxable at the rate of 19% during the tax period in which they arise.

However, domestic law provides several exemptions, including on capital gains obtained without a PE in Spain by a resident in another member state of the EU or European Economic Area (EEA) Agreement if there is an effective exchange of tax information. The exemption does not apply to capital gains arising from the sale of stocks in the following cases:

- when the assets of that entity are mainly – directly or indirectly – real estate situated in Spanish territory;
- when individuals have directly or indirectly held at least 25% of the capital or assets of the entity at any time during the 12 months prior to the sale; and
- when the sale does not satisfy the requirements for the application of the exemption under Article 21 of the CIT Law in the case of non-resident entities (see **6.3 Taxation on Dividends From Foreign Subsidiaries**).

Nevertheless, according to the DTAs, taxation of these gains normally corresponds exclusively to the state of residence, and they are exempt in Spain. However, when it comes to stocks or shares in real estate entities, many DTAs contain exceptions that allow taxation in the state where the real estate is located. Therefore, in order to determine the taxation of non-residents' capital gains on the sale of shares, it is necessary to analyse the applicable DTAs.

5.4 Change of Control Provisions

The change of control resulting from the disposal of an indirect holding should not generate taxable income under the CIT Act. In this respect, Spanish law provides anti-abuse rules that seek to eliminate the tax impact of losses arising from the disposal of shareholdings in the event of a change of control of some companies. See also **5.3 Capital Gains of Non-Residents** with regard to the taxation of non-residents' capital gains on the sale of stock in a Spanish entity.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In general terms, Spanish tax law follows the criteria set out in the OECD Guidelines. Therefore, apart from the arm's length principle, no specific formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

There are no specific rules for determining the proportion of common expenses that a non-local affiliate must re-invoice to the local affiliates. Consequently, the calculation of the expenses chargeable to the local affiliates must be made on an arm's length basis and according to a reasonable criterion.

Once the proportion has been calculated based on the aforementioned criteria, there are no specific rules regarding the deductibility. Therefore, the management and administrative expenses incurred by a non-local affiliate will be deductible if they are ordinary costs of the local affiliates' productive activity and if they have been calculated in accordance with arm's length principles.

5.7 Constraints on Related-Party Borrowing

There are no specific rules applicable to related-party borrowing. However, as with any other related-party transaction, it is necessary to obey the arm's length principle.

For that reason, local affiliates are not allowed to grant interest-free loans or a loan at below-market interest rates. In addition, the deductibility of interest expenses is subject to the interest limitation rules, as explained in **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The CIT regulations subject resident companies to taxation on all their worldwide income, regardless of the country of source. However, profits obtained abroad through a PE located outside Spanish territory will be 95% exempt from taxation when it has been subject to (and is not exempt from) a tax similar to CIT at a nominal rate of at least 10% under the terms of Article 21 of the CIT Law (see **6.3 Taxation on Dividends From Foreign Subsidiaries**). Losses incurred by a PE abroad will immediately cease to be tax-deductible, unless they are due to the PE finally ceasing activity and under certain circumstances.

6.2 Non-Deductible Local Expenses

The profits exempted by application of the process described in **6.1 Foreign Income of Local Corporations** are calculated by attributing to the PE all the income and expenses associated with it, together with the part of the common expenses that is allocated to it. Consequently, local expenses attributable to the PE would hardly be deductible in Spain if they do not comply with the general deductibility requirements.

6.3 Taxation on Dividends From Foreign Subsidiaries

In accordance with the provisions of Article 21 of the CIT Law, dividends obtained by Spanish entities from foreign subsidiaries may be 95% exempt from taxation under the current participation exemption regime. Foreign subsidiaries dividends will generally be 95% exempt when either of the following conditions is met:

- the recipient owns at least 5% of the distributing entity; or
- that stake has at least one year's seniority (the one-year seniority could be fulfilled afterwards).

For a foreign subsidiary, an additional condition is required. In order for the exemption to apply, the foreign subsidiary should be effectively subject to (and not exempt from) a tax similar to CIT at a nominal rate of at least 10%. This requirement is understood to be met when a tax treaty is applicable and includes an exchange-of-information clause.

Furthermore, capital gains resulting from the sale of shares – in both Spanish and foreign entities – would generally be 95% exempt from taxation when requirements for participation exemptions are fulfilled. In the case of the sale of foreign subsidiaries, the minimum taxation requirement must be met during all the years in which the participation has been held. Specific requirements apply in the case of indirect participation through a holding entity.

If the sold company was subject to controlled foreign corporation (CFC) rules and/or if it was a passive income entity, the participation exemption would be limited.

6.4 Use of Intangibles by Non-Local Subsidiaries

Transactions between related parties are subject to the arm's length principle. This principle requires that transactions be valued at fair value and satisfy the obligations under transfer pricing rules. Consequently, the local corporation must recognise income arising from the transfer of intangibles that is taxable according to the local corporation's CIT regime. However, any such income from the use of intangibles may benefit from the regime described in **2.2 Special Incentives for Technology Investments**.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

According to Spanish law, a foreign company is considered a CFC when 50% or more of its equity, capital, profits or voting rights are controlled directly or indirectly by Spanish shareholders, and if the CIT paid by that company is less than 75% of the CIT that would have been paid in Spain.

Under the Spanish CFC rules, the following income must be allocated to the Spanish company:

- income obtained by foreign subsidiaries without material or personal resources (substance); or
- passive income (eg, property, shares, insurance and loans) obtained by foreign subsidiaries.

It should be noted that the CFC rules do not apply to companies or PEs resident in the EU or in a state that is part of the EEA Agreement if it can be proved that they carry out a business activity or are collective investment institutions (CIIs) regulated in EU Directive 2009/65/CE.

With effect from 2021, the scope of the CFC rules applies to dividends and capital gains obtained by foreign holding companies that have held at least a 5% stake in foreign operating subsidiaries for more than one year.

6.6 Rules Related to the Substance of Non-Local Affiliates

Although Spanish law does not contain any rules relating to the substance of non-local affiliates, the interpretative approach adopted by the Spanish tax authorities – following the OECD Guidelines and EU jurisprudence – is to require an examination of the economic substance.

Consequently, in order to determine the application of the tax advantages envisaged in a specific DTA, not only is the identity of the formal owner of the income ascertained but so too is the identity of the person who actually receives the income from an economic perspective. This means analysing both the form and the substance of the transaction in order to determine whether the person applying for the DTA advantages is the beneficial owner of the income.

Accordingly, the criterion followed by the Spanish tax authorities requires that a structure in which a non-local affiliate is interposed be designed for commercial and economic purposes. Otherwise, the situation should be regularised. This means that any tax advantage obtained should be eliminated and the DTA between Spain and the country of residence of the interposed non-local affiliate will no longer apply.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains accrued by the Spanish entity on the sale of shares in non-resident subsidiaries could qualify for the 95% exemption envisaged in Article 21 of the CIT Law (see **6.3 Taxation**

on Dividends From Foreign Subsidiaries). Capital losses from shares that could benefit from the participation exemption are not tax-allowed unless they come from liquidation (with certain requirements).

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

In order to enable the Spanish tax authorities to tackle situations in which a taxpayer artificially avoids the payment of taxes, the Spanish General Tax Law provides the following General Anti-Avoidance Rules (GAAR):

- the substance over form or requalification rule;
- the rule for conflicts in the application of the law; and
- the rules for simulated schemes.

According to the Anti-Tax Avoidance Directive (ATAD), EU member states must implement a GAAR. However, Spain already had such a rule, meaning that there was no need to introduce a new rule. Therefore, no modification was required.

Additionally, the Spanish legislation has numerous Specific Anti-Avoidance Rules (SAAR), of which the most frequently applied are:

- the transfer pricing anti-avoidance rule;
- the limitation of financial interest paid to group entities' deductibility;
- the anti-abuse rule for mergers, spin-offs and the exchange of shares;
- the rule for preventing the transfer of companies with carry-forward tax losses; and
- the rules preventing hybrid mismatches.

The Spanish Tax Agency has long applied the GAAR to recharacterise transactions in accordance with the underlying substance or to disregard operations when they are believed to lack genuine commercial reasons other than tax reasons. Spanish courts have also applied an *"economic substance"* or *"business purpose"* (qualification principle) doctrine to disregard transactions that have no appreciable effect on the taxpayer other than the reduction of income taxes.

The application of the GAAR is commonly litigated, given that its application requires many subjective considerations, and the Spanish Tax Agency's position is not always followed by courts.

Furthermore, following the BEPS Action 6 Report and the ratification of the MLI, affected Spanish DTAs would incorporate the Principal Purpose Test (PPT) clause.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Companies that are required to have their accounts audited by a statutory auditor must annually provide the auditors with all the information necessary to carry out the aforementioned audit.

An audit of accounts consists of an exhaustive review of the financial statements of a company, with the aim of accrediting the reasonableness of the veracity and reliability of its content to third parties.

According to the provisions of the Spanish Law on Corporations, the obligation to audit the accounts applies only to a company that exceeds – for two consecutive years at year-end – two of the following three parameters:

- the total amount of asset items exceeds EUR2.85 million;
- the total amount of its annual turnover exceeds EUR5.7 million; or
- the company has a workforce of more than 50 employees.

9. BEPS

9.1 Recommended Changes

Almost all recommendations resulting from the BEPS Actions, developed by the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, have already been implemented.

In fact, Spain is one of those countries where OECD conventions and guidelines are directly applicable when compatible with domestic legislation – given that it declares that Spanish CIT must be interpreted based on OECD principles.

Following the BEPS and Pillar Two OECD Inclusive Framework initiative and EU Council Directive 2022/2523 of 15 December 2022 (the *"EU Pillar Two Directive"*), the Spanish Parliament approved Law 7/2024 of 20 December 2024, which implements a minimum tax level rule for both large multinational and domestic groups in Spain, meaning those with annual revenues of at least EUR750 million in at least two of the last four fiscal years.

The Law implements the following:

- as of 2024, a domestic minimum top-up tax (MNTT), according to which a Spanish company whose effective tax rate is below 15% will be obliged to pay the shortfall below that amount;
- as of 2024, an income inclusion rule (IIR), according to which the Spanish parent entity of a large group (either Spanish or multinational enterprise (MNE)) is obliged to apply the IIR to its share of top-up tax relating to any foreign subsidiary of the group that is taxed below 15%; and
- as of 2025, an undertaxed profit rule (UTPR), according to which Spanish subsidiaries would collect any residual top-up tax of a group sister company in cases where the entire amount of top-up tax relating to low-taxed sister companies could not be collected by parent entities through the application of either an IIR or an equivalent or qualified MNTT.

The Law introduces reporting obligations and temporary safe harbours for MNEs reaching the thresholds that require paying GLOBE, and for those companies that have a given level of taxation, that provide country-by-country (CbC) information and that have a reduced amount of turnover.

9.2 Government Attitudes

Overall, Spanish tax authorities are extremely supportive of the OECD's tax-related work, where there is a large consensus. This has been the case for the OECD-BEPS outcome as well as for the launching of Pillar 2 of the OECD Inclusive Framework. It is worth mentioning that, as a member state of the EU, Spain has a legal obligation to implement EU Directives that are fully aligned with OECD initiatives.

9.3 Profile of International Tax

Recent economic geopolitical and pandemic crises have resulted in a public deficit increase, which has drawn special attention to MNE taxation and harmful profit-shifting practices. Consequently, Spanish authorities have become more committed to tackling tax avoidance. This situation is boosting the implementation of BEPS and similar international recommendations.

9.4 Competitive Tax Policy Objective

Spain's current administration is more focused on artificially fighting profit-shifting than attracting investments by means of tax competition. Spain relies on the premise that a common approach to taxation (across Europe and beyond) would lead to a more accurate allocation of profits and taxes, based on economic factors other than taxes.

9.5 Features of the Competitive Tax System

Legal uncertainty has usually been the Achilles heel of the Spanish tax system, given that special tax regimes have frequently been frustrated, owing to aggressive interpretation by tax-inspector bodies. Thus, trying to gain legal certainty is a must when it comes to tax-planning investment in Spain.

9.6 Proposals for Dealing With Hybrid Instruments

The Spanish CIT regime has implemented the EU Directive preventing hybrid mismatches. As such, the new Spanish tax system is a perfect implementation of the ATAD II EU Directive (Council Directive (EU) 2017/952) (ATAD II).

9.7 Territorial Tax Regime

Spain does not have a territorial tax regime. Only Spanish branches of foreign companies are taxed exclusively for Spanish-sourced income.

9.8 Controlled Foreign Corporation Proposals

As mentioned in **9.7 Territorial Tax Regime**, Spain does not have a territorial tax system. However, as of 1995, it does have CFC rules. These have been modified slightly to adapt them to OECD-BEPS outcomes and to ATAD II.

9.9 Anti-Avoidance Rules

Spain approving the MLI places a broad limitation on tax benefits resulting from DTAs where it is reasonable to conclude – in light of all facts and circumstances – that obtaining such benefit was the main purpose of the transactions. This limitation, together with the existing GAAR, would make artificial inbound or outbound tax structures easy to challenge for the Spanish Tax Agency. Hence, it becomes critical to gather a defence file justifying the business grounds for any tax structure.

9.10 Transfer Pricing Changes

Transfer pricing rules in Spain were already very detailed and broad. Consequently, almost no changes have been introduced after BEPS, apart from the CbC reporting requirements.

For financial years starting after 22 June 2024, CbC reports must be made public by companies belonging to a large MNE group (ie, sales above EUR750 million).

9.11 Transparency and Country-by-Country Reporting

Spain supports all internationally accepted reporting requirements, such as CbC reporting or aggressive tax planning resulting from EU Council Directive 2011/16 in relation to cross-border tax arrangements (DAC6) and EU Council Directive UE 2021/514 (DAC7).

Spain implemented EU Directive 2021/2101 obliging large MNEs to publicly disclose CbC reporting information (PCbCr).

In contrast to other EU member states, Spain provides that information be published within six months after financial-year closing, which creates great disruption for Spanish companies since part of the information to be provided could not have been available for them.

9.12 Taxation of Digital Economy Businesses

Spain has introduced a Tax on Digital Services (often known as *"Google tax"*) aimed at applying a 3% tax on the revenues of tech giants such as Google, Facebook, Apple and Amazon on Spanish territory (see **2.8 Other Taxes Payable by an Incorporated Business**). It only applies to companies belonging to a group with a total worldwide turnover of more than EUR750 million and with Spanish operations amounting to more than EUR3 million.

9.13 Digital Taxation

Spain will surely align its domestic legislation with international OECD digital economic taxation, as soon as there is sufficient consensus on this. In the meantime, it is important to bear in mind that the Spanish approach to PEs is still one of the most aggressive approaches, leading to the existence of a Spanish PE as soon as there is a virtual presence in Spain (without the need for a clear physical presence).

9.14 Taxation of Offshore IP

Spain has not introduced specific provisions or benefits dealing with offshore taxation of intellectual property.

Trends and Developments

Contributed by:
Raúl Salas, Elena Ferrer-Sama and Cristina Cavero
RocaJunyent

RocaJunyent was established in 1996 and is one of the most prominent Spanish law firms. It has offices in Madrid, Barcelona and Gerona, as well as associated offices in Palma de Mallorca, Lérida, Tarragona, Málaga, Seville, Bilbao, Badajoz, Burgos and Valladolid. The firm offers advice in all areas of law, especially those related to commercial, banking and financial, procedural and tax law. RocaJunyent is the only Spanish member of the international network TerraLex. Taxes are levied on all kinds of entities and in many situations, which is why RocaJunyent's tax department is prepared to respond to all kinds of problems – from large companies and their complex structures/operations to individual wealth/inheritance issues. The firm's services include business taxation, tax wealth management, M&A, transactions taxation, transfer pricing and tax litigation.

Authors

Raúl Salas is a tax partner at RocaJunyent, where he leads the tax practice in the Madrid office. With more than 30 years' experience, he has participated in some of the most important M&A and real estate operations in the Spanish and European markets. Raúl has acted as the lead adviser for several major international groups when litigating with Spanish tax authorities and with the tax authorities in other European countries. Besides M&A, his areas of specialisation include tax advice for financial institutions and energy and infrastructure companies. Raúl has also published numerous articles in financial newspapers and specialised journals, and has appeared as a guest speaker at seminars and courses on tax issues.

Elena Ferrer-Sama is the director of the tax department at the Madrid office of RocaJunyent. She has more than 20 years' experience in general tax planning and advice – for multinational group companies, in particular – and has an extensive knowledge of direct taxation, especially in the business reorganisation and tax inspection areas. Elena has a law degree from the Complutense University of Madrid (UCM) and a master's degree in Business Tax Advice from the Instituto de Empresa. She has published several specialised articles and collaborated in a number of publications on tax matters, and has taken part in many tax seminars and courses.

Contributed by: Raúl Salas, Elena Ferrer-Sama and Cristina Cavero, **RocaJunyent**

Cristina Cavero is a senior associate at the tax department of RocaJunyent. She holds a degree in Law and Business Administration from the Pontifical University of Comillas and a master's degree in Tax Advice from IE Law School. Cristina provides recurrent tax advice to legal entities and individuals, both residents and non-residents, on direct and indirect taxation matters. Additionally, she advises companies and individuals on tax planning and tax auditing.

RocaJunyent

José Abascal Street, 56
6th Floor
28003
Madrid
Spain

Tel: +34 619 015 251
Fax: +34 917 81 97 64
Email: r.salas@rocajunyent.com
Web: www.rocajunyent.com/en/firm

Contributed by: Raúl Salas, Elena Ferrer-Sama and Cristina Cavero, **RocaJunyent**

The following points provide some Spanish tax insights to be considered by any current or future investor in Spain.

Pillar Two – GLOBE Implemented as of 2024

Following the BEPS and Pillar Two OECD Inclusive Framework initiative and the EU's Council Directive 2022/2523 of 15 December 2022 (the *"EU Pillar Two Directive"*), the Spanish Parliament approved Law 7/2024 of 20 December 2024 implementing a minimum tax-level rule for both large multinational and domestic groups in Spain, meaning those with annual revenues of at least EUR750 million in at least two of the last four fiscal years.

The Law implements the following:

- as of 2024, a domestic minimum top-up tax (MNTT), according to which a Spanish company whose effective tax rate is below 15% will be obliged to pay the shortfall below that amount;
- as of 2024, an income inclusion rule (IIR), according to which the Spanish parent entity of a large group (either Spanish or MNE) is obliged to apply the IIR to its share of top-up tax relating to any foreign subsidiary of the group that is taxed below 15%; and
- as of 2025, an undertaxed profit rule (UTPR), according to which Spanish subsidiaries would collect any residual top-up tax of a group sister company in cases where the entire amount of top-up tax relating to low-taxed sister companies could not be collected by parent entities through the application of either an IIR or an equivalent or qualified MNTT.

The Law introduces reporting obligations and temporary safe harbours for MNEs reaching the thresholds that force payment of GLOBE, and for those companies to which a given level of taxation applies, that provide country-by-country information and that have a reduced amount of turnover.

Tax Inspections for Mergers, Divisions, Partial Divisions, Transfers of Assets and Exchanges of Shares Carried Out Under the Neutrality Regime Provided for in Council Directive 2009/133/EC of 19 October 2009

As in all EU countries, the tax regime foreseen for these operations (the *"Neutrality Regime"*) does not apply when the main purpose of operations is to obtain a tax advantage without a stronger economic business reason.

Previously, Spanish companies aiming to conduct such operations would ask the Directorate General of Taxes (DGT) whether or not their business case allowed for applying the Neutrality Regime. The DGT used to analyse the transaction's business case and confirm or reject the existence of sufficient grounds for the application of the Neutrality Regime, hence deferring the capital gains arising from a reorganisation.

From 2023 and 2024, the DGT has changed its approach to these operations and no longer confirms the application of the Neutrality Regime, stating that this can only be established in the course of a tax audit.

In addition, the Tax Inspectorate has taken advantage of such lack of certainty to challenge almost all reorganisations in which companies have opted for the Neutrality Regime.

Moreover, perhaps worst of all is the technical position the Tax Inspectorate is taking when challenging the Neutrality Regime's application, since it not only taxes the capital gains that a reorganisation may trigger but also rejects any future tax credits or relief that may result from the ex post situation, sometimes ignoring that the same tax credits or relief would have been applicable even if the Neutrality Regime had not been applied.

The position being taken by the Tax Inspectorate, together with the lack of certainty resulting from the DGT's reluctance to provide an ex ante criterion (even when asked), has led to an official claim being filed before the European Commission arguing that the Spanish tax authorities have breached EU law.

Limits Imposed on Deduction of Interest

Spain provides limits on deduction of interest, based on 30% of companies' or tax groups' earnings before interest, taxes, depreciation and amortisation (EBITDA).

As of 2024, when calculating EBITDA, non-taxable income or expenses should be considered, respectively reducing or increasing EBITDA (this is the *"EBITDA Exclusion Rule"*). This rule is aimed at avoiding a non-taxable income allowing a higher interest deduction and preventing a non-deductible expense from limiting the interest allowance.

However, through one particular ruling the Spanish tax authorities have interpreted and provided guidance in the sense that the EBITDA Exclusion Rule only applies to non-taxable income or costs that generate a permanent difference, though it will not apply to timing differences.

On this basis, it is possible for a non-taxable income (timing difference) to allow a higher interest allowance, despite the income not being taxable itself.

Obligation to Publish Country-by-Country Information for Spanish Companies

Spain implemented EU Directive 2021/2101 obliging large MNEs to publicly disclose country-by-country reporting information.

In contrast to other EU member states, Spain provides that information be published within six months after financial-year closing, which creates great disruption for Spanish companies since part of the information to be provided could not have been available for them.

Tax Group Regime for Corporate Income Tax

Spain has a very interesting tax consolidation regime both for corporate income tax (CIT) and for VAT. Most multinational groups operating in Spain apply the Tax Group Regime for CIT, while the VAT Group Regime is usually applied by groups acting in certain specific sectors such as insurance, financial, health, etc.

The Tax Group Regime allows investors to optimise their tax burden. Tax consolidation groups are formed by Spanish tax-resident companies with a common ownership, and entail the entire group being taxed as a single taxpayer.

To apply the Tax Group Regime, the following requirements should be met:

- the parent company must hold at least 75% of the shares, or 70% in the case of listed companies;
- this minimum percentage of shares must be maintained during the complete tax period;
- the parent company must be subject to CIT; and
- the parent company must hold the majority of the voting rights.

The group CIT taxable income is determined by aggregating the standalone taxable income of each group entity; the resulting aggregation would then be reduced or increased in the profits and/or losses obtained in *"internal"* operations carried out between entities belonging to the group (*"eliminated result"*). These *"eliminated"* results will be reverted, and will become taxable as soon as the result is realised in an operation with a third party, outside the group or when the transferring entity or the acquiring entity has left the group, as well as in cases where the tax group abandons the consolidation tax regime.

The main advantages of the Tax Group Regime are as follows.

- Taxation of profits (resulting from operations between group entities) would be deferred.
- Tax losses originated within the group, by any group company, could be fully offset with tax profits of any other company belonging to the group. Exceptionally, and only for the 2023 tax year, a limit was established for this offsetting, and current-year tax losses can only be offset by other group companies for up to 50% of that tax loss. The remaining 50% can be freely offset in the following ten years. Carry-forward tax losses originated before joining the tax group can only be offset by the company that generated them.
- Any tax incentives or tax credits generated within the tax group can be freely used by any company belonging to the group. Requirements, conditions and obligations resulting from the application of those tax incentives could be afforded or fulfilled by any entity belonging to the tax group. Tax incentives originated before joining the tax group could only be utilised by the single entity that originated them.
- Dividends, interests or any payments between entities of the same tax consolidation group that could still benefit from the same participation exemption are exempted from the withholding obligation.
- Operations between related entities valued according to arm's length principles and tax consolidation groups are not exempted from the foregoing obligation. However, entities belonging to a tax group are not obliged to prepare transfer pricing documentation in relation to intra-group operations, which entails relevant savings on administrative and financial costs.

The application of the Tax Group Regime requires a decision by the board of directors, taken before the beginning of the year in which it will be applied.

Capital Losses From Transfer of Shares

Following the international trend, Spanish CIT rejects the tax deduction of the capital losses when the participation exemption would have been applicable had there been a capital gain. However, the tax treatment would be far different in cases of liquidation.

Sale of shares that could benefit from the participation exemption

Capital gains resulting from selling an entity's shares, when the selling company had at least 5% interest for at least 12 months, would be 95% exempt.

In cases of capital loss, Spanish CIT provides that this would not be allowed, despite the acquirer and sale price; in other words, a capital loss from the sale to an independent party applying the arm's length principle will result in a non-deductible tax loss. This situation does not change even in cases where both the selling and buyer entities are part of a tax group.

A shareholder planning to transfer a portfolio might consider liquidation instead of a sale.

Liquidating a company
According to Spanish CIT, the process for liquidating a company will have tax consequences for both the shareholder and the liquidated company.

Liquidated company
The liquidated company will transfer all its assets and liabilities to its shareholders, which would likely result in a tax loss. This tax loss cannot be utilised since the company will be extinguished.

Shareholder company
The difference between the value of the shares and the value of the assets received on account of the liquidation will generate a capital loss for shareholders that could be tax-deductible.

To summarise, in practice the only way to obtain tax allowance from a portfolio capital loss is via the liquidation of the company, which should be considered as an alternative to the transfer of shares.

Limits to the Application of Carry-Forward Tax Losses
Like many other countries, after various crises since 2007 Spain has approved limitations on the offsetting of carry-forward tax losses (CFTL).

However, in January 2024 the Spanish Constitutional Court concluded that the legislative instrument followed by the government (a Royal Decree-Law) was not an adequate means for amending the CIT.

In 2024, the Spanish Parliament again approved such tax loss limitations, but only for the years 2024 and onwards. Those limitations apply as follows:

- for all companies regardless of their size and which prevented the offsetting of an amount exceeding 70% of the taxable income for the period;
- only to large companies (those entities which in the previous financial year had a turnover of at least EUR20 million), which would determine that such companies would be subject to a stricter limit of 50% of the previous income amount; and
- a third limit for very large companies (whose turnover in the previous financial year reached EUR60 million), whereby they could not offset more than 25% of the positive taxable income for the period with CFTL.

UK

Law and Practice

Contributed by:
Rebecca Murray

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Author

Rebecca Murray has a busy litigation and advisory practice, specialising in corporate tax, private client and VAT. She acts for FTSE 100 companies, wealthy individuals, HMRC, and as a member of the Attorney General's B Panel of Counsel. She recently appeared in the Upper Tribunal acting for HMRC on the issue of deductibility of a provision in the accounts of companies that had implemented an unfunded unapproved retirement benefit scheme. In this lead case, it was decided that the provision was not incurred wholly and exclusively for the purposes of the trade (CHR Travel & Another v HMRC [2021] UKFTT 445). She was also recently successful for HMRC in the First-tier Tribunal in a case on gifts of shares to charity (Cityblock & others v HMRC [2023] UKFTT) and has acted for HMRC and for taxpayers in IR35 and umbrella company matters. Rebecca was a Vice President at JP Morgan Chase bank before practising as a barrister.

Rebecca Murray

Tel: +44 20 7353 7534
Email: clerks@devchambers.co.uk
Web: www.devchambers.co.uk

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally take the form of a limited company or a limited liability partnership (LLP) but individuals may carry on business as a sole trader/self-employed individual, or in partnership with other self-employed individuals. For tax purposes, a partnership is transparent and the members are chargeable to income tax or corporation tax on their share of the partnership profits.

A limited company is chargeable to corporation tax. In contrast, an LLP that carries on business on a commercial basis with a view to making a profit is treated as a partnership for tax purposes. Although an LLP is considered a corporate body as a matter of the general law, it is not chargeable to income or corporation tax itself. Instead, its members are chargeable to income or corporation tax on their share of the profits of the LLP.

In all instances, in order to be deductible from profits chargeable to tax, expenses must be incurred *"wholly and exclusively for the purposes of the trade"*. For a recent case on that test, see CHR Travel & Anor v HMRC.

Capital gains tax may be chargeable on the partners when assets used in the partnership or LLP are disposed of, or when there is a change in the partners' capital profit sharing ratios.

If an individual works for a client through a personal service company, and the individual would be an employee of the client if engaged directly, then the company will be treated as the individual's employer and liable to pay income tax and NIC on the fees paid by the client. Many cases have been heard in the tribunals and courts in recent years on the question of whether the individual would indeed be an employee (or instead would be self-employed) if engaged directly by the client.

1.2 Transparent Entities

Private equity funds may be structured using a limited partnership structure, whereby the manager of the fund (which may itself be a partnership) is the general partner, and the investors of the fund are the limited partners. As a result, the investors are not liable for the debts of the limited partnership beyond their own capital contributions. For tax purposes, the limited partnership is transparent so that the partners are taxable on their profit shares. Usually, once the investors have received a certain return on their investment, the managing partner is entitled to an additional profit share (called *"carried interest"*). The partnership will generally be carrying on an investment activity rather than a trade, so that gains made from the disposal of investments will in principle be taxable as capital gains and not income. However, in 2015 the UK enacted *"disguised investment management fee income"* rules, which, in certain circumstances, deem receipts from the *"carried interest"* to be income and taxable accordingly. A Consultation was announced in the Autumn Budget 2024 which consults on plans to change the way in which carried interest is taxed.

1.3 Determining Residence of Incorporated Businesses

Corporation tax is chargeable on income and gains arising to a company in a financial year wherever they arise if the company is resident in the UK (as to which see below). If a company is a non-UK resident, it is nevertheless chargeable to corporation tax on income if it:

- carries on a trade in the UK of dealing in or developing land (and if so, then it chargeable on all its profits wherever arising);
- carries on a trade through a permanent establishment in the UK;
- carries on a UK property business; or
- has other UK property income.

A company is resident in the UK if it is incorporated in the UK, or if the *"central management and control"* of its business (usually, control at board level) is exercised in the UK. This is the test of residence originally applied by the House of Lords in De Beers Consolidated Mines Ltd v Howe [1906] AC 455 and more recently applied in Wood v Holden.

However, a company whose central management and control is exercised in the UK may be treated as not UK resident by virtue of a double tax treaty. The OECD model treaty test to be applied is usually where the place of effective management (POEM) of the company is. This was considered by the Court of Appeal in Wood v Holden (and more recently was considered in relation to the residence of trustees in the context of a particular tax avoidance scheme, known as the *"round the world"* scheme, by the Court of Appeal in the case of Smallwood v HMRC [2010] EWCA Civ 778; and in Haworth v HMRC [2024] UKUT 58).

1.4 Tax Rates

The corporation tax rate for companies with profits over GBP250,000, known as the *"main rate"*, is 25%. For companies with profits under that amount but over GBP50,000, marginal relief applies to give an effective rate between 19% and 25%, and companies with profits under GBP50,000 are chargeable at a rate of 19%.

Between 1 April 2015 and 31 March 2023, a single rate of corporation tax at 19% applied.

Partnerships and LLPs are usually transparent for tax purposes, so a corporate partner in a partnership or LLP would pay corporation tax on its share of the profits. There are certain anti-avoidance rules that may apply to charge income tax on such profits where certain conditions are met.

Individuals are chargeable to income tax on their profits, including their share of partnership or limited liability partnership profits, at the following rates of income tax:

- 0% on income of up to GBP12,570 (unless total income exceeds GBP100,000);
- basic rate of 20% on income between GBP12,571 and GBP50,270;
- higher rate of 40% on income between GBP50,271 and GBP125,140; and
- additional rate of 45% on income over GBP125,140.

National Insurance contributions are also payable by self-employed individuals and employees.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Individuals and companies carrying on a trade or other business are chargeable to tax on the accounting profits, subject to statutory adjustments for certain items (for example, depreciation of assets debited to the profit and loss account is disallowed, but capital allowances may be available as a deduction instead).

For corporation tax purposes, the accounting period may be the same as the period for which the accounts are made up, if that is 12 months or less, and otherwise there will be two accounting periods, one of 12 months and one for the remaining period. For example, if accounts are made up for 18 months from 1 January 2023 to 30 June 2024, the accounting periods will be the 12 months to 31 December 2023 and six months to 30 June 2024.

As mentioned above, tax is charged on the accounting profits, which are generally calculated on an accruals rather than a receipts basis.

2.2 Special Incentives for Technology Investments

Research and Development Tax Credits

Different types of research and development (R&D) relief are available for different-sized companies that incur expenditure on part of a specific project to make an advance in science or technology. The project must relate to the company's existing trade, or a trade that is intended to be commenced based on the results of the R&D.

In order to claim relief, it is necessary to explain how a project:

- looked for an advance in the field;
- had to overcome the scientific or technological uncertainty;
- tried to overcome the scientific or technological uncertainty; and
- could not be easily worked out by a professional in the field.

The project may research or develop a new process, product or service or improve on an existing one. Additional detailed criteria must be met and the relief varies depending on the size of the business. For small and medium-sized businesses, relief allows companies to:

- deduct an extra 86% of their qualifying costs from their yearly profit, as well as the normal 100% deduction, to make a total of 186% deduction; and
- claim a payable tax credit if the company has claimed relief and made a loss, with the payable credit worth up to 10% of the surrenderable loss.

For large companies, and small and medium-sized companies which are unable to claim relief, expenditure credit is available (RDEC), calculated as a percentage of qualifying R&D expenditure. The rates are:

- 11% on expenditure incurred from 1 April 2015 up to and including 31 December 2017;
- 12% on expenditure incurred from 1 January 2018 up to and including 31 March 2020;
- 13% on expenditure incurred from 1 April 2020 up to and including 31 March 2023; and
- 20% on expenditure incurred from 1 April 2023 in accounting periods beginning before 1 April 2024.

The merged scheme R&D expenditure credit (RDEC) and enhanced R&D intensive support (ERIS) replace the old RDEC and small and medium-sized enterprise (SME) schemes for accounting periods beginning on or after 1 April 2024. The expenditure rules for both are the same, but the calculation is different. You can choose to claim under the merged scheme even if you are eligible for ERIS, but you cannot claim under both schemes for the same expenditure.

The merged scheme is a taxable expenditure credit and can be claimed by companies who:

- are trading;
- are chargeable to corporation tax; and
- have a project that meets the definition of R&D.

The expenditure credit is classified as trading income and is liable to corporation tax. The rate of R&D expenditure credit under the merged scheme is 20%.

UK Patent Box

The UK patent box enables companies to apply a lower rate of corporation tax to profits earned after 1 April 2013 from qualifying patent inventions and equivalent forms of intellectual property. The lower rate of corporation tax under the regime is 10% (compared with 19-25% depending on the company's profits, see above).

2.3 Other Special Incentives

There are several tax reliefs available for the creative industries, namely:

- film tax relief;
- animation tax relief;
- high-end television tax relief;
- children's television tax relief;
- video games tax relief;
- theatre tax relief;
- orchestra tax relief; and
- museums and galleries exhibition tax relief.

The reliefs allow qualifying companies to increase the amount of their allowable expenditure, and reduce the amount of corporation tax payable.

There are also *"audio-visual expenditure credits"* and *"video games expenditure credits"*, which give a credit based on the amount of qualifying expenditure and can be used to pay off corporation tax liability and to set against other tax liabilities, and may also be paid to the company.

In order to qualify, the company must be directly involved in the production and development of the relevant production (ie, the film, animation, etc, listed above), must have responsibility throughout the production from the start of pre-production until completion, and for theatre, concerts or exhibitions, must be responsible for producing, running and closing it. There is also *"cultural test"* to be met to ensure the production is British.

2.4 Basic Rules on Loss Relief

A company carrying on a trade may make trading losses in a particular period, which can be carried forward and set against profits arising in a future year. Generally, trading losses cannot be carried back to set against profits of earlier years, unless the trade ceases, in which case they can be carried back for up to three years in the prescribed order.

Group relief may be available for trading losses.

Capital losses cannot be set against trading profits. They can be carried forward and set against capital gains that arise in the future. Capital losses may be utilised by another member of the same group.

Detailed anti-avoidance rules apply in relation to groups.

2.5 Imposed Limits on Deduction of Interest

There are several restrictions imposed on the deductibility of interest against profits chargeable to corporation tax (in addition to anti-avoidance rules, which are not discussed here).

The corporate interest restriction, or CIR rules, apply to periods of account starting on or after 1 April 2017. Periods of account straddling 1 April 2017 are treated as two notional periods. A notional period ending 31 March 2017 is subject to Part 7 of TIOPA 2010, commonly known as the World-Wide Debt Cap (WWDC). Only the notional period commencing 1 April 2017 is subject to the CIR.

The CIR applies to restrict the UK net interest deductions (expense less income) to the higher of three amounts:

- the de minimis amount of GBP2,000,000 per annum;
- the Fixed Ratio amount; and
- the Group Ratio amount.

The CIR is designed to target large corporates where it is considered that the greatest BEPs risk lies. Companies with financing costs of under GBP2,000,000 do not have to submit a CIR return, but those with financing costs over that amount have to calculate their interest allowance using the Fixed Ratio or Group Ratio method.

The former produces an interest allowance of the lower of:

- 30% of the company's or group's UK taxable profits before interest, capital allowances, taxes and other reliefs; and
- the company's or group's worldwide interest expense owed to unrelated third parties.

The latter involves appointing a reporting company and making an election. The interest allowance is the lower of:

- the ratio of the company's or group's worldwide net interest expense owed to unrelated parties, to the company's or group's overall profits before interest, capital allowances, taxes and other reliefs, multiplied by the company's or group's taxable UK profits before interest and capital allowances; and
- the company's or group's worldwide interest expense owed to unrelated parties.

Transfer pricing and 'thin cap' rules also apply to interest.

Note that for transfer pricing purposes, the potential tax advantage is calculated without taking into account any CIR disallowances or reactivations (TIOPA10/S155(6)).

TIOPA10/382(1) defines a tax-interest expense amount as an amount that meets certain conditions and which are (or apart from TIOPA10/PT10 would be) brought into account for the purposes of corporation tax in a relevant accounting period of a company. S385(1) takes a similar approach as regards tax-interest income amounts. These tax-interest amounts form the starting point for determining the aggregate net tax-interest expense of the group and it is this amount that may be subject to restriction by the CIR (S373). It follows that other provisions must first be applied to reach the starting point for application of the CIR.

2.6 Basic Rules on Consolidated Tax Grouping

It may be possible for profitable companies to claim group relief if the company is part of a group (broadly, 75% common ownership), or a joint venture or consortium, and set the losses against their profits for the same accounting period or an overlapping period. For consortium companies or joint venture companies, only the relevant percentage of the profits corresponding to the shareholding can be offset. Detailed rules apply in relation to the nature of the shareholdings and rights attaching to the shares.

2.7 Capital Gains Taxation
Companies are chargeable to corporation tax on profits arising on the disposal of assets wherever they are situated (and in some other instances).

If the asset disposed of is shares, the substantial shareholdings exemption may apply, in which case the gain would not be chargeable. Detailed conditions must be met in order for the relief to be available.

If the assets disposed of are shares which are exchanged for shares in another company, then relief may be available (unless there is a main purpose of avoiding tax) so that no gain accrues on the disposal and, instead, the asset acquired is treated as having the same base cost as the asset disposed of.

2.8 Other Taxes Payable by an Incorporated Business
Loans made by a company to its directors may give rise to a charge to tax if the loan is not repaid within nine months of the end of the accounting period in question. Anti-avoidance rules apply to prevent *"bed and breakfasting"*.

Stamp duty may be payable on the acquisition of shares by a company. Stamp duty land tax is payable on the acquisition of land or an interest in land.

Withholding tax may be payable on certain payments made by a company.

2.9 Incorporated Businesses and Notable Taxes
Diverted Profits Tax
Large multinational enterprises with business activities in the UK that enter into contrived arrangements to divert profits from the UK by avoiding a UK taxable presence and/or by other contrived arrangements between connected entities may be caught by the diverted profits tax rules.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses
Most small businesses that have a choice of operating as an individual or a company would prefer to have limited liability and therefore to operate through a company.

In order to ascertain whether a company is more beneficial for tax purposes, a comparison would have to be done between the rates of income tax/NIC and corporation tax for small businesses. The level of profits may not be predictable and income tax and national insurance rates change quickly, therefore it may not be possible to say which is more beneficial for tax purposes over time.

Income could be extracted by way of dividends (currently chargeable at the basic rate of 8.75%, higher rate of 33.75% and additional rate of 39.35%), paid out as salary (currently chargeable at 20%, 40% and 45%, and subject to employers and employees national insurance contributions), or reinvested. A sole trader may incorporate, take an annual salary or dividends at the lowest tax (and NIC) rates available and reinvest profits realised by the company in the company.

3.2 Individual Rates and Corporate Rates

Anti-avoidance rules operate to prevent individuals from seeking to avoid income tax on what would otherwise be earnings from an employment with a client, from operating through a company and therefore paying corporation tax at a lower rate instead. These are known as IR35 and have given rise to extensive litigation, mainly because the test involves asking the question of whether a person would be an employee of the client if engaged directly by them, but this is a common law multi-factorial test that cannot be consistently applied from case to case. The recent case of Atholl House Productions limited v HMRC [2024] UKFTT 37, a BBC presenter who eventually won her case on the basis that she was self-employed under the test, demonstrates the difficulties in this area.

3.3 Accumulating Earnings for Investment Purposes

Close investment holding companies (CICs) are chargeable to corporation tax at the rate of 25% regardless of the level of profits or the number of associated companies.

A close company (broadly, one owned by five or fewer shareholders) is a CIC unless it exists for a prescribed purpose listed in the legislation (such as trading).

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are charged to capital gains tax on the disposal of shares in a company at the applicable rate of capital gains tax (18% or 28%), unless a specific relief is available.

For example, if they exchange the shares for shares in another company within the share exchange rules then no gain arises at that point and instead they will be treated as acquiring the new shares for the same base cost as the shares disposed of.

Shares in a CIC are unlikely to qualify for Business Asset Disposal Relief as the company would likely not be carrying on a qualifying activity.

Dividends from a CIC would be taxed at the rates mentioned in **3.1 Closely Held Local Businesses**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends received from a plc are chargeable to income tax at the dividend rates mentioned in **3.1 Closely Held Local Businesses**.

Business asset disposal relief from capital gains tax, if it applies, reduces the rate of capital gains tax to 10%, but it is only available in relation to gains on disposals of shares in an individual's personal company and a plc is unlikely to be such, as the individual must be an employee or office holder and hold at least 5% of the shares and voting rights.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

There is no withholding tax on the payment of dividends by a UK company, except in the case of property income dividends payable by a UK REITs, which are (subject to certain exceptions) subject to withholding tax at the rate of 20%.

A company making a payment of UK source interest must deduct income tax at the basic rate, again 20%. This is subject to exceptions, the main ones being where the recipient is a UK resident company, interest payable on quoted Eurobonds and interest paid by or to a UK bank.

Royalties and annual payments are also subject to withholding tax at the rate of 20%.

Some specific schemes require the deduction of tax at source, such as the Construction Industry scheme, sportspeople and entertainers doing work in the UK, and non-resident landlords, who are required to have 20% income tax deducted from their UK source rental payments by their UK agent.

4.2 Primary Tax Treaty Countries

There is no need for investors to rely on a treaty for exemption from withholding tax on dividends since there is no withholding tax on dividends.

In relation to interest, treaty relief can be claimed, but the claim can take months to be processed. A double treaty passport scheme may be available to the payer.

A list of treaties under which relief can be claimed is available on HMRC's website.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

The UT recently heard an appeal in relation to the requirement to deduct withholding tax from interest (Hargreaves v HMRC [2023] UKUT).

The taxpayer had not claimed treaty relief under the UK/Guernsey treaty but sought to rely upon treaty relief in circumstances in which it was not entitled to.

4.4 Transfer Pricing Issues

I have discussed the CIR rules in **2.5 Imposed Limits on Deduction of Interest**. The CIR applies after most other tax rules that may impact the calculation of tax-interest amounts, such as transfer pricing rules, and hybrid and other mismatch rules, but before the loss restriction rules.

"Thin cap" rules for transfer pricing adjustments also present a challenge to inbound investors to the UK which are subject to transfer pricing rules.

Broadly speaking, a company is thinly capitalised if it has more debt than it either could or would borrow without the support of the rest of the group, either because it is borrowing from a group company, or it is borrowing from a third party but with support from elsewhere in the group (for example, by way of a financial guarantee).

The thin cap rules require an adjustment to the finance cost deductions of the company in order that it only claims a deduction for an amount of finance which it could obtain if acting on its own.

4.5 Related-Party Limited Risk Distribution Arrangements

Transfer pricing rules may restrict deductions for payments by companies chargeable to corporation tax which are not *"arms length"*.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The UK broadly follows the OECD transfer pricing standards. Indeed, the UK transfer pricing legislation is required to be interpreted as consistently as possible with the OECD standards and guidelines. However, there are some differences. For instance, when determining the terms on which associated entities would lend to one another, guarantees cannot be taken into account.

4.7 International Transfer Pricing Disputes

HMRC is nowadays more willing to litigate transfer pricing disputes. In the past, HMRC would settle transfer pricing cases, so that they hardly ever came to court. Now, however, perhaps because HMRC's litigation and settlement strategy does not permit them to *"do a deal"*, litigation is more likely.

International transfer pricing disputes are sometimes resolved through mutual agreement procedures.

HMRC views the MAP process as a potential means of resolving international transfer pricing disputes, as an alternative to litigation through the UK courts.

However, MAPs are still not a common way of resolving disputes.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments can be made when a transfer pricing dispute is resolved.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

A UK branch of an overseas subsidiary is chargeable to corporation tax on the profits from its UK activities. By contrast, a UK resident subsidiary of a non-UK resident parent company is taxable on its worldwide profits.

5.3 Capital Gains of Non-Residents

A non-UK resident company that holds shares in a UK-incorporated subsidiary would not be chargeable to capital gains tax on the disposal of the shares in the subsidiary unless 75% or more of the subsidiary's gross asset value is UK land (a *"UK property-rich company"*).

In principle, a double tax treaty may apply to eliminate the charge, although many treaties exclude relief where the value of the shares in the subsidiary consists to a specified extent of land in the UK.

5.4 Change of Control Provisions

The UK legislation includes *"value shifting"* provisions, whereby if value passes out of shares in a company into other shares, that could be treated as a disposal of the shares. But this would only be relevant to a non-UK resident company if the shares that are deemed to be disposed of are in a UK property-rich company (see **5.3 Capital Gains of Non-Residents**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are only ever used to determine the income or expenses of a UK subsidiary of an overseas company selling goods or services if the transfer pricing rules apply to the company and the arm's length price of goods or services must be ascertained.

5.6 Deductions for Payments by Local Affiliates

OECD guidelines are applied in the UK to ascertain the arm's length price of goods and services.

5.7 Constraints on Related-Party Borrowing

See **5.6 Deductions for Payments by Local Affiliates**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

A company that is UK resident is chargeable to corporation tax in the UK on its worldwide income unless a treaty exemption or credit is available in relation to particular non-UK source income, for example income of an overseas permanent establishment in *"full treaty territory"*. An election must be made in order for the income of an overseas permanent establishment to be exempt. Certain income is excluded from the exemption, such as income from a trade of dealing in or developing UK land and gains on assets that are not used in the overseas trade. Profits of an overseas branch are calculated by reference to the double tax treaty, or OECD principles.

Where no election is made, profits from overseas branches are computed and taxed in the normal way. UK corporation tax would usually be reduced by way of a credit for local tax paid, under the relevant treaty or by way of unilateral relief.

6.2 Non-Deductible Local Expenses

There is no applicable information in this jurisdiction.

6.3 Taxation on Dividends From Foreign Subsidiaries

Dividends and other distributions from UK and overseas companies are generally exempt if received on or after 1 July 2009. However, distributions within Section 1000(1) E and F of CTA 2009 are not exempt, such as non-dividend distributions comprising interest and other distributions out of assets in respect of non-commercial and special securities.

6.4 Use of Intangibles by Non-Local Subsidiaries

Where a UK company owns intellectual property and allows overseas subsidiaries to use it, the corporation tax treatment in the UK depends on the precise circumstances of the transactions. If the UK company licenses intellectual property to its overseas subsidiaries, it may be that there is royalty income payable to the UK company which is chargeable to corporation tax and may be subject to transfer pricing adjustments. It may be that receipts are of a capital nature instead of income, because a capital asset is disposed of by the UK company to its overseas subsidiaries: see for example Murray v Imperial Chemical Industries Limited [1967] 44 TC 175, and Wolf Electric Tools Limited v Wilson [1968] 45 TC 326.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

The UK has *"diverted profits tax"* and *"controlled foreign companies"* rules which are intended to prevent the artificial diversion of profits out of the UK rather than to tax the profits from overseas commercial trading activities. If the CFC rules apply, the profits of overseas subsidiaries are chargeable to corporation tax in the UK. Diverted profits tax is chargeable at the rate of 25%.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are a number of entity-level exemptions in the CFC rules to reflect the fact that most overseas subsidiaries are set up for genuine commercial reasons and the CFC rules are not intended to apply – for example, if the rate of tax in the jurisdiction of the subsidiary is at least 75% of the UK corporation tax rate. There are also time-based and profit-based exclusions.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

UK companies are chargeable to corporation tax on the sale of shares in an offshore subsidiary unless an exemption is available, such as the substantial shareholdings exemption.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The UK has a General Anti-Abuse Rule which was enacted in the Finance Act 2013, applicable to almost all taxes. There is a chapter on it in *"Tax Avoidance"* (Sweet & Maxwell, 2020 4th ed). Broadly, the rule applies where there are arrangements with a main purpose of obtaining a tax advantage, which no reasonable person would consider a reasonable course of action having regard to the relevant legislation and all the circumstances, including a list of factors. The list includes whether the substantive results of the arrangements are consistent with any principles on which the relevant provisions are based, whether the means of achieving the results involve one or more contrived or abnormal steps, and whether the arrangements are intended to exploit any shortcomings in the statutory provisions.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

A company has to prepare audited financial statements unless it is exempt (micro and small entities which have filed their two preceding annual returns on time), and would usually prepare them annually unless it changes its accounting date.

PLCs and PUCs have to file audited financial statements regardless of the size of the company.

9. BEPS

9.1 Recommended Changes

The Organisation for Economic Cooperation and Development (OECD) produced an *"Inclusive Framework on Base Erosion Profits Shifting"* (BEPS) which is designed to reduce tax avoidance and work towards more coherent international tax rules and greater transparency, and to address challenges with the digital economy. The UK has begun implementing BEPS 2.0 in two phases, Pillar One and Pillar Two.

Pillar One prescribes how the consolidated profits of a multinational enterprise are allocated and taxed, based on the jurisdiction in which the activities are carried out (where the goods or services are used). There is a minimum global revenue threshold of EUR20 billion for Pillar One to apply.

Pillar Two has a minimum threshold of EUR750 million global consolidated group revenues (for at least two of the previous four accounting periods). It sets an effective global minimum rate of corporation tax of 15%. It was approved by approximately 140 participating jurisdictions in

2021. Draft legislation was published in the UK on 18 July 2023 to amend Finance (No 2) Act 2023, which introduced the multinational top-up tax and domestic top-up tax as part of Pillar Two. The multinational top-up tax will apply to the responsible member of the group for financial periods commencing after 31 December 2023 where the criteria mentioned above are met, and at least one of the group members is not in the same territory as the others.

Certain persons are exempt, such as not-for-profit organisations, charities, government organisations and pension funds. Real estate investment trusts are also exempt.

9.2 Government Attitudes

See **9.1 Recommended Changes**.

9.3 Profile of International Tax

International tax has a high profile in the UK, and the OECD considers the UK to be a committed partner. The UK played a vital role in persuading the G20 group of countries to launch the work on BEPS.

9.4 Competitive Tax Policy Objective

The UK government had come under considerable pressure from the consumer population in relation to large corporations obtaining revenue from consumers in the UK but not paying corporation tax on profits earned from those revenue streams. BEPS is a welcome response to the growing pressure on governments worldwide to implement a fairer tax system.

9.5 Features of the Competitive Tax System

The UK is no longer a member of the EU and therefore the rules on EU subsidies no longer apply (limited application continues to trade between Northern Ireland and the EU and in certain other circumstances the EU rules apply, for example, to distribution of residual EU state aid).

A new regime, *"subsidy control"*, operates in the UK, which overlays the EU and World Trade Organization rules on subsidies, and which takes a principles-based approach to the delivery of subsidies by public authorities. The rules are there to protect the UK's internal market and its international trade relationships.

9.6 Proposals for Dealing With Hybrid Instruments

The Finance Act 2018 introduced changes to the CTA 2009, the policy behind which was to enable a deduction for coupons on certain types of hybrid instrument which are in essence genuine debt instruments. This was an important measure and a necessary reaction to changes in regulation which required banks (Basel III) and insurance companies (Solvency II) to issue instruments which enabled loss absorption in the event of financial strain and depleted levels of capital. In order for the rules to apply, the instrument must be a loan relationship on which the debtor is allowed to defer or cancel interest payments. In addition, it must have no other significant equity features, and the debtor must have made an election into the new rules within six months of issue of the instrument.

9.7 Territorial Tax Regime

See **9.6 Proposals for Dealing With Hybrid Instruments**.

9.8 Controlled Foreign Corporation Proposals

The general drift of the Controlled Foreign Companies regime is to prevent profits being taxed at a lower rate overseas and repatriated by way of dividends at a time when the company had been brought onshore so that the dividends were exempt as being from a UK resident company. They have been applied in wider circumstances than intended and in my view were not compliant with EU rules as they were discriminatory.

9.9 Anti-Avoidance Rules

See **9.8 Controlled Foreign Corporation Proposals**.

9.10 Transfer Pricing Changes

It remains to be seen how BEPS will affect tax revenues in the UK as it is early days.

9.11 Transparency and Country-by-Country Reporting

Country-by-country reporting enables tax authorities to assess transfer pricing and other risks and determine where resources are required.

9.12 Taxation of Digital Economy Businesses

The UK introduced the diverted profits tax aimed at charging profits earned from UK activities that are diverted outside the UK.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

The UK has a number of sets of rules regarding tax exploitation of intellectual property that is held offshore. As stated in other sections of this chapter, royalty payments by a UK resident company are subject to withholding tax, transfer pricing rules seek to ensure payments are made at an arm's length rate, there are *"diverted profits tax"* rules, and there are also rules that catch offshore receipts in respect of intangible intellectual property on *"UK derived amounts"* exceeding GBP10 million arising to residents of a territory with which the UK does not have a full double tax treaty.

Trends and Developments

Contributed by:
Rebecca Murray

Author

Rebecca Murray has a busy litigation and advisory practice, specialising in corporate tax, private client and VAT. She acts for FTSE 100 companies, wealthy individuals, HMRC, and as a member of the Attorney General's B Panel of Counsel. She recently appeared in the Upper Tribunal acting for HMRC on the issue of deductibility of a provision in the accounts of companies that had implemented an unfunded unapproved retirement benefit scheme. In this lead case, it was decided that the provision was not incurred wholly and exclusively for the purposes of the trade (CHR Travel & Another v HMRC [2021] UKFTT 445). She was also recently successful for HMRC in the First-tier Tribunal in a case on gifts of shares to charity (Cityblock & others v HMRC [2023] UKFTT) and has acted for HMRC and for taxpayers in IR35 and umbrella company matters. Rebecca was a Vice President at JP Morgan Chase bank before practising as a barrister.

Rebecca Murray

Tel: +44 20 7353 7534
Email: clerks@devchambers.co.uk
Web: www.devchambers.co.uk

Deductibility and Illegality

Introduction

The purpose of this article is to discuss the principles of deductibility of expenditure which apply to all types of wrongdoing, whether civil or criminal, in light of the recent decision of the Court of Appeal in ScottishPower (SCPL) Limited & Ors v HMRC [2025] EWCA 3(*"Scottishpower"*) and the cases cited therein.

Wholly and exclusively for the purposes of the trade

The starting point, of course, is that by virtue of s.54 CTA 2009 (for corporation tax) and s.34 ITTOIA 2005 (for income tax), expenses incurred by a trader are not deductible in calculating the profits of the trade unless they are incurred *"wholly and exclusively for the purposes of the trade"*.

As the Court of Appeal explained in Vodafone Cellular v Shaw [1997] 69 TC 376, in order to determine whether an expense is incurred wholly and exclusively for the purposes of the trade, two questions must be answered by the fact-finding tribunal. The first question involves identifying the purposes for which the expense was incurred: this is a subjective question that requires the tribunal to look into the mind of the trader at the time when the expense is incurred in order to identify the trader's purpose or purposes in incurring it. The second question involves ascertaining the character of that purpose or purposes: this is an objective question, in that the characterisation of the trader's purpose as a trade or non-trade purpose is a matter for the tribunal, not the trader.

This article will focus on the latter question in the context of unlawful conduct: that is, in what circumstances does the fact that the trader's conduct was unlawful mean that the purpose of incurring an expense must be characterised as a non-trade purpose? In short, in what circumstances can it be said that unlawful conduct is not within the scope of the trade?

Statutory prohibitions

Before embarking on this discussion, it should perhaps be mentioned that by virtue of s.1304 CTA 2009 (for corporation tax) and s.55 ITTOIA 2005 (for income tax), no deduction is allowed for expenses incurred in making a payment if the making of the payment constitutes a criminal offence (or would do so if it were paid in the UK). For example, a dealer in illegal drugs cannot deduct the cost of buying their trading stock.

Fines and penalties

The next point to make is that expenditure incurred by a trader in satisfying a liability to pay a fine or penalty, or in settling a claim for payment of a penalty or fine, must be regarded as having a non-trade purpose. As Lord Hoffmann explained in McKnight v Sheppard [1999] 1 WLR 1333, if the fine or penalty were deductible then the public policy of penalising the trader would be diluted, and part of the cost of the penalty would be borne by the general body of taxpayers, which Parliament cannot have intended.

In Scottishpower, it was recognised that this is an inflexible rule of public policy that applies to any payment made in satisfaction or settlement of a fine or penalty, even if the liability arises as a regular and almost unavoidable incident of the trade.

However, that particular public policy rule applies only to the fine or penalty itself. It does not apply to prohibit the deduction of legal costs incurred by the trader in unsuccessfully disputing liability to the fine or penalty, as in McKnight v Sheppard itself.

Still less does that rule apply to expenditure in satisfying a claim that is compensatory rather than punitive in nature, such as damages for loss suffered as a result of a defamatory article published by a newspaper company, as in The Herald and Weekly Times Ltd v FCT [1932] 48 CLR 113. In that case, the court held that such claims against the newspaper company were a regular and almost unavoidable incident of publishing the newspaper, and therefore expenditure incurred in meeting the claims was within the scope of the trade and must be characterised as having a trade purpose.

The Court of Appeal overturned the decision of the Upper Tribunal in Scottishpower v HMRC [2023] UKUT 218, finding that there was no basis for extending the rule to payments that were not in fact fines or penalties. Lady Justice Falk held:

"I do not consider that any general considerations of policy, whether legislative or otherwise, require a conclusion that a principle which prohibits a deduction for fines or penalties must extend to payments that are not in fact fines or penalties, even if they can be seen as replacing them. As Mr Goldberg fairly pointed out, judges have been warned against making decisions based on vague concepts of 'public policy' (see, albeit in the very different context of breach of promise, the comments of Lord Atkin in Fender v St John-Mildmay [1938] AC 1, 10-12). More specifically here, in my view such a conclusion could be seen – with some justification – as going beyond the proper role of the judiciary." (per Falk LJ at [61]).

In the author's view, this decision provides welcome certainty on the scope of an inflexible rule of public policy, at least at the time of writing.

Unlawfulness of itself is not necessarily a bar to deduction

In light of the above, we can say that, provided always that the trader's expense does not consist of a payment the making of which is a criminal offence, and also does not consist of satisfying liability to pay, or settling a claim for, a fine or penalty, the fact that the expense arises out of unlawful conduct on the trader's part is not, of itself, a necessary bar to deduction. This is self-evidently the case where the conduct involves a mere civil wrong, such as negligence or a breach of contract.

But it is also the case, in my view, where the conduct involves the commission of a criminal offence. For example, in IRC v Alexander Von Glehn & Co Ltd [1920] 2 KB 553, the taxpayer company traded with a German company during WW1, thereby breaching the Customs (War Powers) Act 1915, and so became liable to a penalty. The penalty was held not to be deductible, but this was not because trading with the German company was characterised as not being within the scope of the trade. On the contrary, as Lord Sterndale MR put it, *"during the course of the trading the company committed a breach of the law"*.

Nor does it matter that the criminal conduct is also morally wrong. For example, in Commissioner of Taxation v La Rosa [2003] FCA FC 125, an Australian case, a drug dealer claimed a deduction in respect of money stolen from him in the course of a drug deal. The Revenue argued that the loss was not deductible in computing the dealer's profits because the activity was illegal, but the court disagreed. Hely J. commented that a professional assassin can deduct the cost of the bullets and depreciate the cost of his gun, because purchasing them is part of his trade, and it is for Parliament to refuse to permit a deduction of those costs (as indeed the Australian Parliament did shortly after the decision in La Rosa), not for the courts to do so on the ground that the costs are not incurred in the course of the trade.

McLaren Racing

In HMRC v McLaren Racing [2014] UKUT 269, the UT remarked that *"a deliberate activity which is contrary to contractual obligations and the rules and obligations governing the conduct of the trade, which is not an unavoidable consequence of carrying on a trade and which could lead to the destruction of the trade is not an activity carried on in the course of that trade"*.

This remark was an obiter dictum because, as the UT itself noted, the taxpayer company did not contend that the activity in question was within the scope of its trade.

In my view, the UT's remark should not be interpreted as purporting to lay down any rule of law. First, because the courts have no power to do so. Second, because the UT's remark was made, and should be understood, in the context of the particular facts of the case.

In that case, the taxpayer company carried on the trade of Formula 1 racing pursuant to an agreement, called the Concorde Agreement, which provided for the exploitation of commercial activities in relation to Formula 1 and thereby generated income for those involved. Under the Agreement, Formula 1 teams agreed to abide by the International Sporting Code (ISC) rules, and in return the ISC licensed them to participate in motor sport competitions such as the Formula 1 championship. The ISC rules provided for penalties for breach, including expulsion, which would lead to inability to compete, and therefore destruction of the trade. Thus, the taxpayer company's trade was defined and governed by the ISC rules: the continued ability to generate income from Formula 1 racing, and therefore the very existence of the trade, was dependent on compliance with those rules. In those circumstances, the UT's remark that a deliberate and avoidable breach of those rules was not done in the course of the trade makes complete sense.

Phone hacking

Readers will no doubt recall that many civil damages claims have been brought against some newspaper publishing companies, who have incurred very large sums in investigating, defending and settling those claims. Could HMRC argue, in reliance on the McLaren Racing case, that those expenses are not deductible because phone hacking was not only a civil wrong, but was also a breach of the PCC Code and a criminal offence punishable with imprisonment, and therefore must have been outside the scope of the companies' trades?

In his sentencing remarks in R v Coulson, Saunders J. said that phone hacking was carried out in an increasingly competitive market where whoever got the best stories and created the biggest headlines would sell the most newspapers, so that editors put pressure on journalists to get stories for publication with little concern for how they got them, and as a result a culture of illegal information access (including covert surveillance, going though rubbish bins, and *"blagging"*, as well as phone hacking) was deployed in order to produce stories for publication.

In light of that factual background, in my view, it is clearly arguable that phone hacking, although unlawful, was not outside the scope of the trade.

In particular, first, it was not one-off or extraordinary conduct. On the contrary, it was a prolonged and long-standing means of obtaining information for publication in the newspaper, which was approved by the editor as being necessary in order to maintain a competitive edge.

Second, although phone hacking was in breach of the PCC Code and the general law, the companies' trades were not defined and governed by a set of rules the breach of which could lead to expulsion from the activity of publishing newspapers and therefore destruction of the trade.

Third, I do not think that conduct can be regarded as outside the scope of a trade merely because, viewed objectively, it puts the existence of the trade at risk. For example, consider a professional gambler who regularly places very high stakes such that a run of bad luck may well lead to his insolvency and the destruction of the trade. It could not possibly be argued that placing such stakes is outside the scope of the trade: on the contrary, that is the very nature of his trade. Thus, whether conduct is outside the scope of a trade depends on the context of the particular trade.

In this connection, although the News of the World eventually ceased publication, this was not an inevitable or even probable consequence of phone hacking; after all, The Mirror continues to be published. Moreover, as Saunders J's sentencing remarks indicate, editors judged at the time that hacking was beneficial, indeed, necessary, to the trade, and I do not consider that determining the scope of the trade involves HMRC or the FTT second-guessing that judgement.

Finally, as already explained above, the mere fact that phone hacking was unlawful does not, of itself, prevent it from being within the scope of the trade. The unlawfulness is a potentially relevant factor, but it is not determinative.

It might be argued that this analysis cannot be correct because it means that if a reporter were, for example, to threaten to beat someone up unless he provides information, that too would be within the scope of the trade, which is absurd. In my view, however, whether the making of such a threat is within the scope of a trade depends on the context of the trade: if the threat is a one-off, extraordinary, unauthorised act of a single rogue reporter, it may well be regarded as outside the scope of the trade, but in the context of a trade where the making of such threats is a widespread and approved practice, the result may well be different. (Of course, a payment made to a professional hoodlum to carry out the threat would not be deductible if the making of the payment is a criminal offence.)

HMRC's published practice

At BIM38525, HMRC asserts that costs arising from a breach of the law, and costs incurred to settle an action alleging a breach of the law, are not allowable. For the reasons given above, in my view that is not correct.

HMRC relies for this proposition on Cattermole v Borax & Chemicals Ltd [1949] 31 TC 202, but that was just about the non-deductibility of a payment made to settle a penalty claim.

At BIM38530, HMRC asserts that the costs of civil damages arising as a result of *"normal"* trading operations are generally allowable, but civil damages arising outside the *"normal"* course of the trade are not allowable. In my view, this too is not correct: an expense is deductible if it arises from conduct which is within the scope of the trade, whether that conduct is *"normal"* or not. I would agree that the *"normality"* or otherwise of conduct is relevant in determining whether it is within the scope of the trade (that is why an unlawful act is more likely to be regarded as outside the scope of the trade if it is a one-off or extraordinary).

HMRC relies for this proposition on Fairrie, v Hall [1947] 28 TC 200, but that was a case about duality of purpose: the taxpayer brought a libel action against a trade rival; his legal costs were not deductible because he had a non-trade purpose (the libel action was malicious) as well as a trade purpose.

Conclusion

The deductibility of payments by way of compensation and associated legal costs does not turn on whether its conduct giving rise to the compensation claims was unlawful. In particular, the unlawfulness of the conduct cannot of itself mean that it falls outside the scope of the trade.

USA

Law and Practice

Contributed by:
Devon M Bodoh, Greg W Featherman, Joseph M Pari, Alexander P Dobyan and Grant S Solomon
Weil, Gotshal & Manges LLP

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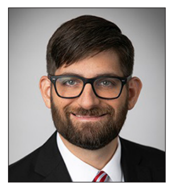
Contributed by: Devon M Bodoh, Greg W Featherman, Joseph M Pari, Alexander P Dobyan and Grant S Solomon, **Weil, Gotshal & Manges LLP**

Weil, Gotshal & Manges LLP was founded in 1931 and has provided legal services to the largest public companies, private equity firms and financial institutions for more than 90 years. Widely recognised by those covering the legal profession, Weil's lawyers regularly advise clients globally on their most complex litigation, corporate, restructuring, and tax and benefits matters. Weil has been a pioneer in establishing a geographic footprint that has allowed the firm to partner with clients wherever they do business. Weil's global tax department offers comprehensive knowledge of how the complex and continually evolving nature of tax law plays a crucial role in some of the most significant and high-profile domestic and cross-border transactions, restructurings and other commercial matters. The firm not only understands the nature of its clients' transactions, but also understands their businesses, and is a critical part of the team that works to accomplish each client's business goals.

Authors

Devon M Bodoh is a partner in Weil Gotshal & Manges LLP's tax department and is based in Miami and Washington, DC. Devon is the head of the firm's international and cross-border tax practice, a member of the tax department's leadership team and managing partner of the Miami office. He advises clients on cross-border mergers, acquisitions, spin-offs and other divisive strategies, restructurings, bankruptcy and non-bankruptcy workouts, the use of net operating losses, foreign tax credits, and other tax attributes and consolidated return matters. Mr Bodoh is recognised as a leading lawyer by Chambers USA.



Greg W Featherman is a partner in Weil, Gotshal & Manges LLP's tax department and is based in New York. Mr Featherman has extensive experience in advising on a variety of largely cross-border transactions, including corporate acquisitions and mergers, spin-offs and other divisive strategies, internal restructurings, financings, business formations and joint ventures. He also represents SPACs in their formation and public offerings, as well as in their acquisition transactions.

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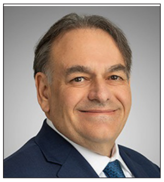
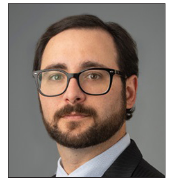
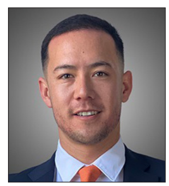


Joseph M Pari is co-chair of Weil, Gotshal & Manges LLP's tax department and is based in New York and Washington, DC. Mr Pari has extensive experience in advising on federal income taxation of domestic and cross-border mergers, acquisitions, spin-offs, other divestiture types, restructurings, bankruptcy and non-bankruptcy workouts, acquisition financing and the use of pass-through entities in acquisitive and divisive transactions, with an emphasis on corporate tax planning, the utilisation of net operating losses, and other tax attributes and consolidated return matters. Mr Pari has been recognised as a leading lawyer by Chambers USA and Chambers Global.



Alexander P Dobyan is an associate in Weil, Gotshal & Manges LLP's tax department and is based in Washington, DC. Mr Dobyan advises clients with respect to cross-border mergers, acquisitions, spin-offs, other divisive strategies, restructurings, bankruptcy and non-bankruptcy workouts, the use of net operating losses, foreign tax credits, and other tax attributes and consolidated return matters.



Grant S Solomon is an associate in Weil, Gotshal & Manges LLP's tax department and is based in Washington, DC. Mr Solomon advises clients with respect to the tax aspects of a wide range of corporate transactions, including domestic and cross-border mergers and acquisitions, joint ventures and financing transactions.

Weil, Gotshal & Manges LLP

Devon Bodoh
Weil, Gotshal & Manges LLP
2001 M Street, NW
Suite 600
Washington, DC
20036 USA

Tel: +1 202 682 7060
Fax: +1 202 857 0940
Email: devon.bodoh@weil.com
Web: www.weil.com

Contributed by: Devon M Bodoh, Greg W Featherman, Joseph M Pari, Alexander P Dobyan and Grant S Solomon, **Weil, Gotshal & Manges LLP**

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

The most commonly used business types in the United States of America (USA) include:

- sole proprietorships;
- partnerships;
- limited liability companies (LLCs); and
- corporations.

Unlike other jurisdictions, the type of business entity selected does not alone determine its US federal tax classifications.

Under the *"check-the-box"* regulations, domestic entities may be classified as corporations, partnerships or entities disregarded as separate from their owners (a *"disregarded entity"*). A business entity with two or more owners is classified either as a corporation or a partnership; and a business entity with only one owner is either classified as a corporation or as a disregarded entity. An entity is classified as *"per se corporation"* if it is organised under a US federal statute or a US state statute that describes the entity as incorporated or as a corporation, body corporate or body politic. If an entity does not meet any of these requirements, it is an *"eligible entity"* and its classification is elective. Default classification rules determine initial classification, which can be changed by filing the appropriate forms with the Internal Revenue Service (IRS); by default, a domestic eligible entity is a partnership if it has two or more owners or is a disregarded entity if it has a single owner.

In addition, certain entities (such as corporations and LLCs) can qualify for, and elect to be taxed under, certain specialised tax regimes, such as those governing S corporations, regulated investment companies (RICs) or real estate investment trusts (REITs), provided various requirements are satisfied.

Generally, the LLC is the most commonly used entity type. LLCs are hybrid entities created under state law that are neither partnerships nor corporations. From a state law perspective, they offer their members protection from personal liability for the debts of the LLC's business, much like the liability protection that a corporation offers to its shareholders. From a federal tax standpoint, the IRS treats the LLC as an eligible entity under the *"check-the-box"* rules, meaning the LLC has flexibility to be classified as either a partnership, an association taxable as a corporation (including as an S corporation, RIC or REIT) or a disregarded entity depending on its business and ownership characteristics.

1.2 Transparent Entities

Partnerships and LLCs (that have elected to be taxed as partnerships) are the most commonly used *"pass-through"* entities in the USA across industries (including private equity and hedge funds). Unlike corporations (other than S corporations, RICs or REITs, discussed further below), partnerships are not viewed as *"taxpaying"* entities. Instead, the partners are, generally speaking, liable for the federal income tax on the income (or loss) derived by the partnership. While the determination of income (or loss) for the year is determined at the entity level (treating it as the computational entity), the income or loss is allocated to the partners pursuant to their respective distributive shares. Accordingly, partnerships provide owners significant flexibility (within parameters including that the allocations have *"significant economic effect"*) in how items of income and loss are allocated among themselves for tax purposes.

Another method of eliminating *"entity-level"* tax is for an entity to qualify for, and elect to be taxed as, an S corporation, RIC or REIT. While these regimes vary, they share a common theme – corporate income of a qualifying entity is taxed only to the shareholders, and not to the corporation itself (similar to a partnership). Due to strict ownership requirements, S corporations are available only to US *"individual"* investors and generally involve closely held businesses. RICs and REITs, by contrast, can be significantly larger and attract different investor bases based on the types of assets owned by each such entity. For example, REITs are companies that own or finance income-producing real estate across a range of property sectors, while RICs are companies that derive their income primarily from passive investment sources (ie, dividends) and generally include mutual funds, closed-end investment companies and exchange-traded funds.

1.3 Determining Residence of Incorporated Businesses

There are four classes of *"person"* for US income tax purposes:

- individuals;
- corporations;
- partnerships; and
- trusts and estates.

Under US tax rules, as under most countries' tax systems, such persons are further classified as *"resident"* or *"non-resident"* based on a variety of tests.

For individuals, the US system treats both US citizens and resident alien individuals as income tax residents. *"Resident"* aliens are defined using two tests, as follows.

- First, lawful permanent residents (ie, US green card holders) are residents so long as they hold that status.
- Second, other individuals are considered residents if they are in the USA under a day-count test. Under the day-count test, a person is considered a resident if the total number of days such person is present in the USA in the current year, plus one third of the days present in the prior year, plus one sixth of the days present in the second prior year, equals or exceeds 183 days.

For corporations, the USA generally uses the *"place of incorporation"* rule for determining tax residence, under which a corporation is *"domestic corporation"* if it is created or organised under the law of the USA, any US state or the District of Columbia. Note that a special set of rules, referred to as the *"anti-inversion rules"*, may in limited circumstances cause a non-US corporation to be treated as a US tax resident.

Generally, partnerships are determined as domestic or foreign in the same manner as corporations – ie, based on the jurisdiction of formation. However, as partnerships are not subject to income tax (see **1.2 Transparent Entities**), their status as resident or non-resident is largely irrelevant for purposes of determining their taxation (although the jurisdiction of the entity could impact on the tax treatment of the partners – eg, under a relevant income tax treaty). Trusts are classified as *"domestic"* or *"foreign"* according to whether they have a US trustee and are subject to US legal jurisdiction, and then are subject to tax as *"US persons"* or non-resident aliens according to such status. Although estates do not have a formal classification, they tend to be categorised along principles similar to those used for trusts.

1.4 Tax Rates

The maximum US corporate income tax rate is currently 21%. In addition, US states and local governments may levy corporate income taxes on the same (or similar) tax base, but such taxes are generally deductible from the federal income tax base for corporations (subject to certain limitations). Therefore, a corporation operating in the US could face a combined tax rate in excess of 21%. On average, corporations have paid a combined US federal, state and local corporate income tax rate of approximately 26%.

The USA also applies a corporate minimum tax (effective from 1 January 2023) that generally imposes a 15% minimum tax on the financial statement income for US corporations (including consolidated groups; see **4.4 Transfer Pricing Issues**) with financial statement income of more than USD1 billion for three taxable years (or USD100 million in the case of a US corporation that is part of a non-US multinational group that has combined financial statement income of more than USD1 billion).

The fiscal year 2025 will be a transitional one from a tax policy perspective, with several significant business tax provisions set to change (or phase out) beginning at the end of the year. Although President Trump did not provide a formal tax plan as part of his 2024 campaign, he did discuss – as relevant here – lowering the corporate tax rate from 21% to 20%. In addition, in the case of domestic manufacturing, President Trump discussed lowering the effective corporate tax rate from 21% to 15%, which would tentatively be achieved through the restoration of the prior domestic production activities deduction (DPAD) set at 28.5%. Tax advisers, business leaders and individuals alike will need to evaluate the potential effect of the tax policies proposed by President Trump.

In contrast to corporations, the maximum income tax rate for individuals (including individuals invested in certain pass-through entities) is 37%. Furthermore, US states and local governments may levy additional taxes on the same (or similar) income incurred by such individuals, the rate of which fluctuates significantly between the various states and municipalities. Additionally, some US states and local governments may also levy an entity-level tax on the business entity notwithstanding its US federal tax classification.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The US federal income tax is imposed on *"taxable income"*, which is calculated as *"gross income"* reduced by deductions allowed under the Internal Revenue Code (the *"Code"*). Gross income is defined as *"income from whatever source derived"*; thus, the USA employs a global definition of income based on the accretion concept, where any accession to wealth (other than mere appreciation of asset value with nothing more) constitutes income unless the Code expressly excludes it.

Every taxpayer must figure taxable income for an annual accounting period called *"tax year"*. The calendar year is the most common tax year; however, other tax years can be selected (ie, fiscal year). Taxpayers must use a consistent accounting method, which is a set of rules for determining when to report income and expenses. The most commonly used accounting methods are:

- the cash method (generally used by individuals and other small businesses); and
- the accrual method.

Under the cash method, a taxpayer reports income in the tax year it receives it, and deducts expenses in the tax year in which it pays them.

Under the accrual method, the taxpayer reports income in the tax year it earns it (regardless of when payment is received) and deducts expenses in the tax year incurred (regardless of when payment is made).

2.2 Special Incentives for Technology Investments

The Code includes a wide variety of credits that can help reduce, or fully satisfy, the income tax obligations (as well as payroll tax obligations) of taxpayers across a variety of industries, and that can even simply result in a net payment from the government to the taxpayer. These credits have many rules regarding who can claim them and the timing of when, in what order and how much of the credit(s) can be used (or carried forward or backward).

Notably, the R&D tax credit provides an incentive to invest in R&D (ie, performing activities related to the development, design or improvement of products, processes, formulas, technology or software) by allowing companies to claim credits for spending on certain qualified research expenditures (QREs). The R&D tax credit has four separate components:

- the regular credit (equal to 20% of QREs above a base amount);
- the alternative simplified credit (equal to 14% of QREs above half the average of QREs over the prior three years);
- the energy research credit (equal to 20% of QREs); and
- the basic research credit (equal to 20% of QREs above a base amount).

In any year, taxpayers can take the energy research credit and the basic research credit, along with either the regular credit or the alternative simplified credit.

In addition to credits, the Code also allows taxpayers to recover certain types of R&D expenses over a specified recovery period (generally five years, but which may be extended to 15 years in cases of research conducted outside the USA). President Trump has discussed eliminating these R&D amortisation provisions and fully restoring the ability for taxpayers to immediately expense such costs (as existed under pre-Tax Cuts and Jobs Act law).

Additionally, the USA also has a regime that offers domestic corporations a deduction for *"foreign-derived intangible income"* (FDII), which is an amount that exceeds a deemed return on tangible assets. However, rather than being a patent box, the deduction for FDII is designed to neutralise the effect of global intangible low-taxed income (GILTI) (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**) to incentivise US corporations to allocate intangible income to controlled foreign corporations (CFCs).

2.3 Other Special Incentives

In addition to the R&D tax credit (see **2.2 Special Incentives for Technology Investments**), there are several other credits that can provide tax benefits in the form of a dollar-for-dollar reduction to tax liability. For example, there are a variety of general business credits that can be claimed by a broad range of businesses ranging from hiring certain classes of employees (eg, the work opportunity and empowerment zone employment credits) to utilising certain resources in the manufacturing process (eg, the renewable electricity production credit). Moreover, in any year, a taxpayer can choose whether to take – as a foreign tax credit (FTC) or as a deduction of foreign income – war profits and excess profit taxes paid or accrued during the tax year to any foreign country or US possession. An FTC reduces US income tax liability dollar for dollar, while a deduction reduces the US income tax liability at the marginal rate of the taxpayer.

There are generally limited incentives related to inbound investment at the federal level, such as the portfolio interest exemption (PIE), bank deposit exceptions and trading safe harbours. Very generally, the PIe, enables non-residents and foreign corporations to invest in certain obligations in the USA without being subject to US income (or withholding) tax on the interest income (see **4.1 Withholding Taxes**). The bank deposit exception allows non-US investors to deposit funds in US banking institutions without being subject to US tax on the interest earned, provided that the investment meets the statutory definition of *"deposit"* and the funds are held by persons carrying on a banking business, or certain other supervised institutions.

There also are statutory securities- and commodities-trading safe harbours that provide exceptions from being treated as engaged in a US trade or business for non-US persons trading in stocks, securities or commodities through a resident broker or other agent. Additionally, interest income received on certain qualified private activity bonds is generally exempt from US federal income tax, which enables a business to issue the bonds at a lower interest rate.

The aforementioned incentives are not intended to represent an exhaustive list of all the benefits that are available; however, they do illustrate some of the core incentives utilised by businesses in a range of industry sectors.

2.4 Basic Rules on Loss Relief

Under the US tax system, a taxpayer with deductions exceeding gross income can have a net operating loss (NOL) that may be carried to and deducted in another year. The amount of an NOL is equal to the taxpayer's gross income minus deductions, computed with certain modifications. The modifications that must be made depend on whether the taxpayer is a corporate or non-corporate taxpayer. In addition, special rules apply when determining the NOLs of a group of corporations filing a US consolidated return, which require NOLs to be computed on a consolidated basis (see **2.6 Basic Rules on Consolidated Tax Grouping**).

For NOLs arising in tax years that begin after 2020, there is no longer a carry-back period, except a two-year carry-back for certain NOLs attributable to farming losses and NOLs incurred by non-life insurance companies. The carry-forward period is unlimited for NOLs arising in post-2017 tax years; however, a 20-year carry-forward period applies to the NOLs of non-life insurance companies and pre-2018 NOLs.

In addition, post-2017 NOLs may only offset 80% of taxable income; however, this 80% limitation does not apply to non-life insurance companies. Apart from the 80% limitation, certain anti-loss trafficking rules may limit a company's NOL utilisation where there has been a sufficient change of ownership.

Individual taxpayers may offset capital gains with capital losses and, if such losses exceed the gains, ordinary income up to USD3,000 per year. Individuals may carry unused capital losses forward indefinitely. In contrast, corporate taxpayers may only offset capital gains with capital losses and may carry unused capital losses back three years and forward five years.

2.5 Imposed Limits on Deduction of Interest

In 2017, the USA passed legislation that limits the deductibility of business interest expense. Under these rules, a taxpayer's interest expense for any year is limited to the sum of:

- business interest income; plus
- 30% of adjusted taxable income (which, for 2022 and onwards, is generally equal to EBIT, rather than EBITDA); plus
- floor plan financing.

Any interest disallowed can be carried forward indefinitely and deducted in subsequent years. While certain taxpayers are exempt from this limitation (eg, certain small taxpayers and real property businesses), it applies regardless of whether related-party debt is involved, regardless of whether the debt is incurred by a sole proprietor, a corporation or a pass-through entity and regardless of whether the taxpayer is thinly capitalised. Recently, as part of President Trump's 2024 campaign, he discussed having the business interest deduction once again be based on EBITDA, rather than EBIT, which, if implemented, would enable taxpayers to deduct more business interest expense going forward.

Other rules also exist that have the potential to limit or deny interest deductions (eg, interest on certain applicable high-yield debt instruments).

In addition to the foregoing rules, the USA has also introduced two *"anti-hybrid"* rules which, if applicable, generally deny US tax deductions in certain situations involving entities and payments of interest, royalties or dividends, if such entities or payments are treated differently under US and foreign tax laws and if such different treatment results in double taxation. Furthermore, rules provided in tax regulations can recharacterise debt between related parties as *"stock or equity"* instrument if such indebtedness is issued in certain related-party transactions (see **5.7 Constraints on Related-Party Borrowing**). These rules are specifically designed to target earnings-stripping transactions.

2.6 Basic Rules on Consolidated Tax Grouping

The Code and tax regulations (and several US states) allow a group of US corporations to file a consolidated federal income tax return, which effectively allows the profits of one group member to be offset by the losses of another group member.

The consolidated return rules, which are mostly in the tax regulations, are very detailed and complex. Very generally, certain US entities classified as corporations for US federal income tax purposes may elect to join in filing a consolidated return if they are members of an *"affiliated group"*. An affiliated group is generally one or more chains of corporations connected through stock ownership with a common parent corporation, which must satisfy certain detailed stock-ownership rules with respect to the subsidiary corporations (generally requiring at least 80% ownership measured by voting power and value, but disregarding certain debt-like preferred stock). Sales, dividends and other intercompany transactions between group members are generally deferred until a transaction occurs with a non-member (or when a member leaves the group). Groups of corporations filing consolidated returns are subject to various special rules, such as:

- rules on intercompany transactions;
- loss disallowance rules;
- loss-sharing rules;
- several liability among members of the group with respect to federal income taxes; and
- basis adjustments with respect to subsidiary member stock.

Regarding losses, a consolidated group is required to determine its NOL on a consolidated basis. For this purpose, the separate income and loss of each member is determined without taking into account any separate NOL deduction. Separate member income and losses are then aggregated and taken into account in determining the group's NOL for that year – meaning that the positive net income of some members is netted against the NOLs of other members to determine whether, on a net basis, the group has an NOL. In addition to certain general anti-loss trafficking rules (see **2.4 Basic Rules on Loss Relief**), certain loss disallowances apply only to consolidated groups.

2.7 Capital Gains Taxation

For corporate taxpayers, gains from the disposition of capital assets are subject to regularly applicable tax rates, and losses from the disposition of capital assets may only offset capital gains (see **2.4 Basic Rules on Loss Relief**).

The Code includes various non-recognition provisions under which a built-in gain may be deferred (or in the case of a tax-free subsidiary spin-off, eliminated) rather than recognised and included in taxable income in the specified transaction. For example, such provisions include:

- like-kind exchanges of real property;
- involuntary conversion; and
- certain corporate reorganisations such as mergers, stock sales or liquidations.

In addition, the 2017 tax reform introduced a regime under which taxpayers may defer or partially eliminate certain capital gains by investing in *"qualified opportunity fund"* located in any of the *"qualified opportunity zones"* enumerated by the IRS.

2.8 Other Taxes Payable by an Incorporated Business

Various other transaction taxes may apply at the state and local levels. For example, most US states impose an ad valorem real property transfer tax. In addition, beginning on 1 January 2023, stock repurchases or redemptions of more than USD1 million by a US corporation (and in certain cases, a non-US corporation) that has stock traded on an established securities market will be subject to a 1% US federal excise tax.

2.9 Incorporated Businesses and Notable Taxes

Various other taxes may apply in addition to the taxes discussed elsewhere in this chapter, such as:

- the federal excise tax imposed on insurance and reinsurance premiums paid to non-US persons;
- the federal excise tax on certain stock repurchases or redemptions (see **2.8 Other Taxes Payable by an Incorporated Business**);
- social security; and
- Medicare tax and unemployment tax imposed on employers.

In addition, US states and local governments impose various other direct taxes (ie, franchises tax) and indirect taxes (ie, excise taxes, mortgage recording taxes, telecommunications taxes or insurance premium taxes) that may vary greatly between such US states.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

As noted in **1.1 Corporate Structures and Tax Treatment**, the LLC (a hybrid-type entity) is the most commonly used entity type in the USA. This is because it not only affords liability protection for its members (similar to the protection that a corporation offers its shareholders) but also permits significant flexibility from a tax-planning perspective. Specifically, an LLC, as an eligible entity, can generally elect to be classified for federal tax purposes as a corporation, a partnership or a disregarded entity depending on its ownership. That said, by default LLCs are generally taxed like sole proprietorships or partnerships, meaning the owners are considered self-employed and generally are required to pay self-employment tax on all business profits.

Another popular form is the S corporation. As noted in **1.2 Transparent Entities**, S corporations are generally exempt from a federal income tax (meaning that any income is taxed only at the individual level) and, notably, provide certain self-employment tax benefits to their owners that are generally not available to other types of entities. Along with the tax advantages, S corporations enjoy the same protection from liability offered by corporation status. There are, however, a number of stipulations for operating as an S corporation that may disqualify or disincentivise a business seeking S corporation status. Perhaps the most important are the strict limits around shareholders, which are restricted largely to US individuals. Furthermore, unlike other types of pass-through entities (ie, partnerships), S corporations do not have flexibility when it comes to the allocation of income.

3.2 Individual Rates and Corporate Rates

Corporations in the USA are subject to what is referred to as the classic regime of corporate taxation. Specifically, corporations (other than certain types of corporations qualifying under special tax regimes – see **1.1 Corporate Structures and Tax Treatment** and **1.2 Transparent Entities**) are for the most part regarded as entirely separate legal entities and, as such, are subject to tax on their income; and shareholders are considered to receive income fully subject to tax when they receive distributions from corporations that are out of corporate earnings and profits (E&P). Thus, in the USA, corporate income is taxed twice, once at the entity level and again at the shareholder level when earnings are distributed; as a result, such system generally prevents individuals from earning income at solely corporate rates.

As discussed in **1.1 Corporate Structures and Tax Treatment** and **1.2 Transparent Entities**, certain types of corporate entities (ie, S corporations, REITs and RICs) provide a mechanism of avoiding corporate-level tax where various requirements are satisfied.

3.3 Accumulating Earnings for Investment Purposes

The retention of profits may trigger additional tax liability, such as the accumulated earnings tax (AET) (ie, a 20% penalty tax) imposed on corporations formed or availed for the purpose of avoiding the income tax with respect to their shareholders, or the personal holding company (PHC) tax (ie, a 20% tax on undistributed PHC income) imposed on corporations that mainly derive passive-category income and the majority of which is owned by five or fewer individuals.

Notably, the PHC tax contrasts with the AET in several respects. First, if the requirements of the PHC tax are met, it applies automatically – there is no *"intent"* element that the government must establish. Second, if the PHC tax applies, the corporation must self-assess the tax by making certain filings with its annual tax return – failure to do so may subject it to additional penalties (ie, the AET is imposed by the IRS upon audit).

3.4 Sales of Shares by Individuals in Closely Held Corporations

For US individuals, gains from the disposition of capital assets (ie, shares) held for more than one year (ie, long-term capital gains) are subject to preferential capital gains tax rates – losses from the disposition of capital assets may offset capital gains and, if they exceed such gains, ordinary income up to USD3,000 per year. Any unused capital losses can be carried forward indefinitely.

Distributions by a corporation to individual shareholders are taxed as *"dividends"* only to the extent that they are paid out of the corporation's current or accumulated E&P. Dividends received from domestic and certain qualifying foreign corporations received by individual shareholders (*"Qualified Dividends"*) may be taxed at a preferential tax rate or, if not Qualified Dividends, then at regular individual tax rates. If the corporation has no E&P (or if the distribution exceeds the corporation's E&P), the individual shareholder will be allowed to treat the distribution (or the excess, in the latter case) as a return of capital, to the extent of the shareholder's basis in the stock. Any distribution in excess of basis will be treated as gain from the sale of stock.

US-sourced dividend income generally constitutes fixed or determinable annual or periodic gains, profits and income (collectively referred to as FDAP) (see **4.1 Withholding Taxes**) and is subject to a 30% withholding tax if paid to a non-US tax resident, unless reduced by an applicable treaty. Gains from the sale of stock by a non-US tax resident are generally treated as giving rise to foreign-sourced income and, as such, are not subject to US tax.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals (both US residents and non-US residents) are generally subject to the same rules discussed in **3.4 Sales of Shares by Individuals in Closely Held Corporations** with respect to dividends from, and gain on, shares in publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Non-US tax residents are generally taxed in the USA on FDAP income (ie, interest, dividends and royalties), to the extent that such items of income are not effectively connected with the conducting of a US trade or business or attributable to a permanent establishment. Such FDAP income is subject to a 30% gross basis tax that is enforced by withholding at the source, unless such tax is reduced by exemption or an applicable income tax treaty.

Notably, the PIe, generally exempts, from the otherwise applicable withholding tax previously discussed, interest paid on registered obligations held by non-US persons who own less than 10% of the voting power of the payer. The PIe, is subject to various requirements and exceptions – for example, it is not available to:

- banks receiving interest on ordinary-course loans; and
- certain CFCs.

Special withholding rules also apply in the cases of:

- dispositions of US real property interests; and
- partnerships (with foreign partners) having effectively connected income.

Dispositions of US real property interests are generally subject to the FIRPTA withholding rules, which generally require the transferee to withhold 15% on the total amount realised by the foreign person on such disposition (see **5.3 Capital Gains of Non-Residents**). Partnerships (foreign or domestic) having income effectively connected with a US trade or business (or income treated as effectively connected) generally must pay a withholding tax on the effectively connected taxable income that is allocable to its foreign partners. The tax rate for such withholding varies depending on whether the foreign partner is a corporation or an individual. Currently, the withholding tax rate for effectively connected income allocable to non-corporate foreign partners is 37%, and is 21% for corporate foreign partners.

4.2 Primary Tax Treaty Countries

The USA currently has 58 income tax treaties in force covering 66 jurisdictions. While most US income tax treaties provide reduced rates for dividends (with reduced rates generally ranging from 10% to 25%) and for interest (with reduced rates generally ranging from 0% to 17.5%), foreign investors generally must satisfy certain ownership, income and other requirements before such beneficial rates can be obtained. Of note, on 19 December 2023, the US Department of the Treasury announced the entry into force of the tax treaty between the USA and Chile. The USA-Chile treaty is only the second comprehensive bilateral tax treaty that the USA has with a South American country (the other country being Venezuela). In addition, the USA-Hungary income tax treaty was terminated, effective on 8 January 2023. However, in accordance with Article 26 (Termination) of the convention, the treaty ceased to have effect with respect to tax withheld at source on amounts paid or credited on or after 1 January 2024. For other taxes, the treaty ceased to have effect with respect to taxable periods beginning on or after 1 January 2024.

Furthermore, because most US income tax treaties include *"limitation on benefits"* article as well as other anti-treaty shopping provisions (see **4.3 Use of Treaty Country Entities by Non-Treaty Country Residents**), foreign investors are somewhat limited as to which treaty country can be used to facilitate such investment (ie, as some amount of substance in such jurisdiction is generally required).

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Most US income tax treaties in force include *"limitation on benefits"* article and, in addition, those treaties may contain other anti-treaty shopping provisions. The 2016 US Model Income Tax Convention includes:

- the *"limitation on benefits"* article, which prevents residents of third-country jurisdictions from obtaining benefits under a treaty;
- *"triangular branch"* provision, which limits treaty benefits for income attributable to a

third-country permanent establishment if little or no tax is paid in the permanent establishment's jurisdiction;
- the *"special tax regime"* concept, which denies treaty benefits for items of income subject to a preferential tax regime; and
- a limitation that denies treaty benefits for certain payments made by expatriated entities.

Two of the most significant income tax treaties that do not include either *"limitation on benefits"* article or a triangular branch provision are the treaties with Hungary and Poland. However, new treaties that include both such provisions are currently awaiting US Senate approval to replace these treaties.

In addition to the *"limitation on benefits"* provisions, certain US income tax treaties also contain *"anti-hybrid"* provisions (such as in the *"residency"* article) that address a taxpayer's entitlement to treaty benefits for amounts derived through or paid by a hybrid entity – that is, an entity characterised as fiscally transparent in one jurisdiction and fiscally opaque in another. For example, an item of income may not be treated as *"derived by"* treaty resident if it is derived by the resident through an entity that is not resident in the same country as its owner(s) (the entity could be resident either in the source country or in a third country) and that is not treated as fiscally transparent in the owner's country of residence.

4.4 Transfer Pricing Issues

Specifically, the Code authorises the IRS to adjust items of income, deductions, credits or allowances of commonly controlled taxpayers to prevent tax evasion. The applicable standard in examining intercompany transactions is that of *"taxpayer dealing at arm's length with an uncontrolled taxpayer"* (ie, the arm's length standard), which generally is met if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances. The US tax regulations include detailed rules regarding how such standards may be met.

If the IRS exercises its adjustment authority, the taxpayer bears the burden of proof to show that the arm's length standard was met; and, depending on the circumstances, taxpayers may be subjected to adverse penalties for non-compliance. Consequently, it is recommended that taxpayers routinely maintain robust, contemporaneous documentation to support their transfer pricing practices given that valuation misstatement penalties and reporting penalties may apply.

The USA's aggressive transfer pricing regime has caused controversy with some of its trading partners, not all of whom have agreed with the USA's interpretation of this arm's length standard. The tax regulations, together with a greater level of enforcement activity, have resulted in an increasing number of transfer pricing issues being considered through the competent authority process under the mutual agreement article of tax treaties concluded between the USA and most of its major trading partners.

4.5 Related-Party Limited Risk Distribution Arrangements

A typical limited risk distributor (LRD) agreement may provide for the LRD to earn a predictable, fixed margin and for all residual profit or loss to inure to the principal. While the LRD agreement may provide for the principal to bear most of the LRD's costs and risks in the ordinary course of business, tax authorities might challenge whether the agreement should be respected based on such agreement's compliance with the transfer pricing rules and regulations, especially in circumstances (eg, the impacts of COVID-19) where significant deviations from the arm's length standard arise (see **4.4 Transfer Pricing Issues**).

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Local transfer pricing rules and/or enforcement are generally consistent with OECD standards. That said, the OECD standards are generally less restrictive concerning market penetration strategies than the US regulations, which require a very extensive factual showing and documentation. Additionally, unlike the more restrictive US rules, OECD standards generally do not include specific rules for establishing (or benchmarking) an appropriate arm's length range.

Moreover, the primary focus of the US regulations is on whether a taxpayer has reflected arm's length results on its US income tax return, rather than focusing on the method and procedures used to set such prices. The OECD standards, by contrast, focus significantly less on results and more on whether the transfer prices were established using an arm's length manner; this therefore places considerable emphasis on factors known by the taxpayer at the time the transfer prices were established.

Finally, while the OECD standards acknowledge that penalties may play a legitimate role in improving tax compliance in the transfer pricing areas, they do not provide for any such penalty regime. In contrast, the US system employs a detailed penalty regime that includes both transaction penalties and net adjustment penalties (that escalate depending on the severity of the transfer pricing deviations and/or tax return results).

4.7 International Transfer Pricing Disputes

The USA participates in the OECD International Compliance Assurance Programme (ICAP). Accordingly, the procedures the USA takes to handle any international transfer pricing disputes are generally consistent with those set forth in the ICAP. In addition, enhanced engagement programmes, such as advance pricing agreements (APAs), mutual agreement procedures (MAPs) and other avenues, are available mechanisms in the USA for preventing and/or resolving transfer pricing disputes.

With respect to APAs, the USA was the first country to issue a formal, comprehensive set of procedures relating to the issue of binding APAs dealing with the application of the arm's length standard to intercompany transfer prices. The effect of an APA is to guarantee that the IRS will regard the results of the transfer pricing method as satisfying the arm's length standard if the taxpayer complies with the terms and conditions of the APA. In addition, when a taxpayer and the IRS enter into an APA, the US competent authority will, upon a request by the taxpayer, attempt to negotiate a bilateral APA with the competent authority of the treaty country that would be affected by the transfer pricing methodology. The IRS has encouraged taxpayers to seek such bilateral APAs through the US competent authority.

Furthermore, MAP arbitration is also available under most US tax treaties. Taxpayers should consult the MAP article under the applicable US tax treaty to determine whether it is an arbitration treaty and the extent to which mandatory arbitration applies under such treaty. Generally, US tax treaties contain a provision which would oblige the USA to make corresponding adjustments or to grant access to the MAP with respect to the economic double taxation that may otherwise result from a primary transfer pricing adjustment (ie, paragraph 2 of Article 9 of the OECD Model Tax Convention, or the UN Model Double Taxation Convention, is included in the USA's tax treaties under the Advance Pricing and Mutual Agreement Program).

While the provisions contained in these US tax treaties do not require the competent authorities to reach an agreement eliminating double taxation, such treaties do require that the competent authority make a good faith effort to reach such an agreement. Thus, there is no guarantee that competent authority assistance will result in the elimination of double taxation in every case; however, the vast majority of cases are concluded with an agreement that avoids double taxation.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally, compensating adjustments are allowed/made. A taxpayer may file a competent authority request with respect to a US federal court's final determination of its tax liability, but only for the purpose of seeking correlative relief from a foreign competent authority. Such final determinations include litigation settlements with the Office of Chief Counsel or the Department of Justice. If it accepts such a request, the US competent authority will seek correlative relief from the foreign competent authority only for the amount of such final determination and will not authorise competent authority repatriation.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Generally, local branches are not taxed differently. The imposition of corporate income tax on effectively connected income (ECI) is the equivalent of the tax that would be imposed if a US trade or business were incorporated as a US subsidiary of a foreign corporation, rather than an unincorporated operation. A US subsidiary of a foreign corporation would normally pay a 30% tax on dividends distributed to the foreign corporation (without an applicable tax treaty).

To achieve a similar tax result, the foreign corporation is made liable for a 30% tax computed on its dividend equivalent amount (DEA). This is referred to as *"branch profits tax"* (BPT), although it is imposed on most income that is effectively connected to a trade or business, even if formally there is no established branch. Thus, the BPT substitutes for the taxation of the foreign corporation's shareholders while ensuring that US income is taxed twice, in accordance with the US two-tier system for taxing corporate profits (see **3.2 Individual Rates and Corporate Rates**).

5.3 Capital Gains of Non-Residents

Generally, capital gains from sales of stocks or bonds (ie, personal property) by non-US residents are exempt from US taxation and withholding (ie, as the residence of the seller generally determines whether such gain is foreign- or US-source). This rule, however, is supplanted to the extent that the stock constitutes *"US real property interest"* (USRPI), which includes an interest in stock of *"US real property holding corporation"* (USRPHC). A USRPHC is generally a US corporation that holds US real property whose fair market value is at least 50% of the fair market value of all its real property and assets used in its trade or business. This regime is colloquially referred to as FIRPTA as it was enacted by the Foreign Investment in Real Property Tax Act.

If applicable, such tax is enforced by a withholding regime that generally requires buyers to withhold 15% of the fair market value of the disposed USRPI. Sellers of corporate stock may generally provide a certification by the corporation upon sale that the corporation is not a USRPHC and may thus avoid FIRPTA tax and withholding (although the IRS is not bound by the certification). Publicly traded corporations are subject to certain exceptions from both the substantive tax and withholding requirements.

5.4 Change of Control Provisions

There are, in general, no specific indirect transfer rules, nor any specific indirect change-of-control provisions that should be subject to local taxation.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

To the extent goods or services are provided to related parties, transfer pricing principles apply (see **4.4 Transfer Pricing Issues**). Specifically, taxpayers are required to apply the arm's length standard in establishing compensation amounts for the provision of intercompany goods and/or services. Accordingly, if one member of a group of related entities provides goods or services for the benefit of (or on behalf of) another group member without charge or at a non-arm's length charge, the IRS can make appropriate reallocations to reflect an arm's length charge for those goods or services. If the services benefit more than one group member, the IRS bases the allocation on the relative benefit intended for each group member when the services are performed.

These rules generally stipulate that taxpayers must apply one of six specified transfer pricing methods in evaluating the appropriateness of their intercompany services transactions. The six specified transfer pricing methods include three transactional approaches (ie, CUSPM, GSMM and CSPM), two profit-based approaches (ie, CPM and PSM) and a cost-based safe harbour (ie, SCM).

5.6 Deductions for Payments by Local Affiliates

Management fees between controlled taxpayers are subject to US transfer pricing principles (see **4.4 Transfer Pricing Issues** and **5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates**). As discussed previously, entities should be charging an arm's length fee for the services they provide; and, if this standard is not met, the situation can become exacerbated for tax purposes if the foreign subsidiaries are profitable in their home country while the US business is reflecting losses (meaning that the expenses in the USA are really supporting the foreign operations).

In such circumstances, the IRS has the power to reallocate income and deductions between such parties in order to reflect what it believes to be the true economic nature of the cross-border activity; and, depending on the adjustments, a penalty can be imposed on an underpayment of taxes that results from improper management and administrative expenses incurred.

5.7 Constraints on Related-Party Borrowing

The Code and tax regulations contain rules that broadly impact on the tax treatment of certain related-party debt issued by US corporate borrowers to certain related parties (including non-local affiliates) (the *"Debt Recast Rules"*). Generally, the intention of these rules is to prevent erosion of the US tax base through placement of debt owed by a US corporation to a foreign affiliate; and, if applicable, they have the effect of recharacterising certain related-party debt as equity to eliminate US tax deductions on interest payments.

The Debt Recast Rules generally apply to debt issued in connection with certain enumerated transactions (*"Specified Transactions"*). Specified Transactions include:

- distributions within an expanded group;
- asset acquisitions from within the expanded group; and
- stock acquisitions within the expanded group.

In addition, the Debt Recast Rules also contain certain presumptions (such as related to the per se funding rule) that further expand the scope and applicability of the Debt Recast Rules. While the Debt Recast Rules are exceedingly complex, it should be noted that they contain many material exceptions that can mitigate or prevent the applicability of such rules in a broad range of cases.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The USA taxes its citizens and residents (including domestic corporations) on their worldwide income directly earned from whatever source derived, which is generally taxed at a 21% rate (see **1.4 Tax Rates**). As described in later sections (see **6.3 Taxation on Dividends From Foreign Subsidiaries**), a special set of rules applies to income earned through a foreign subsidiary. That said, the USA generally permits an FTC (or deduction) against US income tax for taxes that are properly paid to other countries on income sourced to such other countries (see **2.3 Other Special Incentives**).

In addition, US taxpayers are generally permitted to utilise foreign losses to offset US-source income subject to certain recapture rules (see **6.2 Non-Deductible Local Expenses**). The USA's *"worldwide"* system of taxation is in stark contrast to many foreign jurisdictions that impose a territorial tax regime, which generally excludes (or exempts) the profits earned by non-local companies.

6.2 Non-Deductible Local Expenses

The USA generally taxes US persons on their worldwide income, including their foreign taxable income. If a taxpayer's losses (including deductions and expenses) from foreign sources exceed its foreign-source income, the excess, which is referred to as an overall foreign loss, can be used to reduce US-source income and, as such, the effective rate of tax on such income. In a subsequent year, however, the full allowance of an FTC may result in a double-tax benefit. To eliminate this benefit, foreign losses (claimed in a prior year) are recaptured by treating a portion of the foreign-source income in the later year as US-source income.

6.3 Taxation on Dividends From Foreign Subsidiaries

When a CFC makes a distribution to its US shareholder, the nature and character of that distribution must be determined. Specifically, whether the CFC has any E&P must be determined, as must the character of the E&P. If E&P exists, a distribution is generally sourced from the CFC in the following order:

- previously taxed E&P (PTEP) (ie, the E&P of a CFC attributable to income that has already been included in the gross income of a US shareholder);
- not previously taxed E&P (non-PTEP) (ie, the E&P of a CFC that has not been included in a US shareholder's gross income);
- return of capital; and
- capital gain.

Generally, PTEP distributions are excluded from a shareholder's gross income. However, a US shareholder must reduce its basis in its CFC stock by the amount of such PTEP distribution and, if a PTEP distribution exceeds stock basis, the excess results in capital gain. In contrast, non-PTEP distributions are included in a shareholder's gross income.

Notably, however, certain corporate shareholders may be eligible for a full dividends-received deduction (DRD) provided certain requirements are satisfied. The DRD, however, is not permitted for dividends received from tax-exempt organisations, certain entities subject to specialised tax regimes, or for certain hybrid dividends (or if certain holding period requirements are not satisfied). *"return of capital"* distribution is not a taxable event to the recipient US shareholder.

Finally, if a distribution exceeds the amount of non-PTEP and the US shareholder's basis in its CFC stock, any excess generally gives rise to a capital gain.

6.4 Use of Intangibles by Non-Local Subsidiaries

The use of intangible property (including transfers or licences of such intangible property) are subject to US transfer pricing principles and other provisions of the Code (see **4.4 Transfer Pricing Issues** and **5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates**), which require that arm's length compensation and/or consideration be furnished. Regarding transfers or licences of intangible property, the income must be commensurate with the income attributable to the intangible. In this regard, the IRS has authority to mandate the method used to value transfers of intangible property (in the context of outbound transfers and intercompany pricing allocations) as well as to require that the valuation of such transfers be made on an aggregate basis (or on the basis of the realistic alternative principle if the IRS determines that such method constitutes the most reliable means of valuation of such transfers).

Certain special rules apply for outbound transfers of intangible property (eg, intellectual property) by a US person to a foreign corporation in certain specified transactions. Generally, under these rules, when a US person transfers intangible property to a foreign corporation in an otherwise tax-free exchange under US tax law, the US transferor is treated as having sold the intangible property in exchange for annual royalty payments over the useful life of the intangible property (or a lump sum payment in the case of a disposition of the intangible property following the initial outbound transfer). The US transferor treats such annual inclusion and lump sum as ordinary income and royalties for purposes of determining source and the FTC limitation category.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

A foreign corporation is a CFC if US shareholders (ie, US resident persons that directly, indirectly or constructively own at least 10% of the vote or value of the foreign corporation) own stock that represents more than 50% of the vote or value in such corporation. In addition, application of certain attribution rules may deem (for example) sister companies to be constructive CFCs. The two major consequences of CFC classification are that its 10% US shareholders must include in income:

- their pro rata share of the CFC's *"subpart F income"* (generally passive-category income such as dividends, interest, royalties, capital gains or *"foreign base company income"*) and
- their GILTI, which is generally the excess of the shareholders' pro rata share of the CFC's gross income (reduced by certain items) over a 10% deemed return on the CFC's aggregate adjusted bases of depreciable tangible property used in the CFC's trade or business.

US corporations are generally taxed on GILTI at a preferential tax rate (currently ranging from 10.5% to 13.125%, but expected to increase to a range of 13.125% to 16.406% starting in 2026), and amounts taken into account in determining subpart F income are disregarded in calculating GILTI.

In addition, a foreign corporation with predominantly passive-category income or assets may be classified as *"passive foreign investment company"* (PFIC), which may subject its owners to several onerous consequences, but which may generally be ameliorated by certain elections.

The USA imposes worldwide taxation on US business entities, and a foreign branch is not considered an entity separate from its owner. As such, foreign branch income is deemed to be derived directly by its US corporate owner and is subject to corporate income tax on a net basis. Branch income is generally determined based on the income reflected in the foreign branch's separate books and records, and the US home office is allowed an FTC on taxes paid in the branch's jurisdiction (subject to certain limitations and *"basketing"* rules).

6.6 Rules Related to the Substance of Non-Local Affiliates

There are various US judicially developed doctrines that are designed to look beyond the form of a transaction and disallow otherwise applicable tax benefits if the transaction violates the spirit of the law (see **7.1 Overarching Anti-Avoidance Provisions**). Furthermore, the limitation on benefits and other anti-treaty shopping provisions contained in US tax treaties generally look at the *"substance"* of a non-local affiliate in such jurisdiction in determining whether the benefits afforded by such treaty may apply (see **4.3 Use of Treaty Country Entities by Non-Treaty Country Residents**).

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

A US corporation that is a US shareholder of a CFC will recognise a portion of any gain on the sale or exchange of stock in a CFC as a dividend, generally to the extent of the E&P in the CFC that are attributable to the stock sold or exchanged. In the case of the sale or exchange by a US corporation of stock in CFC held for one year or more, any amount received by the US corporation that is treated as a dividend may also qualify for exemption under the DRD rules (see **6.3 Taxation on Dividends From Foreign Subsidiaries**) to the extent that the sale does not result in an *"extraordinary reduction"* under the applicable rules. In the case of an extraordinary reduction, certain elections can be made (either solely by a buyer of the CFC stock or by both the buyer and the US shareholder of the CFC) to ensure qualification for the exemption under the DRD rules.

Furthermore, if a CFC sells or exchanges stock of a lower-tier CFC and any gain is treated as a dividend (similar to the rules noted above), the foreign-source portion of that dividend will be treated as subpart F income of the selling CFC for which a US shareholder may be permitted a DRD.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

There are various judicially developed doctrines that are comparable to a general anti-abuse rule, such as the *"substance over form"*, *"step transaction"*, *"economic substance"*, *"business purpose"* and *"sham transaction"* doctrines. All these doctrines generally serve a similar purpose: to look beyond the form of a transaction and disallow otherwise applicable tax benefits if the transaction violates the spirit of the law. In addition, the economic substance doctrine was added to the Code and carries with it a 20% non-compliance penalty, which can be increased to 40% if the transaction is not properly disclosed.

Apart from the judicially developed doctrines described above, there are various statutory and regulatory provisions that provide anti-avoidance rules. Recently, the IRS released separate guidance imposing anti-avoidance-related party basis adjustment rules in the context of partnership acquisitions, and re-affirming the IRS' sentiments regarding the realisation of tax benefits upon the acquisition of control of a corporation, which, in each case, further highlight the IRS' attitudes regarding transactions where otherwise applicable tax benefits would have been realised.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Code requires that the IRS assess, refund, credit and collect taxes within specific time limits, known as the statute of limitations. When the statute of limitations expires, the IRS can no longer assess additional tax, allow a claim for refund by the taxpayer or take collection action. The determination of statute expiry differs for assessment, refund and collection.

The basic rule is that the IRS generally has three years after a return is filed to *"assess"* tax and begin any court proceeding, though numerous exceptions exist that provide more time for the IRS (ie, six years or longer). For example, the IRS has six years to audit a return if a taxpayer omitted more than USD5,000 in income attributable to specified foreign financial assets and, notably, no time limits apply in situations where a taxpayer either failed to file or fraudulently filed tax returns. The filing of a tax return is generally the event that triggers the running of the statute of limitations on assessments. Once a tax assessment is made, the IRS generally has ten years to collect an assessed liability (subject to certain extensions).

9. BEPS

9.1 Recommended Changes

The OECD BEPS project has been continuously evolving to develop an agreement on a two-pillar approach to help address tax avoidance, and ensure coherence of international tax rules and a more transparent tax landscape. Pillar One, which applies to large multinationals, will reallocate certain amounts of taxable income to certain impacted jurisdictions, resulting in a change in effective tax rate and cash tax obligations, as well as impacting on transfer pricing arrangements. Pillar Two, in contrast, aims to ensure that income is taxed at an appropriate rate and has several mechanisms to ensure that tax is paid.

In 2017, the USA enacted legislation generally intended to be consistent with the recommendations in the two final reports under Action 2 of the BEPS project. This legislation, and the tax regulations issued thereunder, generally neutralise double non-taxation effects of:

- inbound dividends involving hybrid arrangements, by either denying a participation exemption or requiring domestic inclusion (depending on whether the hybrid dividend is received by a domestic corporation or a CFC); and
- outbound deductible interest or royalty payments that produce a deduction/no inclusion outcome owing to hybridity by disallowing such deduction.

In addition, the USA enacted the BEAT, which targets base erosion by imposing additional tax on certain large US corporations that make deductible payments to foreign related parties. Such additional tax is designed as a 10% minimum tax (scheduled to increase to 12.5% in 2025) imposed on modified taxable income.

The USA also enacted a limitation on the deductibility of interest expense (which, very generally, is limited to 30% of EBIT) and country-by-country reporting consistent with the BEPS recommendations, and has the limitation on benefits article in most of its income tax treaties. Finally, it should be noted that the USA recently enacted a new 15% corporate minimum tax based on financial statement income (see **1.4 Tax Rates**).

The USA is still working on finalising tax regulations under the various tax provisions enacted in 2017, many of which are consistent with the BEPS recommendations. More recent legislative proposals (generally modifying the provisions introduced in 2017 and/or aligning with the minimum tax and undertaxed profits rules under Pillar Two of BEPS) have not been adopted. It is worth noting that, in the context of Pillar Two's implementation guidance, the USA has been largely successful in obtaining favourable treatment from the OECD for GILTI and transferrable energy credits, but is seeing more difficulty in gaining relief for the non-refundable R&D tax credit. This development sets the stage for subsequent rounds of negotiations between the USA and OECD as to whether Pillar Two taxes are creditable against US tax.

9.2 Government Attitudes

While the USA generally agrees that the issues addressed by BEPS (both as related to Pillars One and Two) should be remedied (which, as discussed in this chapter, the USA has taken great strides towards implementing – see **9.1 Recommended Changes**), the implementation of Pillar Two in the USA remains stalled. Passage of law to align the US international tax regime with Pillar Two appears unlikely, especially given President Trump's recently issued Executive Order to notify the OECD that any commitments related to BEPS (among other things) have no force or effect. In fact, President Trump recently issued a separate Executive Order, which provides for potential retaliatory measures against countries and their citizens that impose *"discriminatory"* or *"extraterritorial"* taxes on US citizens or corporations. Such *"discriminatory"* or *"extraterritorial"* taxes may include the so-called *"top-up tax"*; however, the effect of any retaliatory measure is unknown at this juncture.

To the extent that government attitudes change, the implementation of Pillar Two taxes abroad could have a significant impact on US-based multinational companies.

9.3 Profile of International Tax

Owing to substantial activity by US multinationals and the overall strength of the US economy, international tax has a high public profile in the USA. This is evidenced by President Trump's Executive Orders, which renege on commitments to the OECD and provide for the potential use of a Code provision, never used before, to support any retaliatory tax, which could include the doubling of certain tax rates. Given the stance of the current Trump administration regarding tariffs, it is possible that international tax will remain at the forefront of US political and economic consciousness, and the structuring of cross-border transactions could be of further import as both US and non-US companies navigate this new landscape.

9.4 Competitive Tax Policy Objective

The US government's main goal is to prevent other countries from taxing what it views as *"its"* tax base through the BEPS initiative (see **9.2 Government Attitudes**). In this respect, the USA is already balancing its competitive policy objectives against the pressures that BEPS will bring in its wake, so as to ensure that US interests, and more specifically its tax base, are appropriately safeguarded. Under the Trump administration, it remains to be seen how likely the USA is to continue engaging with the international community to help address tax avoidance and ensure coherence of international tax rules (see **9.3 Profile of International Tax**).

9.5 Features of the Competitive Tax System

While the US tax system provides many benefits for companies operating in its borders (as discussed throughout this chapter), a major drawback to the US system is its overall complexity. Specifically, the current tax law was not enacted all at once but is a result of numerous provisions added or subtracted in multiple tax bills. Often, Congress designs legislation under self-imposed constraints, such as short-term revenue goals or effects on the distribution of tax burdens among income groups. For example, the hybridity of the US international system may be seen as more vulnerable, given its complexity. Such complexity in itself can be viewed as a deterrent to cross-border investment. Another element of this complexity is the myriad laws that separately apply at the state and local level, which may or may not conform to federal provisions.

9.6 Proposals for Dealing With Hybrid Instruments

The 2017 tax reform introduced two *"anti-hybrid"* rules that generally deny US tax deductions in certain situations involving entities and payments of interest, royalties or dividends, if such entities or payments are treated differently under US and foreign tax laws and such different treatment results in double taxation (see **2.5 Imposed Limits on Deduction of Interest**). The amendments made to the Code were a direct response to Action 2 of the OECD BEPS Project designed to address hybrid and branch mismatch arrangements.

9.7 Territorial Tax Regime

The USA does not have a territorial tax regime. That said, for tax years beginning on or after 1 January 2018, US international taxation has shifted to a more *"hybrid"* system that exempts some foreign-source income (foreign-source dividends and certain returns on foreign asset investments), but that currently taxes, at reduced rates, a much broader scope of previously deferred foreign profits (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**) while also enacting new provisions (and regulations) designed to curtail certain types of base erosion payments. These include the following:

- the BEAT (see **9.1 Recommended Changes**);
- anti-hybrid rules (see **2.5 Imposed Limits on Deduction of Interest**);
- limitations on interest deductibility (see again **2.5 Imposed Limits on Deduction of Interest**); and
- the Debt Recast Rules (see **5.7 Constraints on Related-Party Borrowing**).

9.8 Controlled Foreign Corporation Proposals

The USA does not have a territorial tax regime (see **9.7 Territorial Tax Regime**) and already has a CFC regime in place (see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**).

9.9 Anti-Avoidance Rules

DTC limitation on benefit or anti-avoidance rules are not likely to have an impact. As discussed previously, most US income tax treaties already include *"limitation on benefits"* article, and also contain various other anti-treaty shopping provisions (see **4.3 Use of Treaty Country Entities by Non-Treaty Country Residents**).

9.10 Transfer Pricing Changes

The transfer pricing changes introduced by BEPS are generally consistent with the US transfer pricing rules and regulations; however, they do diverge in some respects (see **4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards**). For intellectual property, it is worth noting that the BEPS proposals place significantly more emphasis on the *"economic ownership"* of intangible assets, which contrasts with the US position that focuses more on *"legal ownership"*.

9.11 Transparency and Country-by-Country Reporting

The authors are not currently in favour of such provisions. Although the USA issued tax regulations requiring country-by-country reporting by US multinational enterprises, the information the government obtains is strictly confidential and used solely for tax purposes.

9.12 Taxation of Digital Economy Businesses

A number of countries have reached an agreement with the USA as to the treatment of their existing digital services taxes (DSTs), pending the implementation of Pillar One. This is known as the Unilateral Measures Compromise. This compromise, which was agreed upon by the USA, Austria, France, Italy, Spain, the United Kingdom, Turkey and India, covers the interim period between January 2022 and the earlier of either the date Pillar One formally takes effect or 31 December 2023.

Notably, under the compromise, these countries can keep their existing DSTs in place until the implementation of Pillar One; however, corporations (primarily US multinational corporations) that are subject to DSTs may receive a tax credit against future tax liabilities. While the USA had agreed to terminate certain punitive trade actions against such countries in light of the compromise, sentiments under the Trump administration have changed drastically from the prior Biden administration. It is possible that DSTs, in light of President Trump's recent Executive Orders, could be an *"extraterritorial"* or *"discriminatory"* tax subject to US retaliation; however, the interaction of such retaliatory tax in light of the complex web of US tax treaties remains uncertain (see **9.3 Profile of International Tax**).

9.13 Digital Taxation

The USA opposes unilateral action to tax digital presence (see also **9.12 Taxation of Digital Economy Businesses**).

9.14 Taxation of Offshore IP

Though such provisions have been introduced, much of the focus in the USA relates to *"outbound"* transfers of intellectual property, and as discussed previously, the use of intangible property (including transfers or licences of such intangible property) are subject to US transfer pricing principles and other provisions of the Code, which generally require the arm's length standard to be satisfied (see **6.4 Use of Intangibles by Non-Local Subsidiaries**). Accordingly, in the USA the consideration paid for an intangible asset (or use of an intangible asset) will be evaluated consistent with the statutory requirement that the consideration be commensurate with the income derived from exploitation of the intangible.

For US transfer pricing purposes, the owner of legally protected intangibles is the legal owner. However, in the case of non-legally protected intangibles, the owner is the party with *"practical control"* over the intangible (ie, the party that possesses legal ownership under intellectual property law or that holds rights constituting an intangible pursuant to contractual terms (such as a licence). When the legal ownership standard is inconsistent with *"economic substance"*, these rules may be dismissed, and the substance of the overall arrangement is given effect.

Trends and Developments

Contributed by:
Devon M Bodoh, Greg W Featherman, Joseph M Pari, Alexander P Dobyan and Grant S Solomon
Weil, Gotshal & Manges LLP

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Authors

Devon M Bodoh is a partner in Weil Gotshal & Manges LLP's tax department and is based in Miami and Washington, DC. Devon is the head of the firm's international and cross-border tax practice, a member of the tax department's leadership team and managing partner of the Miami office. He advises clients on cross-border mergers, acquisitions, spin-offs and other divisive strategies, restructurings, bankruptcy and non-bankruptcy workouts, the use of net operating losses, foreign tax credits, and other tax attributes and consolidated return matters. Mr Bodoh is recognised as a leading lawyer by Chambers USA.

Greg W Featherman is a partner in Weil, Gotshal & Manges LLP's tax department and is based in New York. Mr Featherman has extensive experience in advising on a variety of largely cross-border transactions, including corporate acquisitions and mergers, spin-offs and other divisive strategies, internal restructurings, financings, business formations and joint ventures. He also represents SPACs in their formation and public offerings, as well as in their acquisition transactions.

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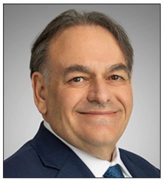
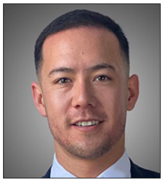


Joseph M Pari is co-chair of Weil, Gotshal & Manges LLP's tax department and is based in New York and Washington, DC. Mr Pari has extensive experience in advising on federal income taxation of domestic and cross-border mergers, acquisitions, spin-offs, other divestiture types, restructurings, bankruptcy and non-bankruptcy workouts, acquisition financing and the use of pass-through entities in acquisitive and divisive transactions, with an emphasis on corporate tax planning, the utilisation of net operating losses, and other tax attributes and consolidated return matters. Mr Pari has been recognised as a leading lawyer by Chambers USA and Chambers Global.

Alexander P Dobyan is an associate in Weil, Gotshal & Manges LLP's tax department and is based in Washington, DC. Mr Dobyan advises clients with respect to cross-border mergers, acquisitions, spin-offs, other divisive strategies, restructurings, bankruptcy and non-bankruptcy workouts, the use of net operating losses, foreign tax credits, and other tax attributes and consolidated return matters.



Grant S Solomon is an associate in Weil, Gotshal & Manges LLP's tax department and is based in Washington, DC. Mr Solomon advises clients with respect to the tax aspects of a wide range of corporate transactions, including domestic and cross-border mergers and acquisitions, joint ventures and financing transactions.

Weil, Gotshal & Manges LLP

Devon Bodoh
Weil, Gotshal & Manges LLP
2001 M Street, NW
Suite 600
Washington, DC
20036 USA

Tel: +1 202 682 7060
Fax: +1 202 857 0940
Email: devon.bodoh@weil.com
Web: www.weil.com

Contributed by: Devon M Bodoh, Greg W Featherman, Joseph M Pari, Alexander P Dobyan and Grant S Solomon, **Weil, Gotshal & Manges LLP**

In 2024, the United States Supreme Court (the *"Court"*) released two landmark decisions impacting on US tax law and policy. Each decision is described in further detail below.

Loper Bright Enterprises v Raimondo (*"Loper Bright"*)

In a 6-3 decision written by Chief Justice Roberts, the Court in *Loper Bright* overturned the Court's decision in Chevron v Natural Resources Defense Council, 467 US 837 (1984) (*"Chevron"*) and held that federal agency interpretations of law are not entitled to any deference (such as the deference provided to the Department of Treasury (*"Treasury"*) and the Internal Revenue Service (IRS) in the promulgation of tax regulations.

The doctrine of administrative deference, established in *Chevron*, required deference to an agency's reasonable interpretation of an ambiguous statute, so long as Congress had not spoken directly to the precise question at issue. The two-part test for requiring deference first addressed whether *"Congress had directly spoken to the precise question at issue"*. If so, the court was required to enforce the *"unambiguous express intent of Congress"*. To be deemed *"ambiguous"*, the statute must have two or more reasonable interpretations. If the statute is silent or ambiguous, part two of the test then required the court to defer to the agency's interpretation of the statute, provided such interpretation was viewed as *"reasonable"*, regardless of whether the court may have an alternative or conflicting interpretation.

By overruling what was known as *"Chevron deference"*, the Court's opinion has the potential to substantially change the administration of taxes, which may have impacts on:

- revenue collection;
- additional costs of tax administration;
- complexity and uncertainty in the promulgation of regulations; and
- more generally, questions relating to fairness and certainty for taxpayers.

Post-Chevron Effects on Tax Law

Only time will tell what impacts the Court's decision in *Loper Bright* may have on the administration of tax laws. The following are preliminary observations on some (but definitely not all) of the potential impacts stemming from the *Loper Bright* decision.

Revenue consequences

By overturning *Chevron*, courts are no longer bound to uphold IRS regulations as authoritative interpretations of ambiguous statutes. The reinterpretation and litigation of issues could trigger a generational upheaval in tax law and open the floodgates for further litigation. As such, seemingly subtle differences in statutory interpretations could have substantial effects on federal revenues. Challenges to Treasury regulations typically involve taxpayers contending that they owe less tax. Where those challenges are successful, the impact would result in a reduction in federal tax revenue. For example, profit shifting by multinationals is estimated to cost tens of billions of dollars in corporate tax revenue per year. Although taxpayers have, in recent years, been unsuccessful in their challenging of the transfer pricing regulations under Section 482, now that *Chevron* has been overruled, such outcomes could now favour taxpayers and thus reduce federal tax revenues.

General administration of tax law

The overturning of *Chevron* deference could also affect how an agency interprets a statute when it promulgates regulations for fear that a court may disagree with that interpretation (which has the potential of propagating existing taxpayer uncertainties). With the end of *Chevron* deference, Treasury and the IRS will likely be required to bolster the *"persuasiveness"* of a regulation to align with a lower standard of deference; this will necessarily precipitate further consultation and collaboration with practitioners such that their interpretations stand up to judicial scrutiny, notwithstanding the lack of *Chevron* deference.

Increased variability in application of law

The demise of *Chevron* could cause fairness disparities for similarly situated taxpayers. Rather than speaking in one regulatory voice, the taxing authority would be disaggregated. Judges do not necessarily arrive at uniform and broadly consistent views, and taking into account technical complexities of tax law, the decisions that are reached may foment disparate outcomes. The *"frankensteined"* approach that arises as a result of judicial determinations may significantly complicate tax planning and compliance for all taxpayers. Clear, unambiguous statutes can guide tax policy without the involvement of the judicial system – even in a post-*Chevron* world. The following are several regulatory examples that may be ripe for challenge in a post-*Chevron* world:

Transfer pricing

As noted above, transfer pricing and profit shifting by multinationals may be a hotly contested area ripe for litigation – owing to Section 482's lack of regulatory delegation and sparse delineation on appropriate profit allocation methods. The question is whether Treasury and the IRS' interpretation of Section 482 will withstand the challenge under a lower level of agency deference.

Debt equity

Section 385 is designed for determining when nominal corporate debt is treated as equity for tax purposes. Prior to what the Court held in *Loper Bright*, several commentators questioned whether the delegation of regulatory authority under Section 385 was either too broad or whether the *"recast regulations"* as written dramatically exceed the statutory scope of the delegation of regulatory authority granted to Treasury. This is yet another area that is ripe for challenge in the post-*Chevron* world.

Tax Cuts and Jobs Act (TCJA) regulations

The TCJA contained many changes to US federal income tax law. For example, the TCJA:

- disallowed or scaled back a number of deductions;
- revised international tax rules;
- altered cost-recovery provisions;
- reduced the corporate tax rate; and
- allowed a pass-through deduction for certain unincorporated business.

To the extent that these provisions are ambiguous and are the subject of regulations that attempt to clarify ambiguities, *Chevron* deference would have made it easier for the Treasury to defend those regulations. In a post-*Chevron* world, the courts, rather than Treasury, will need to resolve whether the regulations seeking to clarify those statutory ambiguities pass muster under a lower level of deference.

Moore v United States (*"Moore"*)

On 20 June 2024, the Court issued its opinion in *Moore*, ruling 7-2 that the TCJA's mandatory repatriation tax (MRT) under Section 965 does not violate the *"Direct Tax Clause"* of the Constitution. Congress enacted the MRT as part of the TCJA's shift to a more territorial tax system.

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Background

The MRT required US shareholders owning 10% (by vote or value) of a controlled foreign corporation (CFC) as defined under Section 951 to pay a one-time transition tax in a deemed repatriation of realised but undistributed income of the CFC. Such income had, until the enactment of the MRT, enjoyed deferred taxation in the hands of the CFC's US shareholders (until distributed to such shareholders).

Key takeaways

In plain terms, the decision reaffirms the principle that Congress can attribute a foreign corporation's income to its US shareholders and tax them accordingly (even if the earnings relating to the income have not been distributed).

In the ruling, a majority of the Justices found that the MRT operates in a way that does not require the Court to weigh whether the Constitution's Sixteenth Amendment prohibits Congress from taxing unrealised income. In doing so, the Court sidestepped the contentious issue of whether *"realisation is required for an income tax"*. Specifically, the Court ruled that the MRT taxes income realised by foreign corporations with US shareholders, and Congress has the authority to attribute certain realised but undistributed income of certain companies to its shareholders for taxation.

The Court's ruling, however, is narrow and is limited to entities treated as *"pass-throughs"* (ie, entities that are fiscally transparent from their owners). In this respect, the Court noted that nothing in their opinion should be read as authorising any hypothetical congressional effort to tax both an entity and its shareholders (or partners) on the same undistributed income of the entity, nor does the decision attempt to resolve the parties' disagreement over whether realisation is a constitutional requirement for an income tax.

Ruling breakdown

The Moores challenged the MRT after they were assessed with a nearly USD15,000 tax bill for 2017 as a result of the law, which required them to pay the MRT based on the undistributed earnings allocable to them from an India-based CFC called KisanKraft. The Moores paid the tax and then sued for a refund, claiming, among other things, that the MRT violated the Direct Tax Clause of the US Constitution as the MRT was an unapportioned direct tax on their shares of KisanKraft stock. The District Court dismissed the suit, and the Ninth Circuit affirmed.

Taxes on income v taxes on property

Ruling: the MRT does tax realised income – income realised by the corporation, KisanKraft

The Court notes in its analysis that the ruling does not address the distinct issues that would be raised by:

- an attempt by Congress to tax both the entity and the shareholders or partners on the entity's undistributed income;
- taxes on holdings, wealth or net worth; or
- taxes on appreciation.

The Court makes a concerted effort to cite the government's brief, which explains that a hypothetical unapportioned wealth tax *"could of course raise different issues"*. The government's brief also distinguishes an income tax from a tax on wealth or net worth, as an income tax targets economic gain *"between two points of time"*. The Court notes that the constitutionality of a hypothetical unapportioned tax on appreciation may depend on (among other things) whether realisation is a constitutional requirement for an income tax.

The Court found that *Moores'* reliance on Eisner v Macomber, 252 US 189 (*"Macomber"*) was misplaced. In *Macomber*, the question was whether a pro rata distribution of additional common stock to all existing common shareholders was taxable income. The Court said such a distribution is not taxable income as income requires realisation. The Court further explained that there was no change in the value of the shareholders' total stock holdings in the corporation before and after the stock distribution. The Court said separately in dicta that *"what is called the stockholder's share in the accumulated profits of the company is capital, not income"*. The Moores interpreted that language to mean that a tax attributing an entity's undistributed income to its shareholders or partners is not an income tax. The Court noted in its opinion that the clear and definitive holdings of other court precedent render the *Moores* reading of *Macomber* implausible. The Court noted that those cases squarely addressed and allowed attribution, whereas *Macomber* did not address attribution.

Attribution

Ruling: Congress may attribute an entity's realised and undistributed income to the entity's shareholders or partners and then tax the shareholders or partners on their portions of that income

Instead of arguing that partnership taxes, S-corporation taxes and subpart F taxes are all unconstitutional (and that all of the Court's precedent regarding such taxes should be overruled), the Moores tried to distinguish the MRT from the other taxes and argued that that only the MRT is unconstitutional, conceding that partnership taxes, S-corporation taxes and subpart F taxes *are* income taxes that are constitutional and need not be apportioned. The Moores sought to differentiate the MRT from the other taxes by noting that:

- taxes on partnerships are distinguishable from the MRT and are not controlled by precedent as partnerships are not separate entities from their partners;
- taxes on S-corporations are distinguishable from the MRT because shareholders choose to be taxed directly on the corporation's income; and
- the pre-TCJA aspects of subpart F are distinguishable from the MRT as subpart F applies the *"doctrine of constructive realisation"* which – by targeting specific events such as a foreign corporation's earning of investment income while being controlled by a small number of domestic shareholders – allows the pre-TCJA portion of subpart F to satisfy the constructive realisation requirement.

The Court found that the Moores failed to sufficiently distinguish the MRT from the other taxing regimes – specifically, as follows.

- In response to the Moores' attempt to distinguish partnership tax from the MRT, the Court noted that when the Sixteenth Amendment was ratified, the courts, Congress and state legislatures treated partnerships as separate entities in many contexts, and numerous states imposed taxes directly on partnerships for partnership income. As such, the federal and state treatment of partnerships as separate legal entities for tax purposes contravenes the Moores' theory.
- In response to the Moores' attempt to distinguish S-corporation tax from the MRT, the Court noted that consent cannot explain Congress's authority to tax the sharehold-

ers of S-corporations directly on corporate income. Rather, S-corporations are another example of Congress's authority to either tax the corporation itself on corporate income or attribute the undistributed income to the shareholders and tax the shareholders.
- In response to the Moores' attempt to distinguish the pre-TCJA aspects of subpart F tax from the MRT, the Court noted that the level of control with the MRT (at least 10%) is the same as under the longstanding subpart F tax principles (and, thus, if the Moores concede that subpart F is not unconstitutional under the *"constructive realisation"* theory, the MRT is likewise not unconstitutional under that theory).

With *Moore* providing some semblance of stability, *Loper Bright* poses a significantly broader challenge to the stability of administrative law writ large – by no means excluding tax regulations.

ZIMBABWE

Law and Practice

Contributed by:
Miranda Khumalo and Thomas Chagudumba
Atherstone & Cook

Contents

Atherstone & Cook has provided legal services in Harare, Zimbabwe, for more than 60 years, during which time it has served clients promptly, efficiently and authoritatively. It has built a reputation for providing solid advice that has subsequently been upheld by the courts. The firm has tended to concentrate on commercial work, including advising firms wishing to invest in Zimbabwe. It has considerable experience in this area, including specialising in the tax regime, exchange control restraints, indigenisation requirements and generally all local laws affecting investment in Zimbabwe. The firm has acted for all four recognised leading accounting firms, many major banks, leading commercial firms, many firms listed on the Zimbabwe Stock Exchange, numerous external legal firms in South Africa and leading solicitor firms in England, the United States, Asia and Europe.

Authors

Miranda Khumalo graduated from Rhodes University with a Bachelor of Social Science (BSS) degree and a Bachelor of Law (LLB) degree, and has a Higher Diploma in Tax Law from Thomas Jefferson University. She was admitted as a legal practitioner in 2009 and as a partner at Atherstone and Cook in 2013. Miranda has experience in leading business transactions concerning corporate investments, corporate restructuring, tax law advisory and general cross-border transactions. She has represented local and international entities in an expansive range of commercial transactions in different sectors, including oil and gas, mining, transportation and logistics, banking and finance, and real estate.

Thomas Chagudumba graduated from the University of Zimbabwe in 2013 with an LLB (Hons) degree. He was admitted as a legal practitioner and joined Atherstone & Cook in 2014, before being admitted as a partner in January 2019. Thomas specialises in labour law, general civil litigation, tax law litigation and advisory matters.

Contributed by: Miranda Khumalo and Thomas Chagudumba, **Atherstone & Cook**

Atherstone & Cook

Praetor House
119 Josiah Chinamano Avenue
Corner J Chinamano Avenue
& Simon Muzenda Avenue
Harare
Zimbabwe

Tel: +263 8677044999
Fax: +263 242 705 180
Email: miranda@praetor.co.zw
Web: www.atherstoneandcook.com

ATHERSTONE & COOK

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form. The alternative forms of corporate structures are private business corporations and other business entities.

Companies

The following business entities are registrable under the Companies and Other Business Entities Act (Chapter 24:31):

- public limited company;
- private limited company;
- company limited by guarantee;
- co-operative company;
- foreign company; and
- private business corporation.

A public company is broadly defined as a company that is neither private nor limited by guarantee. The securities of the public company may be freely offered to the public, which facilitates the raising of capital therefrom. The shareholders in a public company may freely transfer their securities. A private company has the following characteristics:

- the transferability of shares is restricted;
- the number of members is limited to 50;
- the liability of members is limited to the number of shares held by each member respectively; and
- shares are prohibited from being offered to the public.

A company limited by guarantee has no share capital, but its Memorandum of Association limits the liability of its members to such amount as the members respectively undertake to contribute to the assets of the company in the event of it being wound up. A co-operative company is a company other than a private company, whose main object as stated in its Memorandum of Association is the provision for its members of a service facilitating the production or marketing of agricultural produce or livestock, or the sale of goods to its members. The right to transfer shares is restricted. A foreign company is an entity incorporated in a jurisdiction outside Zimbabwe.

Private Business Corporation

This form of business entity is mainly meant for small businesses. It can accommodate sole traders and has a legal persona of its own, separate from its members. Only individual natural persons acting in their own rights can be members of a private business corporation.

Other Business Entities

These include partnerships, joint ventures, syndicates and consortiums:

- a partnership is a formal arrangement between two or more parties to manage and operate a business and share its profits;
- a joint venture is a business arrangement in which two or more parties agree to pool their resources for the purpose of accomplishing a specific task;
- a syndicate is a self-organising group of individuals, companies, corporations or entities formed to transact some specific business, to pursue or promote a shared interest; and
- a consortium is an association of two or more individuals, companies, organisations or governments (any combination of these entities) with the objective of participating in a common activity or pooling resources to achieve a common goal.

All these entities are taxed as separate legal entities.

1.2 Transparent Entities

Partnerships and joint ventures are the commonly used transparent entities. In most cases where they are used, they would be mandatory by law. Partnerships are commonly adopted in the legal fraternity and in the accounting or financial sectors. Joint ventures are commonly used as vehicles of investment in the mining and infrastructure sectors.

1.3 Determining Residence of Incorporated Businesses

Zimbabwe taxes on a source basis rather than a residence basis, but also taxes its inhabitants on income earned from activities outside the country. The object of the source basis is to tax only income that arises from activities in the country itself. A rigid application of the source principle may lead to inequities, and the law has created exceptions by using the concept of *"deemed source"*, whereby the source is outside Zimbabwe but is regarded as a source within Zimbabwe. The law is concerned with the originating cause of the income, so one must identify where the originating cause is located, taking into account the deeming provisions.

1.4 Tax Rates

The tax rate paid by incorporated businesses and businesses owned by individuals directly or through transparent entities is 25%, with effect from 1 January 2025.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Income tax in Zimbabwe is charged on income. In terms of the Income Tax Act (Chapter 23:06), tax is chargeable on *"gross income"*, which means the total amount received by or accrued to or in favour of a person, or deemed to have been received by or to have accrued to or in favour of a person, in any year of assessment from a source within or deemed to be within

Zimbabwe, excluding any amount that is of a capital nature.

2.2 Special Incentives for Technology Investments

There are no specific incentives for technology investments. However, if the technology investment is located in an area that is designated as a special economic zone (SEZ), the investment will be tax-exempt for the first five years, and will have a 15% tax rate thereafter. Further, the company will enjoy import duty exemptions on the importation of capital equipment.

With respect to R&D expenses, a deduction is allowed for any amount of expenditure incurred by the taxpayer during the year of assessment in carrying out experiments and research relating to its trade.

2.3 Other Special Incentives

Build-Own-Operate-Transfer and Build-Operate-Transfer Arrangements

All taxpayers in these types of arrangements enjoy a tax holiday for the first five years.

Contractors may enter into contracts with the State or statutory corporations, under which they undertake to construct infrastructure for the State or statutory corporations in consideration for the right to operate or control such infrastructure for a specified period; after which the contractor will transfer ownership or control to the State or statutory corporation.

The second five years are taxed at 15%, and the taxpayer will be taxed at the normal rate thereafter.

Manufacturing Companies

Since 1 January 2015, the rates of tax for manufacturing or processing companies that export are as follows:

- if between 30% and 41% of its output is exported, 20%;
- if between 41% and 51% of its output is exported, 17.5%; and
- if more than 51% of its output is exported, 15%.

Mining Companies

All capital expenditure on exploration, development and operating incurred wholly and exclusively for mining operations is allowed in full.

There is no restriction on the carryover of tax losses; these can be carried forward for an indefinite period.

The taxable income of a holder of a special mining lease is taxed at a special rate of 15%.

The amount of any mining royalty paid during the year of assessment is allowed as a deduction in the determination of taxable income.

Special Initial Allowance (SIA)

This is a capital allowance, which ranks as a deduction. It is allowed on expenditure incurred in the construction of new industrial buildings, farm improvements, railway lines, staff housing and tobacco barns. Additions or alterations to existing items are also allowed.

SIA is also allowed on articles, implements, machinery and utensils purchased for the purposes of trade. The definition of *"articles, implements, machinery and utensils"* now includes tangible or intangible property in the form of computer software that is acquired, developed or used by the taxpayer.

The allowance is optional; once claimed, it replaces wear and tear.

SIA is allowed at the rate of 25% of cost from year one for the next three years.

The rate of SIA for small to medium enterprises is 100%, of which 50% is allowed in the first year of use, with the balance over two years at 25% being accelerated wear and tear. These rates have been in effect since 1 January 2011.

The rate of SIA for a licensed investor is 100%, of which 50% is allowed in the first year of use and the balance over two years at 25% is accelerated wear and tear. These rates have been in effect since 1 January 2017.

Farmers' Special Deductions

Farmers are allowed special deductions over and above the normal deductions. Examples include expenditure on:

- fencing;
- clearing and stamping land;
- sinking boreholes and wells; and
- aerial and geophysical surveys.

Tourist Facility Operators

The taxable income of an operator of a tourist facility in an approved tourist development zone is tax-exempt for the first five years; and after the fifth year of operation, the taxable income will be subject to income tax at the rate of 25%.

Renewable Energy Companies

Energy generation equipment used in connection with energy generation projects prescribed by the Minister of Energy and Power Development are eligible for a deferment on the collection of value-added tax (VAT).

VAT

Services supplied by operators of facilities designated as tourist facilities in terms of the Tourism Act (Chapter 14:20) (Section 10(2)q)

Tourist facility operators conducting business in approved tourism development zones and operators of hunting safaris are required to charge VAT at 0% for services offered to persons who are not residents of Zimbabwe and who are required under the Exchange Control Act to pay for such services in a foreign currency. Such operators end up in a refund position for goods and services acquired locally.

Farming inputs and equipment (Section 10 a r w second schedule of the Value-Added Tax General Regulations (S.I.273/2003))

Most farm inputs are subject to VAT at 0%, such as for animal feed, animal remedies, fertiliser, plants, seeds, pesticides and equipment or machinery used for agricultural purposes, fuel and fuel products.

Deferment of collection of VAT on the importation of capital goods

VAT could be deferred on some capital equipment for exclusive use in the mining, manufacturing, agricultural and aviation industries, whose investment generally relies on imported capital. Any person who produces proof to the satisfaction of the Commissioner General of the Zimbabwe Revenue Authority (ZIMRA) that they have imported goods of a capital nature for their own use can qualify for this incentive.

2.4 Basic Rules on Loss Relief

An assessed loss is recovered in the next tax year.

2.5 Imposed Limits on Deduction of Interest

Zimbabwe has thin capitalisation rules based on a debt-to-equity ratio of 3:1. A portion of the overall interest may be disallowed if this ratio is exceeded. Any disallowed interest may be treated as a deemed dividend and be subject to withholding tax.

2.6 Basic Rules on Consolidated Tax Grouping

An assessed loss is utilised per company; there are no intra-company transfers of losses. The losses can only be utilised in the ensuing tax year by the respective companies, not retrospectively.

2.7 Capital Gains Taxation

Capital gains tax is chargeable from a source within Zimbabwe on a sale or deemed sale of a specified asset. The sale must be in Zimbabwe or deemed to be in Zimbabwe, and must generate a gain. The specified assets are immovable property, any marketable security and any right or title to property – whether tangible or intangible – that is registered or required to be registered in terms of:

- the Mines and Minerals Act;
- the Patents Act;
- the Trade Marks Act;
- the Industrial Designs Act;
- the Brands Act; or
- the Copyright and Neighbouring Rights Act.

Sections 10 and 11 of the Capital Gains Tax Act (Chapter 23:01) provide for exemptions and deductions, while Section 15 provides for an exemption in respect of the transfer of assets between companies that are under the same control. Where a loss has been incurred on the disposal of an asset, an offset is allowed against any capital gain on the disposal of another specified asset in the same year of assessment.

A special capital gains tax on the transfer of a mining title was recently introduced in terms of the Finance Act No 13 of 2023. The special capital gains tax will be levied on the value of any transaction concluded within or outside Zimbabwe, whereby any mining title has – at any time after 31 December 2023 – been transferred to an entity. This special capital gains tax shall be payable at the rate of 20% of the value of the transaction concerned by the transferee entity or, in default of the transferee entity, by the owner of the mining title immediately before the mining title was transferred.

2.8 Other Taxes Payable by an Incorporated Business

VAT is payable on transactions, and is applicable in all situations where goods or services move from one person to another in such a manner that the recipient is said to receive enhanced value. The rate of tax is fixed, currently at 15%.

Intermediated money transfer tax (IMTT) is levied on US dollar transactions and outbound foreign currency payments at a rate of 1% on every US dollar and every payment, respectively. Where a taxable transaction equals or exceeds USD500,000, a flat IMTT of USD10,150 shall be payable.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are not subject to any other notable taxes.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most local businesses operate in corporate form as private companies.

3.2 Individual Rates and Corporate Rates

The income of individuals from trade and investments and the income of companies are charged at the same rate: 25%.

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules that prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are taxed on net gains at 20% in respect of sales of shares in closely held corporations acquired after 22 February 2019, and at 5% of the proceeds in respect of shares acquired before 22 February 2019.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The dividends from companies listed on the Zimbabwe Stock Exchange are taxed at a rate of 10%. This is a withholding tax, while the tax on the gain in respect of the sale of shares by individuals in publicly traded corporations is 4% of the capital gain if such security was held for less than 180 days on the date of its sale.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest

A withholding tax of 15% is payable on interest accruing to any person resident in Zimbabwe, calculated on the gross amount of interest. This applies to interest arising from a registered banking institution or unit trust scheme. The tax withheld is a final tax, and the financial institution is responsible for withholding the tax.

Non-resident investors, however, are currently exempt from any withholding tax on interest.

Dividends

A withholding tax called non-resident shareholders' tax is payable on dividends declared by a Zimbabwean company to a non-resident holding company, at a rate of 15%. Dividends from companies listed on the Zimbabwe Stock Exchange have a rate of 10%. In the case of a dividend distributed from a security that is listed on the Victoria Falls Stock Exchange, the rate of tax is 5%. The non-resident shareholders' tax is payable within 30 days after the dividend declaration.

Any amount paid outside Zimbabwe by a local branch or subsidiary of a foreign company in excess of the amount allowable as a deduction shall be deemed to be the payment of a dividend, upon which shareholders' tax shall be charged.

Royalties

A withholding tax on royalties is payable once a Zimbabwean company pays a royalty to a non-Zimbabwean resident. Withholding tax is levied at a rate of 15% and is payable within ten days of the date of payment. A royalty includes payment for the use or right to use any patent or design, trade mark, copyright, model, pattern, plan, formula or process, or any other property or right of a similar nature. It also includes the imparting of any scientific, technical, industrial or commercial knowledge or information for use in Zimbabwe. The amount payable should therefore be carefully considered in order to determine whether it represents a royalty.

Like income tax, withholding tax is payable upon accrual.

A payer or an agent in Zimbabwe who fails to withhold or pay any amount of non-resident tax on royalties shall be personally liable for the payment to the Commissioner. The Commissioner may impose a further amount equal to 100% of such non-resident tax on royalties as a penalty and may institute collection measures to collect any unpaid non-resident tax on royalties.

4.2 Primary Tax Treaty Countries

Zimbabwe has signed several double taxation agreements (DTAs), which are meant to avoid or mitigate double taxation of the same income in the two countries to the agreement – ie, where a business entity operates in the two territories. The agreements restrict some withholding taxes to the amounts specified. The DTAs offer reduced rates of withholding taxes on dividends, interest, royalties and technical fees. Almost all the DTAs that have been signed limit the rate of tax to 10% or less.

The primary tax treaties are with the following countries:

- Bulgaria;
- Canada;
- China;
- France;
- Germany;
- Malaysia;
- Mauritius;
- the Netherlands;
- Norway;
- Poland;
- South Africa;
- Sweden; and
- the United Kingdom.

With effect from 1 January 2024, a domestic minimum top-up tax will be levied at a rate of 15% on taxable income earned in Zimbabwe during a year of assessment by a foreign entity if the country in which the foreign entity is resident pays no corporate tax or pays corporate tax at an effective rate of less than 15%; this is despite any double taxation agreement subsisting between Zimbabwe and the country which has the effect of rendering the foreign entity concerned not liable to tax in Zimbabwe.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Local authorities challenge the use of treaty country entities by non-treaty country residents.

4.4 Transfer Pricing Issues

The biggest transfer pricing issues for inbound investors operating through a local corporation are the provisions in the Income Tax Act on income splitting and associate transactions.

4.5 Related-Party Limited Risk Distribution Arrangements

ZIMRA holds the general position that 80% of fiscal revenue loss is due to transfer pricing, and may challenge the use of related-party limited risk distribution arrangements. As such, the tax avoidance provision is widely interpreted to include all transactions or schemes that have been entered into with the aim of avoiding, postponing or reducing liability, and where the

Commissioner is of the opinion that the avoidance of such liability was the sole purpose of the transaction.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The transfer pricing rules generally mirror the OECD standards.

4.7 International Transfer Pricing Disputes

The local authorities are more aggressive on transfer pricing now, particularly when a resident in Zimbabwe engages in any transaction with a person resident in a jurisdiction that is considered to provide a taxable benefit in relation to that transaction.

The local authorities also strictly enforce the submission of returns disclosing the details of the transaction or contemplated transaction by taxpayers that engage in or will engage in a transaction with an associated person, and the keeping of the prescribed documentation that will assist the Commissioner in ascertaining whether a transaction was conducted in accordance with the arm's length principle.

International transfer pricing disputes are resolved through double tax treaties and mutual agreement procedures, although the latter are not commonly used.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are allowed when a transfer pricing claim is settled.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

The local branches and local subsidiaries of non-local corporations are considered as permanent establishments, and are subject to the normal income tax rules as resident taxpayers, subject to any applicable exceptions.

5.3 Capital Gains of Non-Residents

The capital gains of non-residents on the sale of stock in local corporations will be subject to capital gains tax in Zimbabwe. The tax will apply where the gain is on the shares of a non-local holding company that owns the stock of a local corporation directly.

A tax treaty may eliminate or reduce the capital gains tax.

5.4 Change of Control Provisions

A change of control will trigger tax in Zimbabwe if there is a direct change of ownership in respect of a local corporation.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No formulas are currently applied to determine the income of foreign-owned local affiliates.

5.6 Deductions for Payments by Local Affiliates

The Income Tax Act prohibits the deduction of amounts incurred in excess of specified amounts of management and general administration expenses. Any expenditure incurred prior to the commencement of trade or during the production of income in excess of 0.75% is disallowed. A formula is applied to obtain the amount.

5.7 Constraints on Related-Party Borrowing

Constraints are only placed on borrowing by local affiliates from non-local affiliates. If the ratio of debt to equity of the company, branch or subsidiary exceeds 3:1, the company is considered to have thin capitalisation.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations will form part of a local corporation's taxable income, and will be subject to tax in Zimbabwe at the corporate tax rate if the income is deemed to be from a source in Zimbabwe. The Income Tax Act deems an amount derived from a source outside Zimbabwe by way of interest or dividends on securities, that is received by or accrues to or in favour of a person, to be income from a source within Zimbabwe, if the person is ordinarily resident in Zimbabwe at the time the amount is so received or so accrues, or is deemed to be so received or to so accrue.

Relief in respect of any foreign taxes paid will be granted, unless it is established that the true source of the income is Zimbabwe.

6.2 Non-Deductible Local Expenses

Local expenses and losses may be treated as non-deductible because of their attribution to exempt income, to the extent to which they were incurred in the production of the exempt income.

6.3 Taxation on Dividends From Foreign Subsidiaries

The dividends from foreign subsidiaries of local corporations are taxed at a flat rate of 20%. However, relief will be granted by allowing any foreign tax suffered as a tax credit (up to a maximum of the 20% local rate of tax).

6.4 Use of Intangibles by Non-Local Subsidiaries

The income earned through intangibles developed by local corporations and used by non-local subsidiaries will be subject to tax in Zimbabwe, as part of the company's income.

6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Zimbabwe currently has no controlled foreign corporation rules.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no specific rules relating to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains tax is levied on the sale of shares that are registered in Zimbabwe. The sale of shares in non-local affiliates will be subject to taxation in the country of incorporation, and the provisions of any DTA will apply on the income received in Zimbabwe by the local corporation.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Income Tax Act contains an overarching anti-avoidance provision (Section 98), the aim of which is to determine the tax liability for any transaction, operation or scheme entered into or carried out with the effect of avoiding or postponing liability for any tax, or reducing the amount of the tax payable. The transaction, operation or scheme must have been entered into in a manner that would not normally be employed when entering into a scheme of that nature, or the transaction must create rights that would not normally be created between persons dealing at arm's length.

The anti-avoidance provision also sets out the law governing income splitting, transactions between associates and the reporting of unprofessional conduct.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Commissioner of ZIMRA publishes an annual public notice calling on taxpayers to furnish their returns for assessment. When tax auditors at ZIMRA detect possible misdemeanours regarding tax and/or customs issues from the information they have, the Authority initiates investigations. The information can be obtained from investigations that are underway already, or it can be received from the public or other sources.

The Commissioner of ZIMRA may require any person, by means of a written disclosure notice served on them, to disclose without delay any information in respect of any money, funds or assets which may be held by that person on behalf of another person as a professional custodian.

9. BEPS

9.1 Recommended Changes

Zimbabwe has implemented BEPS-recommended changes on the taxation of transactions between associated entities.

9.2 Government Attitudes

The government of Zimbabwe has been incorporating BEPS principles to align with the rest of the world on the tax treatment of certain transactions. BEPS Pillar One and Pillar Two are yet to be given full effect in addressing the tax challenges arising from the digitalisation of the world economy.

9.3 Profile of International Tax

International tax is an area that is still developing in Zimbabwe.

9.4 Competitive Tax Policy Objective

Zimbabwe is yet to develop a competitive tax policy.

9.5 Features of the Competitive Tax System

Zimbabwe is yet to develop a competitive tax system.

9.6 Proposals for Dealing With Hybrid Instruments

This area of taxation is still being considered, and the BEPS process will certainly be taken into account as international guidelines.

9.7 Territorial Tax Regime

Zimbabwe has a territorial tax system, whereby income earned by companies in foreign countries will only be taxed in Zimbabwe if it is deemed to be from a source within Zimbabwe. There are currently no specific interest deductibility restrictions tailored to that regime. Any interest deductibility restrictions will reduce the cost of investing in the country.

9.8 Controlled Foreign Corporation Proposals

The CFC proposals are seen as being generally beneficial, as they assist in managing or eradicating tax evasion.

9.9 Anti-Avoidance Rules

Anti-avoidance rules will have an impact on investors if a transaction, operation or scheme has been entered into or carried out with the aim of avoiding or postponing liability for any tax, or of reducing the amount of such liability. The Commissioner of the Revenue Authority must be of the opinion that the transaction or operation has been entered into in a manner that would not normally be employed, or that it has created rights or obligations that would not normally be created between persons dealing at arms' length, and that the avoidance or postponement of such liability was the sole purpose of the transaction.

9.10 Transfer Pricing Changes

Transfer pricing rules were introduced for the first time in Zimbabwe in 2016, with a major focus on arm's length principles. In 2019, a requirement to submit annual transfer pricing returns to the Commissioner showing transactions entered into between controlled and/or associated enterprises was introduced. This was considered to be a major requirement by many organisations.

Profits from intellectual property have always been taxed.

9.11 Transparency and Country-by-Country Reporting

Zimbabwe is in favour of provisions for transparency and country-by-country reporting through various legislative instruments.

9.12 Taxation of Digital Economy Businesses

Zimbabwe has introduced a digital services tax for electronic and e-commerce services, levied at 5% on all non-resident satellite broadcasting service providers and electronic commerce operators who receive revenues in excess of USD500,000 in any year of assessment from the provision or delivery of services to persons resident in Zimbabwe.

9.13 Digital Taxation

Zimbabwe amended the Income Tax Act to tax the income earned by satellite broadcasting service providers and electronic commerce operators for digital services provided by non-residents to customers based in Zimbabwe. The tax is levied in respect of revenues in excess of USD500,000. In implementing the digital taxation, reference is made to Action 1 of the OECD/G20 BEPS plan.

VAT was also amended to tax the supply of radio and television services from outside Zimbabwe to an address in Zimbabwe, or the supply of electronic services by an electronic commerce operator domiciled outside Zimbabwe to a person resident in Zimbabwe.

9.14 Taxation of Offshore IP

In Zimbabwe, the nature and source of income determine whether or not it is taxable. With respect to offshore intellectual property that is deployed within Zimbabwe, if a payment is made to a non-resident from a source within Zimbabwe for the right to use such intellectual property, the amount paid will be taxed at 15% in the form of a withholding tax on royalties.

The provisions on non-residents' tax on royalties do not distinguish between owners of intellectual property in tax havens and in countries that have the benefit of a double tax treaty. However, where a double tax treaty is in place, the provisions of that treaty will be applied.

CHAMBERS GLOBAL PRACTICE GUIDES