PANORAMIC

TAX ON INBOUND INVESTMENT 2025

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LEXOLOGY

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Panoramic guide (formerly Getting the Deal Through) enabling side-by-side comparison of local insights into acquisitions (from the buyer's perspective), post-acquisition restructuring, and disposals (from the seller's perspective), including stock versus asset/liability transactions; domicile of acquisition company; company mergers and share exchanges; tax benefits of issuing stock as consideration; transaction taxes; treatment of deferred tax assets; interest relief; protections for acquisitions; spin-offs; migration of residence; interest and dividend payments; tax-efficient extraction of profits; methods of disposal including for tax mitigation and deferral purposes; and recent trends.

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Introduction

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We are very pleased to introduce the 19th edition of *Lexology Panoramic – Tax on Inbound Investment*.

This revised anthology provides a set of tax summaries for investment into 14 of the world's key capital-importing jurisdictions. It is intended as a user-friendly guide, presented in a consistent question-and-answer format in each country, for ease of use and comparison across potential target jurisdictions. The resource should assist both tax and finance professionals alike who require up-to-date and accurate summaries of the key tax considerations when undertaking transactions in different territories. It remains, of course, a summary guide – tailored advice that manages appropriately the tax effectiveness of planned inbound investment should always be sought.

We hope you find this updated guide helpful, particularly in light of ongoing developments in the geopolitical, tax and investment environment during 2024.

In a worrying downward trend, the UNCTAD World Investment Report 2024 shows that global foreign direct investment (FDI) has fallen for a second consecutive year, down 2 per cent to US$1.3 trillion in 2023. More alarming still, excluding the large swings in investment flows in a few European conduit economies, global FDI flows were actually more than 10 per cent lower than in 2022. This decline was largely attributable to rising trade and geopolitical tensions amid a slowing global economy, and was also reflected in the developing world. Despite a 4 per cent increase in 2022, FDI flows to developing countries dropped 7 per cent to US$867 billion last year, with the decrease varying significantly across regions. These lacklustre financial flows were not however due to a lack of investment facilitation effort, with 86 per cent of the investment policy measures taken by developing countries being more favourable to investors.

Tight financing conditions in 2023 led to a 26 per cent downturn in international project finance, which in turn impacted sustainable development, with new funding for sectors such as agrifood systems and water and sanitation dropping over 10 per cent. M&A also saw a 46 per cent drop in value. Last year did, however, see some limited areas of growth, with greenfield investment project announcements up 2 per cent on 2022 figures.

Looking ahead, the global environment for international business and cross-border investment remains challenging in 2024. Weakening growth prospects, continuing trade and geopolitical tensions, industrial policies and supply chain diversification are reshaping FDI patterns, causing some multinational enterprises (MNEs) to adopt a cautious approach to overseas expansion. However, MNE profit levels remain high, financing conditions are easing and concerted efforts towards investment facilitation should positively impact FDI, suggesting modest growth for the year is possible.

In light of this, the need to have a clear understanding of local effective tax rates, efficient repatriation options and exit strategies at an early stage of a potential transaction has arguably never been greater. There can still be value derived from tax efficiencies at a target jurisdiction level, despite the increasing challenges and complexity that exist and that are on the horizon in the international tax landscape from a holding company perspective.

A key development impacting deal structuring, financial modelling and negotiations in an international context arises from the ongoing progress being made during 2024 in relation to the implementation of the Organisation for Economic Co-operation and Development (OECD) Pillar Two rules. Pillar Two effectively requires multinational groups with annual revenues over €750 million to suffer a minimum 15 per cent tax in each jurisdiction in which they operate. Where a group does not meet this minimum rate (eg, through operations in low-tax jurisdictions) two potential mechanisms will take effect to seek to ensure the 15 per cent rate is effectively achieved. The principal approach will be for the group's ultimate parent entity to pay additional top-up tax (the Income Inclusion Rule (IIR)). Should the IIR not take effect (eg, because it has not been implemented in the jurisdiction in which the ultimate parent entity is resident), then deductions or other adjustments will be imposed by the Undertaxed Payments Rule (UTPR) in other jurisdictions in which the group has a presence.

As various jurisdictions and the European Union develop and implement the relevant legislative frameworks, it has become increasingly clear that operation of the rules will give rise to considerable complexity and differentiating factors at a local level – it will of course not be sufficient to consider only the headline corporate tax rate. For example, certain deductions and tax incentives that may be permitted under existing domestic law may not be treated as 'qualified refundable tax credits' for the purposes of Pillar Two, with the effect of driving the effective tax rate of a target in a jurisdiction below the 15 per cent threshold.

The rules and approach have been under consideration for several years, with over 130 members of the OECD signing up to a framework agreement in October 2021 and model rules being published in December 2021 (with a consolidated version of the accompanying commentary released in April 2024). Following a year-long delay to the planned implementation timeline, the IIR is now in force in a number of jurisdictions, with the UTPR planned to follow in 2025. The United Kingdom, for instance, has already introduced the Pillar Two IIR into domestic law for accounting periods beginning on or after 31 December 2023, and has consulted on draft UTPR legislation. Similarly, the European Union passed a 'Global Minimum Tax Directive' requiring EU jurisdictions to transpose the rules into domestic law by the end of 2023, for entry into force in 2024 (IIR) and 2025 (UTPR). Although many member states have enacted such legislation, a number are yet to do so (eg, Cyprus, Poland, Portugal and Spain). Jurisdictions such as Singapore and Hong Kong are expected to introduce the IIR from 2025, while others (notably the United States and China) have yet to initiate implementation.

There are numerous considerations when it comes to M&A and the potential ramifications of Pillar Two. Buyers and bidders are already starting to need to consider if a target located in a relatively low tax jurisdiction will become subject to Pillar Two. In such circumstances, while undertaking modelling of the impact of an acquisition, the headline tax rates cited in this publication may cease to look as attractive. More drastically, a buyer may find its entire group brought within the scope of the rules if the combined enterprise post-acquisition will breach the €750 million threshold. Where a group has few operations in low-tax jurisdictions there may not be a material tax impact, but there will be considerable additional compliance costs involved. Groups below the threshold and with a material presence in low-tax jurisdictions will want to evaluate the full implications of a transaction that will take the group over the threshold. Such factors will, depending on the target and buying or bidding group tax profile, potentially have a significant impact on pricing, which may narrow the field of potential bidders in a competitive scenario.

As ‘groups’ for the purposes of Pillar Two are determined on the basis of accounting consolidation, private equity fund bidders may have a competitive advantage on pricing as a fund’s portfolio investments will typically not be consolidated and may remain below the threshold. On the other hand, a private equity fund bidder will also be mindful of potential buyers as regards the future disposal and the rules may also slightly reduce the recent trend of add-ons and buy-and-build acquisition strategies.

After financial modelling and acquisition structuring, Pillar Two also potentially impacts deals at the negotiating table. Thought will need to be given to the respective implementation of Pillar Two in the countries involved and whether obligations or liabilities will carry across with the intended target or remain with the selling group. Buyers will often also need greater assistance and cooperation from a selling group as regards tax disputes and tax compliance post-acquisition than has traditionally been the case in some jurisdictions. From a liability perspective, certain jurisdictions may also make group entities jointly and severally liable for IIR and UTPR debts, as has been provided for in the United Kingdom IIR rules, adding a further potential secondary tax liability for which buyers may require contractual protection.

Pillar Two will clearly have a significant impact on M&A in various contexts, to add to the existing headaches for groups and advisers that have developed over the last few years in the international tax landscape. Such issues include the increasingly restrictive availability of tax deductions for interest and other expenses; greater focus and sophistication of (albeit under-resourced) local tax authorities in challenging intra-group transfer pricing arrangements; more frequent challenges to the availability of double tax treaty relief following the OECD’s multilateral instrument implementing changes to thousands of treaties; and the increasingly widespread employee base of many groups, giving rise to payroll and employee tax considerations, as well as permanent establishment risks.

Of course, Pillar Two is only part of the current global tax reform story, with the OECD’s Pillar One proposals potentially set to increase international tax complexity further. If enacted, these rules will introduce a new taxing right for 'market jurisdictions' over MNEs with a global turnover above €20 billion and a profit margin exceeding 10 per cent that is not dependent on the MNE's physical presence in that jurisdiction. Where at least €1 million in revenue is derived from a market jurisdiction, it may impose tax on 25 per cent of the MNE's profits in excess of the 10 per cent threshold. Pillar One is also intended to deliver a simplified application of the existing arm's-length principle of transfer pricing to baseline marketing and distribution activities performed by related parties, which will apply to all taxpayers and not just MNEs.

However, despite concerted efforts over the past year, final agreement has yet to be reached on the Pillar One package. It had been hoped that the multilateral convention (MLC) to implement the model rules for 'Amount A' (ie, the reallocated residual profits of an MNE taxable in a market jurisdiction) would be ready for signing by the end of June 2024 (the planned timeline having already slipped by six months). However, this deadline was not met, and while the OECD is confident that negotiations are nearing completion, finalising the MLC is only part of the issue. The far greater challenge is securing sufficient signatories for the MLC to come into effect, as ratification is required by at least 30 jurisdictions accounting for at least 60 per cent of the ultimate parent entities of in-scope MNEs. Without the buy-in of the United States, which is looking increasingly unlikely, it is difficult to see how this can be achieved.

Amid this rapidly moving international tax landscape, we and our fellow contributing authors thank you for reading this guide and hope that the local insights provide helpful guidance when it comes to considering investments and acquisitions in the numerous jurisdictions covered.

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