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Corporate Taxation of Virtual Zone Entities

This guideline contains information about granting and revoking the Virtual Zone Status, as well as the rules of conducting operations under this status, including associated tax liabilities and rights.

[In Articles 8.35 and 8.36 of the Tax Code of Georgia](#) (hereinafter referred to as “TCG”) a Virtual Zone entity is defined as a legal entity engaged in Information Technology (hereinafter referred to as “IT”) related activities and holding an appropriate status. IT activities are defined as *studying, supporting, developing, designing, producing, and introducing computer information systems, as a result of which software products are obtained*.

A legal entity can request the Virtual Zone Status by applying to the LEPL Financial-Analytical Service, which is authorized to request additional information about IT activities conducted by the applicant. According to [Article 99 of TCG](#), the exemption from profit taxation covers the distribution of profit generated from the supply of Information Technologies outside Georgia developed by a legal entity of the Virtual Zone.

The main purpose of the [Law of Georgia on Information Technology Zones](#) is the development of IT products in the territory of Georgia. Article 6 of the above-mentioned Law specifies that the economic activity carried out by a Virtual Zone entity should be directed to creating IT products in the territory of Georgia. For this purpose, it is **essential** for the Virtual Zone entity to be operating with the utilization of appropriate **assets** and **human resources** with the required **qualifications** in the IT field.

We will look at 6 examples and examine the tax exemptions for each.

Example 1:

A legal entity of the Virtual Zone creates IT products in the territory of Georgia and supplies them exclusively outside the country. The company is founded by natural persons. Furthermore, the company has employees who create IT products in the territory of Georgia.

The Virtual Zone entity has distributed a net profit of 100,000 GEL to its shareholders.

In this case:

The Virtual Zone entity:

- Creates IT products in the territory of Georgia.
- Generates profit solely from the delivery of IT products to customers outside the country.
- Substantively utilizes the work of employees who have appropriate qualifications in the IT field and who create IT products in the territory of Georgia.
- Owns appropriate assets for the purpose of creating IT products in the territory of Georgia.

Based on the above, due to the profit tax benefit granted to Virtual Zone entities, the distribution of profit (100,000 GEL) to the shareholders of the company will be exempt from corporate income tax according to the provisions of [Article 99\(e\) of TCG](#).

Example 2:

A Virtual Zone entity creates IT products in the territory of Georgia and is engaged in the provision of these products to foreign clients solely by **providing the right to use** said software. Additionally, the company has employees, who develop these IT products in the territory of Georgia.

In this case:

Since the Virtual Zone company also fulfills the requirements mentioned above (see Example 1), by the virtue of [Article 73\(9\)\(a\) of TCG](#), the mere fact that the provision of IT products to foreign customers is done by licensing and **not transfer of ownership** will not exclude this company from taking advantage of the corporate income tax benefit at the point of profit distribution.

Example 3:

A Virtual Zone entity is established by natural persons. IT products are created in the territory of Georgia **solely** by the shareholders. The company only has a director and an accountant. Therefore, the company does not utilize the work of Georgian-based employees with qualifications in the IT field.

The company generates profit solely from the provision of IT products to customers outside the country.

The shareholders, who are resident natural persons, receive income from the company only in a dividend form.

In this case:

According to [Article 73\(9\)\(b\) of TCG](#), for the purpose of determining tax liability, the tax authority has the right to *change the classification of a business transaction based on its form and substance if the form of the transaction does not correspond with its substance* (Substance over Form Principle).

According to the substance of the transaction, the tax authority has the right to reclassify the transaction and recategorize the dividend payments as salary payments.

Based on the above scenario, where the IT products are deemed to be created by individuals working in the territory of Georgia, the profit generated (profit distributions) from providing these products **outside** the country will be covered under the corporate income tax benefit.

For this purpose, 40% of the **financial income** of the enterprise can be reclassified as expenses in the form of salary payments to individuals employed in the IT field.

Additionally, the work performed by individuals employed in the appropriate field might, if possible, be evaluated at a **reasonable market price**.

It is important to determine whether the distribution of profit generated from the supply of IT products outside Georgia, which were created before obtaining Virtual Zone Status, is a taxable event or falls under the profit tax exemption.

[Article 99.1.p of TCG](#) states that *the distribution of profit earned from the supply of Information Technologies outside Georgia, created by a legal entity of the Virtual Zone, is exempt from corporate income tax.*

By the virtue of the above-mentioned Article, in order to get a profit tax exemption under Virtual Zone Status, two requirements need to be met:

- i. IT products have to be created and provided by a legal entity of the Virtual Zone.
- ii. IT products have to be provided outside Georgia by a legal entity of the Virtual Zone.

However, if the distributed profit was not generated by the Virtual Zone entity, then the distribution of profit generated before obtaining the Virtual Zone Status will not be exempt from corporate income tax, and will be taxable at the standard corporate tax rate.

It is also important to determine the profit tax liability of the Virtual Zone entity, while such an entity supplies IT products, which were created in Georgia, both in and outside the country.

Considering that the profit tax exemption exclusively applies to the distribution of profit which was generated by the supply of IT products **outside Georgia**, but, at the same time the Virtual Zone entity is entitled to generate profit through the provision of IT products in the territory of Georgia, it is essential to identify which portion of the profit distribution is exempted from the profit tax.

In that regard, if the attribution of the expenses to the specific part of the profit is impossible, the exempted profit shall be calculated in proportion to the portion of the profit generated by the supply of IT products outside Georgia.

Furthermore, if in specific circumstances a more reasonable and exact method of calculation is available, the Virtual Zone entity is entitled to use that method of calculation.

It is also important to note that regarding [Article 99.3 of TCG](#), for the purposes of determining the exempted portion of profit while distributing dividends, it is deemed that the exempted profit is distributed first.

Example 4:

The Virtual Zone entity is established by natural persons. The entity creates IT products in the territory of Georgia. It has employees who specialize in the IT field, and they are actively involved in creating Information Technologies.

The entity provides IT products both in and outside Georgia.

The annual profit of the Virtual Zone entity constituted 1,000,000 GEL. The annual **Financial Income** was 2,500,000 GEL. The overall income was generated by supplying IT products, which were developed in Georgia, outside Georgia (2,000,000) and within the territory of Georgia (500,000).

The profits were wholly distributed to its shareholders.

In the present case, if there is no other calculation method, using of which would be more reasonable and precise:

The portion of profit exempted from profit tax will be 800,000 GEL ($1,000,000 \times 2,000,000/2,500,000$).

The portion of taxable profit will be 200,000 GEL ($1,000,000 \times 500,000/2,500,000$).

It is also notable that since the distribution of profit generated by the supply of IT products outside Georgia created by the Virtual Zone entity in the territory of Georgia is exempted from corporate tax while distributing the profit, it is considered that the exempted profit was distributed first.

In light of that, the profit in the amount of 200,000 GEL will be taxed with profit tax.

According to [order #996 of the Minister of Finance of Georgia](#), the following shall be exempt from the profit/income tax:

1. The entity which is created under or has been granted the special status for the purposes of being exempt from income/profit tax (i.e., a legal entity of the Free Industrial Zone, a Special Trading Company, a Tourist Zone Entrepreneur, a High-Mountain Settlement Enterprise, an Agricultural Cooperative, or a **legal entity of the Virtual Zone**).
2. The entity which performs any activity exempt from income/profit tax (i.e., organizing entities of a gambling club, a slot machine saloon, or a betting house, except for the entities organizing games in a systemic-electronic form).

Example 5:

The legal entity of the Virtual Zone is a sole shareholder of a resident LLC (hereinafter referred to as “A”). The Virtual Zone entity has two shareholders who are natural persons.

“A” distributed the whole pure profit in the amount of 100,000 GEL to its shareholder.

Since the shareholder of “A” is a legal entity, the distribution of profit by “A” to its shareholder will not be classified as a profit distribution in accordance with [Article 98^1.2.c of TCG](#); therefore, it will not be a taxable event. However, the Virtual Zone entity will not get the corporate income tax exemption on the redistribution of profit generated by receiving a dividend from “A”, and thus, distributing that profit by the Virtual Zone entity to its shareholder individuals will be taxed. Additionally, the legal entity of the Virtual Zone is liable to withhold the dividend income tax at the source of payment, since the Virtual Zone entity is considered a tax agent based on [Article 154 of TCG](#).

Example 6:

The legal entity of the Virtual Zone creates IT products in the territory of Georgia and supplies them only outside Georgia. It does not operate within the Georgian market. The shareholders of the entity are natural persons. The entity has employees, who are creating IT products in the territory of Georgia.

The entity distributed profit in the amount of 100,000 GEL and paid salaries to its employees in the amount of 20,000 GEL.

In the present case, the distribution of profit shall be exempted from profit tax. The legal entity of the Virtual Zone is entitled to withhold the dividend income tax at the source of payment at a 5% rate by virtue of [Article 130 of TCG](#).

In terms of salary payments in the amount of 20,000 GEL, the legal entity of the Virtual Zone has the liability to withhold salary income tax at the source of payment as well.

Virtual Zone Status revocation:

Virtual Zone status shall be revoked if the legal entity of the Virtual Zone abuses the Virtual Zone status and uses it for the purposes of tax evasion. If this is the case, the Financial-Analytical Service shall revoke the Virtual Zone status.

Additionally, the status shall be revoked if:

- i. The Virtual Zone entity requests revocation.
- ii. The Virtual Zone entity obtains International Company Status. In that regard, the status is considered to be revoked starting from the first day of the month in which the entity was granted International Company Status.

The information about the status revocation shall be sent to Revenue Service by the Financial-Analytical Service within 2 business days after the status revocation.