



ECONOMIC SUBSTANCE IN ZERO TAX UAE

Increasingly onshore tax authorities are not only looking at the place where central management and control is exercised in order to determine where a company is taxable but are also looking at the economic rationale behind a company in a particular jurisdiction. More so, if that jurisdiction happens to be a low or no tax.

An increasing number of tax treaties incorporate anti-avoidance provisions. Transactions which lack commercial substance or not entered into for bona fide purposes, are caught by the provisions.

The UAE is particularly well positioned to cope with the increasing requirements from onshore tax authorities to provide real economic substance. By making use of the UAE there are now opportunities available, even for small companies, to locate business functions there and realize the promised tax savings, even if the structure is reviewed by onshore tax authorities.

A key question is whether domestic anti-avoidance provisions take precedence over the terms of a double tax treaty. The OECD published guidance on this which states “a guiding principle is that the benefits of a DTT should not be available where the main purpose for entering into certain transactions or arrangements is to secure a more favourable tax position and obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions”. The first clause is stretching it, as it is difficult to imagine in a world of high taxes, how taxes cannot be a significant reason. It is clear that the OECD maintains the stance that domestic anti-avoidance provisions take precedence over double tax treaties.

The “beneficial ownership” requirement is a specific anti-avoidance clause that, in contrast to newer versions of anti-avoidance clauses, has been a feature of the OECD model treaty for a long time. For instance, a recipient of dividends, interest and royalties also has to be the “beneficial owner” of the dividends in order to benefit from the tax treaty.

The question here is “who is the beneficial owner”? Only a few examples of situations in which the recipient is not considered to be the beneficial owner were included in the OECD commentary to the model tax treaty - namely if the recipient is an agent or nominee, then it is not the beneficial owner of received income. It has been left to case law to fill in the gaps as to whether there are other circumstances in which the recipient is not considered to be the beneficial owner.

While countries differ to the extent to which they allow anti-avoidance legislation to take precedence over tax treaties, and case law is still not conclusive on “beneficial ownership”, a clear direction has emerged that if an entity does not have economic substance, there is an increasing risk that it will not hold up upon review by tax authorities and, therefore, will not achieve the intended tax benefits. Essentially substance is increasingly necessary to counter the charge that an entity or structure was set up solely for tax reasons is artificial, or is not set up for bona fide reasons which can trigger the anti-avoidance legislation.

Certain offshore jurisdictions are better positioned to benefit from this trend than others. It is hard to think of a place where it is so easy and quick to set up in business in a free zone in the UAE. Free zones as a concept were started in Dubai, the first one being Jebel Ali free zone. Benefits of operating from a free zone include 100 percent foreign ownership, no restrictions on hiring foreign labour, streamlined procedures for dealing with government formalities and a guarantee against future imposition of taxation for a specified period.



This regime makes it possible for multinationals and entrepreneurs to establish a foothold in the UAE while transferring genuine economic functions to the newly formed entity, thus countering anti-avoidance charges. The main advantage of UAE is that there are ample non-tax reasons for setting up business there. The strategic location between East and West makes it a logical choice for setting up, say, a customer service, IT support, or a procurement centre. Dubai is the main airline hub, en route from East to West and, vice versa, which provides further commercial rationale for establishing a business in the UAE and the fact that it is an international financial centre ensures the availability of quality professional services.

The UAE also has free immigration without minimum wage requirements which is important and enables realizing substance. A foothold can be established in the UAE by incorporating a free zone company with a visa allocation of one or two persons and renting a small office space from the free zone. The parent company could then send a few well-trained staff to the UAE to carry out specified corporate functions possibly assisted by a corporate service provider which provides qualified directors, has a professional network and assists with ensuring substance in the UAE.

The IT infrastructure in the UAE, provides a compelling non-tax argument for setting up in the UAE. Asymmetric digital subscriber line (ADSL) technology has now been replaced by fiber-optic connections. This provides a business rationale for operating an e-commerce server in the UAE. The goal is to attribute sufficient functions to the company so that it would amount to a permanent establishment (PE) in the UAE. This would provide the justification for allocating profits to the company.

The UAE has concluded nearly 80 double tax treaties, many of them with OECD countries. Some of the tax treaties are not very attractive because of the limitation of benefits clauses, inclusion of liable to tax clauses and uncertainty as to whether UAE residents are considered to be liable to tax in the context of the treaty. Also some treaties restrict the benefits of the treaties for individuals to UAE nationals, and some can only be accessed by government entities.

There are, however, several treaties which are significant. The treaties with New Zealand, Austria, the Netherlands, Cyprus and many more. None of these has a liable to tax requirement. The treaty with the Netherlands was ratified in June 2010. Its most important effect for outbound investment - from the perspective of the UAE - is that it limits the dividend withholding tax rate to 5 percent. The Netherlands is a particularly attractive country for inward investment into the UAE now, because for most items of income the Netherlands will exempt a Dutch company from corporation tax on UAE income even though it has not been subject to tax in the UAE. In particular, UAE real estate gains and income from a UAE permanent establishment are exempt from tax in the Netherlands. Employment income derived by a resident of the Netherlands from a UAE employer follows the exemption with progression method.

Cyprus is another example. It concluded a tax treaty with the UAE with a similar participation exemption system regime as in the Netherlands and exempts profits made by permanent establishments abroad from tax under domestic legislation.

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