# The UAE: ideally suited to implement economic substance in a zero tax environment

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**Increasingly onshore tax authorities are not just looking at the place where central management and control is exercised in order to determine where a company is taxable, but they are also looking at the economic rationale behind setting up a company in a particular jurisdiction; in particular of course if that jurisdiction happens to be a low tax or no tax jurisdiction.** The hot topics in international tax planning circles that deal with these issues are "anti-avoidance" and "beneficial ownership". Offshore tax planning is not as straightforward as it used to be.

An increasing number of tax treaties incorporate anti-avoidance provisions. Most countries now include general anti-avoidance rules (GAAR) in their tax legislation. The latest countries that plan to do so are the United Kingdom and India. In India GAAR, were planned to enter into effect in April 2012, however, this was postponed for two years, apparently after intensive talks between Mauritius and India. These rules would have included specific anti-avoidance provisions (CFC-rules) and general anti-avoidance provisions. In line with existing anti-avoidance provisions in other countries, transactions which lack commercial substance, or are not entered into for a bona fide purpose, would be caught by the provisions. An important question here is whether domestic anti-avoidance provisions should take precedence over the terms of a tax treaty (in which the domestic anti-avoidance provisions are not included). The OECD published guidance on this in 2003. Its 2003 commentary to its model treaty worryingly states that "A guiding principle is that the benefits of a DTC 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 very far-reaching, considering that it is hard to imagine, in this world of high taxes, how taxes cannot be a significant reason and as such, the second clause leaves confusion. In any case, it is very clear that after the publication of this commentary, the OECD maintains the stance that domestic anti-avoidance provisions take precedence over 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 big question here is "who is the beneficial owner". Some direction on this question has emerged through case law.

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. However, 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. In the well-known Indofood[1] case, beneficial ownership of interest income was found to be lacking because the recipient had no choice but to pass on the income to another company. The recipient did not enjoy the full privilege of benefiting directly from the income, and was therefore not found to be the beneficial owner, hence could not benefit from reduced treaty withholding taxes.

While countries differ in 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 is undeniably beginning to emerge; that is, that if an entity does not have clear economic substance, there is an increasing risk that it will not hold up upon review by the interested 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, or even mainly, for tax reasons, is wholly artificial, or is not set up for bona fide reasons, which can trigger the anti avoidance legislation in the country which seeks to impose taxation.

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 one of its Freezones and to access the world's labour pool as Ras al Khaimah in the United Arab Emirates. It is even more difficult to think of any other traditional zero-tax jurisdiction offering this. Freezones as a concept were pioneered by the Emirate Dubai, the first one being Jebel Ali Freezone. Benefits of operating from a Freezone include: 100% foreign ownership; no restrictions on hiring foreign labour; streamlined procedures for dealing with government formalities; and sometimes a guarantee against future imposition of taxation for a specified period. The absence of VAT and restrictions on hiring foreign labour are also very important benefits.

Ras al Khaimah is probably the most free-market oriented Emirate of all. The Emirate markets its Freezone in terms of appealing to entrepreneurs and investors in general: lack of red tape; no restrictions on foreign labour; and business friendly policies. The Emirate does not have a dormant tax law on its books (unlike Dubai, Abu Dhabi and Sharjah), never instituted rent controls during the property boom, and refused to rescue the loss-making airline RAK Airways (after which it made a successful relaunch under new management). It is no surprise, therefore, that Ras al Khaimah is also the Emirate that pioneered low cost Freezone setups. While in most of Dubai's Freezones, high office rents had to be paid (although significantly reduced now compared to the height of the property boom in 2008), Ras al Khaimah pioneered the idea of provision of mini-offices, with office space starting from ten square metres as well as a desk sharing solutions.

It is easy to see how this regime makes it possible for multi-nationals or 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 Ras Al Khaimah has in contrast to some of the traditional offshore jurisdictions, is that there are many non-tax reasons for setting up business in the UAE. The strategic location between East and West makes it the logical choice for setting up for example 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 a main business centre ensures the availability of a wide array of professional services. Historically, the provision of administration services offshore has often been difficult, particularly in the provision of staff to undertake more complex functions, this often necessitated that elements of the administration were put back onshore. This entails increased risk if these structures were to be reviewed. The fact that in the UAE there is de-facto free immigration for anyone willing to work without minimum wage requirement is really the most important enabling factor for realising substance. A foothold can be established in the UAE by incorporating a RAK Freezone company with a visa allocation of one or two persons and renting a small office space from the Freezone. The parent company could then send one or 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 the realisation of maximum substance in the UAE in order to maximise the chance that the structure will withstand the scrutiny of tax authorities when reviewed.

The IT infrastructure in the UAE, while not previously on a par with western countries, has improved to the extent that it also provides a compelling non-tax argument for setting up in the UAE. Asymmetric digital subscriber line (ADSL) technology has now mostly been replaced by 40Mbps fiber-optic connections. This provides a business rationale for operating an e-commerce server from the UAE. The goal should be 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 PE concept applied to e-commerce is generally applied as follows:

- Data and software do not constitute a PE, ie a website does not constitute a PE;
- Computer equipment may constitute a PE. This would be the case when the company owns the server (as opposed to renting space from an ISP) and transacts business through it;
- The activities are not of an auxiliary nature;
- The PE does not necessarily need personnel if no personnel is required to carry out the business.

The server could, for example, host a website selling digital products, such as downloadable music or an online social networking community. In order to maximise the profit that can be attributed to the e-commerce operation, maintenance and development could be sourced locally and order processing and customer service could be provided by local staff. A RAK Freezone company would be an ideal low cost vehicle to operate an e-commerce operation.

The UAE has concluded approximately 60 tax treaties, many of them with OECD countries. Many 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. However there are several treaties which are significant: the treaties with New Zealand, Austria and the Netherlands. None of these have 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%. 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. Gains and dividends derived from a UAE subsidiary are exempt under domestic legislation in the Netherlands, provided it is not mainly holding passive investments. Cyprus is one of the latest countries to conclude a tax treaty with the UAE. It has a similar participation exemption system regime as in the Netherlands and exempts profits made by permanent establishments abroad from tax under domestic legislation. So even before the tax treaty was concluded, setting up a branch of a Cyprus company in the UAE was an attractive option.

The UAE is particularly well positioned to cope with the increasing pressure 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 realise the promised tax savings, even if the structure is reviewed by onshore tax authorities.

## END NOTES:

1. *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A., London Branch [2006] EWCACiv 158*

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