

Implementing Economic Substance through RAK FTZ

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Offshore tax planning isn't as straightforward as it used to be. Onshore tax authorities are increasingly looking not just at the place where central management and control is exercised in order to determine where it is taxable, but also at the economic rationale behind the use of an offshore company. The hot topics in international tax planning circles that deal with these issues are 'anti-avoidance' and 'beneficial ownership'.

An increasing number of tax treaties incorporate 'anti-avoidance' provisions in their tax treaties. Most countries now have anti-avoidance provisions in their tax legislation. The latest country planning to do so is India. The new direct tax code (DTC), that is scheduled to come into effect in April 2012, includes specific anti-avoidance provisions (CFC rules) and general anti-avoidance provisions. In line with existing anti-avoidance provisions in other countries, transactions that lack commercial substance, or are not entered into for a bonafide purpose, will 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 those anti-avoidance provisions are not included). Guidelines were released by the OECD in 2003, with an accompanying commentary that, worryingly, stated: '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 they cannot be a main reason; and the second clause leaves confusion. In any case, it is very clear that, after the publication of this commentary, the OECD approves of domestic anti-avoidance provisions taking precedence over tax treaties.

The 'beneficial ownership' requirement is a specific anti-avoidance clause that, contrary to newer versions of anti-avoidance clauses, has been included in tax treaties for a long time. It 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 meant by the beneficial owner. A few examples of the situations in which the recipient is, in any case, not the beneficial owner, have for a long time been included in the OECD commentary to the model tax treaty, namely that if the recipient is an agent or nominee then he/she is not the beneficial owner of received income. In the Indofoods 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 didn't enjoy the full privilege to directly benefit from the income, and was therefore not the beneficial owner, and hence couldn't benefit from reduced treaty withholding taxes.

While countries differ to the extent in which they let anti-avoidance legislation take precedence over tax treaties and the case law is still not conclusive on beneficial ownership, a clear direction is definitely starting to emerge. If an entity does not have clear economic substance, then there is increased risk that it will not hold up upon review by the interested tax authorities and therefore 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 wholly artificial, or is not set up for bonafide reasons, which can trigger the anti-avoidance legislation in the country that seeks to tax.

How is this relevant for the UAE or Ras Al Khaimah in particular? It is hard to think of any other place in the world where it is so easy and quick to set up in business in one of its free zones and to access the world's labour pool. It is even more difficult to think of any other traditional zero-tax jurisdiction offering this. Free zones, as a regional concept, were pioneered by the emirate of Dubai, the first one being Jebel Ali Free Zone. The benefits of operating from a free zone 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 very important benefits as well.

Ras al Khaimah is probably the most free market oriented emirate of all. The emirate markets its free zone in terms that are appealing to entrepreneurs and investors in general, with a lack of red tape, no restrictions on foreign labour, and business-friendly policies. The emirate doesn't have a dormant tax law on its books (unlike Dubai, Abu Dhabi and Sharjah), has never instituted rent controls during the property boom, and refused to rescue the loss-making airline RAK Airways. No surprise then, that Ras Al Khaimah is also the emirate that pioneered low-cost free zone setups. While high office rents were originally payable in Dubai's free zones, Ras al Khaimah pioneered the provision of mini offices.

It is easy to see how this regime makes it possible for multinationals 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 difference with many traditional offshore jurisdictions is that there are many non-tax reasons for setting up in business. The strategic location between East and West make it the logical choice for setting up a customer service entity, IT support, or a procurement centre. The fact that Dubai is the main airline hub, en route from East to West, and vice versa, provides further commercial rationale. 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. The fact that 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 free zone company with a visa allocation of one or two persons, and rental availability of a small office from the zone. The parent company could then send several well-trained staff to the UAE to carry out specified corporate functions, possibly assisted by a corporate service provider with qualified directors, which has a professional network and can assist in order to increase the chance that the structure will withstand the scrutiny of tax authorities when reviewed.

The IT infrastructure in the UAE, also provides a compelling non-tax argument to set up in the UAE. ADSL has mostly been replaced by 40 Mbps fibre optic connections. This provides a business rationale for operating an e-commerce server from the UAE. The purpose would be to positively establish a permanent establishment (PE) in the UAE, or in case the company is to be managed and controlled from the UAE, to attribute those functions to this company that would otherwise amount to a PE. This would provide the justification for allocating profits to the company. The PE concept applied to e-commerce is generally understood as follows:

- Data and software do not constitute a PE, i.e. a website does not constitute a PE
- Computer equipment may constitute a PE. This would be the case where the company owns the server (as opposed to renting space from an ISP) and transacts business through it
- These activities are not of an auxiliary nature
- The PE does not necessarily need personnel if none are 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, they could think of sourcing maintenance and development locally to have order processing and customer service provided by local staff. A RAK Free Trade Zone company would be an ideal low cost vehicle to operate an e-commerce operation as well.

The UAE has concluded approximately 50 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 tax in the context of the treaty. Some treaties also 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 that are worth mentioning, namely those with New Zealand, Austria and the Netherlands. None of these have liable tax requirements. 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 currently a particularly attractive country for inward investment into the UAE 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. 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 the latest country to conclude a tax treaty with the UAE. It has a similar participation exemption system regime, as in the Netherlands.

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