

# UAE tax treaties and benefits and dealing with anti-avoidance provisions

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**T**he days of “brass plaque” operations are coming to an end. More and more tax treaties incorporate anti-avoidance provisions and more and more countries are enacting specific and general anti-avoidance rules. The latest country planning to do so is India. The new direct tax code intended to enter 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 those which are not entered into for a *bona fide* purpose, will be caught by these provisions.

The Organisation for Economic Co-operation and Development (OECD) in its 2003 commentary to its model treaty worryingly states “A guiding principle is that the benefits of a DTC [Double Tax Convention] should not be available where the main purpose for entering into certain transactions or arrangements was 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 main consideration. The second clause causes confusion. But what is very clear in any case after the publication of this commentary, is that the OECD approves of domestic anti-avoidance provisions taking precedence over tax treaties.

The “beneficial ownership” requirement is an anti-avoidance clause which is normally included in tax treaties. It has been a long-standing requirement that the recipient of

dividends, interest and royalties is also the “beneficial owner”. A direction is emerging. No longer is it just agents and nominees that do not qualify as the beneficial owner of received income. In the well-known *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. The recipient did not enjoy the full privilege to directly benefit from the income.

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”, it is undeniable that a clear direction is beginning to emerge; 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 may 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 *bona fide* reasons, all of which can trigger the anti-avoidance legislation in the country that seeks to tax.

What does this have to do with the UAE or Ras al Khaimah in particular? It is hard to think of any other place in the world where it is so quick and easy to set up in business and to access the world’s labour pool. It is even more difficult to think of another traditional zero-tax jurisdiction which offers this. Freezones as a concept were pioneered by Dubai, the first one being Jebel Ali Freezone. Benefits of operating from a freezone include: 100% foreign ownership, guarantee against future imposition of taxation for a specified

period, no restrictions on hiring foreign labour. There is currently no direct taxation or VAT imposed in the UAE, nor are there significant restrictions on hiring foreign labour even for non-freezone companies; therefore freezones in this respect offer more peace of mind and investor security than anything else. However, a real direct benefit is that a local sponsor is not needed, a sponsor which otherwise could wield significant power. Another advantage of setting up in a freezone is that the freezone authorities provide a one-stop shop for dealing with government formalities, which makes it quick and easy to get started.

Ras al Khaimah is probably the most free-market oriented emirate of all. The Ras al Khaimah Investment Authority (RAKIA) markets its freezone in terms of appealing to the entrepreneurs and investors in general: lack of red tape, no restrictions on foreign labour, and business friendly policies. RAK Offshore (a company registry for IBCs) is marketed under the slogan: "an entrepreneur's paradise". 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. It is no surprise then that Ras al Khaimah is also the emirate that pioneered low cost freezone setups. Whereas in Dubai freezones, high office rents had to be paid (these have been significantly reduced now), Ras al Khaimah pioneered the provision of mini-offices, with office space starting from ten square metres as well as desk sharing solutions. RAKIA is currently the only freezone in the UAE that doesn't require a minimum capital.

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 difference with many traditional offshore jurisdictions is that there are abundant non-tax reasons for setting up in business. The strategic location between east and west make it the logical choice for setting up say a customer service centre, 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. 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 elements of the administration having to be put back onshore. This entails increased risk if these structures were to be reviewed. The fact that there is de-facto free immigration for anyone willing to work 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 who provides qualified directors, has a professional network, and assists with the realisation of a maximum of 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 ideal in the past, now also provides a compelling non-tax argument to set up in the UAE. ADSL 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 purpose would be to positively establish a permanent establishment (PE) in the UAE or where 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 in the UAE. This would provide 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, one could think of sourcing maintenance and development locally and have order processing and customer service provided by local staff. A RAK free 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 to tax in the context of the treaty. For example 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 that 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. The most important effect for outbound investment (from the perspective of the UAE) is it 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 most items of income that can be attributed to the UAE will be exempt from Dutch corporation tax even if has not been taxed in the UAE. In particular, UAE real estate gains and income 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. Another country that can be beneficially used for inward investment into the UAE is Cyprus. Cyprus has no tax treaty with the UAE but has an even more favourable participation exemption system than the Netherlands and it exempts profits made by permanent establishments abroad under domestic legislation.

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 offshore and realise the promised tax savings even if the structure is reviewed by onshore tax authorities.



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