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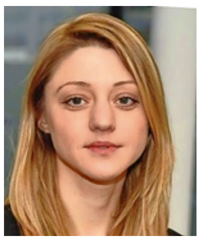
UAE

INSIGHT: BEPS Action 5—Impact on the UAE


BY SHIV MAHALINGHAM, ALENA KOVALOVA AND JAN RODERICK VAN ABBE

BEPS Action 5 focuses on no or low preferential corporate tax rate (preferential regimes) that can be classified as harmful tax practices.

In November 2018, the Organization for Economic Co-operation and Development (''OECD'') issued a press release relating to BEPS Action 5 preferential regime reviews conducted by the Forum on Harmful Tax Practices (''FHTP''). This article discusses the press release and accompanying guidance (or ''Global Standard Report'') specifics before concluding on the likely impact on no or only nominal tax jurisdictions (''NOONs'') such as the United Arab Emirates (''UAE'').

BEPS Action 5 Press Release and Global Standard Report A new Global Standard was announced for inclusive framework jurisdictions to prevent business activities from being relocated to NOONs to avoid the substantial activities requirement that applies to preferential regimes for geographically mobile income.

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The Global Standard Report highlights the importance of ensuring compliance via a common and effective approach, i.e. there should first be a mechanism to identify the entities conducting the relevant mobile activities and to detect whether the core income generating activities were being carried out. Second, there should be a mechanism to take action in the event an entity failed to meet the substantial activities requirement. Thirdly, there should also be enhanced spontaneous exchange of information.

Substantial Activities These are confirmed to include (but not be limited to) headquarters, distribution centers, service centers, financing, leasing, fund management, banking, insurance, shipping, holding companies, and the provision of intangibles. The activities should be undertaken in the location in question and employees/expenditures should be adequate and identifiable.

Geographically Mobile Income This will include income such as financial and other service activities, including the provision of intangibles (see below).

Distinction between Intangible v Non-Intangible Property The Global Standard Report identifies two basic categories of activities:

- activities earning non-Intangible Property (''IP'') income (which is set out in Annex D of the 2017 Progress Report); and

- activities for the exploitation of IP assets (which is the nexus approach set out in the Action 5 Global Standard Report).

Intangible Where the business activities are the exploitation of IP assets, the substance requirements used by the FHTP are the ''nexus approach'' which consists of two parts:

- a first part which sets out a formula to determine the amount of eligible income which can benefit from a lower tax rate; and
- a second part which is a consequence for the non-eligible income which is then taxed at the normal (i.e., higher) tax rate.

For a NOON jurisdiction, the challenge is that even though the formula could be applied (the result of which might be that there is zero eligible income), it is unclear how to apply the second part. In order to apply the principle underlying the nexus approach to NOONs, the Global Standard Report states that the best way forward is to apply a similar concept as applies for non-IP income, which is the core income generating activities guidance.

The Global Standard Report also provides guidance on how the substantial activities requirements will apply to NOONs for more specific cases generating IP income, i.e. patents and similar assets, marketing intangibles and other exceptional cases.

Non-intangible For activities within scope that earn non-IP income, this would mean that the NOONs would be required to meet the same substantial activities criterion applicable for IP-regimes, meaning that it would need to introduce laws to:

- define the core income generating activities for each relevant business sector;
- ensure that core income generating activities relevant to the type of activity are undertaken by the entity (or are undertaken in the jurisdiction);
- require the entity to have an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities; and have a transparent mechanism to ensure compliance and provide an effective enforcement mechanism if these core income generating activities are not undertaken by the entity or do not occur within the jurisdiction. The new Global Standard states that one enforcement mechanism could include striking an entity off the register. We also note that for example the draft legislation in Jersey provides for penalties of up to 10,000 pounds ($12,671) (first year) and up to 100,000 pounds for consecutive non-compliance with the new rules.

Planning Points The OECD press release opened with the following statement:

''An OECD-led coalition of 120+ nations has agreed that countries that impose no or only nominal taxes should be considered to have harmful tax regimes if multinationals are permitted to apply the country's advantageous tax regime to intellectual property or other mobile business income without having ''substantial activities'' — such as employees or expenditures — in the country''.

At first sight, jurisdictions such as the UAE in which a plethora of multinational groups operate, should not be impacted as it would be possible to demonstrate ''substantial activities'' as discussed in this article. The writers agree that a jurisdiction with strong commercial drivers for foreign direct investment (''FDI'') would be more robust to defend from challenge than a low tax jurisdiction with less commercial arguments; however, experience has demonstrated a few important considerations:

- BEPS guidance that intends to catch artificial transactions often pulls commercial transactions into the compliance net (in having to defend the position even if there is no artificiality in place); and
- Demonstrating commercial substance (especially when there is also a fiscal benefit) is not a straightforward process.

Therefore, we would caution groups operating in NOONs to review their operations in line with the above guidance.

It should be noted that the UAE (and many other NOONs) were not mentioned in the latest round of assessments that covered 53 preferential tax regimes. We may obtain more clarity at the next round of reviews in January 2019 and in defense of the UAE:

- A recent United Nations Conference on Trade and Development (''UNCTAD'') report on World Investment for 2017–18 confirmed that more than 25 percent of the world's 500 largest companies have the UAE as the regional base of their operations in the Middle East and North Africa (″MENA″);
- In the same study, the UAE is ranked 30th (globally) in terms of the quantum of FDI inflows (rising five positions from 2016–17 and continuing to move up this prestigious list). The UAE has moved above Luxembourg and is closing in on the UK when the comparison is honed down to global financial centers attracting FDI; and
- A recent World Bank 2018–19 ''Ease of Doing Business'' study witnessed the UAE climb 10 places from the previous year to rank 11th out of 190 business hubs. The World Bank study confirmed that ''The UAE has become a global hub for innovation, entrepreneurship and investment.''

It is a good commercial approach to attract investment across the spectrum with important business initiatives rather than attempting to appease international bodies by introducing a low level of corporate income tax (that may still fall under the definition of ''no or only nominal tax'').

That said, 2019 will continue the trend of significant tax change in the Middle East (and other locations impacted by these developments). Jurisdictions that will have the most success are the ones that will be able to manage both compliance with international standards and a commitment to attracting FDI.

See here for a high level comparison of regional holding companies.

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