

The introduction of corporate tax in the UAE: myth or reality?

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In recent years, the UAE has undergone significant tax changes to modernise its tax system to bring it in line with international best practices and standards and to diversify state revenue.

Looking ahead, the UAE may consider imposing additional taxes to help achieve its economic vision over the next 50 years. This article discusses the UAE's evolving tax environment and explores the possibility of the future introduction of a Federal corporate tax in the UAE.

Implementation of indirect taxes

The introduction of VAT had been under discussion in the GCC for more than a decade prior to the UAE establishing the Federal Tax Authority in 2016 to administer, collect and enforce Federal taxes, which currently comprise excise tax and VAT.

In 2015, the International Monetary Fund ('IMF') recommended that the GCC countries reform their existing tax systems by introducing VAT to tackle fiscal deficits and increase government revenue. The IMF estimated that the potential revenue from VAT at 5 per cent would represent around 1.5 to 2 per cent of the gross domestic product, depending on the individual country.

With a view to diversifying government revenue and reducing dependence on hydrocarbons, GCC countries agreed to a common legal framework to implement excise tax on selective goods that are considered harmful to human health and VAT on the supply and import of goods and services.

In line with these GCC agreements, the UAE introduced its first two taxes at the Federal level: Excise Tax at the rate of 100 per cent on energy drinks and tobacco products; and at 50 per cent on carbonated drinks from 1 October 2017 (expanded to e-smoking devices and liquids at the rate of 100 per cent and sweetened drinks at the rate of 50 per cent from 1 December 2019) and VAT at the standard rate of five per cent with effect from 1 January 2018.

Current direct tax environment for businesses

There are limited direct taxes in the UAE.

Currently there is no corporate tax in the UAE at the Federal level, but some individual Emirates impose a limited corporate tax on enterprises engaged in exploration and production of oil and gas at rates up to 55 per cent and on branches of foreign banks operating in the UAE at the rate of 20 per cent.

The UAE has also established many free zones that provide tax holidays and exemptions for terms of between 15 to 50 years.

UAE's drive to modernise tax rules

Over the past few years the UAE has taken significant steps to enhance tax transparency and facilitate the exchange of information for tax purposes by bringing its domestic tax rules in line with international standards. Many of the changes in the UAE were driven by the Organisation for Economic Cooperation and Development's ('OECD'), Base Erosion Profit Shifting ('BEPS') project which seeks to tackle international tax avoidance and address gaps in existing tax rules that allow the profits of multinational companies to be artificially shifted from high tax jurisdictions to low or no tax environments where little or no economic activity takes place. A 15-point BEPS Action Plan was developed by the OECD in partnership with the G20 countries in 2013.

The UAE already has a wide tax treaty network with over 90 double taxation treaties in place with other countries. These treaties seek to eliminate double taxation and facilitate the exchange of tax information on a bilateral basis. In addition, the UAE has implemented the Common Reporting Standard for the automatic exchange amongst tax authorities of financial account information of foreign tax residents. In this regard, the UAE signed the OECD Convention on Mutual Administrative Assistance in Tax Matters in April 2017 and ratified the same in April 2018.

The UAE became a BEPS inclusive member in May 2018, together with more than 135 other countries, committing to the implementation of four minimum BEPS standards, namely countering harmful practices (Action 5), countering treaty abuse (Action 6), transfer pricing documentation and country-by-country reporting (Action 13) and improving dispute resolution mechanisms (Action 14).

In July 2018, the UAE signed and subsequently ratified the Multilateral Competent Authority Agreement to complete the implementation of the Common Reporting Standard and to facilitate compliance with various BEPS transparency measures including the exchange of country-by-country reports under BEPS Action 13.

In line with its commitments as a BEPS inclusive member, the UAE has taken various measures to implement the minimum BEPS standards. The UAE signed up to the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in June 2018 (also known as the "multilateral instrument") allowing the UAE to modify existing double tax treaties without the need for protracted bilateral negotiation. The UAE also issued initial substance regulations and a cabinet resolution on country-by-country reporting with effect from April 2019.

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Recent international tax developments

One of the key areas of focus of the OECD BEPS project was Action 1 which addressed the tax challenges of the digital economy. There was a concern that existing international tax rules were outdated and had not kept pace with the rapid digitalisation of the global economy, which has changed the way many businesses are structured and conduct business. The OECD work on Action 1 is based on two pillars and has become known as the BEPS 2.0 project. Pillar 1 deals with the allocation of taxing rights between jurisdictions and nexus rules whereas Pillar 2 deals with the proposal for a global minimum tax regime.

Recently the OECD issued a blueprint on Pillar 2 which deals with the development of global minimum tax rules to ensure that worldwide income of businesses is subject to an agreed minimum rate of tax regardless of where they are headquartered or operate thereby limiting the incentives for businesses to locate functions, activities and profits in low-tax jurisdictions.

The blueprint includes an income inclusion rule and an undertaxed payments rule (known as the global anti-base erosion (GloBE) rules) and a Subject to Tax rule. The income inclusion rule gives countries the ability to include foreign income of overseas subsidiaries and branches in its tax base if that income is taxed at below a minimum effective tax rate in the jurisdiction of the subsidiary or branch. The undertaxed payments rule increases the tax base of the payer by disallowing a tax deduction or requiring an adjustment where the payment is not subject to tax at the global minimum effective tax rate in the hands of the recipient. The Subject to Tax rule denies treaty benefits and imposes a withholding tax or other means of source taxation on payments if they are not subject to a minimum rate in the country of the recipient.

While there are still some political and practical obstacles to the proposals under Pillar 2 and building consensus amongst member jurisdictions of the Inclusive Framework has been a major obstacle, the blueprint is intended as a basis for future agreement. A number of areas require further work and agreement, including the minimum tax rates (the blueprint suggests 10 per cent to 12 per cent for the GloBE proposal and 7.5 per cent for the Subject to Tax rule). The timeline for reaching an agreement and resolving any outstanding issues has been set at mid-2021. As a next step, the Inclusive Framework will need to achieve an agreement on the development of model legislation, standard documentation and guidance, designing a multilateral review process if necessary and exploring the use of a multilateral convention.

The proposals under Pillar 2 represent a radical change to the international tax rules and go beyond taxing only digital businesses. Previously, the OECD had stated that the digital economy was becoming the entire economy itself and so specific rules designed for the digital economy would not work and, as such, the digital economy cannot be ring fenced. Accordingly, if the proposals under Pillar 2 are implemented, it would have major implications for multinational companies headquartered or operating in the UAE. A number of countries have already taken unilateral measures and implemented their own digital services tax based on the OECD work under Action 1 and Pillar 2 and it is possible that other countries could implement their own minimum tax rules based on the OECD framework if a consensus is not reached by mid-2021.

Currently most jurisdictions tax income if the entity generating the income is resident or has a permanent establishment in the country or otherwise the entity derives local source income. A consequence of Pillar 2 is that, subject to any minimum threshold (currently a EUR 750 million annual group consolidated revenue threshold is proposed in order for the rules to be applicable to a multinational enterprise), overseas jurisdictions will be granted additional taxing rights where other jurisdictions such as the UAE have not exercised their taxing rights or income is subject to low rates of tax.

Concluding thoughts

Taxes are the main source of revenue for most countries globally. While taxes generally help governments to generate additional revenue and fund public expenditure, there is a major difference between direct taxes such as corporate tax and indirect taxes like VAT and excise tax.

VAT and excise tax are indirect taxes collected by businesses on behalf of the government and are intended as taxes on consumption that should be borne by the final consumer. As such, although there is a compliance burden and a cost for businesses in accounting for indirect taxes, the economic cost of VAT and excise tax should be passed on to the ultimate consumer and generally should not represent a direct cost to businesses. Therefore, such taxes are generally investment neutral. On the other hand, corporate tax is a disincentive for foreign direct investment because it is directly imposed on the taxable profits of companies. The absence of a Federal corporate tax in the UAE is very attractive for businesses operating or seeking to invest in the UAE and the encouragement of foreign investment into the UAE is an important

part of domestic policy.

It is for these reasons that the implementation of VAT and excise tax was a popular choice and historically limited direct taxes have been maintained on businesses. While the UAE has expanded its tax base with the implementation of indirect taxes and Federal corporate tax has been under discussion in the past, it has so far been reluctant to introduce a corporate tax at the Federal level.

Although the UAE introduced substance rules and implemented other measures based on its international commitments, this was with a view of facilitating tax transparency and tax information exchange in order to prevent companies from avoiding taxes in other countries by artificially shifting profits from those countries to the UAE with little or no local substance. No country or institution can require or force the UAE to introduce corporate tax. Indeed, countries are entitled to have limited or no corporate tax to give themselves a competitive advantage and to attract foreign investment. As such, the right to introduce corporate tax is the UAE's sole prerogative and whether or not corporate tax is ultimately adopted will be a sovereign decision taken by the UAE based on local economic and political considerations.

However, in determining whether or not to introduce corporate tax, the UAE will also need to monitor and take into account international developments arising as a result of the OECD's BEPS 2.0 project. In light of these radical changes to the international tax landscape, the UAE faces an interesting policy dilemma.

Clearly there are benefits in introducing a Federal corporate tax as it would enable the UAE to generate additional revenue in line with its diversification strategy and future vision. In addition, the implementation of a Federal corporate tax at the rate of between 10 per cent and 15 per cent should not necessarily make the UAE less competitive in the region given that four of the six GCC countries already have a comprehensive corporate tax system with Saudi Arabia imposing corporate tax at 20 per cent, Qatar at 10 per cent, Kuwait at 15 per cent and Oman at 15 per cent.

The question is, therefore, whether the UAE should further expand its tax base by introducing a minimum level Federal corporate tax and realise tax revenue from companies that operate in the UAE, or risk maintaining the status quo and allow other countries to tax UAE businesses in the future which would erode one of the historical benefits of doing business in the UAE. Going forward, the introduction of corporate tax in the UAE may become a necessity rather than strictly a "choice".

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