

UAE signs BEPS Multilateral Instrument: potential impact for UAE businesses

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Executive summary

On 27 June 2018, the United Arab Emirates (UAE) signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Multilateral Instrument or MLI). Once ratified, the MLI will modify the effect of many UAE tax treaties. Businesses operating in the UAE should review their holding, financing, intellectual property (IP) and supply chain structures to ensure that:

- ▶ The structures remain relevant in light of current and potential Base Erosion and Profit Shifting (BEPS) developments.
- ▶ The MLI will not limit access to benefits under UAE tax treaties.

Detailed discussion

Background

Since the Organisation for Economic Co-operation and Development (OECD) and G20 countries adopted a 15-point BEPS Action Plan in 2013, BEPS has remained a key priority for governments around the globe. The Final Reports, issued in 2015, represent a package of measures that governments should implement to address features of tax regimes that facilitate BEPS. The package includes a set of minimum standards.

In December 2017, the UAE Government committed to implementing the BEPS minimum standards by the end of 2018. As a result, the European Union (EU) removed the UAE from a blacklist of countries that were not considered to be cooperating sufficiently in progressing international anti-BEPS initiatives.

In May 2018, the UAE became the 116th country to become an Associate Member of the BEPS Inclusive Framework, committing the UAE to aligning with the shared international consensus on international tax rules. On 27 June 2018, the UAE signed the MLI, which is an important step in implementing the minimum standard relating to tax treaty abuse.

This Alert focuses on the MLI, and what it might mean for businesses located in Dubai.

The MLI

One of the BEPS minimum standards (Action 6) involves the prevention of treaty abuse, where taxpayers claim treaty benefits that the treaty countries did not intend to grant. Treaty shopping is one example, when a multinational may establish a passive holding company in a jurisdiction solely to benefit from preferential treaty rates available to tax residents in that jurisdiction.

The minimum standard under Action 6 require countries to implement rules in their treaties that limit the opportunities for treaty abuse. For existing treaties, this would be a problematic exercise if bilateral solutions (i.e., treaty renegotiation) were required. The MLI was developed to address this. The MLI allows a signatory to indicate those of its treaties (referred to as Covered Tax Agreements or CTAs) to which the MLI will apply. If the treaty partner is also a signatory and identifies the treaty as a CTA, the MLI provisions will be incorporated into the bilateral treaty once the MLI is ratified by both countries.

As noted, the UAE signed the MLI on 27 June 2018 and is expected to deposit the instrument of ratification by early 2019. The UAE provisionally identified 114 treaties as CTAs when it signed the MLI, so the MLI will have significant effect. The final list of CTAs will be determined when the UAE submits the instrument of ratification.

Effect of the MLI provisions

Many MLI provisions allow each country to either decide whether to adopt the provision, or to select one of several possible approaches on an issue. When the MLI is applied to a CTA, the lower of the standards that the two countries adopt will apply to that CTA.

Generally, where positions in the MLI are optional, the UAE has elected not to adopt them. For issues on which each country must adopt a position, the UAE has generally adopted the position that has the least effect on CTAs. Many countries have adopted a similar approach. However, the UAE has been required to adopt a position on several key issues that could significantly affect the application of UAE tax treaties.

New preamble

The MLI requires countries to adopt a preamble that updates the objectives of CTAs:

- ▶ Eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided for the indirect benefit of residents of third jurisdictions).
- ▶ Further develop their economic relationship and enhance the cooperation in tax matters.

Because the preamble forms part of the context of a treaty, the statement and objectives should be taken into account when interpreting provisions of the treaty, including anti-abuse rules inserted by the MLI. The primary objective will still be avoidance of double taxation, but it remains to be seen how countries will understand the reference to non-taxation in the absence of corporate taxation in the UAE. In principle, the preamble should raise concerns only if non-taxation arises through tax evasion or avoidance, but this standard is not applied consistently around the world.

Principal purpose test

The main component of Action 6 was to choose between the limitation of benefits (LOB) and principle purpose test (PPT) approach to tax treaty abuse:

- ▶ LOB would limit the availability of treaty benefits to entities that meet certain conditions, based on the legal nature, ownership in, and general activities of the entity.
- ▶ The more general PPT is based on the principal purposes of transactions or arrangements. If one of the principal purposes is to obtain treaty benefits, these benefits may be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

The UAE has chosen to apply the default PPT rule in its CTAs.

The PPT is mainly likely to affect outbound investment. Currently, a UAE entity will generally be able to obtain treaty relief based on demonstrating that it is tax resident in the UAE (e.g., based on a tax residence certificate) and if necessary demonstrating that the beneficial owner of income is resident in the UAE. Once PPT comes into effect, outbound investors may also need to show that tax treaty considerations have not been the driver for the investment structure. It is also unlikely that countries will, initially, understand and apply PPT consistently, so it may take some time before it is clear what approach each country will adopt to applying PPT.

Enhancing dispute resolution

The MLI contains a provision that allows taxpayers to initiate a Mutual Agreement Procedure (MAP) to resolve treaty problems with either party to a CTA. The UAE has not made a reservation on this provision. If CTAs incorporate this provision, it may allow UAE investors to initiate MAP in a source country, which may not be an option under current tax treaties.

Implications

The UAE Government's decision to join the Inclusive Framework and commit to implementing the BEPS minimum standards will help to strengthen the UAE's business and investment reputation in the Middle East. Signing the MLI is an important step in the ongoing BEPS process.

Businesses operating in the UAE need to review their holding, financing, IP and supply chain structures to ensure that they remain relevant in light of current and potential BEPS developments, and to reduce the risk that the MLI could impact access to benefits under UAE tax treaties. Businesses with limited economic operations are most at risk. Investment structures should be stress-tested to determine the potential level of risk once the MLI is ratified, and to determine whether new business models should be adopted.

Beyond the ratification of the MLI, businesses will need to monitor how the tax authorities in jurisdictions where UAE entities invest or operate apply the PPT rule. Businesses also need to monitor how those jurisdictions address broader BEPS concerns. Outside the minimum standards, several Actions focus on tightening the rules for measuring income, such as interest deductibility. Anti-BEPS initiatives will create significant challenges for groups whose income recognition does not align with value creation.

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