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The application of tax treaties in GCC low-tax jurisdictions

The GCC states, in their efforts to attract larger volumes of foreign investment, are increasingly willing to enter into and conclude bilateral foreign investment treaties, including bilateral investment treaties, free trade agreements and double taxation agreements. Of particular interest and some debate is the application of tax treaties in the low-tax jurisdictions of Bahrain and the UAE. Bahrain's tax laws only apply to the profits of oil companies, while, within the UAE, although general taxing provisions apply to all businesses, in practice only the profits of oil companies are taxed.

A typical (OECD) residence definition is provided as follows:

the term "resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, place of management, place of head office or any other criterion of a similar nature. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

In the case of Bahrain, an absence of a general tax law, could, if read literally, preclude a Bahrain-registered company from qualifying for treaty benefits in those treaties where the standard OECD language is used.

In the case of the UAE, which has promulgated general income taxing laws, the point that needs to be addressed, in the treaty context, is whether UAE entities are liable to tax (notwithstanding that, in practice, most businesses do not pay income tax) and, as a corollary to that, whether such tax arises by reason of, for example, its domicile or residence.

Application of treaty "residence" provisions in the context of UAE tax laws

Even if it is established that a UAE entity is liable to tax although not enforced, a further contentious requirement under the OECD Model Treaty, is that liability to tax should have arisen "by reason of domicile, residence...".

A literal reading of the OECD Model Treaty would imply that to qualify as being resident "by reason of domicile, residence...etc", an entity should be taxable on all income from wherever it is derived (that is, world income). This is underscored by the closing paragraph of the residence definition (reproduced above), which disqualifies any person from being resident if he "is liable to tax in that State in respect only of income from sources in that State or capital situated therein".

Based on the above definition a UAE-registered entity would not be resident because its income even if it is deemed to be taxable would be limited to UAE source income under the terms of the UAE tax decrees.

However, it would appear that the OECD Model Treaty when drafted was not intended to be interpreted in this manner. In this context it is useful to consider the commentary or rationale leading to the inclusion of a residence definition worded similar to the extract above. In particular, the OECD does recognize that there may sometimes be conflict in applying standard treaty terminology, where the tax systems of partner states conflict. The commentary recognizes that treaties between countries with a territorial basis of taxation and a residence basis of taxation can create ambiguity on the way in which "residents" are defined and interpreted by the respective tax authorities. The commentaries make the following observation:

...a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in the State or to capital situated in that State.....This, however, has inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended.

It is clear from the above observation that a pragmatic approach is encouraged, since the denial of treaty benefits on the issue of residence renders the treaty worthless. The commentary advocates the "development of spontaneous exchanges" by governments to clarify the issue where there is doubt or to create "special provisions in the Convention" at the time treaties are drafted.

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