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Dubai makes a bid for e-business

Substantial inward investment taking place in a sensible and efficient tax system makes Dubai Internet City a serious consideration for any company seeking a suitable location for its e-business hub. Robert Peake, Dubai, explains why

Despite only being formally launched in October 2000, Dubai Internet City has achieved considerable success. About 200 companies have registered so far and the first phase of accommodating new businesses is already over-subscribed. Companies who have committed themselves to locating operations in Dubai Internet City include several major multinationals such as Microsoft, Oracle, Sun Micro-Systems, Compaq, IBM, and MasterCard.

Dubai has established itself as the regional leader in establishing new and innovative free zones: Jebel Ali Free Zone, with its large multi-purpose sea port, is the most famous; there is also the more recent Dubai Airport Free Zone, offering close proximity to Dubai International Airport. Dubai Internet City is part of the third free zone to be established in Dubai.

Dubai Internet City is a dedicated location a short distance from the centre of Dubai City. It is at the heart of a major construction of residential and leisure properties that will create a new city, easily reached from Dubai International Airport. Companies locating in Dubai Internet City will have the choice of offices in pre-built office buildings or, like Oracle and Microsoft, building their own purpose-built offices within the site. The City is committed to providing a world-class technical infrastructure, including high bandwidth and low-cost access to a state-of-the-art telecommunications infrastructure. However, its greatest strength is probably its ability to bring together a community of companies and facilitate strategic alliances.

Dubai Internet City is actually one of three initiatives situated within the Dubai Technology, Electronic Commerce and Media Free Zone. The other two initiatives are Dubai Media City and the Dubai Ideas Oasis.

Dubai Media City is designed to provide a location and infrastructure for all kinds of media business, broadcasting, publishing, advertising, public relations, research, music, post-production etc.

Dubai Ideas Oasis is a "community of entrepreneurs, incubators, venture capitalists and other enabling organisations". The objective is to capture new e-business ideas and bring together the incubation, capital and other support necessary to take the ideas from concept to the market place.

Whilst Dubai Internet City may be the most successful of the three initiatives to date, its unique combination with the other two initiatives makes the free zone the first of its kind in the world. A measure of the impact of the Dubai Internet City after such a short period is that it will be the host in January 2001 of the OECD Emerging Market Economy Forum on Electronic Commerce. The Forum is due to discuss a wide range of issues including current views on the taxation of e-commerce.

Investment incentives

Businesses located in Dubai Internet City (and the other two initiatives) benefit from a renewable 50-year tax holiday. This may seem unnecessary when neither the United Arab Emirates nor Dubai generally tax companies or individuals. In fact, Dubai, like most of the other emirates, does have a comprehensive tax decree. Introduced in 1969, the decree subjects any company (wherever incorporated), that carries on a trade or business through a permanent establishment in Dubai, to tax on the profits derived from that trade or business.

In practice, only oil and gas production companies and branches of foreign banks are actually assessed for and pay income tax. The tax holiday therefore gives an investor the assurance that, should Dubai ever start to universally apply a tax system, then both the business profits and the salaries of employees arising in Dubai Internet City will continue to be free of income tax. There is no federal income tax legislation in the UAE.

The other major incentive offered by Dubai Internet City is that 100% foreign ownership of enterprises located in the free zone is permitted. Companies have the option of either establishing a branch or founding a separate corporate legal entity known as the free zone limited liability company (FZLLC). The FZLLC may have one single or several shareholders.

The significance of this freedom of foreign participation needs to be placed within the context of a historical restriction on foreign participation in businesses throughout the Gulf region. Outside the free zones, foreign companies operating within the UAE typically have to use joint venture companies in which their shareholding is limited to 49%. Alternatively, they must enter into commercial agency arrangements with a local business to sell their products within each emirate.

Whilst neighbouring states are in the process of investment reform to open up investment by foreigners, restrictions continue. Even in the case of Saudi Arabia, whose new investment law has received a warm welcome from foreign investors, the publication of the excluded activities list has been delayed due to internal disagreement over its scope.

In principle, a business located in one of the free zones wishing to conduct business within one of the emirates needs to operate in exactly the same way as a foreign company. For example, a company using one of the free zones to import and distribute in the region, should still appoint a local commercial agent if it wishes to distribute the products within Dubai. However, Dubai appears to accept that the role of a commercial agent does not fit easily with a situation where transactions may be conducted directly over the internet with companies located in Dubai Internet City.

This obviously has wider international implications in the region. Countries that normally restrict foreigners from selling certain types of product within their country are going to find it difficult to prevent the same products being sold directly to their residents over the internet. Potentially this may include such sensitive sectors as insurance and banking. From the perspective of countries in the region, e-business may do more to break down restrictions on foreign participation in the domestic market than changes to foreign investment laws or impending WTO membership.

Other incentives in Dubai Internet City include the ability to acquire land on 50-year renewable leases, customs duty exemption on the import of equipment and materials, and a simplified and less bureaucratic government registration process for the issue of trade licences, work permits, visas etc. The latter is particularly welcome as a contrast to the bureaucracy and delays that unfortunately so often characterize business affairs in the region.

Dubai Internet City as an e-business centre

What clearly distinguishes Dubai Internet City from other tax-favoured locations is that it has the infrastructure to maintain real business operations. This is not only in terms of technology; its geographical position allows it to access the skills pools of e-business workers in the Indian sub-continent, Egypt and Jordan. It is also an attractive location for executives relocating from Europe or North America. Its tax-free environment for salaries enables it to be a highly competitive location with reasonable salary costs.

In due course, a local pool of trained workers will become available as various e-education initiatives in the emirates develop, including the establishment of an Internet University within Dubai Internet City. Furthermore, the free zone is establishing a 'talent bodyshop' to provide temporary and contractible skilled workers.

All the above make Dubai Internet City a realistic base for business operations. Consequently, an operation in the free zone can meet the substance requirements of many of the controlled foreign company and other anti-tax haven legislation found in many investor countries.

Tax treaties

The United Arab Emirates is a signatory to about 20 tax treaties. This is clearly a large number for a country that does not generally tax companies or individuals. However, the value of these treaties may be limited by the fact that they generally follow the OECD model by determining a "resident of a contracting state" as a person who, under the laws of that contracting state, is "liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature".

The issue is that there is no UAE tax law and liability to tax in the individual emirates is by virtue of trading through a permanent establishment and not by virtue of domicile, residence etc. Thus it would seem that many of the UAE treaties may not be used by a company incorporated within Dubai Internet City (or within the UAE generally). There are one or two possible exceptions.

The French treaty defines a resident as simply any person "domiciled, established or with its place of management in the UAE, including the state of the UAE, its political subdivisions and local authorities". This would appear to include a company incorporated in Dubai Internet City. The German tax treaty has a comparable definition of residence to the French tax treaty. However, a limitation on benefits article and a protocol make it clear that ultimately only individuals who are residents of the UAE or a government institution of the UAE should benefit from the treaty.

A broader definition of "resident" in the Pakistan treaty may enable this treaty to be used by any "industrial or commercial establishment" located in Dubai Internet City.

Generally speaking, the tax treaties are more interesting for the way that they may determine the tax liability in an investor country rather than in enabling Dubai Internet City as an international e-business hub. The degree to which the free zone's lack of access to treaties for outward activities affect tax liabilities, will depend on the nature of the e-business and the domestic tax legislation of the countries into which business is conducted.

To the extent the activities would benefit from tax treaties, the best option is for tax treaties to be accessed by making the Dubai Internet City operation a branch of a country with a significant treaty network. Possible options are covered in the next section.

Investing in Dubai Internet City

An important aspect of the flexibility possible when investing into Dubai Internet City is undoubtedly the choice of whether to use a branch or an incorporated entity. This assists in structuring the investment in a tax-efficient manner. The following looks at alternative holding arrangements for Dubai Internet City operations.

France is the only country with a significant treaty network in the region. France, therefore, has immediate potential as a location for an entry strategy. The France-UAE tax treaty is an interesting one. Under the elimination of double taxation article, a branch of a French company in the free zone is subject to tax in France. However, provided it can be shown that the branch is not situated in the UAE "mainly for tax purposes", a tax credit is available that is equivalent to the French tax payable. In other words, there is a tax-sparing provision that effectively results in no tax being borne in France.

However, this analysis is subject to the French 209B controlled foreign companies legislation. An important exemption to 209B is the "local market" test, that will exclude a foreign branch or company from French taxation under 209B if more than 50% of its income is from active business in the local market. The definition of "local market" is not entirely clear. Should it include just Dubai, the UAE or neighbouring Gulf states? Furthermore, it has yet to be seen how the concept of local market can be applied to e-business conducted through the internet. However, despite these questions, a free zone branch of a French company clearly raises interesting possibilities for regional e-business.

The position under the Germany-UAE tax treaty is possibly clearer than in the French position. In the relief from double taxation article, a German company will not generally be taxed on the profits arising from a branch located in Dubai Internet City. Nor will a German company be taxed on dividends received from a company incorporated in the free zone, and in which there is at least a 10% holding. However, the treaty relief is subject to the anti-abuse provisions of the German foreign tax law. Provided that the activities in Dubai Internet City constitute an active trading business, it should be possible to fall outside these provisions.

It is understood that a UK-UAE tax treaty is awaiting ratification. It is unlikely that this treaty will alter the usual treatment of branch profits being taxable on a current-year basis, and the profits of a company being taxed when distributed as a dividend. Provided Dubai Internet City is used for real business, the 'exempt activities' test of the controlled foreign companies legislation should be passed. Recent changes to the UK system of double tax relief has restricted the possibilities of offshore dividend mixing of the zero-taxed dividends from the free zone with dividends from high-taxed jurisdictions. It may be expected that future tax-efficient structures will focus on using an offshore jurisdiction to 'mix' profits from high- and low-taxed branches.

The optimum structure for US companies will depend on the particular circumstances and foreign tax credit position of individual companies. However, in this context, it may be noted that the free zone limited liability company should qualify for check-the-box categorization as a branch or partnership.

For many US and UK multinationals, the use of intermediate companies continues to play an important role in international tax planning. This raises the obvious question as to whether the Dutch participation or branch exemptions will be available if a Dutch intermediate company is used. To date there have been some favourable Dutch tax rulings with respect to corporate entities located in other free zones. These rulings have relied on the fact that the companies are subject to tax under the relevant emirate tax decree.

In some cases, the position appears to have been improved by the existence of tax holidays, since their existence confirms that companies are subject to tax but for the tax holidays. This position regarding the participation exemption should also extend to the overseas branch profits exemption.

However, previous examples of free zone entities qualifying for the participation exemption have been where the tax holiday has been available for up to 15 years.

It remains to be seen how the Dutch tax authorities will view the 50-year tax holiday in Dubai Internet City. It may mean that alternative holding locations such as Austria and Switzerland, that do not have the same stringent 'subject to tax' provisions are better suited. Although, of course, the tax treaty networks of these latter countries make a free zone branch less attractive than if it were a branch of a Dutch company.

Conclusion

The investment being made in the infrastructure of Dubai Internet City as well as its geography make the free zone an attractive e-business location. Together with the beneficial tax position, Dubai Internet City provides a combination of commercial substance with tax efficiency that is rare.