Establishing an RTC in ADGM for MNCs headquartered in the UK

Abu Dhabi Global Market

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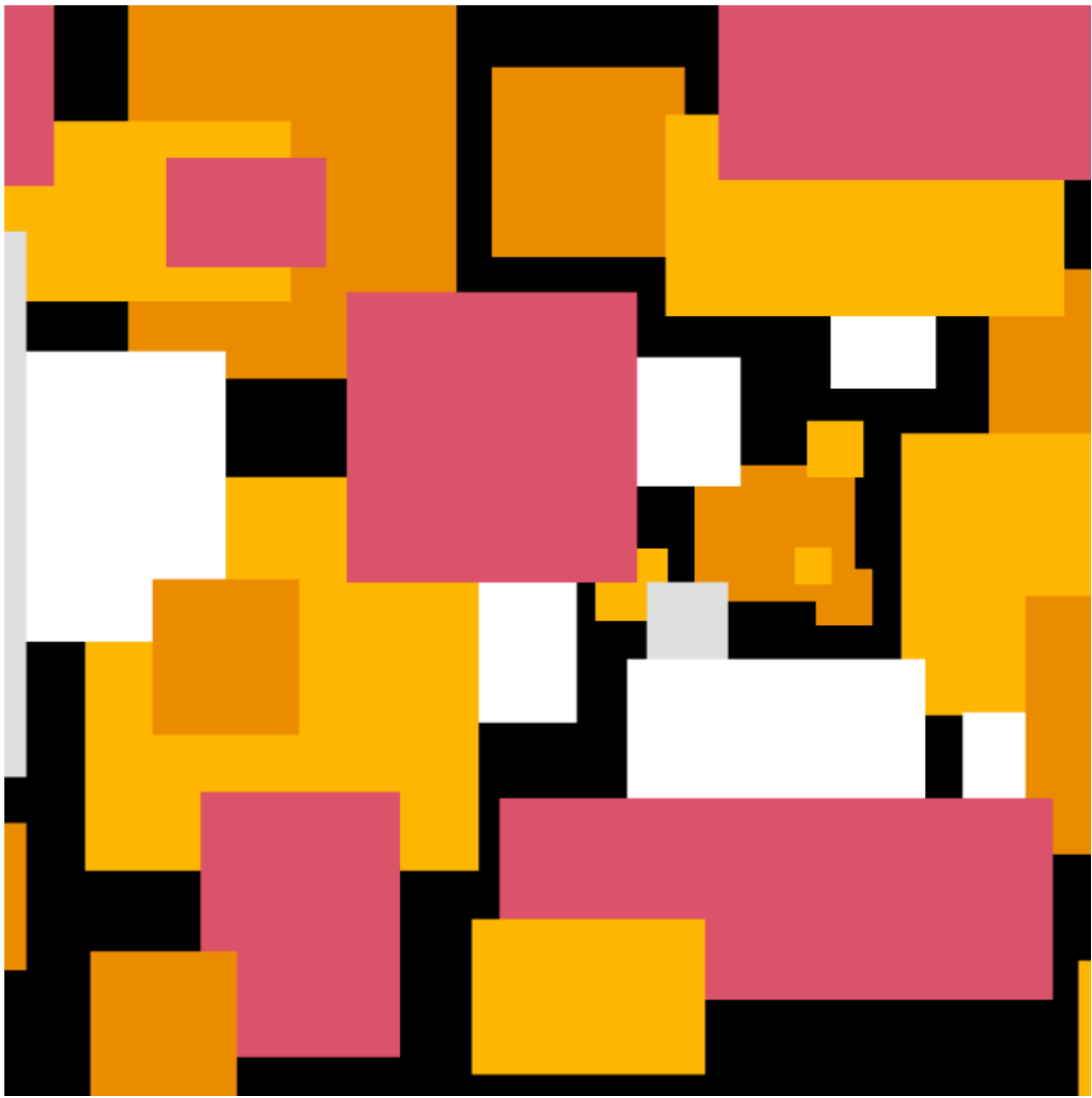

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Contents

1. Establishing an RTC in ADGM for MNCs headquartered in the UK

1.1. Introduction

A number of multinational companies ('**MNCs'**) and other organisations have established Regional Treasury Centres ('RTCs') in the United Arab Emirates ('**UAE'**) in recent years, including in Abu Dhabi Global Market ('**ADGM**').

The UAE and ADGM in particular are often chosen as a preferred location because of the business-friendly environment, political stability, internationally aligned regulatory and judicial regimes, quality of the infrastructure, a favourable tax environment and a geographic location which is particularly convenient for treasury transactions across Europe, Middle East and Africa. A number of UK and other European headquartered groups have therefore chosen the UAE as a location for their regional headquarters and related functions.

This document provides an overview of the legal and tax framework applicable to RTCs in ADGM and discusses some of the UK tax issues that may be relevant to establishing and managing RTCs in ADGM from the perspective of a UK headquartered MNC.

1.2. ADGM

ADGM is a federal financial free zone located in Abu Dhabi that was established in 2013 as a strategic initiative of the Government of Abu Dhabi with a mandate to provide the physical, market and financial infrastructure required to establish Abu Dhabi as a global financial and business centre.

ADGM has its own civil and commercial legal regime, directly applying English common law, within the defined geographical area of the free zone. The regime is broadly independent of the existing legal regime in Abu Dhabi; Abu Dhabi civil and commercial laws (comprising both emirate laws and Federal laws of the UAE) do not apply in ADGM. ADGM also has its own independent registrar, financial services regulator and independent courts with a bench made up of highly experienced and eminent judges from leading common law jurisdictions around the world. Essentially, ADGM is a common law jurisdiction within, but independent from, the civil law jurisdiction of the UAE.

ADGM offers a 0% corporate income tax rate to ADGM companies and branches. In addition, the UAE does not impose stamp taxes, withholding taxes, wealth taxes, or employment taxes. As such, an ADGM RTC should not be subject to income or transactional taxes in the UAE.

Interest income and FX margins would generally not be subject to VAT in the UAE or would be zero-rated. The provision of advisory and transaction services may be zero-rated or subject to a 5% VAT, depending on the nature of the service and the location of the customer. Accordingly, depending on the specific circumstances, an ADGM RTC should be able to recover at least a portion of the input VAT it incurs on costs.

ADGM entities can benefit from the extensive UAE double tax treaty network, which includes 92 in-force treaties and a further 40 in various stages of negotiation, signature or ratification. Many of these treaties allow UAE companies to benefit from a zero-withholding tax on interest payments, or, if not zero, the lowest withholding tax rate which is generally available under double tax treaties. The UAE's double tax treaties reduce the average withholding tax on interest from 9.58% to 6.63%, compared to 7.08% under the double tax treaties of the UK.

With a number of the fastest growing African economies in close proximity to the Gulf, the UAE has become a gateway for multinational companies and investors doing business in Africa and the Middle East. This has been coupled with a fast-growing double tax treaty network in the African continent and the Middle East.

The UAE has the most (in force and awaiting ratification) double tax treaties in Middle East and Africa compared to the UK and other comparison jurisdictions. The UAE double tax treaty network includes in-force double tax treaties with key markets such as Saudi Arabia, Egypt, Algeria, South Africa, Morocco and Kenya.

1.3. UK tax considerations

Set out below are some key issues to be taken into consideration with respect to establishing and managing RTCs in ADGM from the perspective of a UK headed MNC.

Key issue	Implications for an ADGM RTC
UK CFC regime	The UK CFC regime is intended to focus on corporate profits in low tax subsidiaries which are not supported by commercial business rationale, or by significant 'substance' (in the form of people with significant roles, business premises etc. outside the UK). Therefore, an ADGM RTC formed for commercial reasons, interacting with local financial services counterparties, and supported by significant senior staff on the ground in ADGM should be well placed to ensure it is not subject to tax under the UK CFC regime provided it does not rely on UK capital, people functions and management of risks. For UK headed groups the capital of a newly formed RTC is likely to be considered UK sourced but a partial exemption should ensure that a maximum rate of 4.75% applies to the relevant finance profits (i.e. 75% exemption based on a headline rate of 19%).
Residence	If a UAE company's board exercises its decision-making power from the UK, that company could be considered as UK resident (and subject to UK corporation tax) even if day to day management and operations (as well as place of incorporation) are based elsewhere.
Dividend exemption	If distributions are made from an ADGM RTC to a UK parent company, then they should not be taxable in the UK by virtue of the distribution exemption.
Gain from the disposition of RTC shares	A gain from the disposition of the shares of an RTC by its UK parent may give rise to a chargeable gain unless the requirements of the Substantial Shareholding Exemption are met (largely dependent on whether the RTC is considered 'trading' for UK tax purposes).
Deductibility of interest expense	Where a UK company may be borrowing from an ADGM RTC, anti-avoidance measures such as the Corporate Interest Restriction ("CIR") rules will be relevant in determining whether there should be a limit to the UK tax deductions that can be taken for associated financing costs. Such rules are intended to prevent companies from taking a disproportionate share of the group's finance expense in the UK to reduce their UK tax burden.
Withholding tax exemption under UK-UAE tax treaty	Interest paid to an ADGM RTC from the UK should be exempt from withholding tax in the majority of cases. Advanced clearance would be required from HMRC before interest could be paid without withholding tax.
Transfer pricing	The UK's transfer pricing legislation sets out how transactions between connected parties are to be priced and is based on the 'arm's length principle'. Conformity with this principle is determined by comparing the price of transactions between connected parties to the price of transactions between unrelated parties in comparable conditions. Accordingly, care needs to be taken in determining whether the split of profits of RTCs is in line with the division of risk and responsibility.
Taxation of deposits in overseas operating companies	Care should be taken where a company whose business is itself exempt from a CFC charge has excess cash which it deposits at the RTC. There is a risk that the excess cash gives rise to non-trading income which is not exempt. In general, cash giving rise to profits which represent less than 5% of the operating company's profits of a period would be considered 'incidental' and therefore not subject to tax under the UK CFC rules.

1.3.1. UK CFC regime

UK CFC rules could potentially subject the profits of an ADGM RTC to UK taxation if found to apply. UK MNCs would need to consider whether and how the CFC rules would apply in their specific circumstances and factor any incremental UK tax into their considerations around establishment of an ADGM RTC.

The current UK CFC legislation was introduced with effect from 1 January 2013. A CFC is a company which is resident outside the UK, but controlled by UK residents (directly or indirectly). A UK resident company may be taxed on a proportion of the profits of certain UK-controlled, non-resident companies in which the resident company has an interest. The overall intention is to tax profits that have been artificially diverted from the UK.

1.3.1.1. Overview of the UK CFC regime

Broadly, profits of a non-UK resident CFC will be taxed, using normal corporation tax rates and rules, on the persons controlling the CFC if (i) the profits pass through the CFC 'gateway' and (ii) are not exempt.

The 'gateways' are a series of tests that identify profits that are, broadly, artificially diverted from the United Kingdom. The gateway tests are contained in Chapters 4 to 8 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010):

- **Chapter 3** – Initial gateway to determine which, if any, of chapters 4 to 8 apply. Its purpose is to exclude CFCs that present a low risk of UK profit diversion from the regime in a relatively simple way.
- **Chapter 4** – Profits attributable to UK activities – This chapter determines profits that are attributable to Significant People Function ("SPFs") carried out in the UK for the purposes of determining the appropriate CFC charge.
- **Chapter 5** – Non-trading finance profits – Profits pass through this chapter broadly when non-trading finance profits are earned by CFCs from, for example, lending to other members of the multinational group and/or third parties to the extent that either the funding for the loans is provided from UK capital investment or the key management functions relating to the loans and their associated risks are undertaken by UK resident SPFs.
- **Chapter 6** – Trading finance profits – This chapter considers whether a CFC with trading finance profits (a financial trading CFC) is overcapitalised and determines how much trading finance profits of a CFC pass through the gateway.
- **Chapter 7** – Captive insurance business – This chapter captures both the underwriting and investment of profits arising from the receipt and investment of insurance premiums from certain UK contracts of insurance.
- **Chapter 8** – Solo consolidation – This chapter contains the rules that identify the profit that is within the scope of the CFC charge because the CFC is the subject of a solo consolidation waiver, or because there are arrangements that have broadly equivalent regulatory effect.

If the gateways do catch a company's profits, various exemptions exist to ensure that certain companies are not brought within the scope of the CFC rules. These exemptions seek to ensure that entities which present a low risk of UK profit diversion are excluded from being subject to CFC charges. These exemptions, contained in Chapters 10 to 14, are:

- Exempt period exemption – a CFC is exempt for the 12 months after it first becomes a CFC provided there is no CFC charge in relation to the CFC's first accounting period after that exempt period. This is intended to relieve the immediate administrative burden where a UK MNC takes over a non-UK headed group.
- Excluded territory exemption – CFCs resident in specific territories (perceived to be low risk with regards to artificial profit diversion) are exempt provided their total income within certain categories does not exceed 10% of the company's pre-tax profits for the accounting period (or £50,000 if greater). However, this exemption will not be available where significant IP has been transferred to the CFC from the UK in the accounting period or the previous six years.
- Low profits exemption – a CFC will be exempt if its accounting profits do not exceed £50,000 in an accounting period, or if its accounting profits do not exceed £500,000 and its non-trading income does not exceed £50,000.
- Low profit margin exemption – a CFC will be exempt provided its accounting profits do not exceed 10% of its relevant operating expenditure.
- Low level of tax exemption – a CFC that has paid local tax of at least 75% of the corresponding UK tax that would be payable will be exempt.

There is also an exemption for intra-group financing profits, in Chapter 9, that can result in an exemption of between 75% and 100% of the financing profits on qualifying loans. This exemption is currently the subject of an in-depth investigation by the European Commission into whether it constitutes fiscal state aid.

Since the launch of the state aid investigation the UK government has announced two amendments to the UK's CFC rules in light of the EU ATAD requirements. These changes, effective from 1 January 2019, are:

- Broadening the definition of 'control' so that the interest of non-resident associates are taken into account when considering whether a foreign company is a CFC
- Amendments to the finance company exemption so that the full or partial exemption will not be available in respect of profits attributable to UK SPFs. However, for completeness any other profits of the CFC not attributable to UK SPFs can generally still claim the full or partial exemption (see next page).

1.3.1.2. Does a CFC charge matter?

As noted above, a UK CFC is a company which is resident outside the UK (and conducts business outside the UK) but is controlled by UK residents. The purpose of the UK CFC regime is to tax profits that are considered to represent profits that should rightly attach to the UK operations of the MNC, but which have been artificially diverted from the UK.

MNCs frequently wish to centralise certain funding operations in a single company which may be outside the UK. In this context, the commercial objectives of treasury management will be paramount but consideration must also be given to the potential impact of a CFC charge as, despite the stated purpose of the regime, the effect of the rules is often to charge UK tax where UK companies generate profits in low-taxed offshore subsidiaries, even where there has, in fact, been no artificial diversion of profits from the UK.

The effect is broadly that if the CFC exemptions do not apply, the offshore profit (in this case the profit of the RTC) would be taxed in the UK as if it were the profit of a UK company. There is a difference compared to the profits of a UK company, in that the group would not be able to offset losses of other group companies against the RTC profit. Depending on circumstances, this charge may or may not be worse than the group's position without an RTC.

1.3.1.3. Application to ADGM RTCs

The fundamental point from a UK CFC perspective is ensuring that treasury companies continue to function in their own right with limited reliance on UK assets, risk management or funding. The two most common chapters UK MNCs would need to consider in respect of an ADGM RTC are Chapter 4 ('Profits attributable to UK activities') and Chapter 5 ('Non-trading finance profits').

The table below provides an overview of the potential UK CFC implications with regard to the different income streams that may be relevant to RTCs. It is necessary to assess the income streams separately, as there are different tests which can apply to determine those profits that are subject to CFC apportionment and, ultimately, subject to UK corporation tax.

It is assumed that none of the entity level exemptions would apply to an RTC.

Income	Implication
Interest in respect of intragroup lending	The only CFC Chapters which can apply to these profits would be (a) Chapter 5 (non-trading finance profits), with the possible application of Chapter 9 (the Finance Company Partial Exemption regime, or (b) Chapter 6 (trading finance profits). Which of these Chapters applies depends on whether the RTC is classed as 'trading' or 'non trading'. The distinction here is not straightforward, and will depend on whether the RTC's activities include active dealing, with a view to profit maximisation, in a manner akin to a bank (which could be considered trading) or whether its activities are more in the nature of a finance and service function to the operating businesses (which would be non-trading). A business within Chapter 6 (trading) can elect to be taxed under Chapter 5 (non-trading) if it prefers. **Chapter 5** Chapter 5 treats profits as taxable in the hands of the UK resident parent company to the extent the treasury company is financed by UK capital, or where there is business attributable to UK SPFs. It should be noted that an RTC formed as a direct or indirect subsidiary of a UK parent company may well be regarded by the UK tax authority as having all its capital sourced from the UK. Where Chapter 5 profits arise on loans to group companies, and would otherwise be subject to apportionment to the UK parent (e.g. as capital seen to be sourced from UK), if none of the SPFs relating to the income are in the UK, an election may be available under Chapter 9 (full or partial exemption for finance companies), which provides a full or partial exemption on profits of 'qualifying loan relationships'.
Interest in respect of intragroup lending (cont'd)	**Chapter 6** If the activities of the RTC amount to trading activity, then the trading finance profits provisions in Chapter 6 may instead apply. Broadly Chapter 6 exempts the profits of the financing trade. However, where the profits arise due to overcapitalisation of the RTC, they are subject to a CFC charge at the full rate. Overcapitalisation is determined by reference to the capitalisation which would be required under UK financial services regulation.

Income	Implication
	Chapter 6, however, includes a provision allowing group treasury companies to elect for Chapter 5 (non-trading finance profits) treatment instead.
FX gains and losses in respect of intragroup lending	FX gains and losses are taxed in the same way as other types of income on the asset or liability in question. They would therefore be taxed on an accruals basis, under Chapter 5 or 6 as described above.
FX dealing income	Chapter 5 may apply to profits on back-to-back derivative arrangements (i.e. where the RTC goes to market to hedge FX exposures on behalf of regional operating companies). Such income would not be attributable to particular intra group loan relationships therefore Chapter 9 election would not be relevant. Other FX dealing income (e.g. arising on spot transactions or as service fees) may only fall within the scope of Chapter 4 (business diverted from the UK). If there are no UK diverted profits or UK involvement in the activities of the RTC are minimal, and not essential, the profits should not be subject to UK tax.
Treasury management fees	Treatment would depend on whether the fees were attributable to specific loans and derivatives. If so, Chapter 5 may apply as for FX dealing income above. If not attributable to specific loans, then profits should only be taxed (under Chapter 4) if they pass through the gateway tests for whether the profit is diverted from the UK.
Treasury advice provided to operating companies for a fee	It is unlikely that this income would be considered to be related to loan relationships of the RTC and therefore could only fall within the scope of Chapter 4. If no UK diverted profits or UK involvement in the activities of the RTC are minimal, and not essential, the profits should not be subject to UK tax.

From a governance and controls perspective, the following factors are relevant in ensuring that RTCs do not fall within the scope of the UK's CFC rules:

- Avoid (if possible) capital injections into RTCs which originate from the UK group
- Maintain clear autonomy of operations and avoid UK involvement in activities, including supervisory activities
- Maintain clear and robust operational procedures, within the RTC, around assessing potential counterparties, monitoring activities and documentation. For example;
  - Enquire, consider and document purpose(s) of lending.
  - If loans to be used to fund onwards lending seek to identify ultimate borrowing entity.
  - Seek to identify and document if loans used to pay off non-UK external debt or associated with arrangements giving rise to increased UK debits/decreased UK credits.
- Avoid back-to-back derivative transactions and instead operate as service provider where possible.
- Where not perfectly hedging lending activity externally, consider internal management of position to avoid volatility being subject to CFC apportionment

1.3.2. Residence

A company is UK resident if it is either:

- Incorporated in the UK; or
- Centrally managed and controlled in the UK;

and not regarded as resident outside of the UK for purposes of the relevant double tax treaty (due to, for example, effective management and control being located in the other jurisdiction).

Central management and control refer to where the main strategic decisions are made – if a company's board exercises power from the UK, that company could be considered as UK resident even if day to day management and operations are based elsewhere.

A UK incorporated company should be viewed as being tax resident in the UK unless its highest level of decision-making takes place in another country, such that under a double tax treaty, a tie-breaker clause causes the company to be resident in that other country.

1.3.2.1. Governance and controls

A robust structure is important to ensure management is in the UAE. Set out below are a number of high level guidelines from a governance and controls perspective in this regard:

- The board of directors should have sufficient skills, knowledge and expertise to effectively oversee the RTC activities.
- Board meetings should be held in the UAE and all (or at the very least a majority of) participating directors should be physically present in the UAE.
- Strategic decisions of the company should be agreed at meetings of the board of directors and the minutes must reflect those decisions.
- All company records and minutes must be kept in the UAE.
- An adequate level of (qualified) employees should be based in the UAE proportionate to the activities of the company.
- Adequate physical offices and/or premises should be maintained in the UAE.

1.3.3. Dividend exemption

Dividends received by UK tax resident companies are subject to UK corporation tax unless one of the exemptions is met. In practice, most dividends fall into one of five exempt categories:

- Distributions from controlled companies (>50%)
- Distributions in respect of non-redeemable ordinary shares
- Distributions from portfolio holdings (<10%)
- Transactions not designed to reduce tax
- Distributions in relation to shares accounted for as liabilities

There are specific and general anti-avoidance rules in place.

To the extent distributions are made from RTCs to UK parent companies, these should not be taxable in the UK as they are likely to fall within the controlled companies and/or ordinary shareholding exemptions. The anti-avoidance is unlikely to be in point in this scenario although consideration of the application of the detailed rules to the precise circumstances of the distribution would be required. In particular, if distributions are not made out of normal retained profits, or are not paid in respect of ordinary shares, we would recommend seeking advice.

1.3.4. Substantial Shareholding Exemption (SSE)

The SSE provides relief from chargeable gains taxation on the sale of trading subsidiaries.

Broadly, the SSE is available if, throughout a continuous 12-month period starting not more than six years before the disposal, the company disposing of its shares (referred to as the 'investing company') held a substantial shareholding (i.e. at least a 10% interest) in the company being sold (referred to as the 'investee company').

In the context of RTCs, it should be noted that determining the extent to which activities are trading/non-trading can be a difficult exercise and advice should be sought as to the potential implications from UK chargeable gains perspective if a sale or transfer of the RTCs shares (or any intermediate holding company shares) by a UK parent is to be considered.

1.3.5. Deductibility of interest expense

Interest payments are generally treated as a tax-deductible expense. Thus, where UK companies may be borrowing from RTCs, measures such as the CIR rules will be relevant as they will limit deductions that can be taken for financing costs. Such rules have been introduced in order to prevent companies from intentionally increasing their debt financing in order to reduce their tax burden.

As previously noted, these rules broadly apply where the aggregate tax deductions for net financing costs of UK group companies exceed either 30% of tax EBITDA or, if the taxpayer elects, the ratio of group net interest expense compared to accounting EBITDA. Interest deductions are also subject to further debt cap limits broadly based on the net interest expense of the group. There is a de minimis exemption from rules, under which the first £2m of interest expense is allowable on a group wide basis. Where certain conditions are satisfied, restricted interest can be carried forward and deducted in future periods if additional capacity arises. Unused interest capacity can be carried forward for five years.

1.3.6. Withholding tax exemption under UK-UAE tax treaty

The UK-UAE tax treaty entered into force on 25 December 2016 and took effect on 1 January 2017.

There is no requirement to deduct withholding tax from dividends in the UK. Therefore, dividends may always be paid gross, regardless of the terms of the applicable tax treaty.

With respect to interest, the treaty provides that interest will not be subject to withholding tax at source in the UK (rather than 20%). The UK will not be entitled to impose a withholding tax if the UAE lender is either:

- An individual
- A listed company
- A pension scheme
- A financial institution (unrelated to, and dealing wholly independently with, the UK debtor)
- Any other company (provided, critically, one of the main purposes the UAE company exists is not to secure the benefit of the interest Article)

This means that interest paid to the UAE from the UK should be exempt from withholding tax in the majority of cases. Advanced clearance would be required from HMRC before interest could be paid without withholding tax.

1.3.7. Transfer pricing

The activities of RTCs may include a wide range of roles including the provision of intra-group funding, raising external financing, intermediating long term funding and pooling cash, investing excess cash and hedging. The reward to the treasury function for these activities typically requires an assessment of the nature, complexity, size and frequency of transactions being intermediated and managed.

The UK's transfer pricing legislation sets out how transactions between connected parties are to be priced and is based on the 'arm's length principle'. Conformity with this principle is determined by comparing the price of transactions between connected parties to the price of transactions between unrelated parties in comparable conditions.

Accordingly, care needs to be taken in determining whether the split of profits of RTCs is in line with the division of risk and responsibility.

1.3.8. Taxation of deposits in overseas operating companies

To the extent that operating companies are carrying on substantive business, which is not artificially diverted from the UK, then it is expected that there should be a CFC exemption to exempt that business from UK taxation. However, Chapter 4 will apply a tax charge if the CFC has business profits, where the CFC is unable to satisfy at least one of the following tests:

- the CFC does not hold assets or risks under an arrangement to avoid tax;
- the CFC does not have any UK managed assets or bear any UK controlled risks; and
- the CFC could operate effectively if its UK managed assets or UK controlled risks were managed/controlled other than from the UK.

Care should be taken where a company whose business is itself exempt from a CFC charge has excess cash which it deposits at the RTC. There is a risk that the excess cash gives rise to non-trading income which is not exempt (because Chapter 5 applies, rather than Chapter 4, as described above). In general, cash giving rise to profits not more than 5% of the company's profits of a period would not be considered to be non-trading.

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