UAE double tax avoidance agreement with Brazil - A unique treaty

Introduction

The UAE has the largest double tax avoidance agreement ('DTAA') network amongst the GCC countries, with over 85 treaties in force to date and over 30 treaties awaiting final ratifications by the respective contracting states and enforcement. The UAE is a BEPS[1] inclusive framework member and has also signed the Multilateral Instrument ('MLI') to implement the tax treaty related provisions of the BEPS action plans. In contrast to some of the recently signed treaties of UAE (wherever treaty text is available in the public domain) with San Marino, Maldives, Moldova, the DTAA signed by UAE with Brazil ('the Treaty') is unique and may shape the direction of future treaties that UAE may be negotiating.

We have summarised below some key features of the treaty that are significantly different from the other treaties of UAE and our analysis thereof.

Key features of the Treaty

The Treaty is largely based on the OECD[2] Model Tax Convention, 2017 ('MTC 2017'), and incorporates a number of OECD's BEPS related recommendations. The UAE-Brazil treaty is not a covered tax agreement under the Multilateral Instrument ('MLI'), which was signed by the UAE earlier this year and accordingly, UAE's MLI positions will not affect the said treaty. Brazil, on the other hand, has not yet signed the MLI. As of now, there is some doubt as to whether Brazil will actually sign it.

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[1] *Base Erosion and Profit Shifting*
[2] *Organisation for Economic Co-operation and Development*

Some of the key features of the Treaty are:

- **Preamble** - Inclusion of the MTC 2017 preamble language i.e. to enhance tax cooperation and to eliminate double taxation on income without creating opportunities for tax evasion/ avoidance.

- **Residence** - The Treaty provides that to be a resident of UAE, a company must be:

  a) incorporated in the UAE; **and**
  b) have a place of effective management in the UAE; **and**
  c) its capital should be beneficially owned and controlled (directly/ indirectly) by:
     i. the UAE; and/ or
     ii. government institution of the UAE; and/ or
     iii. political subdivision or local government thereof; and/ or
     iv. individuals being residents of the UAE (being UAE nationals and domiciled in the UAE).

  Thus, according to the above definition, in addition to satisfying the incorporation and place of effective management tests, the UAE company must be directly/ indirectly owned by the UAE/ government institution of the UAE/ political subdivision or local government thereof or owned and controlled by UAE nationals domiciled in the UAE to qualify as "Residents" for the purpose of this treaty and accordingly receive treaty benefits.

  The majority of treaties signed by the UAE provide for residency to be based either on, or cumulatively on, the incorporation and place of effective management. The requirement of a company to be owned and controlled by (other than UAE/ government bodies etc.) UAE resident individuals to be categorised as a resident appears in very few old UAE treaties with Canada (2002), Germany (2011) and Poland (1993) and is not present in any of the recent treaties signed by the UAE (including San Marino, Maldives, Moldova, Jordan, UK, etc.).

  One would have to wait to see whether, practically, the Ministry of Finance would issue Tax Residency Certificates ('TRCs') to companies that are incorporated and managed in the UAE, carry out genuine/ active business activities in the UAE and satisfy other eligibility criteria but are not beneficially owned by UAE resident individuals. Also, even if TRCs are issued, a key question would be whether the Brazil tax authority allows treaty benefits in such cases.

- **Dual resident entities** - A company which becomes a resident of both countries shall not be treated as a resident of either country, and accordingly, treaty benefits shall not be available. This deviates from the MTC 2017 and the MLI provisions which regard a company to be resident either where its place of effective management is situated or based on determination by the competent authorities of the contracting states of the sole residence of the company.

- **Permanent Establishment ('PE') clause** - PE definitions under the treaty include BEPS Action 7 suggestions relating to artificial avoidance of PE status by incorporating following provisions.

Areas of concern	Treaty provisions
Commissionaire arrangements and similar strategies	• Expanded scope of agency PE to include "*playing principal role leading to conclusion of contracts* test" • Clarifying that an independent agent would not include a person acting exclusively even on behalf of a closely related enterprise • Clarifying the meaning of a closely related enterprise
Specific activity exemptions	• Activities exempted only if they are of a preparatory/ auxiliary nature and includes anti-fragmentation provisions
Splitting-up of construction contracts	• Provides instances where aggregation of different periods is required to determine PE status

Withholding taxes – The treaty provides withholding tax rates for payments in the nature of dividends, interest and royalties. The following table captures the withholding tax rates:

Nature of payment	Withholding tax rate as per the Treaty	Domestic withholding tax rate in UAE	Domestic withholding tax rate in Brazil
Dividend	15% (5% if beneficial owner is a contracting state/ political subdivision/ local government/ government institution)[3]	0%[4]	0%[5]
Interest	15% (10% if beneficial owner is a bank and certain conditions are met)	0%[4]	15%[6]
Royalty	15%	0%[4]	15%[6]
Fees for Technical Services	15%	0%[4]	15%[6]

To deal with the issue of tax avoidance, Brazil, along with certain other Latin American countries, had blacklisted perceived tax havens, which has the following key effects on all transactions that take place between Brazilian residents and residents of the blacklisted territories:

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[3] *No withholding tax applies on dividends as per the current domestic tax law in Brazil*
[4] *Currently, there is no withholding tax regime in UAE*
[5] *No withholding tax applies on dividends as per the current domestic tax law in Brazil*
[6] *25% for payment to residents of tax havens which include UAE residents currently*

- Payments from a Brazilian resident to the blacklisted jurisdiction resident are subject to a withholding tax of 25%;
- Transfer pricing, thin capitalization and stricter deductibility rules apply irrespective of whether the entity in the blacklisted jurisdiction is related to the Brazil tax resident; and
- More stringent Controlled Foreign Company rules apply if a controlled or affiliated entity or a shareholder thereof is in the blacklisted jurisdiction.

The UAE features in this blacklist, and accordingly, transactions between UAE and Brazil tax residents are subject to such treatment.

With the signing of the Treaty, one can expect a change in the UAE's "blacklisted" status. Also, from a Brazilian tax perspective, while remittances to UAE residents should arguably be subject to the lower rates provided by the Treaty vis-à-vis the 25% rate for payments to residents of blacklisted countries as per the domestic tax law in Brazil. However, Brazilian tax authorities may take a contrary view till UAE's blacklisted status is changed, particularly in light of the provision that specifies that the Treaty will not prevent a contracting state from applying its domestic legislation aimed at countering tax evasion and avoidance. Taxpayers will need to wait for any clarification in this regard.

- **Taxation of capital gains** - Contrary to most of the recent treaties signed by the UAE (including San Marino, Maldives, Moldova, Jordan, UK, etc.), which provide in the residual clause that capital gains on the sale of shares of a company (not deriving value from immovable property) shall be taxable only in the country where the alienator is a resident, the UAE-Brazil treaty provides that such gains may be taxed in the country in which such gains arise. For instance, if a UAE resident sells shares of a Brazilian company, the gains may be taxed in Brazil according to Brazilian tax law provisions.

- **Entitlement to benefits (Article 29)** - This article was introduced for the first time in the MTC 2017 to provide for reducing tax evasion or avoidance primarily through treaty-shopping arrangements. The Treaty includes the Principal Purpose Test ('PPT') for granting of treaty benefits, which provides that benefits under the Treaty are not to be granted if obtaining the benefit was a principal purpose of the arrangement/ transaction unless the same is in accordance with the object and purpose of the Treaty. This is also a minimum BEPS standard under the MLI.

  Apart from this, the article also requires satisfaction of the base-erosion test i.e. proving that only upto 50% of its gross income is used (directly or indirectly) to meet liabilities (including interest/ royalties) to persons not entitled to benefits of the treaty.

  The Treaty further provides that entitlement of benefits will not prevent a contracting state to apply its domestic legislation aimed at countering tax evasion and avoidance.

  The "Entitlements to Benefits" has appeared in a UAE treaty for the first time and accordingly could be subject to various interpretations.

- **Others**

  Other key features of the Treaty include:

  - The article on 'Fees for Technical Services' is being included by Brazil in recently signed treaties (including Singapore and Switzerland). This seems to be triggered by controversies regarding the possibility of applying Article 7 (business profits) to avoid payment of withholding taxes on service remittances abroad. Please note that the Brazilian tax authorities' definition of technical services is very broad and encompasses almost all services.

- Independent personal services clause to tax professional/ service income earned by residents of one country performing services in the other country provided certain conditions are met;
- Principles for elimination of double taxation via the foreign tax credit method; and
- Establishment of a mutual agreement procedure (minimum BEPS standard).

The Treaty is not yet in force and UAE and Brazil would need to notify each other regarding the completion of the requisite domestic law procedures through diplomatic channels.

Key takeaways

While UAE has signed the MLI, it has expressed reservations on most of the BEPS measures that appear in its treaty with Brazil, a G20 country committed to adopting most of the BEPS measures.

In a nutshell, the following are the "Must-Haves" for a UAE company seeking treaty benefits:

A) Meet the residency criteria (i.e. in addition to incorporation and having place of management in the UAE, the company is owned by UAE/ government bodies/ UAE nationals); and
B) Satisfy the Principal Purpose Test; and
C) Satisfy the 50% base erosion test.

However, even where the above criteria are satisfied, more clarity would be required on the withholding tax rates for any payments to UAE residents considering that the UAE still appears in Brazil's blacklist.

With the above elements, the UAE-Brazil treaty is quite unique, and it is possible that other subsequent UAE treaties may carry similar provisions, particularly limiting treaty access under residency or base erosion criteria. It is imperative for businesses operating in the UAE and Brazil to note the impact of the Treaty provisions on their operations and tax positions in dealings with businesses/ residents of the other country.

For further information or to discuss your structure and operations in UAE and/ or Brazil, please feel free to get in touch with us at nilesh.ashar@dhruvaadvisors.com or vartika.jain@dhruvaadvisors.com.

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