

Establishing an RTC in ADGM for MNCs headquartered in the US

Tax and Regulatory Analysis



ABU DHABI GLOBAL MARKET
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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 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 European and US headquartered groups have therefore chosen the UAE as 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 US tax issues that may be relevant to establishing and managing RTCs in ADGM from the perspective of a US headquartered MNC.

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 11.5% to 6.3%, compared to 13.5% under the US double tax treaties on interest payments from participating territories to RTCs.

With a number of the fastest growing African economies in close proximity to the Gulf, the UAE has become a gateway for multinational companies 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.

With 64 in-force treaties and 21 treaties awaiting ratification or entry into force, the UAE has the most double tax treaties in Europe, Middle East and Africa compared to the US (43 in-force double tax treaties) 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. Out of the remaining 44 countries in Europe, Middle East and Africa with which the UAE currently does not have a double tax treaty, 39 also do not have treaties with the US, placing the UAE on a comparable footing from a tax perspective but with a strong geographical advantage.

3. US Tax Considerations

This section provides a high level discussion of the some of the US tax issues that may be relevant for a US headquartered MNC looking to perform regional treasury activities from ADGM. For the purposes of this discussion, the parent company ('TopCo') of the MNC is assumed to be a C corporation formed under the laws of a State of the US and the ADGM RTC is a wholly owned subsidiary of TopCo.

THE DISCUSSION BELOW IS A GENERAL SUMMARY. IT DOES NOT COVER ALL TAX MATTERS THAT MAY BE OF IMPORTANCE TO A PARTICULAR US MNC. EACH US MNC IS URGED TO CONSULT ITS OWN TAX ADVISER ABOUT THE TAX CONSEQUENCES TO IT OF ESTABLISHING AN ADGM RTC IN LIGHT OF THE US MNC'S OWN CIRCUMSTANCES.

3.1 US Federal Income Tax Implications – Summary Table

Key issue	US federal income tax implications for an ADGM RTC
Income earned by the RTC	
<i>Interest in respect of intragroup lending</i>	Interest income of the RTC, as well as income treated as equivalent to interest (e.g., notional principal contracts, loan commitment fees) should be treated as foreign personal holding company income ("FPHCI") but may not be Subpart F income to the extent the exception for income received from a related controlled foreign corporations ("CFC") applies. If the income is not taxed as Subpart F income, it should generally be included in the income of ADGM RTC's US parent company as GILTI. The ADGM RTC's US parent company may, subject to certain limitations and requirements, receive foreign tax credits for non-US withholding income taxes suffered by the RTC on its non-US source interest income.
<i>FX gains and losses in respect of intragroup lending</i>	Net FX gains in respect of intragroup lending of the RTC should be treated as FPHCI, subject to US tax in the year the RTC earns such income.
<i>Non-finance profits</i>	Assuming that the RTC has relatively low basis in tangible assets used in its trade or business in relation to its income, income of the RTC that is not Subpart F income should generally be included in the income of ADGM RTC's US parent company as GILTI.
<i>FX dealing income</i>	As mentioned above, net FX gains of the RTC should be treated as FPHCI, subject to US tax in the year the RTC earns such income. Other income on foreign currency transactions, such as service fees from services performed in the UAE, should not be treated as Subpart F income. Modelling is very important to understand the actual impact of GILTI.
<i>Treasury management fees</i>	Treasury management fees from services performed in the UAE should not be treated as Subpart F income. Modelling is very important to understand the actual impact of GILTI.
<i>Treasury advice provided to operating companies for a fee</i>	Treasury advice fees from activities carried out in the UAE should not be treated as Subpart F income. Modelling is very important to understand the actual impact of GILTI.
Distributions from an ADGM RTC	If an ADGM RTC makes a distribution of its earnings to its US parent company, such distribution should be exempt from US tax
Sale or transfer of RTC shares	Any gain from the disposition of the shares of the RTC by its US parent should be treated as a dividend to the extent of the RTC's earnings and profits, and any remaining gain is treated as a capital gain

3.2 Anti-deferral regimes

US federal income tax law provides several anti-deferral regimes, designed to prevent US taxpayers from utilizing various offshore strategies to defer US taxation of their income for a period of time or indefinitely. In particular, the US taxes on a current basis certain earnings of CFC under the Subpart F or GILTI rules. The below discussions provides an overview of these and related rules and considers how they might apply in the context of the aforementioned business structure.

3.3 CFC – Controlled Foreign Corporation

A foreign (i.e., non-US) corporation is treated as a CFC for US federal income tax purposes if more than 50% of its stock, by vote or by value, is owned by US persons who each own at least 10% of the corporation's stock. Such persons are referred to as 'US Shareholders.' A US Shareholder must include in gross income its pro rata share of the CFC's Subpart F income and GILTI, regardless of whether the income is distributed to the US Shareholders.

Because TopCo is formed under the law of a US State and it wholly owns the RTC, a company organized under the law of the UAE, TopCo should be treated as a US Shareholder and the RTC should be treated as a CFC for the purposes of the US CFC regime. As the sole US Shareholder of the RTC, TopCo should be subject to tax on the RTC's Subpart F income and GILTI on a current basis.

3.4 Subpart F income

TopCo as a US Shareholder must include in gross income its pro rata share of the RTC's Subpart F income. Included in the definition of Subpart F income is Foreign Base Company Income ("FBCI"). FBCI is defined as income that falls within one of the following categories:

- Foreign Personal Holding Company Income ("FPHCI");
- Foreign Base Company sales income ("FBC sales income"); and
- Foreign Base Company services income ("FBC services income").

3.4.1 Financing income

Many types of income typically generated from financing activities are captured as FPHCI. FPHCI generally includes the following passive types of income:

- Dividends, interest, rents, royalties, and annuities;
- Income equivalent to interest;
- Gains from certain property transactions;
- Certain commodities gains;
- Certain foreign currency gains;
- Income from notional principal contracts; and
- Payments in lieu of dividends derived from certain equity securities lending.

Income equivalent to interest generally includes income from investments and transactions reflecting the time value of money, and expressly includes income from certain conversion transactions, loan commitment fees, and income from certain transfers of debt securities. The types of gains falling within the definition of FPHCI generally are gains from transactions involving property that gives rise to passive types of income (e.g., dividends, interest, rents and royalties), and gains from non-income producing property. Generally, income from commodities transactions (including futures, forwards and similar transactions) as well as foreign currency gains fall within the definition of FPHCI.

As the RTC is expected to earn types of income mentioned above, such income earned by the RTC is generally expected to be included in the gross income of TopCo in the year earned, unless the exception mentioned below applies.

3.4.2 Exception

An exception is provided to certain types of passive income from FPHCI treatment. The exception provides that FPHCI generally does not include dividends, interest, rents and royalties received or accrued from a related CFC. The exception applies, however, only to the extent the payments are attributable or properly allocable to non-Subpart F income of the related CFC. Thus, interest received by the RTC may not be characterized as FPHCI even if paid by a related CFC provided that the related CFC does not earn any Subpart F income. However, the provision, unless extended by Congress, expires for taxable years beginning after 2019.

3.4.3 Service income

FBC services income means income derived from services performed for a related person outside the CFC's country of incorporation. This category does not include income from services performed in the CFC's country of incorporation. As the RTC is expected to provide financing services only from the UAE, the country where it will be incorporated, income derived from such services should not be considered as Subpart F income.

3.5 GILTI – Global Intangible Low-Taxed Income

A US Shareholder of a CFC must include in income its GILTI in a manner similar to Subpart F income. Generally, GILTI operates as a US minimum tax on 'above-routine' CFC earnings, with the 'routine' CFC earnings defined generally as a 10% return on the CFC's tangible property 'Qualified Business Asset Investment' or ("QBAI").

The GILTI inclusion amount is equal to the excess of a US Shareholder's (1) net CFC tested income, over (2) its Net Deemed Tangible Income Return ("Net DTIR").

Net CFC tested income is the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which the shareholder is a US Shareholder, over the aggregate of the shareholder's pro rata share of the tested loss of each CFC with respect to which the shareholder is a US Shareholder for such taxable year.

In general, a CFC's tested income is the excess (if any) of its non-Subpart F gross income over any deductions (including taxes) allocable to such income. Correspondingly, a CFC's tested loss is generally the excess (if any) of such deductions over its non-Subpart F gross income.

Net DTIR is generally equal to 10% of the aggregate of the shareholder's pro rata share of the QBAI of each CFC with respect to which it is a US shareholder reduced by certain interest expense taken into account in determining net CFC tested income. QBAI is generally the average of the CFC's aggregate adjusted bases as of the close of each quarter of such taxable year in tangible property that generates tested income.

Correspondingly, gross income of the RTC that is not Subpart F income is tested income and generally taxed as GILTI to the extent it exceeds a 10% routine return of the RTC's tangible assets.

A US Shareholder that includes the GILTI of a CFC, such as TopCo and the RTC respectively, is allowed a deduction equal to 50% of GILTI for 2018 through 2025. The deduction will decrease to 37.5% beginning in 2026.

Modelling is very important to understand the actual impact of GILTI in conjunction with the other rules.

3.6 Foreign Tax Credits (FTCs)

Generally, in any year, a taxpayer can choose whether to take as a credit (subject to limitation) or as a deduction foreign income and excess profit taxes paid or accrued during the tax year to any foreign country. An FTC reduces US income tax liability dollar for dollar, while a deduction reduces the US income tax liability at the marginal rate of the taxpayer. TopCo may claim a credit for the foreign taxes associated with Subpart F income, subject to complex limitation calculations. Credit for the foreign taxes associated with GILTI is limited to 80%. In general, unused FTC may be carried back one year, and if not fully used, carried forward ten years. FTCs arising on GILTI may not be carried back or forward.

Subpart F income should generally be subject to tax at a headline rate of at 21%, but a US Shareholder may use all of its FTCs arising on its Subpart F income. In contrast, a US Shareholder's GILTI should generally be subject to tax at a headline rate of 10.5% (rising to 13.125% in 2026), but the US Shareholder may use 80% of the FTCs arising on its GILTI. While a US Shareholder's GILTI FTCs may equal or exceed the US Shareholder's GILTI for a tax year, the complexities of the FTC limitation rules can mean that such FTCs do not entirely offset the tax liability on the GILTI.

In summary:

- Subpart F income is fully subject to tax, with foreign tax credits potentially available for offset;
- The remaining income of a CFC over and above 10% of QBAI is taxed under the GILTI regime, with a 50% deduction available plus 80% of foreign tax paid as a credit;
- Whether Subpart F or GILTI results in, and if so how much, residual US tax depends on complex calculations; and
- Any CFC income not taxed under Subpart F or GILTI (which is expected to be small) should be exempt from tax.

3.7 Distributions from RTC

In general, to the extent that distributions from a CFC to its US Shareholders are treated as dividends (i.e., to the extent of the CFC's earnings and profits), such dividends should be exempt from tax.

In particular income that has previously been subject to tax as Subpart F income or GILTI is not again subject to tax when actually distributed to the US shareholder. Furthermore, US Shareholders of CFCs are allowed a deduction in an amount equal to the foreign-source portion of any dividend received from the CFC ('dividend received deduction' or 'DRD') to the extent that the income is not already treated as previously taxed Subpart F income.

Thus, when the RTC makes an actual distribution of its earnings to TopCo, such distribution should be exempt from US tax.

3.8 Gain from the disposition of RTC shares

In general, when a shareholder disposes of their shares of a corporation, the shareholder will recognize gain or loss on the exchange equal to the difference between the consideration received and the shareholder's basis in the stock disposed of. Such gain or loss is generally characterized as capital gain or loss. However, any gain realized by a US Shareholder of a CFC upon disposition of its shares in the CFC should be treated as a dividend to the extent of the CFC's earnings and profits, eligible for the DRD. Any remaining gain is treated as a capital gain under the general rules and subject to tax at 21%. Consequently, any gain from the disposition of the shares of the RTC by TopCo should be treated as a dividend (and thus eligible for the DRD) to the extent of the RTC's earnings and profits, and any remaining gain is treated as a capital gain.

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