

DIFC AND ADGM FOUNDATION LAWS

A UAE/US perspective

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ABSTRACT

- *In March 2018, the Dubai International Financial Centre (DIFC) enacted a new foundation law (the DIFC Law)¹ and amended its existing trust law to provide enhanced flexibility for settlors, trustees and beneficiaries in relation to the administration of DIFC trusts.² The DIFC's pronouncements followed the Abu Dhabi Global Market's (ADGM's) enactment of regulations permitting the creation of foundations in December 2017 (the ADGM Law).³*
- *The enactment of both laws marked a major turning point for families originating from the Gulf Cooperation Council (GCC)⁴ region, who now have a solution to professionalise the ownership of the family wealth located in the region, including shares in family businesses and real estate, in line with global leading practices.*
- *Many families resident in the GCC have US family members who are subject to worldwide taxation and anti-abuse rules that penalise accumulations of income in foreign structures. The new laws present planning challenges, but will permit many clients to structure their assets so that US family members can benefit in a tax-efficient manner.*

¹ DIFC Law No. 3 of 2018

² DIFC Law No. 3 of 2018 and DIFC Law No. 4 of 2018

³ The ADGM Foundation Regulations 2017 (the Trusts (Special Provisions) Regulations that were effective in the ADGM as of 17 April 2016 remain unchanged.

⁴ The member states of the GCC are the UAE, the Kingdom of Saudi Arabia, the Kingdom of Bahrain, the Sultanate of Oman, Kuwait and Qatar.

‘Foreign investment restrictions applicable in most GCC countries prohibit foreign ownership of specific local assets, such as certain local businesses and real estate’

The Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM) are financial free zones, and are the only jurisdictions in the UAE where fiduciary vehicles, namely trusts and foundations, can be established. DIFC and ADGM legal entities are relevant in the context of regional wealth preservation because they are generally treated as Gulf Cooperation Council (GCC) legal entities while having their own legal framework based on the common law of England and Wales, and their own independent courts.

GCC families have historically held regional assets through companies, which are more similar to foundations. Indeed, unlike a trust, a foundation has its own legal personality and can hold assets in its own right, so that family members, acting as directors, can retain control over their assets rather than placing them in the custody of a third party (e.g. a trustee).⁵ Retaining control is particularly important in the context of ownership in a family business.

Foreign investment restrictions (FIR) applicable in most GCC countries prohibit foreign ownership of specific local assets, such as certain local businesses and real estate.⁶ As a result, the portion of ownership in GCC assets that is subject to FIR must be held through GCC legal entities owned by GCC citizens. This restriction means that US family members may not be able to benefit from assets that must be wholly owned by GCC or UAE nationals, such as real property located in certain areas of Dubai and Abu Dhabi. Where

mixed ownership is permitted, it may be possible to use planning techniques employed by non-GCC families, holding up to a certain percentage (e.g. 49 per cent) of a local company in an offshore structure.

Legal entities created under the laws of the DIFC and ADGM are generally treated as GCC entities for FIR purposes. The use of a foundation, as opposed to a trust, may simplify enforceability issues, as it is easier to test its compliance with FIR (both the legal entity and its beneficial owners must be tested). An ADGM or DIFC foundation should generally be treated as a GCC-incorporated legal entity in line with other corporate vehicles available in these free zones. The GCC status of the beneficiaries may be substantiated through the inclusion of a specific beneficial entitlement restriction to GCC nationals in the constitutional documents of the foundation. In the context of a DIFC foundation, it may also be achieved through the creation of a register of depositary certificates that can be shared with the relevant authorities in charge of monitoring compliance with FIR.

PRACTICAL APPLICATIONS OF THE DIFC AND ADGM LAWS OWNERSHIP AND GOVERNANCE OF GCC FAMILY BUSINESSES

For various reasons, including FIR and, until recently, the absence of strong regional tools to facilitate succession, GCC families have historically owned their local businesses in the personal name of the patriarch, through local sole proprietorships or limited liability companies.

Some families, in an attempt to professionalise the ownership and governance of their businesses, have gone one step further and incorporated a

⁵ art.10 (1) DIFC Law; art.3(5) ADGM Law

⁶ While some local assets can be owned up to a certain percentage (e.g. 49 per cent in the UAE) by foreign nationals, other local assets must be wholly owned by GCC citizens, directly or through a GCC legal structure. It is worth noting that a third category of local assets is exclusively reserved to local citizens (i.e. not to citizens of other GCC countries).

holding company to consolidate all their assets. They would typically have gone through a corporate-, family- and wealth-governance exercise and would have tried to incorporate the outcome of such exercise into the legal documentation of the holding company.

Family constitutions or charters are not legally binding documents,⁷ and the enforceability of their provisions has historically been an issue under the laws of GCC countries. This can be attributed to family constitutions not being limited to a set legal requirement of a company or trust law, and rather caters to the specific characteristics of family dynamics and unique interactions between the family and the business and wealth structures.

Moreover, the standard forms of articles of association for onshore companies incorporated in the UAE and other GCC countries are straightforward, which makes it challenging to introduce bespoke provisions, even if they may suit the requirements and interests of a family business and its owners.⁸ As such, a foundation governed by the laws of the DIFC or ADGM should permit GCC families to include family governance provisions in their governing documents, therefore turning them into legally enforceable provisions.

GCC FAMILIES HOLDING REAL ESTATE IN THE UAE
DIFC foundations constitute a sustainable option to own real estate located within the Emirate of Dubai, while ADGM foundations provide the same for real estate located within both the Emirates of Abu Dhabi and Dubai.

This has been made possible through the signature by the DIFC and ADGM of several memoranda of understanding (MoUs) with the relevant authorities in charge of real estate registration in the Emirates of Dubai and Abu Dhabi.⁹

It is important to note that real estate subject to FIR could be owned by a DIFC or ADGM foundation only to the extent that the FIR are met at the level of the beneficiaries of such foundation. In other words, real estate assets in the UAE that are subject to FIR may only be held through GCC legal entities (a DIFC or ADGM foundation) if the beneficial owners are GCC citizens.

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SUBSTITUTE TO A WILL FOR NON-MUSLIM EXPATRIATES

As a general rule in the UAE, inheritance matters for Muslims and non-Muslim resident individuals are dealt with in accordance with Shari’a. This means that the estate of a UAE-resident individual is meant to follow Shari’a forced-heirship rules on death. However, non-Muslim expatriates may elect for the law of their country of origin to apply to their will as long as their heirs are neither UAE nationals nor Muslims. Such will should, however, be duly registered with the relevant UAE authorities in order to be valid on death.

The Foundation Laws can be used as a substitute to a will for non-Muslim families who wish to plan their future and allocate their estate on death as per their wishes.

This development is particularly welcomed by owners of assets such as real estate located in the Emirate of Abu Dhabi in the absence of a local equivalent of the DIFC Wills Service Centre.¹⁰

ECONOMIC SUBSTANCE REQUIREMENTS FOR INTERNATIONAL FAMILIES

The incorporation and management of DIFC and ADGM foundations are not restricted to GCC families. Therefore, international families can also use these vehicles as an alternative to legal entities set up in offshore financial centres.

In the context of rapidly evolving regulations focusing on transparency, compliance and substance, the DIFC and ADGM are well positioned to assist families with the creation of legacy planning structures that adhere to

⁷ The GCC Governance Code, Family Business Council-Gulf (2016), available at bit.ly/2HkXpxn

⁸ See M. Selim and F. Abed, ‘Overview: UAE Trust Law’, *Emirates Law*, Volume 10 (June 2018), pp.8-11

⁹ Respectively, the Dubai Land Department and the Abu Dhabi Municipality.

¹⁰ The scope of the DIFC Wills Service Centre is currently limited to assets located within the Emirates of Dubai and Ras Al Khaimah.

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economic substance law requirements, as both are practicable locations in which to create local economic substance (i.e. to hold or attend board meetings, or conduct day-to-day management).

At the time of writing, the UAE’s economic substance requirements have not been publicly released. However, *Cabinet decision no. 31 of 2019 concerning setting the requirements for economic substance* was approved on 30 April 2019.

Before the enactment of such document, there is no requirement to have a local council member or protector. The new cabinet decision is not expected to change this, except if the foundation carries out a relevant activity in the sense of the decision (such activities are in line with the ones included in the relevant economic substance legislations enacted by offshore financial centres).

THE US CONNECTION

Many GCC families have members who are US citizens, green-card holders or otherwise resident in the US for income tax purposes under US domestic law (US Persons).¹¹ US Persons are subject to income tax on their worldwide income and gains and are subject to a variety of anti-abuse rules that require special planning in the context of DIFC and ADGM foundations. A summary of three key issues is included below.

IS THE FOUNDATION A TRUST OR A COMPANY FOR US TAX PURPOSES?

The foundation is a civil-law concept; the US, being a common-law jurisdiction, characterises foundations as either trusts or companies for US tax purposes.

¹¹ The following are considered to be US Persons for tax purposes: an individual who is born in the US; an individual who had at least one parent who was a US citizen who met the requisite US presence requirements as of the date of the individual’s birth; an individual who is naturalised as a US citizen; an individual who is a long-term resident alien or green-card holder who has not made a treaty claim to be treated as a non-resident alien for US income tax purposes; an individual who is taxed as a US resident under the ‘substantial presence’ test based on the individual’s presence in the US during the current year and the two prior years; and an individual who has elected to be taxed as a US resident for US tax purposes.

The DIFC Law states that the ‘foundation is a body corporate’ and that the property of a DIFC foundation is not held by it on trust for any other person.¹² While the plain language of the DIFC Law clearly indicates that the law is not intended to create a trust, that intent is not dispositive for US tax purposes.

Regulations issued by the US Department of the Treasury¹³ defining ‘ordinary trusts’ state in part that:

‘generally speaking, an arrangement will be treated as a trust ... [for US tax purposes] if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.’¹⁴

The regulations also state that trusts are generally governed by the ‘ordinary rules applied in chancery or probate courts’; however, as discussed below, this language is not dispositive of the issue.

The seminal case determining this issue, *Estate of Swan v Commissioner*,¹⁵ determined that, generally, a Liechtenstein foundation (*stiftung*) will be characterised as a trust for US estate tax purposes.¹⁶ In reaching this conclusion, the US Tax Court (the Court) placed significant weight on the fact that the *stiftungs* in issue were created to hold property for the benefit of the founder’s family and he retained the right to amend or revoke the *stiftung* during his lifetime.

The Court considered the factors that cause a *stiftung* to resemble a corporation, including:

- the option of perpetual existence;
- its status as a separate juridical entity; and
- its management by a council, which is analogous to a corporate board of directors, that governs documents that are similar to those of a corporation.

¹² art.1 para.1-2 DIFC Law

¹³ The US Code of Federal Regulations (or CFR) includes regulations issued by the US Treasury interpreting provisions of the US Internal Revenue Code of 1986.

¹⁴ 26 CFR § 301.7701-4(a)

¹⁵ 24 TC 1955, *aff’d on this matter*, 247 F. 2d 144 (2d Cir. 1957)

¹⁶ The US Internal Revenue Service Chief Counsel’s Office guidance issued in 2009 concluded that, generally, Liechtenstein *anstalts* (establishment) will be characterised as corporations because their primary purpose is to actively carry on business activities. *Stiftungs* must be considered on a case-by-case basis but will generally be characterised as trusts because their primary purpose is to conserve assets rather than to carry on a business. AM 2009-12 (7 October 2009).

Both the DIFC and ADGM foundation share these attributes.¹⁷ Nonetheless, the Court concluded that these were ‘largely the general formal characteristics of a *stiftung*’. The Court determined that the most significant characteristic was that the *stiftung* was created to conserve and manage assets for the benefit of the founder’s family.

Both the DIFC Law and the ADGM Law permit the founder to reserve the right to revoke a foundation or to vary or amend its governing documents.¹⁸ While under the DIFC Law a foundation may not be created for a commercial purpose (other than as necessary and ancillary or incidental to its objects), it may issue securities as well as depository receipts. Interests in DIFC foundations are freely transferable, other than as limited by the by-laws. Interests in ADGM foundations, however, are not transferable.

Applying the Court’s analysis to ADGM and DIFC foundations, both entities may be created so that they qualify as trusts for US tax purposes.¹⁹ The creation of an entity that is classified as a trust may be preferable where the family wishes to shelter their assets from US estate tax on the death of a US Person. Indeed, the ability to preserve the family’s legacy for future generations is the primary advantage of the ADGM and DIFC foundations from a US perspective.

THE FOUNDATION AS A FOREIGN GRANTOR TRUST

Both Laws lend themselves to the creation of trusts that will qualify as ‘foreign grantor trusts’ (FGTs) in the event that the founder is not a US Person. The rules for determining FGT status are given under s.672(f)(2)(A) of the *US Internal Revenue Code of 1986* (the Code) and state that any portion of trust attributable to assets settled by a non-US Person will be deemed a foreign grantor trust if:

- the settlor has the right to revest the trust assets in the settlor, acting alone or with the consent of a ‘related or subordinate party’ that is ‘subservient’ to the settlor; or

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- the only persons who can benefit during the settlor’s lifetime are the settlor and/or the settlor’s spouse.²⁰

These provisions also facilitate the step up in basis of a foundation’s assets to fair market value for US tax purposes on the founder’s death.²¹

During the founder’s lifetime, any accumulated income and gains will be treated as capital and US Persons who are beneficiaries of the foundation in question (US Beneficiaries)²² may receive distributions from the foundation free from US income tax.

PLANNING FOR THE DEATH OF A NON-US FOUNDER

In many respects, the issues that must be considered in connection with the death of the founder are no different than those that arise in connection with the death of the settlor of an FGT. The foundation’s assets will need to be analysed to determine whether any of its assets will be characterised as ‘passive foreign investment companies’ or controlled foreign corporations²³ and whether various elections (such as entity elections) need to be made to optimise the position of the US Beneficiaries.

Distributions of accumulated income and gains to US Beneficiaries may be subject to ‘throwback

17 See *ADGM Regulations 9* (governing documents) and 19 (council); and the DIFC Law at art.11 (may be perpetual); art.19 (charter); art.20 (by-laws); and art.22 (council).

18 *ADGM Regulation 17(1)(a)*; DIFC Law art.26

19 Compare Rev. Rul. 2013-14, 2013-26 IRB 1267. A *fideicomiso* (Mexican Land Trust) is not a trust for US tax purposes, because its only function is to hold land in areas where foreign ownership is restricted; no duty to defend or maintain property.

20 26 CFR § 301.7701-18(b)(2); a marriage entered into outside the US is recognised for federal tax purposes ‘if the relationship would be recognised as a marriage under the laws of at least one state, possession, or territory of the United States, regardless of domicile’. Currently no state, possession or territory of the US recognises marriages to multiple women at the same time.

21 See the Code § 1014.

22 (or Qualified Recipients under the DIFC Law.)

23 The Code § 951-962. For more on CFCs, see M. Stern and P. Harper, ‘It’s Time to Review CFCs’, *STEP Journal* (Vol27 Iss4), p.53

rules',²⁴ which tax distributions or accumulated income and gains as ordinary income regardless of their character when earned by the trust. This is disadvantageous in the current environment where ordinary income is taxed at marginal rates of up to 37 per cent, while capital gains are taxed at a rate of 20 per cent. Accumulation distributions are subject to interest charges based on the number of years that the accumulation is deemed to have been held by the trust. The issue may be complicated in this instance due to the limitations imposed by various GCC FIR. If the foundation holds property that cannot be distributed to individuals who are not GCC nationals, it may not be possible to decant income and gains to a US domestic trust. Once again, additional planning will be required to optimise the position of US Beneficiaries.

CONCLUSION

The enactment of the DIFC and ADGM Laws is a significant development. These laws provide valuable tools to regional and international

families, allowing them to establish investment and wealth preservation structures that are in line with global leading practices. Such structures allow for the alignment of ownership and family governance and may provide a basis for the legal enforceability of a family constitution, while providing greater protection against the diminution of family wealth held for the benefit of US Beneficiaries.

They are also useful in the context of planning the succession of a regional family who have US family members and provide an alternative to legal entities incorporated in offshore financial centres within a jurisdiction where it is possible to create strong local economic substance.

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²⁴ See the Code § 665-668.