Aruba: a new fiscal framework for 2006

By Prof. Jaap Bellingwout,
Baker & McKenzie,
Amsterdam, the Netherlands[1]

In 1998, the OECD launched its Project on Harmful Tax Competition. This project also focused on low tax jurisdictions (OECD Report: Harmful Tax Competition, An Emerging Global Issue, 1998). On the basis of the criteria set out in this report, 35 jurisdictions were blacklisted in the OECD's Progress Report of early 2000. Aruba was included in the blacklist, although it never had a significant low tax offshore or financial services sector.

In the course of 2000 and in the spring of 2001, Aruba negotiated with the OECD, which resulted in the signing of an OECD commitment by Aruba on 31st May 2001.[2] Aruba agreed to amend its legislation and to remove elements of its tax legislation and tax practice that were deemed to be harmful. Aruba also committed to become party to a Tax Information Exchange Agreement (TIEA) with any OECD member country that wants to have such a TIEA with it. As a result of the above, Aruba was removed from the OECD's blacklist. Since that date, from an OECD perspective, Aruba is considered to be a "Participating Partner" of the OECD (ref. the 2004 OECD Progress Report, page 11, footnote 10).

OECD Tax Information Exchange Agreements

In 2001, the focus of the OECD project transformed completely into an effective exchange of information. In 2004, Aruba enacted a General Tax Act that allows the Tax Authorities of Aruba to obtain information about taxpayers from third parties, eg, banking information, and to exchange tax information with other countries. The introduction of this legislation made it possible for Aruba to meet its obligations to provide tax information to foreign tax authorities under the future TIEAs. On 21st November 2003, Aruba concluded a TIEA with the US that became effective as from 13th September 2004.

The final implementation of the OECD commitment is an ongoing process. Most elements of the commitment have been put in place. Other elements are waiting until a level playing field with OECD members has been established. The Caribbean states share the feeling that there is still a long way for the OECD to go until a level playing field has been established.

European Code of Conduct

More or less simultaneously with the OECD, the EU launched its own harmful tax competition project back in 1997 (Code of Conduct for Business Taxation, 1st December 1997). On the basis of this political document, the Code of Conduct working group (the Primarolo Group) published a blacklist in 1999, including 66 harmful tax regimes of EU member states and their dependent or associated territories. Four regimes of Aruba (being an associated territory of the Netherlands) were blacklisted (offshore regime, captive insurance, free zone and Aruba Exempt Company regime). Aruba voluntarily committed to abolish these four regimes or to remove their harmful elements by the end of 2005. Due to this commitment, all these regimes have been removed from the blacklist, so Aruba is also "clean" from an EU perspective. This commitment has been implemented in the two major tax reforms that took place in 2002 and in 2005, as discussed below.

European Savings Directive

Finally, Aruba committed vis-à-vis the EU to implement the EU Savings Directive, that provides for an automatic exchange of information on the interest income of individuals resident in the EU. As a consequence, Aruba recently amended its General Tax Act to allow for

this automatic exchange of banking information with the 25 EU member states. It concluded bilateral agreements with 24 member states of the EU to provide a legal basis for the international exchange of information on savings income. (Aruba already had a legal basis for the exchange of information with the Netherlands). The Savings Directive became effective on 1st July 2005, and Aruba will exchange information on savings income with retroactive effect from 1st January 2005.

Abolition of Offshore Regime

Between Christmas and New Year's Eve 2002, Aruba enacted a major tax reform that became effective as from 1st January 2003: the New Fiscal Framework (NFF). The general corporate income tax rate was converted from a slightly progressive rate into a flat rate of 35%; the low-tax offshore regime was abolished (grandfathering until mid- 2008) as well as the tax holiday regime which was mainly used for the hotel business. A regular dividend withholding tax was also enacted (general tax rate of 10%, but 5% for quoted companies) and an imputation regime (IPC regime) was introduced, the latter after consultation with, and approval from, the OECD. The abolition of the offshore regime satisfied Primarolo's wishes. The amendment of the Exempt Company regime and the Free Zone regime was postponed until 2005.

IPC Regime

The IPC regime was introduced to stimulate domestic enterprises (the hotel business and the oil & gas sector) as well as to attract foreign investment, preferably of a nature that combines well with Aruba's fully developed tourist industry. For example, fashion-related R&D and investment in intellectual property, related to the music industry, would be likely to benefit from the IPC regime. However, the more general financial services sector was also accommodated by the regime. A company that qualifies for the IPC regime pays the standard corporate income tax rate of 35%, but its direct shareholders are entitled to an imputation payment if and when the company distributes its earnings. The imputation payment is made by the government and is equal to 33/65 of the dividend distribution. The imputation payment can be triggered by a dividend distribution shortly after the payment of corporate income tax in Aruba. Although the dividend distribution and the imputation payment are subject to dividend withholding tax, this is not the case if the dividend is distributed to a direct holding company in Aruba, because this holding company can benefit from the participation exemption that is embedded in the Aruban Corporate Income Tax Act.

The IPC regime is open to companies (NVs) engaged in qualifying activities. These are: hotel business (upper segment), airline and shipping operations, holding activities, research and development, exploitation of intellectual property, passive investment (with the exception of investment in real estate), captive insurance, and finance or group finance activities.

Since the EU Code of Conduct not only prescribes a "rollback" of existing regimes, but also a "standstill" with respect to newly introduced preferential regimes, the IPC regime that was introduced in 2003 in Aruba has also been reviewed thoroughly by the Primarolo Group. It approved the regime (with some amendments to its list of qualifying activities) in February 2005, which decision has been formalized by the Ecofin Council of 6-7th June 2005.

New Fiscal Framework 2006

On 6th December 2005, Aruba enacted the second phase of the New Fiscal Framework (NFF 2006). This tax reform became effective from 1st January 2006. In this tax reform, commitments that were made to the EU in 2003 were implemented. The tax reform has two legs: one act relates to the amendments of the Aruba Exempt Company regime; the other act relates to the introduction of a check-the-box regime (fiscal transparency regime).

Aruba Exempt Company Regime

The general tax exemption of the Aruba Exempt Company (AVV) was abolished from 1st January 2006. A much more specific tax facility was introduced. Under this new legislation, an AVV will not be taxed if it exclusively derives its income from the following activities: holding activities, finance activities, passive investment activities, and/or licensing activities. Existing AVVs that qualify for this new exemption regime may convert automatically from the old into the new exemption regime, on the sole condition that outstanding registration fees (if any) have been paid. AVVs that do not qualify for this new exemption regime are taxed, as any other taxable entity, with corporate income tax in Aruba (35%). To avoid this, existing AVVs may also opt for fiscal transparency (see below).

Fiscal Transparency Regime

In a similar system to the US check-the-box regime, Aruba introduced the possibility for domestic companies (NVs or AVVs) to opt for fiscal transparency, effective as from 1st January 2006. The fiscally transparent company (the "Aruba Transparent Entity," or "ATE") will be treated as a partnership for purposes of corporate income tax, dividend withholding tax and personal income tax. This means that the assets and liabilities and the income of the ATE are directly attributed to the shareholders of the ATE for tax purposes. Domestic enterprises may use this regime to file the tax return of a group of companies on a consolidated tax basis, by having the subsidiaries opt for fiscal transparency. Foreign investors may use the regime to have the best of both worlds: the use of a legal entity, but without the burden of adding a new taxpaying entity to their investment structure. Foreign investors who use the transparency regime will be taxed in Aruba if the activities of the ATE constitute a branch ("permanent establishment," or "PE") for the foreign investor in Aruba, or if the ATE owns real property in Aruba. Whether the foreign investor owns a PE in Aruba will be decided along the lines of the OECD-model convention. For instance, if the transparent entity is not engaged in business activities, but in mere passive investment or in the holding of shares in subsidiaries, the activities of the ATE will most likely not constitute a PE for the foreign shareholder of the ATE in Aruba. This is also true if the management of the ATE is conducted by a domestic trust office in Aruba (ref. Article 5(2) of the OECD-model convention).

Conclusion

With these two major tax reforms, its OECD commitment and positive approach towards the EU (Primarolo and the Savings Directive), Aruba has clearly moved away from its tax haven image. It is now becoming an ordinary tax jurisdiction that is very much willing to comply with the international standards of transparency and exchange of information. As a next step, Aruba is considering the introduction of a more flexible type of corporate entity in its company laws. The government of Aruba has also made a strong commitment to strengthen its financial services sector. Although the tourist industry is flourishing in Aruba, as is the large oil refinery, diversification of its economy is really a must for the jurisdiction, as was also pointed out by the IMF and the World Bank in their recent reports about Aruba.

www.arubafinancialcenter.aw

ENDNOTES

1 The author is an advisor to the Aruba Financial Center and the Ministry of Finance and Economic Affairs of Aruba.

2 The commitment can be found on the website of the OECD: www.oecd.org.