

## RECENT AMENDMENTS TO KUWAITI COMPANIES LAW

by

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The Kuwaiti government recently enacted amendments to three provisions of the Commercial Companies Law.<sup>1</sup> The text of these amendments (and the accompanying official explanatory memorandum) suggest that the changes are primarily intended to facilitate investments by Kuwaiti holding companies. (Holding companies are designed to establish, acquire and support the operation of other commercial companies.)

The amendments, which became effective July 23, 1995, should also have a significant impact on foreign companies doing (or seeking to do) business in Kuwait, as both Kuwaiti and foreign juristic persons will now be permitted to directly hold shares in Kuwaiti limited liability companies. As a result, the recent amendments should eliminate the need for certain stop-gap measures adopted by businesses to overcome the practical difficulties created by the prior law.

In order to provide context to the recent Companies Law amendments, we initially review some related matters in Kuwait pertaining to nominee shareholders and income taxation rules.

### A. Limited Liability Companies

#### 1. Background

Kuwaiti was the first Gulf Arab country to enact a company law<sup>2</sup>. The Kuwaiti Commercial Companies Law, Law No. 15 (1960) as amended, like many other Middle Eastern company laws, was derived from civil law (French and Egyptian) sources. As a result, civil lawyers will be familiar with most features of the Kuwaiti Companies Law. For example, as in the Franco-Egyptian model, the Kuwaiti Companies Law makes some distinction between societes de personnes and societes de capitaux.

In general, only two types of companies are available to a foreign party planning to establish a company in Kuwait. These are a limited liability company, which in Kuwait is referred to as a company "with limited liability" ("WLL" company), and is similar to the limited liability company in other Middle East countries (and the French societe anonyme responsabilite limitee); and a closed shareholding company (similar to the continental societe anonyme).<sup>3</sup> Under Articles 68 and 191 of the Kuwaiti Companies Law, respectively, Kuwaiti-owned equity cannot be less than 51 percent of the total share capital in either the shareholding company or WLL company. Article 23(1) of the

Kuwaiti Commercial Code, Law No. 68 (1980), contains a similar requirement, stating:

No person other than a Kuwaiti may carry on a trade in Kuwait, unless he has one or more Kuwaiti partners, provided that the capital invested by the Kuwaitis in the commercial establishment is not less than 51 percent of the total capital of the business.

For many years, businessmen and lawyers criticized aspects of the Kuwaiti Companies Law. For example, businessmen encountered some unusual obstacles in the Companies Law rules for the WLL company, the most common form of Kuwaiti company in which foreigners invest. In particular, under Article 185 of the Companies Law, all partners in a WLL company have been required to be natural persons. Juristic persons (corporate entities) could not own shares of a Kuwaiti WLL company.

This restrictive rule of the Kuwaiti Companies Law might be explained through a quick look at the history and development of the limited liability company in France<sup>4</sup>. In fact, the limited liability company first appeared in Germany, in 1892, but the concept was borrowed by the French legislator in 1925 -- perhaps in response to the desire of French merchants for a form of company which limited their liability to the value of their shares, but without the intricacies and complications arising from the establishment and management of the societe anonyme. The limited liability company was a quick and impressive success, even though (or perhaps because) it was a form of company that mixed elements of societes de personnes and societes de capitaux.

In 1966, the new French company law adopted the latest legal developments in the limited liability company form, which generally reflected its evolution closer towards a societe de capitaux, particularly towards the societe anonyme form, in such aspects as its establishment, management, supervision and transfer of its shares. By this time in France, one might have called the limited liability company a "mini" societe anonyme, with some residual features of a societe de personnes, such as in the limited number of shareholders permitted, and the restrictions against completely free transferability of shares. At this same time (1966), however, French company law no longer prohibited corporate shareholders in the limited liability company form.

Some Middle East countries, which had already adopted the continental limited liability company form, tended to lag behind the subsequent developments taking place in Europe -- particularly the change allowing corporate shareholders in limited liability companies. Egyptian Company Law No. 26 (1954) prohibited such corporate shareholders, until the Egyptian law was amended in 1977<sup>5</sup>. A similar prohibition had been adopted by the Kuwaiti government, when the Kuwaiti Companies Law was enacted in 1960, presumably under the influence of Egyptian

jurisprudence and the then-current Egyptian company law. This prohibition has remained as part of Kuwaiti company law, perhaps without thorough consideration on the significance (or theoretical rationale) of the prohibition.<sup>6</sup>

## **2. Nominee Arrangements.**

To avoid the restriction in Article 185 of the Kuwaiti Companies Law, i.e. prohibiting corporate shareholders in WLLs, businessmen (presumably with the active involvement of their legal and other advisors) developed an arrangement whereby corporate shareholders (including foreign companies) held their WLL shares through individual trustees or nominees, either Kuwaiti or non-Kuwaiti nationals. Such nominee arrangements would usually involve a "side agreement" between the nominal and true owner of the shares, with the other WLL shareholders providing either an explicit or (more commonly) an implicit acknowledgement of the nominee arrangement.

Many businessmen believed that these nominee arrangements might be enforceable under general principles of Kuwaiti contract law. Over the years, however, the permissibility of such arrangements under Kuwaiti law was questioned, particularly as they apparently had not been tested in the Kuwaiti courts.<sup>7</sup>

Similarly, at least a few attorneys advised that unofficial/unregistered WLL shareholding contracts were null and unenforceable, because the Companies Law requires that WLL articles of association (in which the WLL shareholders are named) be drawn up in an official writing (Article 192 of the Companies Law), and that WLL share transfers (again, naming the WLL shareholders) take place through an official writing (Article 197 of the Companies Law).<sup>8</sup> Such corporate documents presumably become "official" only after registration with the Companies Department at the Ministry of Commerce and Industry.

Of course, nominee arrangements would be particularly suspect if used in an effort to evade other provisions of Kuwaiti law, such as the requirement that WLL companies be majority-owned by Kuwaitis. Thus, where a foreign company uses a Kuwaiti nominee to gain ownership of all (or a majority share) of a WLL company, the nominee arrangements would seem to be clearly void under Kuwaiti law, as violating the requirement of majority Kuwaiti ownership -- a matter of local public order.

In addition, as discussed below, Kuwaiti tax authorities could (and in some cases did) attack nominee arrangements under which a taxpayer intentionally or unintentionally avoids payment of Kuwaiti income taxes.

## **3. Income Taxation**

Kuwaiti Decree No. 3 of 1955 (the "Tax Law") established a corporate income tax in Kuwait. Article 1 of the Tax Law imposes

tax on "every body corporate wheresoever incorporated carrying on trade or business in Kuwait ...".<sup>9</sup> Individuals, whether of Kuwaiti or foreign nationality, are not subject to Kuwaiti income tax.

Although the Tax Law was enacted in 1955, it was not actively enforced for many years, with some exceptions (such as to income of oil companies).<sup>10</sup> Over the past decade, the Kuwaiti tax authorities have gradually become more active in applying and assessing income tax to a wider range of companies.

Because foreign companies -- but not individuals -- are subject to Kuwaiti income tax, some foreign companies may have avoided that tax in the past as a result of nominee shareholding arrangements. In many cases, foreign companies' use of the nominee arrangement has been designed primarily to overcome the Article 185 prohibition discussed above. In other cases, some foreign companies may have used the nominee arrangement as a tax planning device to avoid (in fact, evade) Kuwaiti income tax.<sup>11</sup>

In either case, the Kuwaiti tax authorities have become increasingly diligent in recent years, in looking beyond the nominal shareholders in a WLL and uncovering the true owners of shares.<sup>12</sup> Supported by the rule of "substance over form", the Kuwaiti tax authorities take the position that a nominee arrangement should not exempt a foreign shareholder from otherwise applicable Kuwaiti income tax.

In that light, the Ministry of Finance has required in recent years<sup>13</sup> at least some foreign individuals holding shares in Kuwaiti WLL companies to either disclose the identity of the shareholder(s) for whom the individual is acting as nominee, or else sign the following "Certification and Declaration":

In accordance with this certification (declaration), \_\_\_\_\_ Partner/Stockholder in \_\_\_\_\_ do hereby certify that I am personally a Partner/Stockholder and not representative of any other foreign company -- and if anything to the contrary does appear (surface) I shall be solely legally responsible in accordance with the terms and conditions of Article 12 of the Internal Tax Decree No. 3 for the year 1955 which states that any false declaration which affects the Tax Decree shall be considered guilty of and in violation of the conditions of said Decree.

Signature: \_\_\_\_\_

Civil I.D. No.: \_\_\_\_\_

Date: \_\_\_\_\_

Seal

Under the Kuwaiti Tax Law, any person convicted of falsifying financial records, certificates or a tax declaration is subject to fine, imprisonment up to two years, or both penalties. In the event a taxpayer fails to file its tax return or pay the income tax owed, without reasonable excuse, the taxpayer will also be assessed a fine of 1% for each 30 days of delay.

#### **4. Recent Amendments.**

Although a number of large Western multinational companies invested in WLL companies based on a nominee shareholder arrangement, most of these companies were uncomfortable with it. Such investing companies usually took care to appoint nominee shareholders who were trusted senior employees of the investing company, thereby minimizing some of the risk inherent in the arrangement. However, a number of risks remained -- such as the risks of a nominee's death, job termination or relocation. Moreover, each time WLL shares are transferred to a new nominee, the other WLL shareholders must agree to waive their statutory right of pre-emption.<sup>14</sup>

For over a decade, legal observers have been anticipating a redrafted Kuwaiti companies law, which would include an appropriate amendment to allow corporate shareholders in WLL companies. In the aftermath of the Gulf War, however, the timing of such legislation initiatives became dependent on how speedily the Kuwaiti government resolved other legal issues of greater priority during the reconstruction period.<sup>15</sup>

In early 1993, a comprehensive draft of a new Kuwaiti commercial companies law was published serially in a local Arabic newspaper.<sup>16</sup> Article 289 of that draft law contained the most relevant provisions as to WLL shareholders and, unlike Article 185 of the then-existing law, did not contain any explicit restriction against corporate shareholders. Thus, it seemed that corporate entities would have been allowed to participate in WLLs, if the comprehensive draft law had been enacted. Sources in the Kuwaiti National Assembly recently advised that there is little current momentum for enactment of any such comprehensive new Kuwaiti companies law.<sup>17</sup>

Although the recent amendments to the Companies Law are quite limited in scope (when compared to an overhaul of the entire law), they are also attractive in their simplicity. For example, the obstacle to corporate shareholding in WLLs is eliminated by the simple deletion of the sentence in Article 185 which states that "[o]nly natural persons are allowed to be partners in limited liability companies". Article 185 otherwise

remains unchanged.

Somewhat surprisingly, at least in our view, the explanatory memorandum which accompanied the recent amendments neither mentions the evolution of the limited liability company form in comparable civil law jurisdictions; nor does it mention Kuwait's conscious decision to permit evolution of the WLL form closer towards a societe de capitaux. Rather, at least according to the explanatory memorandum, much of the impetus for this change in the Companies Law is attributable to the increasing importance given to Kuwaiti holding companies.

### **B. Holding Companies**

The Kuwaiti Companies Law was amended twice in 1992. Law No. 16 added an important new section, permitting the merger and consolidation of Kuwaiti companies. Many observers believe that those provisions were designed, at least in part, to permit the merger of Kuwaiti banks.<sup>18</sup>

The other 1992 amendment, Law No. 117, added another new (albeit shorter) section to the Companies Law, permitting the formation of Kuwaiti holding companies. Some observers believe that the impetus for holding companies comes, at least in part, from the Kuwaiti government's desire for the private sector to take a larger role in domestic economic activity. Local economists believe that the Kuwaiti private sector has an increasingly important role to play in pulling the country's economy out of the doldrums. Kuwaiti investment, privatization and other rationalization measures would be encouraged (and facilitated) through domestic holding companies<sup>19</sup>, offering an alternative to capital outflow.

The permitted purposes and activities of Kuwaiti holding companies are remarkably similar to those permitted for Lebanese holding companies, under Lebanese Legislative Decree No. 45 (1983), which seems to have strongly influenced the relevant Kuwaiti legislation.<sup>20</sup>

The explanatory memorandum for Law No. 117 acknowledged that the Companies Law prohibited corporate entities from holding shares in Kuwaiti WLLs, but recognized that holding companies might hold shares of foreign limited liability companies, if the laws of the applicable jurisdiction so permitted. The explanatory memorandum stated that Kuwaiti holding companies are extremely important to the national economy: such holding companies play the role of financier in the establishment of new commercial companies, and provide a vehicle for banks and investment companies to conduct lending and financing operations. These statements are repeated verbatim in the explanatory memorandum for the 1995 amendments to the Companies Law.

That latter explanatory memorandum also emphasizes the

importance and advantages of allowing holding companies to establish (and own shares of) WLL companies. Given that explanatory memorandum's emphasis on holding companies, a few observers in Kuwait initially thought that the amendments might be applicable only to Kuwaiti holding companies. Under that view, shareholding in WLLs would be permitted only to natural persons and (now) Kuwaiti holding companies, which would have meant that foreign companies were still prohibited from shareholding in WLLs.

However, most legal observers did not agree with this interpretation, at least in part because the amendment to Article 185 could have been, but was not, amended so narrowly. Officials at the Kuwaiti Ministry of Commerce and Industry were quick to end any doubts in this regard, by advising all interested parties that foreign and Kuwaiti companies (and not only Kuwaiti holding companies) may register as shareholders in Kuwaiti WLLs.

### **C. Effects on Foreign Firms**

By eliminating the Article 185 restriction described above, the Kuwaiti government has removed the most defensible justification for companies' use of the nominee shareholder device. As a result, some companies have already begun the process of formalizing their ownership in Kuwaiti WLLs by transferring the relevant shares from their nominees.

Nonetheless, some foreign companies may be reluctant to end their nominee shareholder arrangements - - at least in the past, the device has often had the practical effect (described above) of relieving foreign companies of a significant Kuwaiti income tax burden. The temptation has been powerful, given the high rate of Kuwaiti income tax (up to 55 percent of net income) and the absence of a comprehensive set of bilateral treaties for the prevention of double taxation.

Two possible developments might reduce that temptation in the future. First, the Kuwaiti tax authorities will probably continue, or increase, their efforts to ferret out the substance rather than the form of WLL shareholding, perhaps, for example, through wider use of the shareholder "Certification and Declaration" quoted above.

Second, the Kuwaiti government has begun to discuss reductions in income tax rates (perhaps a reduction of the top rate to 30 percent of net income). Such tax rate reductions should presumably not only increase foreign investment into Kuwait, but also reduce the perceived advantage of such devices as nominee shareholders.

**ENDNOTES**

1. These amendments to Law No. 15 (1960) were enacted under Law No. 29 (1995), published in the Kuwaiti Official Gazette (Al-Kuwait Al-Youm), v. 41 n. 216, 23 July 1995.
2. Nabil Saleh, "Company Legislation in the Gulf: Recent Developments", p. 91, in Commercial Law in the Middle East (1995). Iraq has been excluded from most descriptions of "Gulf Arab" states, perhaps more frequently after the establishment of the Gulf Cooperation Council. Mr Saleh is certainly aware that Iraqi company law preceded the Kuwaiti Companies Law. See, e.g., Iraqi Law No. 31 (1957).
3. The public shareholding company is capitalized through public subscription, and is established by Amiri decree.
4. The following discussion is based largely on Dr. Tharwat Abd Al-Raheem, Commentary on Kuwaiti Commercial Law (1975), pp. 421-22.
5. Article 281 et seq. of the Syrian Commercial Code, Legislative Decree No. 149 (1949), preceded Egyptian Law No. 26 (1954) in recognising the limited liability company form.
6. Dr. Al-Raheem, supra note 4, at p. 427, provides the following justification for the prohibition against corporate shareholders in WLLs: it prevents WLLs from being used to form cartels and other economic monopolies (!). Dr Al-Raheem notes that Egypt at the time applied the same prohibition, unlike Lebanon, Syria, France and Germany. (As noted above, Egypt eliminated the prohibition in 1977, two years after Dr. Al-Raheem's treatise was published.)
7. See Kassim, "A Guide to Joint Venture Law", Middle East Executive Reports (March 1985), at p. 17.
8. See, e.g., the "Legal Consultation Services" column of Sabah Al-Shamri in Al-Qabas (15 January 1995), at p. 31. In that column Mr. Al-Shamri also makes an initial (and uncited) reference to Article 65(2) of the Kuwaiti Civil Code, which states:

Failure to comply with a requirement of law, providing for a certain specified form for concluding a contract, renders the contract null.
9. Corporations, companies and even forms of partnership are all deemed "corporate bodies" for purposes of the Kuwaiti Income Tax law. A partnership would not seem to constitute

a "corporate body", but is regarded as a separate legal entity under Kuwaiti company law. Wholly Kuwaiti-owned companies and partnerships also fall within this definition, but in practice the Kuwaiti government does not impose income tax on such Kuwaiti entities.

10. See, e.g., Baker, "Kuwait: The Taxation of International Commercial Transactions", 1 Arab Law Quarterly 141, at 143 (Feb. 1986).

11. See, e.g., Kassim, supra note 7.

12. See, e.g., "Reconstruction in Kuwait: Investment and Tax Rules", Middle East Executive Reports (May 1991), at p. 14:

[T]hose foreign entities [participating in WLLs through nominees] have also been exempted by the tax department in the past. In effect, the department has not attempted to look beyond the individual nominees to the ultimate corporate owners. There are indications, however, that this practice is changing.

13. Id., at p. 15.

14. Under Article 197 of the Kuwaiti Companies Law, a WLL shareholder must

notify all other shareholders of any proposed sale of shares to an outside party. Those other shareholders have one month to exercise their right to purchase the shares on the same terms and price offered by the outside party.

15. See, e.g., Radwan and Stovall, "Reconstruction of Kuwait: Emerging Legal Issues", Middle East Executive Reports (April 1991).

16. Al-Qabas began publishing excerpts of the draft company law on 14 January 1993 and throughout the remainder of that month.

17. Incidentally, the Committee for Commercial Cooperation of the Gulf Cooperation Council has been working to develop various model or unified laws, including a companies law. In recent press reports, however, the Kuwaiti Minister of Commerce and Industry, Hilal Al-Matairi, has emphasized that any such unified law will be only "a guide" for use by each of the GCC states to revise (and harmonize) their own domestic laws. See "Al-Matairi: Unified Laws of Companies and Commerce for the Gulf States", Al-Qabas, 2 October 1995, p. 12.

18. Ironically, shortcomings in those amendments became evident almost immediately after enactment, at least as to their use for merger of banks. See, e.g., Kabbara, "A Legal Perspective on Merger of Banks", Al-Qabas (6 Dec. 1992). As a result, further amendments were enacted in early 1994. The Kuwaiti Central Bank Governor, Sheik Salam Al-Sabah, subsequently summarized possible advantages of merger for some Kuwaiti banks: "... increasing the capital of the banks, benefiting from the economies resulting by establishment of banking organisations with larger volumes, and enabling them to have a strong and competitive base ....". Interview with Central Bank Governor, Al-Hayat (9 Sept. 1994), p. 10.
19. Earlier this year, the managing director of the Kuwaiti Investment Authority, Ali Rashid Al-Badr, also indicated that "[l]aws and regulations are under review to make it easier and more attractive for foreign investors to enter the market". Middle East Economic Digest, 31 March 1995, p. 18.
20. For a brief description of recent initiatives relating to Lebanese holding companies, see Nasser, "Transforming Lebanon Into a Tax Haven", Middle East Executive Reports (August 1995), p. 8.