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The new Transfer Pricing regime in the United Arab Emirates

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Introduction

On 31 January 2022, the Ministry of Finance (MoF) of the United Arab Emirates (UAE) announced that the UAE will introduce a Federal Corporate Tax (CT) on business profits that will be effective for financial years starting on or after 1 June 2023. On 28 April 2022, a Public Consultation Document (PCD) was published with more detailed information on the proposed UAE CT regime with the intention of seeking views from interested parties and stakeholders before implementation.

On 9 December 2022, the UAE released the Federal Decree-Law No. 47 of 2022, issued on 3 October 2022, on the Taxation of Corporations and Businesses (CT Law). In addition, the MoF released 158 Frequently Asked Questions (FAQs)[1] to provide guidance on the UAE CT regime. The CT Law will be administered by the Federal Tax Authority (FTA).

The following sections provide an overview of the CT Law in the context of the UAE Transfer Pricing (TP) rules, the potential impact, and how UAE businesses can address their TP framework going forward.

A summary on the background of the UAE CT Law and the TP rules

The intention of the Organization of Economic Cooperation and Development's (OECD's) project on Base Erosion and Profit Shifting (BEPS) published in 2013 was to bring more coherence, substance and transparency to the international tax system. The BEPS package provides 15 Actions that equip governments with the domestic and international instruments needed to tackle tax avoidance. The aim was to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.[2]

A key part of the OECD/G20 BEPS Project is to address the tax challenges arising from the digitalization of the economy (Action 1). The OECD/G20 Inclusive Framework, which has 141 members on an equal footing, was mandated to address these challenges. As of 4 November 2021, over 135 member countries and jurisdictions joined a Two-Pillar Solution to ensure that large multinational enterprises (MNEs) pay a global minimum tax where they operate and earn profits.

The UAE became part of the Inclusive Framework (IF) on BEPS on 16 May 2018 and committed to implementing the four anti-BEPS minimum standards. The introduction of a CT regime helps to provide the UAE with a framework to adopt the Two-Pillar Solution. Further guidance is expected on the implementation of the Pillar Two rules in the UAE.

The CT Law introduces a comprehensive TP regime which is broadly in line with the OECD TP Guidelines (OECD TPG). The CT Law provides more details in relation to the TP rules, specifically on the following items:

- Article 34 – The Arm's Length Principle;
- Article 35 – Related Parties and Control;
- Article 36 – Payments to Connected Persons; and
- Article 55 – Transfer Pricing Documentation.

In addition to the above, the CT Law embedded references to Related Party transactions in various Articles to emphasize the application of the arm's length principle.

UAE TP rules

Typically, TP rules apply to cross-border arrangements[3] entered between related parties. However, a key observation from the UAE TP regime is that it appears to apply broadly to any arrangements between related parties and connected persons. These rules should apply to all taxpayers, including corporations, partnerships, trusts, and any other taxpayer. In addition, the rules apply equally to foreign owned enterprises and domestically owned enterprises regardless of the tax regime they may fall within such as that of the mainland or under a Free Zone.

Consequently, the TP regime should apply equally to solely UAE and cross-border transactions or arrangements.

The Arm's Length Principle

Under the CT Law, Article 34 gives the FTA power to reallocate income or expenses between related parties and connected persons to clearly reflect taxable income (or to prevent the evasion of taxes).

The FTA determines the taxable income through an analysis of whether the taxpayer has dealt at arm's length with other related parties. A related party transaction or arrangement, conducted at arm's length, should produce results (profits and conditions) that would have been realized if unrelated taxpayers had engaged in the same transaction under the same circumstances. The standard in every case is that of unrelated parties transacting at arm's length (or the arm's length principle).

Under Article 34(1) of the CT Law:

"A transaction or arrangement between Related Parties meets the arm's length standard if the results of the transaction or arrangement are

1 Source: Corporate Tax FAQs: https://mof.gov.ae/corporate-tax-faq/
2 Source: OECD (2021) Base Erosion and Profit Shifting Project, Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, highlights brochure.
3 Arrangements should be understood in the broadest sense to include all relevant pricing and non-pricing conditions and interactions between related parties and connected persons.

consistent with the results that would have been realised if Persons who were not Related Parties had engaged in a similar transaction or arrangement under similar circumstances."

The general principles of Article 34 are likely to be implemented through more detailed guidance which will address the complexity of related party arrangements by requiring an evaluation of their substance, rather than mere reliance on their form. In this regard, the UAE already has prescriptive rules regarding economic substance (see Ministerial Decision No. 100 for the year 2020 on the issuance of directives for the implementation of the provisions of the Cabinet Decision No. 57 of 2020 concerning Economic Substance Requirements).

Depending on the nature of the related party transactions or arrangements (i.e., transfer of tangible assets, transfer of intangible assets, provision of services, or loans), Article 34 provides for different TP methods to determine appropriate arm's length prices (paragraph 3). While each type of transaction entails a unique substantive analysis, all cases are measured against the arm's length principle.

Taxpayers may apply various TP methods to evaluate whether arrangements between related parties satisfy the arm's length principle. Specifically, Article 34 paragraph 3 provides specific guidance as to appropriate methodologies. Consistent with the OECD TPG, the arm's length methodologies are as follows:

- Comparable Uncontrolled Price (CUP) method;
- Resale Price (RP) method;
- Cost-Plus (CP) method;
- Profit Split Method (residual or contribution) (PSM); and
- Transactional Net Margin Method (TNMM).

Article 34 does not prescribe any particular methodology or preference for the order in which methodologies might be applied to arrive at an arm's length outcome. The objective should be interpreted as allowing the greatest possible scope to use methodologies appropriate in the circumstances, given the myriad of different and unique cases that may arise. The most appropriate methodology should be adopted based on the facts and circumstances of the case.

In this regard, all factors that might affect comparability must be evaluated prior to acceptance of any method. Specifically, comparability typically is evaluated by reference to functions, contractual terms, risks, economic conditions, business strategies, and the property or services that are the subject of the transaction (paragraph 5). Although all factors must be considered, specific factors may be particularly relevant depending on the type of transaction (i.e., a transfer of tangible or intangible property) and the TP method applied. Nonetheless, to be comparable means that none of the differences (if any) between the situations being compared would materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Comparability analysis under the CT Law is consistent with the OECD TPG.

It follows that comparability should be based on a practical weighing of the circumstances and the information available to support the various methodologies, having regard to the following factors amongst others:

- the nature of the activities being examined and the degree of comparability that exists between the controlled and uncontrolled international dealings or enterprises;
- the availability, coverage and reliability of the data used to determine the arm's length price;
- the financial and other data relating to the activities of the company; and
- the nature and extent of any assumptions used or needed to be used.

Preference should be given to the method (or combination of methods) which most closely reflects the operation of market conditions of the taxpayer, and which requires few adjustments, such as it prevails in the open market, in respect of the taxpayer's operations in the UAE. If a method's reliability is disputed, it may be necessary to use another to confirm the results.

Whilst no explicit mention has been made of the principles articulated in the OECD TPG, the following considerations are likely to be relevant in this regard:

- the respective strengths and weaknesses of the possible methods in their application to the actual conditions;
- the circumstances, including the functions performed, assets used, and risks borne by the entities;
- the availability of reliable information required to apply a particular method; and
- the degree of comparability between the actual circumstances and the comparable circumstances, including the reliability of any adjustments to eliminate the effect of material differences between those circumstances.

Further to this, paragraph 4 of Article 34 provides that a taxpayer may use a method other than those specified in the regulations to evaluate whether the results of related party arrangements are consistent with the arm's length principle where such method is the most appropriate under the circumstances. In each case, the other method must evaluate the terms of a transaction by considering the realistic alternatives to that transaction and by evaluating pricing based on the selected transaction only if neither of the alternatives is preferable to it. Therefore, where none of the methods mentioned above can be applied or where another method would produce a more reliable result, such another method can be applied. However, taxpayers would be well advised to explain why this method is the most appropriate.

Following on from the above, there are many occasions where the application of the most appropriate method results in a range of outcomes. This can be because of two main reasons. Firstly, the arm's length principle only produces an approximation of conditions that may have been established by independent enterprises. Secondly, the use of more than one method may produce different results due to the nature and application of the different methods.

On this basis, an arm's length range should use comparable uncontrolled transactions or arrangements with a high degree of reliability compared with controlled transactions or arrangements. Where there is a substantial difference in the range, it may be due to the inclusion of some unreliable data, or distinguishing features of the comparable data such as functions, assets and risks. If material differences are identified between comparable uncontrolled arrangements, adjustments may be necessary to improve the reliability of the data. The OECD TPG states that where an outcome falls within the arm's length range, the controlled transaction or arrangement may be considered arm's length. However, under paragraph 8 of Article 34, should an outcome fall outside the arm's length range, an adjustment should be made to reflect the point within the range that best represents the facts and circumstances of the related party arrangement. In this context, the CT Law provides for TP adjustments which will be discussed below.

TP adjustments

The UAE TP rules state that when the results of a transaction or arrangement between related parties does not fall within the arm's length range, the FTA shall adjust the taxable income by performing an adjustment to ensure that the result in the controlled transaction reflects the best facts and circumstances of the transfer price (i.e., that it is priced on an arm's length basis).

To ensure transparency on domestic adjustments, where the FTA or a taxable person adjusts the taxable income for a transaction or arrangement to ensure that it complies with the arm's length standard, the FTA will make a corresponding adjustment to the taxable income of the related party that is on the other side of the transaction or arrangement. Hence, reducing the administrative burden of the taxpayer by directly adjusting the tax liability of the corresponding related party.

In the event there is a TP adjustment in a foreign country for a transaction involving a UAE entity, the UAE entity can make an application for a corresponding adjustment to eliminate and/or minimize the risk of double taxation. This specific clause in the CT Law reflects the UAE's positive attitude to facilitate businesses and to reduce their burdens. Note that this does not mean they would accept a corresponding adjustment by default. The definition of a corresponding adjustment of the UAE TP rules is consistent with the OECD TPG.

Related Parties

The UAE TP rules define related parties under Article 35 as a natural person or juridical person who has, directly or indirectly, a relationship through **ownership, control, or kinship**. Although the ownership and control definitions are generally aligned with the OECD TPG and the OECD Model Tax Convention definitions, the UAE introduced a threshold of 50% for ownership and defined the criteria of 'control'.

The UAE has a stricter definition than the OECD TPG as the latter only refers to 'participates directly or indirectly in the management, control or capital of an enterprise', without any reference to percentages. In addition, the UAE introduced the concept of kinship as part of its related party definitions for individuals.

The definition of kinship or affiliation is established by the relationship of two or more individuals who are related to the **fourth degree of kinship or affiliation**, which refers to the number of steps between two persons determined by counting the generations separation one person from a common ancestor. The fourth degree of kinship would include great-great grandparents, great-great-grandchildren, nieces, and nephews[4]. This may have broad consequences for the businesses operating in the UAE as there are many family-owned businesses in the UAE.

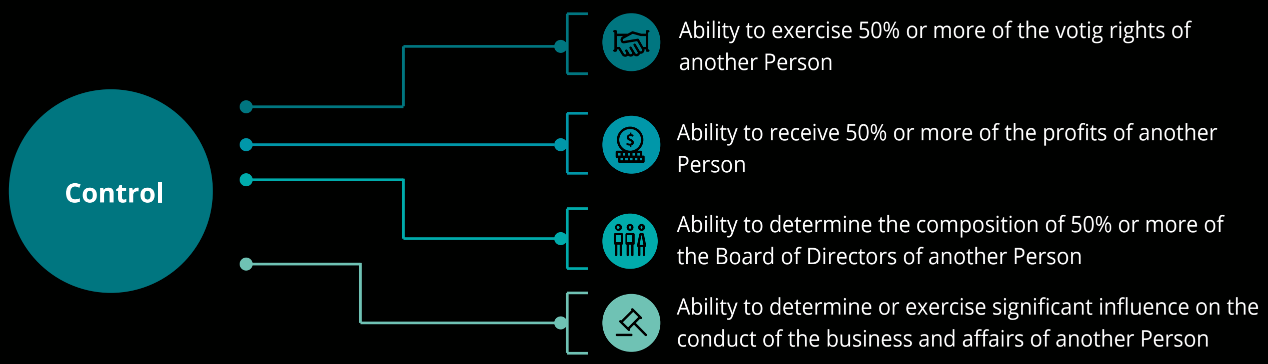
A permanent establishment or branch, and partners in the same unincorporated partnerships are also considered as a related party to the UAE TP rules. Also, related party definitions include a trustee, founder, settlor or beneficiary of a trust or foundation.

4 Definitions based on the Whistle Blower Program for Tax Violations and Evasion of the Federal Tax Authority.

Control

The UAE TP rules include considerations of control to assess the arm's length nature of controlled transactions. The concept of control under the UAE TP rules may be illustrated in the following cases as defined under Article 35 of the CT Law:

Exhibit 1. - Control definitions based on the UAE TP rules



Although the three considerations on ability to **exercise voting rights, receiving profits and establishing the board of directors** are straightforward in delineating additional considerations under control, the definition on ability to determine or exercise significant influence seems to be open-ended and inconclusive.

There are no specific steps outlined in the UAE TP rules on what would be considered as significant influence and/ or to conduct the business of another person, which could have a significant impact between financial and commercial arrangements with independent parties and the interpretation under related party definitions based on control.

Connected Persons

The concept for connected persons is also introduced in the CT Law. While this concept is not common in many jurisdictions where a TP regime is in place, the possible background to the introduction of connected persons is that at present, the UAE does not have any personal income taxes, which may incentivize (excessive) payments from businesses to individuals (that are connected persons to one another) to erode the taxable basis for corporate tax purposes.

The definition of a connected person as per Article 36 of the CT Law is an individual who directly or indirectly has an **ownership interest** in, or **controls**, the taxable person. A director or officer of the taxable person is also considered a connected person.

The UAE TP rules also refer to individuals related to the taxable person's owner, director, or officer. Partners in the same unincorporated partnership are also considered as connected persons.

As a measure to tackle tax base erosion, the UAE TP rules under Article 36 state that payments to connected persons shall be deductible if the following conditions are met:

1. corresponds with the market value of the service provided; and
2. are incurred wholly and exclusively for the taxpayer's business.

To determine that a payment or benefit corresponds with the market value of the service, the transaction must be priced on an arm's length basis. A key observation is that these conditions must be considered for the **deductibility of payments.**

However, deductibility restrictions on payments to connected persons would not apply to taxable persons whose shares are traded on a Recognized Stock Exchange or are subject to the regulatory oversight of a competent authority in the state. More guidance is also expected from the MoF on this item.

Tax groups and group relief

The CT Law grants residents who do not exceed a revenue threshold the ability to be treated as not having delivered any taxable income. The small business relief, as stated under Article 21 of the CT Law, in turn, exempts them from having to prepare TP documentation requirements (i.e., a Master File (MF), Local File (LF) and Disclosure Form, more on this is set out below). The revenue threshold for being subject to small business relief is expected to be set by the MoF at a later stage.

Transfers of assets and/ or liabilities within a group may also qualify for relief under certain conditions based on Article 26. The CT Law provides guidance that for transfers within the same qualifying group, it must be transferred at its net book value/ market value at the time of the transfer and that neither a gain nor a loss arises (i.e., on an arm's length basis).

Article 27 of the CT Law states that transfers or restructurings within a group could qualify for relief (i.e., no gain or loss needs to be considered for determining the taxable income) under certain conditions. The arm's length principle provisions under Article 34 may be relevant if the group cannot maintain the qualification conditions as specified under paragraph 2 and a potential claw back of the relief could be applied.

In relation to the taxable income of a tax group, Article 42 of the CT Law states that transactions between members of a tax group are eliminated in the consolidation of the group's financial statements, and hence there is no need to comply with the TP rules under such circumstances. If a member of a tax group needs to compute its **standalone taxable income** for the purpose of utilizing tax losses incurred before joining the group and/ or when leaving the group, the TP rules would apply.

Allocation of profits to Permanent Establishments

Under the CT Law, UAE residents are prima facie subject to corporate income tax on their worldwide income. One exception to this is provided by the foreign permanent establishment ("PE") exemption under Article 24, which effectively exempts certain foreign-sourced income of a UAE resident, which is derived in carrying on a business at or through a foreign PE. There are specific rules that surround the determination of income and associated expenses to which the exemption applies (although no mention on whether the income should be derived from an 'active' or 'passive' business).

Despite the above, where a foreign PE does exist, it is then necessary to determine the amount of income and associated expenses (business profits) that is attributable to that PE, as a separate and independent person in accordance with paragraph 4 of Article 24. Similarly, where the transfer of any assets or liabilities takes place, the transfer is required to be at Market Value.[5] With this in mind, it will be important to consider the provisions of the business profits article in the relevant double tax agreement (DTA) in conjunction with Article 24. Nonetheless, though the wording of the relevant article frequently differs between DTAs, this allocation broadly seeks to determine the profits that would be attributable to the foreign PE if it were a distinct and independent enterprise in line with the OECD TPG.

Whilst the CT Law does not make any reference to the "2010 Report on the Attribution of Profits to Permanent Establishments" approved by the Committee on Fiscal Affairs and by the OECD for the treatment of PEs, the wording of the above suggests that the UAE has embraced the functionally separate entity approach to allow notional transactions within an entity to achieve the appropriate attribution of profits. That is, there appears to be general acceptance that the separate entity approach is appropriate in determining the economic attribution of profits for the purposes of the CT Law.

Transfer Pricing Documentation

Documentation	Current Guidance & Requirements
Disclosure Form	The CT Law under paragraph 1 of Article 55, provides that certain taxpayers may be required to complete a disclosure form as part of their corporate income tax return which discloses information regarding the taxpayer's transactions with related parties and connected persons. Whilst the precise form and structure of the disclosure form is yet to be confirmed, it may require a considerable amount of information on the taxpayer's related party arrangements, including details about the category of transactions and whether types of transactions have been entered, e.g., business restructurings. In addition, it may also require information about transactions with specified low-tax jurisdictions. The precise details of the disclosure form will be clarified by the FTA in due course.
LF MF	Further to this, paragraph 2 of Article 55, also specifies the preparation and maintenance of a MF and LF in line with the OECD TPG in respect of intercompany transactions with related parties and connected persons subject to certain conditions being met as prescribed by the Minister.[6]
Penalty Considerations	In terms of documentation, the UAE's new TP legislation implements a self-assessment regime for TP, however it remains to be seen whether there will be a legislative link created between contemporaneous (i.e., it must be in existence at the time the taxpayer files its corporate income tax return) TP documentation and the ability of the taxpayer to claim penalty protection in the event of a TP adjustment. This is particularly important as the CT Law does not give any clear indication of TP specific non-compliance penalties that would be applied where taxpayers do not follow the TP documentation requirements and indeed the arm's length principle when they compute their taxable income. According to the OECD TPG, penalties would encourage compliance with the TP rules and incentives for a pre-transaction consideration of the TP rules. In this regard, it will be important to monitor the developments with respect to the Tax Procedures Law referred to in the preamble under Article 2 as its provisions will likely govern the potential penalties and fines relevant to the implementation of the CT Law.

Free Zones

Article 18 describes the conditions for a Qualifying Free Zone Person, which explicitly describes that a Qualifying Free Zone Person should comply with Articles 34 and 55 of the CT Law as this is one of the criteria for qualification.

This means that Qualifying Free Zone Persons should apply the arm's length principle for transactions with related parties (regardless of their location, e.g., foreign country, in other Free Zones or in the UAE mainland) and are obliged to fulfill the TP documentation requirements as described above, which is also explained in FAQ 97 and 115.

The CT Law does not describe the impact of income derived from UAE mainland but suggests that a Qualifying Free Zone Person should only derive Qualifying Income, which will be further specified in a Cabinet Decision, to apply the 0% Corporate Tax rate.

Although there is no further definition of Qualifying Income, this may potentially be aligned with the categories described in the PCD (e.g., income from foreign countries, income from other Free Zones and potentially passive income from UAE mainland, such as interest and royalties).

The CT Law does not reference deductibility of payments from related party mainland entities anymore (as was included in Article 3.31 of the PCD). This may be interpreted in two ways: i) either that the non-deductibility of payments from related party mainland entities is no longer relevant if related parties transact in line with the arm's length principle, ii) or that payments from related party mainland entities will not be included in the Cabinet Decision as one of the Qualifying Income categories. Where the PCD described a complex mechanism to determine the CT impact of transactions between Free Zone Persons and UAE mainland entities, it seems that the CT Law envisages a simpler mechanism. The Cabinet Decision will provide the details on the actual impact for businesses.

5 Defined as the price which could be agreed in an arm's-length free market transaction between Persons who are not Related Parties or Connected Persons in similar circumstances under Article 1 of the CT Law.
6 It should be noted that the UAE implemented the country-by-country (CbC) report in April 2019.

Advanced Pricing Agreement

Businesses could apply for clarifications in relation to the CT Law or for the conclusion of an Advanced Pricing Agreement (APA) for (related party) transactions or arrangements based on Article 59 of the CT Law.

This is in line with global best practices and provides businesses with certainty in relation to their TP positions. This may be considered as one of the incentivizing factors for businesses to establish and expand their activities in the UAE.

An APA in the UAE would effectively result in the protection and support of the UAE authorities in cases where a foreign tax authority would make a one-sided TP adjustment for a transaction that is subject to the APA. With the combination of the UAE's extensive network of double tax treaties, businesses could apply for a Mutual Agreement Procedure to minimize/resolve the risk of double taxation. This may provide businesses with a strategic benefit to obtain upfront certainty in the UAE in respect of their TP arrangements.

Businesses also can apply for a bilateral APA between countries to get certainty for both sides of the transaction.

The process for applying for an APA should be in the form and manner prescribed by the authorities.

Financing

Businesses are allowed to deduct their net interest expenses (i.e., interest expense that is more than interest income) up to 30% percent of the Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) and therefore should consider their financing arrangements to understand the impact of this rule on their current positions. Over leveraging an entity may result in non-deductible interest expenses and in addition, no deductions are allowed for interest expenses incurred on a loan obtained, directly or indirectly, from a related party for:

- A dividend or profit distribution to a related party;
- A redemption, repurchase, reduction or return of share capital to a related party;
- A capital contribution to a related party; or
- The acquisition of an ownership interest in an entity that is or becomes a related party.

However, interest expenses may still be deductible for the above loans if businesses can demonstrate that the main purpose of obtaining the loan is not to gain a Corporate Tax advantage (which is not deemed to arise where the Related Party is subject to Corporate Tax or a tax of a similar character at a rate no less than 9% on the interest).

Transactions between different segments

In accordance with the CT Law, there are certain types of taxpayers or businesses that are specifically excluded from corporate income tax. Most of the provisions relating to specific exempt taxpayers or businesses can be found in 'Chapter Three – Exempt Person' of the CT Law. The following exemptions are particularly relevant for TP purposes as set out under Article 4 paragraph 1:

- A Government Entity;
- A Government Controlled Entity;
- A Person engaged in an Extractive Business, that meets the conditions of Article 7 of this Decree-Law; and
- A Person engaged in a Non-Extractive Natural Resource Business that meets the conditions of Article 8 of this Decree-Law.

It follows that the income derived by these entities or businesses should not fall within the ambit of the CT Law (subject to certain requirements being met). However, there is an important consideration from a TP perspective that has been included in the CT Law with respect to related party transactions or arrangements in the context of exempt persons.

In this regard, the CT law provides that transactions between the exempt person (as set out above) and any other division or segment of the same taxpayer, will be treated as related party transactions and subject to the arm's length principle under Article 34 of the CT Law. This clearly illustrates that despite there being opportunities for certain taxpayers to avail exemptions from the CT Law to the extent there are transactions with divisions, business units or segments that fall outside of the scope of the exemptions listed above, there are TP implications that will need to be considered going forward. Whilst more specific details are likely to be required, it will be important that taxpayers organize their internal reporting accordingly to ensure transparency and accuracy in this regard.

Transitional provisions

The transitional provisions describe that opening balances of businesses should be prepared with a consideration of the arm's length principle. Therefore, businesses should transact at arm's length and value their balance sheet items at market value. This is also emphasized and effectuated by the specific clause that describes that the general anti-abuse rules will apply to transactions or arrangements entered into on or after the date of the CT Law is published in the Official Gazette.

Next steps

The developments in relation to TP in the UAE have far-reaching tax and non-tax/ operational implications for affected businesses. Alongside TP, these implications may also relate to legal structure, business model, contracting, accounting, profit and systems and data organization, and the organization of the tax function with a potential impact for various stakeholders within affected businesses.

Considering the timeframe left to prepare for the implementation of TP rules, companies should start assessing the impact for their business and what they need do to be prepared given the complexity of these rules.

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[1] Source: Corporate Tax FAQs: https://mof.gov.ae/corporate-tax-faq/
[2] Source: OECD (2021) Base Erosion and Profit Shifting Project, Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, highlights brochure.
[3] Arrangements should be understood in the broadest sense to include all relevant pricing and non-pricing conditions and interactions between related parties and connected persons.
[4] Definitions based on the Whistle Blower Program for Tax Violations and Evasion of the Federal Tax Authority.
[5] Defined as the price which could be agreed in an arm's-length free market transaction between Persons who are not Related Parties or Connected Persons in similar circumstances under Article 1 of the CT Law.
[6] It should be noted that the UAE implemented the country-by-country (CbC) report in April 2019.