



The new United Arab Emirates Transfer Pricing regime:

Plan, prepare, and prosper



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.¹

The proposed CT framework also includes a comprehensive Transfer Pricing (TP) regime. The published 47 Frequently Asked Questions (FAQs)² by the MoF clearly referred to TP rules being in alignment with the Organization of Economic Cooperation and Development (OECD) Transfer Pricing Guidelines (OECD TPG). In addition, the PCD provided more detail in relation to TP in section 7, specifically on the following items:

- Section 7.1: Related parties;
- Section 7.2: Connected persons;
- Section 7.3: Arm's length principle; and
- Section 7.4: Transfer pricing documentation requirements.

In this publication, we provide an overview of the background to the new UAE TP rules, their potential impact based on currently available public information, and how UAE based businesses can prepare.

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

The intention of the 2013 OECD's project on Base Erosion and Profit Shifting (BEPS) was to bring more coherence, substance, and transparency to the international tax system with the introduction of 15 actions. The aim was to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.³

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 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 is part of the inclusive framework and supports the Two-Pillar Solution. It has now introduced a Federal CT regime, which will be effective for financial years starting on or after 1 June 2023. As noted in section 2.4 of the PCD, the introduction of a Federal CT regime will also provide a basis for the UAE to execute its support of the global minimum tax as proposed under Pillar Two of the OECD/G20 BEPS Project.

As the intended Federal CT regime will be based on global best practices, and will incorporate principles that are internationally known and accepted, the rules will include an extensive TP regime in line with OECD's TPG as indicated in the FAQs and the PCD.

UAE TP rules

Section 7 of the PCD elaborates on the proposed TP treatment of transactions between related parties. The TP rules will apply the internationally recognized and accepted arm's length principle (ALP) for transactions between related parties and with connected persons.

The PCD refers to the TP rules and ALP as set out in the OECD TPG, which is consistent with the internationally accepted and applied standards. Based on this, and as illustrated below, transactions between related parties or with connected parties should be consistent with the results that would be achieved for transactions between independent parties in the same or comparable cases.



Related parties

The definition of a related party is quite common within TP regulations, as this is generally based on the OECD Model Tax Convention. The OECD refers to associated enterprises where, "an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State."

The PCD refers to a related party as an individual or entity who has a relationship through ownership, control, or kinship. Although ownership and control are generally in alignment with the OECD definition, the criterion of kinship is quite specific. This applies in transactions that may exist between natural persons. In certain cases, the natural persons may not be subject to any taxes (e.g., cases where they are not qualified as a being engaged in a business that is subject to CT), which may result in a situation where the income for that natural person is not taxed. Hence, these situations need to adhere to the ALP.

A branch or a permanent establishment is also considered as a related party for the UAE TP rules. For example, a branch in the UAE mainland may be considered as a related party of a head office in a Free Zone. Partners in the same unincorporated partnership are also considered as related parties.

Connected persons

The existence of the concept for connected persons is very specific to the UAE and is generally not considered in most other countries. The background to this is that the UAE does not have any personal income taxes, which may incentivize (excessive) payments from businesses to individuals (that are connected persons) to erode the taxable basis for CT.

A connected person 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 to be a connected person.

The PCD also refers to individuals that are related to the owner, director, or officer of the taxable person to the fourth degree of kinship or affiliation, including birth, marriage, adoption, or guardianship. This is a criterion which may have far-reaching consequences for businesses in the UAE to apply and maintain as there are many family-owned businesses in the UAE. More guidance is expected from the MoF on this item.

Any partner in an unincorporated partnership is also considered as a connected person in case there is one partner that is a taxable person, e.g., a natural person that is a partner with a legal entity or a natural person that is subject to CT.

To complete the above, a related party of any of the above descriptions is also considered to be a connected person.

As a measure to combat tax base erosion, payments to connected persons are only tax deductible if these:

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

Although there is no guidance on how to prove the market value of the service provided (e.g., with a benchmarking analyses), businesses may, for example, already start gathering information on salaries in the market to prove that the payment is in line with the market value. However, more guidance is also expected from the MoF on this item.

TP documentation requirements

The PCD stipulates the preparation and maintenance of a Master File (MF) and Local File (LF) in line with the OECD TPG in case intercompany transactions with related parties exceed a certain threshold, which is yet to be specified by the MoF.

A disclosure form should also be submitted for transactions with related parties and connected persons.

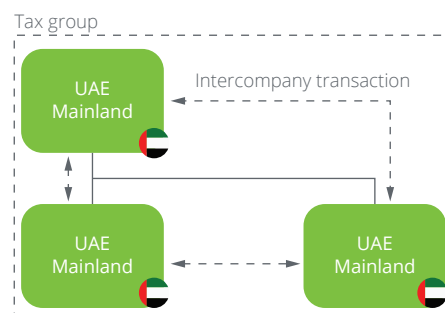
It should also be noted that the MF and LF requirement seems to be applied for related party transactions only, whereas the disclosure form extends to connected persons, as depicted in the below table. The disclosure form requirement also does not refer to any monetary threshold.

Transfer pricing documentation requirement	Prepare & maintain	Submit	Related party transactions	Connected person transactions
Master file	✓		✓	
Local file	✓		✓	
Disclosure forum		✓	✓	✓

Domestic transactions and tax groups

A key observation is that the PCD does not clarify the application of the TP rules in domestic situations. Although the effective tax impact of domestic TP rules may be limited, certain countries do apply the ALP for domestic transactions as the profits/losses of the companies should be determined individually, especially in cases where a tax advantage could potentially arise.

However, the impact of TP will be reduced when transactions with related parties take place within a tax group, or when group companies are allowed to transfer losses under certain conditions. Intercompany transactions within a tax group will be eliminated as the tax group is treated as a single taxpayer, which is illustrated.



Transfers or restructurings within a group may also qualify for relief under certain conditions. Although these may not have an immediate impact on the profits/losses within the group because of the relief, the ALP may be relevant if the group cannot maintain the qualification conditions and a "claw back" is applied.

Based on the above, it may be the case that the UAE will opt not to apply TP in domestic situations. However, more guidance is expected from the MoF on this matter.

Free Zones

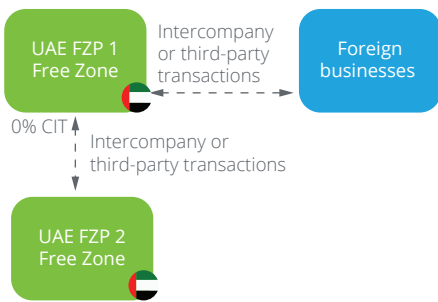
The UAE will maintain its Free Zones and honor a CT rate of 0% for Free Zone Persons (FZPs) if certain conditions are met. However, it should be noted that (intercompany) transactions with parties in the UAE mainland may have an impact on the eligibility of the 0% CT rate for FZPs and the deductibility of cost for the related parties in mainland. Important considerations of the PCD in this regard are illustrated below.

Consideration 1: Transactions between FZPs and foreign businesses

FZPs will maintain the 0% CT rate if they have intercompany or third-party transactions with foreign businesses (including related parties) or with FZPs (including related parties) in other Free Zones. The impact of intercompany transactions in such cases seems to be >

limited at first hand as the 0% CT rate will not be impacted, although the taxable base should still be in line with the ALP.

Please refer to the position of UAE FZP 1 in the below illustration.



Consideration 2: Transactions between FZPs and mainland businesses

When an FZP transacts with UAE mainland businesses (including related parties), the 0% CT rate may still be applied if the income is considered to be "passive income" (e.g., interest and royalties, and dividends and capital gains), as illustrated below.



However, transactions with related parties situated in the UAE mainland may result in non-deductibility of payments for these related parties in the UAE mainland. Non-deductibility of payments may have far-reaching consequences for the taxes paid by the UAE mainland entities. It is not yet clear which category of "payments" trigger non-deductibility for the UAE mainland entities, e.g., whether interest payments and royalty payments qualify for the non-deductibility of expenses.

The following tables illustrate the CT impact in the case of the non-deductibility of payments. The example consists of a UAE FZP that sells products to a UAE mainland related party, which in its turn sells the products to third-party customers in the UAE mainland.

Base scenario: Without non-deductibility of payments for mainland group company

P&L	UAE FZP	UAE Mainland		Group P&L
Revenue	200	250	▶ UAE ML	250
Cost of goods sold	(150)	(200)	▶ UAE FZP	(150)
Gross profit	50	50	▶ Sum	100
Operational expenses	(40)	(20)	▶ Sum	(60)
Net profit/taxable basis	10	30	▶ Sum	40
CT rate	0%	9%		
Corporate tax	0	2.7	▶ Sum	(2.7)
Total result (net profit - CT)	10	27.3	▶ Sum	37.3

Alternative scenario: Non-deductibility of payments for mainland group company

P&L	UAE FZP	UAE Mainland		Group P&L	Group P&L
Revenue	200	250	▶ UAE ML	250	250
Cost of goods sold	(150)	(200)	▶ UAE FZP	(150)	(150)
Gross profit	50	50	▶ Sum	100	100
Operational expenses	(40)	(20)	▶ Sum	(60)	(60)
Net profit/taxable basis	10	30	▶ Sum	40	40
Non-deductible payment		200		200	
Taxable basis	10	230	▶ Sum	240	240
CT rate	0%	9%			
Corporate tax	0	20.7	▶ Sum	(20.7)	(2.7)
Total result (net profit - CT)	10	9.3	▶ Sum	19.3	37.3

The difference of CT in both scenarios clearly shows the significant impact that non-deductibility of payments for intercompany transactions has for businesses.

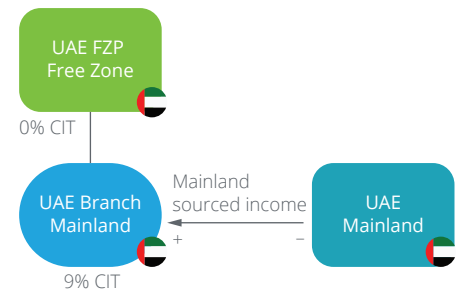
Consideration 3: Transactions between FZP and mainland businesses

Any other UAE mainland sourced income will disqualify an FZP from the 0% CT rate for all their income, as illustrated below. It is currently unclear whether this only applies to income from unrelated parties.

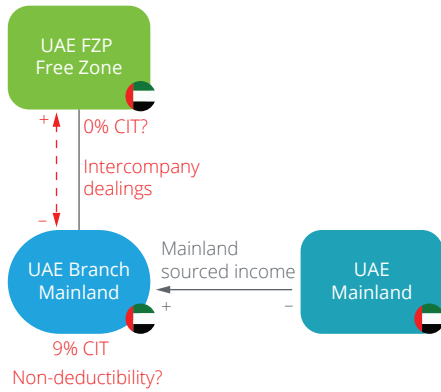


Consideration 4: FZP with a branch in UAE mainland

An FZP with a branch in the UAE mainland will be taxed at the regular CT rate for the mainland sourced income, whereas it will retain the 0% CT rate for its other income, which is illustrated above.



However, as the PCD does not elaborate on the allocation of income to the branch, it may be considered to apply the principles of the OECD TPG to allocate profits to the branch, which may trigger internal dealings between the branch and head office which is an FZP (please refer to the illustration).



These internal dealings between FZP and branch may also have an impact for the application of the 0% CT rate and the deductibility of costs for the branches, as these internal dealings can be considered as transactions that trigger consequences for FZPs.

Conclusion for Free Zones

Given the complexity of the rules for FZPs, it is recommended that businesses carefully consider their (intercompany) transaction flows to understand the tax impact of their current arrangements and to act.

More guidance on this subject is expected from the MoF to clarify the exact impact for businesses.

Clarifications

The PCD says that businesses may apply for a binding clarification for correct or intended treatment in case there is uncertainty in relation to a (proposed) arrangement. Although the extent of the clarifications is not entirely clear yet, this may be a possibility to obtain

Advance Pricing Agreements (APAs) and thus certainty in relation intercompany transactions with related parties.

Considering the above, the PCD provides some details on the intended design of the TP regime in the UAE. However, as noted above, this results in complexity for businesses when considered together with the CT regime based on the current publications. More details and guidance from the MoF are expected to provide further clarification.

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 organizations.

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 in order to be prepared given the complexity of these rules.

Deloitte Middle East has developed a phased framework to assist businesses in effectively managing their preparation and transition into the implementation of TP in the UAE through a holistic approach. This covers areas such as TP and CT advisory and compliance, TP modeling and planning, the organization of the tax function, and the use of technology to effectively manage these areas.

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By **Mohamed Serokh**, Tax Partner, Transfer Pricing Leader, **Rabia Gandapur**, Transfer Pricing Director, **Ahmet Celiktas**, Transfer Pricing Senior Manager, and **George German**, Transfer Pricing Senior Manager, Deloitte Middle East

Endnotes

1. https://www.mof.gov.ae/en/resourcesAndBudget/Documents/UAE_CT-Public_Consultation_Document_English.pdf.
2. <https://www.mof.gov.ae/en/resourcesAndBudget/Pages/faq.aspx>.
3. 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.

