Transfer Pricing in the UAE

Development of transfer pricing landscape in the UAE

- The Organisation for Economic Cooperation and Development (OECD), as a part of the Base Erosion and Profit Shifting (BEPS) project, released 15 Action plans in 2015 to address tax challenges to ensure fair taxation based on economic activities and value creation
- On 16 May 2018, the United Arab Emirates (UAE) joined the OECD's Inclusive Framework (IF), committing to adopting the key BEPS minimum standards in the short term:
  - Action 5 - Measure against harmful tax practices
  - Action 6 - Model provisions against treaty abuse
  - Action 13 - Transfer Pricing documentation and country-by-country reporting (CbCR)
  - Action 14 - Enhancing dispute resolution mechanisms through mutual agreement procedure (MAP).
- To fulfill its pledge, the UAE has implemented various measures from time to time: the most recent one is the introduction of a comprehensive Transfer Pricing (TP) regime
- The following flow chart illustrates the timeline of various BEPS measures implemented by the UAE thus far.

May 2018

The UAE joined the OECD's Inclusive Framework (IF), committing to adopting the key BEPS minimum standards

April 2019

Introduced Economic Substance Regulations (ESR) vide cabinet decision No. 57 of 2020, effective from 1 January 2019

April 2019

Issued cabinet resolution No. 32 of 2019 (repealed by cabinet resolution No. 44 of 2020) on applicability of CbCR rules for multinational enterprises (MNEs)

May 2019

Ratified the multilateral convention to Implement tax treaty-related measures to prevent BEPS (multilateral instruments - MLI)

July 2021

Issued guidance on MAP to manage double taxation

January 2022

The MoF announced that federal CT will be implemented in the UAE from the financial years commencing on or after 1 June 2023

December 2022

Released Federal Decree-Law No. (47) of 2022 on the Taxation of corporations and businesses, encompassing Articles of Law around corporate tax (CT) and TP

April 2023

The MoF issued ministerial decision No. 97 of 2023 providing requirements for maintaining TP documentation

October 2023

The Federal Tax Authority (FTA) released a TP Guide (the UAE TP Guide) providing clarity to businesses on the application of arm's length standards

Scope of transfer pricing

- TP rules are applicable to all the transactions or arrangements between related parties and connected persons. These include:

  - Cross-border transactions as well as domestic transactions, including with that of the Free Zone entities
  - Transactions between the mandated and non-mandated activity segment of the government entity
  - Exempt entities or entities who have elected for small business relief are required to follow the arm's length standards for inter-company transactions or arrangements. However, they are not obligated to prepare and maintain local file and master file.

BDO Insights:
UAE TP rules are broadly aligned with OECD TP guidelines when it comes to related parties, but including transactions with connected persons within the ambit of TP is an outlier move.

The arm's length principle (Article 34)

- Any transactions or arrangements between related parties or connected persons must follow arm's length standards
- A transaction or arrangement is considered at arm's length if the results of the transaction or arrangement are consistent with the results that would have been realised between the unrelated parties engaged in a similar transaction or arrangement under similar circumstances.

BDO Insights:
The arm's length principle defined in the TP rules are in line with the OECD TP guidelines. The arm's length principles are required to be applied to all inter-company transactions, irrespective of the thresholds or conditions.

Transfer pricing adjustment (Article 34)

- If the transaction or arrangement between the related parties and connected persons does not meet the arm's length standard, the FTA can adjust the taxable person's taxable income or loss to align with the arm's length standard
- When a TP adjustment is initiated, either by the FTA or the taxable person, a corresponding adjustment in the taxable income of the local related party can be made
- If the TP adjustment is initiated by a foreign tax authority, the taxable person has an option to request a corresponding adjustment from the FTA through MAP.

BDO Insights:
The corresponding adjustment by the FTA based on an adjustment initiated by a foreign tax authority and ensures a more equitable tax framework. This reduces the risk of double taxation for companies operating in the UAE.

Related parties and control (Article 35)

- For the application of UAE TP rules, the primary condition is to have a related party relationship established between two or more entities or individuals
- The related parties include both natural and juridical persons who have direct or indirect relationships through kinship, ownership or control
- The UAE CT Law identifies the following individuals and legal entities as related parties:

  - Fourth degree of kinship – Individuals related up to the fourth degree of kinship or affiliation, including through adoption or guardianship
  - Direct or indirect ownership and control - an individual or legal entity along with its related parties, directly or indirectly own at least 50% of other legal entity or control such legal entity
  - Common ownership and control - a person (individual or legal entity) along with its related parties, directly or indirectly own at least 50% of such two or more legal entities or control such legal entities
  - A person and its domestic or foreign permanent establishment
  - Partners in the same unincorporated partnership and the trustee, founder, settlor or beneficiary of a trust or foundation are also classified as related parties.

The UAE CT Law defines 'control' as the ability of a person to influence another person. This includes:

- Exercising 50% or more voting rights of the other person
- Ability to appoint 50% or more of board of directors of the other person
- The entitlement of 50% or more of profits of the other person
- The ability to significantly exercise influence over the conduct of a business of the other person.

The UAE TP guide provides a few examples to assess a person's capacity to exercise 'significant influence' over another person. These include:

- Debt-based influence: Loan from a person constitutes 50% or more of the total capital of another person's business
- Entitlement of profits: Royalty arrangement that entitles 50% or more of profits generated by another person from the use of intangible property
- Management function: The ownership of the person is below 50% but the key management functions of another person is performed by that person.

BDO Insights:
The UAE CT Law provides a wider definition of related parties than the OECD TP guidelines. It is essential for a taxable person to accurately identify these relationships to determine if they fall under the definition of related parties and connected persons.

Payments to connected persons (Article 36)

- The following persons are considered as connected persons:
  - Owner of a taxable person
  - Director or officer of taxable person, i.e. the key managerial personnel (KMP), such as Directors, CEO, CFO, head of the department etc.
  - Related parties of the above individuals, including any relatives of the owner or KMPs
- Any payments or benefits provided to connected persons needs to adhere the to arm's length standard
- UAE TP rules will not be applicable to connected persons in the following scenarios:
  - If the shares are traded on a recognised stock exchange
  - If the taxable person is subject to the regulatory oversight of a competent authority in the UAE
  - Any other person as may be determined in a decision issued by the cabinet minister.

BDO Insights:
Any compensation paid to KMPs may fall under the remit of TP. The onus rests on the taxable person to document the basis of arriving at the compensation paid to KMPs, including any external benchmarking in order to support the same.

Interplay between corporate tax and TP

Free Zone persons (Article 18)

- The UAE CT Law allows qualifying Free Zone persons (QFZP) to benefit from a 0% CT rate on qualifying income, provided they meet specific criteria, including adherence to the arm's length standards
- Compliance with the UAE TP rules requires a free zone person to apply the arm's length standard to transactions involving related parties and connected persons, along with maintaining adequate TP documentation.

- Meeting all the conditions outlined in the UAE CT Law is imperative for Free Zone persons to avail themselves of the 0% CT rate, making UAE TP rules a crucial aspect of eligibility.

BDO Insights:
One of the conditions of free zone relief is compliance with the TP rules. Failure to meet TP compliance requirements may result in the loss of free zone status for the current year and the subsequent four years.

Tax grouping (Article 42)

- UAE resident juridical persons have an option to form a tax group if the parent company (UAE resident) holds at least 95% of the share capital and voting rights of its subsidiaries (UAE resident)
- A tax group is considered as a single taxable person for the purpose of calculating taxable income, as per the UAE CT Law
- Transactions among entities within the same tax group are exempt from the application of UAE TP rules, as they are consolidated for tax purposes
- However, if a member of a tax group transacts with a related party outside its tax group, UAE TP rules will be applicable
- There are certain exemptions when transactions between members of a tax group are still required to be adhere to the arm's length standards. These include:
  - ✓ If the member of the tax group has unused pre-grouping tax losses
  - ✓ If a member of the tax group is eligible to claim foreign tax credit (FTC)
  - ✓ A member of the tax group benefits from any specified incentives
  - ✓ A member of the tax group has unused carried forward pre-grouping net interest expenditure.

BDO Insights:
Forming a tax group may result in relaxed TP obligations.

Transfer of assets or liabilities within qualifying group (Article 26)

- The UAE CT Law allows the formation of a qualifying group (QG), subject to specific conditions
- Within a QG, transfers or restructuring of assets / liabilities among members are valued at net book value to prevent taxable gain or loss
- If QG conditions are not met or if QG relief is not elected by the taxable person, transfers are taxed as per the normal tax rate prescribed under the UAE CT Law, following arm's length standards
- QG relief becomes void if, within two years of such transfer:
  - ✓ There is a subsequent transfer of the asset or liability outside of the QG
  - ✓ The transferor or transferee cease to be members of the same QG.

  In such cases, transfers must adhere to the arm's length standards.

BDO Insights:
Determining eligibility under QG could offer relaxation around meeting TP obligations in certain cases, subject to meeting relevant conditions.

Interest deduction (Article 31)

- The net interest expenditure shall be deductible only up to 30% of earnings before interest, tax, depreciation and amortisation (EBITDA)
- No interest deduction shall be allowed on loan borrowed from a related party for:

  ✓ Distribution of a dividend or profit to a related party

  ✓ Redemption, repurchase, reduction or return of share capital to a related party

  ✓ Capital contribution to a related party

  ✓ Acquisition of an ownership interest in a person who is or becomes a related party following the acquisition.

However, the interest expenses may be considered as deductible if the taxable person is able to demonstrate that the primary purpose of obtaining a loan is not to avail CT advantage, i.e. the lender is subject to corporate tax or similar at 9% or more in its jurisdiction.

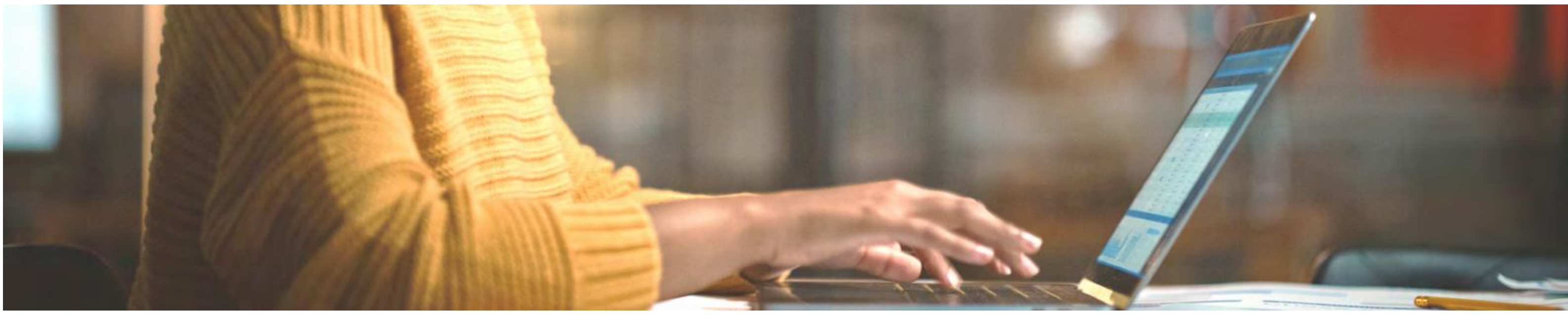
For this, the taxable person needs to ensure that the interest payment to related party is at arm’s length.

BDO Insights:
Suffering higher interest rates on loans availed from related parties could be questioned from a UAE TP perspective.

Transitional rules (Article 61)

- The UAE CT Law introduced transitional rules, which requires that the opening balance sheet for CT purposes will be the closing balance sheet for the year prior to the first tax period
- These rules also require that the opening balance sheet must be prepared taking into consideration the arm’s length standards
- This may have an impact on the transfer pricing arrangements and necessary adjustments in the closing balance sheet may have to be made.

BDO Insights:
It is relevant for the taxable persons to understand as to how these adjustments will be carried out in the books of accounts and how it will be disclosed in the financial statements, to determine the impact of CT in the first tax period.



TP documentation and compliance requirements

- Taxable persons in the UAE must maintain contemporaneous TP documentation to ensure compliance with the UAE TP rules. The FTA expects that TP documentation be maintained either at the time of the transaction or when the tax return for that period is submitted
- In line with the OECD TP guidelines, the TP rules introduced three-tiered documentation requirements, which include local file, master file and CbCR (subject to a threshold). In addition, taxable persons are required to submit a TP disclosure form providing details of the related party transactions.

The TP documentation requirements are summarised below:

SR No.	TP compliance requirement	Details of the compliance requirements	Timeline for submission / maintenance
1.	TP disclosure form	Taxable persons engaging in transactions with related parties or connected persons, whether domestic or foreign, during the reporting tax period must prepare and submit a comprehensive TP disclosure form along with their tax return, subject to meeting materiality threshold. The information to be furnished in the TP disclosure form includes: ▪ Nature and value of the controlled transactions ▪ Details of the related parties ▪ TP method(s) employed to ascertain the arm's length value of the controlled transactions.	To be submitted alongside the tax return within 9 months from the end of the relevant tax period
2.	Master file and local file*	The taxable person involved in domestic or cross-border transactions with related parties / connected persons during a tax period is obligated to prepare and maintain master file and local file, if any of the following thresholds are met: ▪ The total consolidated group turnover in the relevant tax period of AED 3.15 billion or more ▪ The taxable person's turnover in the relevant tax period is AED 200 million or more.	To be maintained on or before filing the tax return of the relevant tax period and to be submitted within 30 days upon the request from the FTA

Exemptions:

- *The requirement to maintain a master file applies only to UAE-based groups having business establishments outside the UAE. However, UAE-based groups having domestic presence are still required to prepare and maintain a local file*
- *Taxable persons who do not meet threshold conditions are not obligated to maintain either a master file or a local file*
- *Exempt entities and entities availing small business reliefs are not required to maintain local file and master file. However, they still need to adhere to the arm's length standards.*

**As per Article 55 of the UAE CT Law, a taxable person is required to submit local file and master file within 30 days of such a request from the FTA. However, as of 25 September 2024, the CT return available on the tax portal indicates that local file and master file must be submitted along with the CT return. Further clarification from the FTA on this matter is awaited.*

SR No.	TP compliance requirement	Details of the compliance requirements	Timeline for submission / maintenance
3.	CbCR	In line with OECD action plan 13, the UAE introduced CbCR under the Cabinet Decision No. 44 of 2020. CbCR requires the UAE-resident ultimate parent entity (UPE) of the MNE group with consolidated revenue exceeding AED 3.15 billion to submit a report containing quantitative and qualitative information per tax jurisdiction and constituent entity.	Submission within 12 months from the end of the financial year of the group
4.	CbCR Notification	The UAE-resident UPE is required to submit a CbCR notification, indicating that it will file the CbCR by the end of the reporting fiscal year. Constituent entities in the UAE who are members of a foreign headquartered MNE are not required submit a CbCR notification.	Submission on or before the end of the reporting fiscal year

BDO Insights:

TP rules require taxable persons to prepare and maintain a master file and local file, subject to meeting threshold requirements, to provide the FTA with a clear understanding of their transactions with related parties and connected persons.

If the prescribed threshold for maintenance of local file and master file is not met, taxable persons are still required to adhere to the arm's length principles. Therefore, it is crucial for taxable persons to have sufficient documentation (TP policy) in place, outlining the nature of related party transactions, functional analysis of the entities involved in the transactions and methodology adopted to substantiate the arm's length nature of related party transactions.

Inadequate documentation may lead to penalties, fines and the risk of double taxation in multiple jurisdictions. It may also result in difficulties in justifying the arm's length nature of related party transactions, potentially leading to adjustments in pricing strategies.

Further, the taxable persons need to have formalised agreements defining the nature of the transaction, terms of intercompany transactions, roles and responsibilities of the parties involved in the transactions, pricing methodology, etc.

Challenges during transfer pricing audit

Some of the key challenges faced by taxable persons during the TP audit are highlighted below:

- For the intra-group services transactions, a detailed analysis is required explaining the nature of intra-group services provided, allocation key used, whether such services are rendered, benefit received and rationale for the mark-up applied, as these kinds of services may be a significant target for the tax authorities during the TP audit
- A closer look is required for the outstanding balances receivable from the related parties, which are not recovered during the normal course of business. The same may be treated as a deemed loan advanced to the related parties and notional interest may be charged
- Understanding the indirect tax implications (VAT, customs, etc.) of transfer pricing adjustments is crucial. Any true-up or true-down adjustment can result in an excess or shortfall in custom duties, which may require amendments in relevant filings or application with the relevant tax authority
- Special consideration is needed when the taxable person incurs losses while the group is profitable. It is essential to analyse whether the losses are on account of related party transactions or due to external factors outside the control of the entities involved in the transaction.

The way forward

- Taxable persons should review their existing TP policies and align them with the UAE TP rules. If taxable persons do not have a formal TP policy in place, they should consider maintaining TP policies to mitigate TP related penalties and litigation risk at a latter stage
- It is equally important to review their existing legal structure and assess if any restructuring warranted to reap benefits available under CT / TP regime, keeping in mind general anti abuse rules (GAAR)
- Taxpayers should also ensure that existing intercompany agreements are aligned with the actual substance of the transactions.

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