UAE Alert Tax

Summary of UAE Corporate Tax and Transfer Pricing Law

The long wait was finally over on 9 December 2022, when the UAE Federal Tax Authority (FTA) released the final version of the UAE Corporate Tax (CT) law (hereinafter referred to as the law) through Federal Decree-Law No. 47 of 2022. The law is largely based on the public consultation document issued earlier during the year 2022. However, it also contains certain new provisions which inter-alia include General Anti Abuse Rules, Small Business Relief, detailed definition of UAE-sourced income, etc. The CT regime would be effective for the financial year starting on or after 1 June 2023.

In this alert, we have summarized the UAE CT regime:

SCOPE AND APPLICABILITY

Taxable Persons

- UAE CT shall be imposed on taxable persons - both residents and non-residents
- A resident person means
  - Entities incorporated under the UAE laws, including Free Zone entities
  - Entities incorporated in a foreign jurisdiction that is effectively managed and controlled from the UAE
  - Individuals who conduct certain categories of business or business activity as determined by the Cabinet of Ministers
- A non-resident would be liable to tax in cases where:
  - It has a Permanent Establishment (PE) in the UAE
  - It derives UAE-sourced income (which is widely defined)
  - It has a nexus in the UAE

Exempt Persons

The following persons are exempt from UAE CT:

- Government and Government-controlled entities
- Persons engaged in extractive business and non-extractive natural resource business that are subject to taxes under the relevant Emirate legislation
- Qualifying public benefit entities and qualifying investment funds satisfying certain conditions
- Public pensions or social security funds
- Regulated private pensions or social security funds

Basis of Taxation

- Resident entities would be subject to CT on global taxable income
- A resident natural person is subject to CT on income that is derived from or outside the UAE to the extent that it relates to business (categories to be notified by the Cabinet of Ministers) conducted by such persons in the UAE
- UAE non-residents would be liable to tax in the UAE on the following incomes:
  - Taxable income attributable to the Permanent Establishment (PE) of the non-resident in the UAE
  - UAE-sourced income that is not attributable to the PE of the non-resident in the UAE
  - Taxable income that is attributable to the nexus of the non-resident in the UAE
- The following shall be considered UAE-sourced income:
  - Where it is derived from a resident of the UAE
  - Where it is derived from a non-resident in connection with their PE in the UAE
  - Where it is accrued or derived from activities performed, assets located, capital invested, rights used, or services performed in the UAE

An Illustrative list of items would include the sale of goods in UAE, income from activities in UAE, loan/insurance income in respect of UAE borrower/asset, disposal of shares/capital, etc.

- The PE concept is similar to what is envisaged in the Organization for Economic Co-operation and Development (OECD) Model Tax Convention. The Cabinet of Ministers may further prescribe conditions under which a mere presence of natural persons in the UAE does not constitute a PE for a non-resident.

Corporate Tax Rates

- CT shall be imposed at the rate of 0% on taxable income below a prescribed threshold limit* and at 9% on taxable income exceeding such limit
- For a qualifying Free Zone person/entity, the CT rate is 0% on qualifying income and 9% on non-qualifying income.

*threshold amount to be approved by the Cabinet of Ministers (which is expected to be AED 375,000 as per the FAQs issued by the Ministry of Finance on the CT regime)

Calculation of Taxable Income for CT

- The taxable income of taxable persons shall be generally determined based on the financial statements prepared in accordance with generally accepted accounting standards in the UAE. It is mentioned in the previously published FAQs that IFRS is generally accepted in the UAE
- The accounting profit is to be adjusted for the following:
  - Unrealized gains or losses
  - Exempt income, reliefs, and deductions as specified in the law
  - Any transfer pricing adjustment in respect of transactions with related parties and connected persons
  - Tax losses
  - Special incentives and reliefs for a qualifying business activity as may be specified
  - Any other income or expenses that have not been taken into account as may be specified
- The following income shall be treated as exempt income:
  - Dividends/profit distributions from resident persons (including dividend paid by a Free Zone person)
  - Dividends/profit distributions from participating interest in a foreign juridical person
  - Any other income from participating interest as specified in the law
  - Income from foreign PEs
  - Income of a non-resident from operating of aircrafts or ships in international traffic
  - Income of foreign PEs of resident persons

Deductible and Non-deductible Expenses

- Expenses incurred wholly and exclusively for the purpose of business and not being capital in nature are allowed as a deduction in computing taxable income
- Expenses incurred for deriving exempt income shall not be allowed as a deduction
- Special provisions for the claim of interest expenses:
  - **General Deduction Rule:** Net interest expenses (interest income less interest expenses after considering carried forward interest expense) shall be restricted to 30% of EBITDA. However, a threshold would be provided. The balance interest expense shall be carried forward for 10 tax periods. Banks, insurance providers, and natural persons carrying out business activity are excluded from this rule
  - **Specific Deduction Rule:** Interest on loan from related parties in respect of specific transactions with related parties such as dividends, redemption or reduction of share capital, capital contribution, and acquisition of ownership interest shall not be allowed as a deduction
- 50% of expenses incurred on the entertainment of customers, shareholders, suppliers, or other business partners shall be disallowed
- Fines, penalties, bribes, donations to others than the qualifying public benefit entity, dividends paid, etc. shall be disallowed
- Input Value Added Tax (VAT) incurred by a taxable person that is recoverable is considered a non-deductible expense

Participation Exemption

- The law has specified conditions subject to which income from participating interest shall be considered exempt. A participating interest would mean having 5% or more ownership interest in the shares or capital of a juridical person, and that meets the following conditions:
  - The participating interest is held or is intended to be held for at least 12 months
  - The participation is subject to CT or similar tax in the foreign jurisdiction at a rate that is not less than 9%
  - The participation entitles the person to receive at least 5% of distributable profits and liquidation proceeds
  - The assets held directly or indirectly by the participants should not contain more than 50% of such interests, which if held directly by the person, would not have qualified for exemption
- If the participation exemption conditions are met, the following income shall be treated as exempt:
  - Dividends/profit distributions from foreign participants
  - Capital gains on sale or disposition of participating interest after the stipulated time period of 12 months
  - Foreign exchange and impairment gains or losses in relation to participation interest
- The law also provides for situations where participation exemptions shall not be available

Qualifying Free Zone Person

- An entity in the Free Zone that:
  - Maintains adequate substance
  - Derives qualifying income as may be specified
  - Complies with transfer pricing provisions of the law
  - Has not elected to be subject to CT, and
  - Meets such other conditions as may be prescribed
  - is treated as a qualifying Free Zone person
- A Free Zone shall be taxed at 0% on its qualifying income and at 9% on all income other than qualifying income
- A Free Zone person that fails to meet the aforesaid conditions at any time during a tax period shall cease to be a qualifying Free Zone person from the beginning of that tax period
- A qualifying Free Zone person can make an application to be subject to CT at rates applicable to other taxable persons

Taxability of Partners in an Unincorporated Partnership

- Unincorporated partnerships have been given a pass-through status and persons conducting business as partnerships shall be treated as individual taxable persons
- Foreign partnerships are also granted such pass-through status if they are treated as pass-through entities in the foreign jurisdiction, and other conditions as specified in the law are met
- An application can be made to treat unincorporated partnerships as taxable persons instead of individual partners
- Family foundations can also make an application to be treated as unincorporated partnerships

Small Business Relief

- Resident taxable persons whose revenue for prescribed tax periods does not exceed a specific threshold and fulfills such other conditions as may be specified may elect to be treated as not having derived any taxable income for a tax period

Group Transfers and Business Restructuring Relief

- Gains/losses on the transfer of assets and liabilities between residents or non-residents having a PE in the UAE and holding at least 75% of direct or indirect ownership or are held (at least 75%) by a third person is not treated as taxable income subject to the fulfillment of certain other conditions
- Furthermore, gains/losses on the transfer of entire businesses or an independent part of the same between taxable persons either by way of exchange of shares or other ownership interest including transfers in a merger arrangement are not treated as taxable income subject to the fulfillment of conditions
- Where conditions prescribed in the various clauses of the article are not fulfilled, the transfer would be treated as having taken place at market value as on the date of transfer

Tax Losses and Transfer of Tax Losses

- The unabsorbed portion of tax loss can be carried forward to subsequent tax periods and 75% of such loss can be set off against taxable income of that tax period
- Tax losses cannot be carried forward in cases where there is a change in ownership of more than 50% and a change in the nature of the business activity
- Furthermore, tax losses of a resident person can be transferred from and offset against the taxable income of another taxable resident person subject to the fulfillment of conditions which inter-alia include conditions of ownership, same tax year, and same accounting standards, amongst others

Tax Group

- Resident persons may, by way of application, form tax groups for smooth administration purposes, provided the parent company owns 95% of the subsidiary companies, holds 95% of voting rights, and is entitled to 95% of the profits and net assets
- The tax group shall be treated as a single taxable person and the parent company shall be responsible for all compliances under the law
- Specific provisions for the formation, cessation, and determination of taxable income of a tax group have been provided

General Anti-Abuse Rules

- Provisions for disregarding transactions not entered for valid commercial reasons and purely for obtaining tax benefits under the law have been introduced

TRANSFER PRICING

Scope and Applicability

- The Transfer Pricing (TP) law would apply to entities both in the UAE Mainland as well as Free Zones. The effective date of the TP regime is the same as the CT law i.e. the financial year starting on or after 1 June 2023
- All 'related party transactions'/'arrangements' must meet the arm's length standard in determining the taxable income
- The concept of the arm's length principle is predominantly in line with the OECD TP guidelines which recommends transactions between unrelated parties as a measure of the arm's length standard

Related Party and Control

- The definition of related parties as provided under the law is broadly in line with the OECD TP guidelines and includes:
  - Two individuals, when they are related
  - An individual and company would be regarded as related parties where the said individual, either alone or jointly with relatives, directly or indirectly are:
    - Shareholders in a company with 50% or greater ownership
    - 'Controls' the company
  - Similarly, two companies would be regarded as related parties where one company, alone or together with its related parties, directly or indirectly:
    - Owns 50% or greater ownership interest in the other company
    - 'Controls' the other company
    - Is controlled by a company that also controls the other company (Common Control)
  - Partners in the same partnership
  - Trustees, founders, settlors, or beneficiaries of a trust or foundation, and its related parties
- The Decree-Law has given a brief understanding with respect to the term 'Control' which inter-alia includes the ability to:

  i. Exercise 50% or more of the voting rights
  ii. Determine the composition of 50% or more of the Board of Directors
  iii. Receive 50% or more of the profits
  iv. Determine or exercise significant influence over the conduct of the business and affairs

Transfer Pricing Benchmarking Method

- The Decree-Law has prescribed 5 Transfer Pricing Methods which are in line with the OECD TP guidelines to determine the arm's length result. The taxable person can choose to apply any other method if it is considered more appropriate to meet the arm's length standard.
- The choice of a TP Method or a combination of TP Methods in relation to a transaction can be made by taking into consideration:

  i. Contractual terms
  ii. Characteristics
  iii. Economic circumstances
  iv. Functions performed, assets employed, and risks assumed
  v. Business strategies

Arm's Length Range is not defined as yet

- While the concept of arm's length price has been introduced, the arm's length range has not been specified (i.e. the use of inter-quartile range, 35th to 65th percentile, minimum to maximum, etc.)
- In a scenario where the pricing in relation to the transaction or arrangement does not fall within the arm's length range, the Authorities can make a TP adjustment on the taxable income to achieve the arm's length result

Corresponding Adjustment is possible

In a scenario where the Authorities decide to make a TP adjustment, the Authorities shall also make a corresponding adjustment to the taxable income of the related party

Payment to Connected Persons

- Under Article 36, the law seeks to ensure that the payments made by taxable persons to certain connected persons are not excessive and as per market standards. Such payments include:
  - Payments to the owner or owner's related parties
  - Payments to the director or director's related parties
- The law further clarifies that for the purpose of determining market value, the TP provisions should be applied

Compliance Requirements

- The taxable person is required to file a disclosure form that encapsulates details of transactions and arrangements with related parties and connected persons along with their Tax Return
- The taxable person shall maintain and prepare both a Master File and a Local File on the fulfillment of conditions prescribed by the Minister, in the form prescribed by the Authorities
- The documentation as mentioned above must be submitted to the Authorities within thirty days following a request by the Authorities, or by any such other later date as directed by the Authorities.

Administrative Provisions

- As such, the law does not provide for any withholding tax regime. However, currently, a withholding tax rate of 0% is provided for state-sourced income of a non-resident not having a PE in the UAE.
- Furthermore, provisions of registration for obtaining the tax identification number, claim of foreign tax credit, and corporate tax refund have been prescribed
- A tax period shall generally be the Gregorian calendar year (January to December) or any 12-month period
- Tax returns and corporate tax payments must be completed within 9 months from the end of the relevant tax period
- Books of accounts and all other records and documents are required to be maintained by taxable persons for at least a period of 7 years. This requirement also applies to exempt persons
- Fines and penalties shall be prescribed for contravention under the law
- It is also provided that provisions of international agreements shall prevail over the provisions of the law

Our Comments

The overall intent of the UAE CT law was to keep it simple with fewer compliance burdens. However, there are certain areas that may require further clarification, mainly on aspects such as what would constitute meeting substance test for Free Zones, attribution rules for UAE-sourced income, base erosion concept under transfer pricing, etc. Furthermore, on reading the law, it appears that Free Zone companies may not be eligible for the basic exemption limit. This may again require clarity.

In our view, there are many nuances that would have to be looked at by corporates, including aligning their transfer pricing policies. It would be important for organizations to carry out an impact analysis to determine the tax impact and also gear up for upcoming compliances.

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