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The UAE's Corporate Tax Law: A Closer Look At Transfer Pricing Regulations

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The OECD's Inclusive Framework on Base Erosion and Profit Shifting (BEPS) has developed a two-pillar approach to combat tax avoidance, promote coherence and transparency in the international tax system, and address the tax challenges arising from the digitalization of the economy. One of the key objectives of the BEPS project is to ensure that large multinationals pay a minimum global tax.

The United Arab Emirates (UAE) became a part of the Inclusive Framework in 2018 and committed to implementing anti-BEPS minimum standards. As a part of this commitment, in 2019, the UAE Ministry of Finance (MoF) introduced Economic Substance Regulations (ESR) to ensure that the entities operating in the UAE accurately report profits that align with the economic activity they carry out within the country. In addition, in April 2019, the UAE MoF also introduced the Country-by-Country Reporting (CbCR) rules, which are broadly aligned with the BEPS Action Plan 13 of the OECD.

On January 31, 2022, the MoF of the UAE announced the introduction of the Federal Corporate Tax (CT), which will be effective for financial years starting on or after June 1, 2023. The government released a Public Consultation Document in April 2022. It later issued the Corporate Tax Law (the Law) in December 2022 through the ***Federal Decree-Law No. (47) of 2022*** to provide further guidance on the tax regime. The MoF has also published ***158 Frequently Asked Questions*** to provide guidance on the UAE CT regime. The new regulations aim to provide businesses with a clear understanding of the tax framework and how they can prepare for implementing the Corporate Tax in the UAE.

The Law contains transfer pricing regulations relevant to companies operating in the UAE concerning transactions involving related parties and connected persons and is broadly consistent with the OECD Transfer Pricing Guidelines. The Law also includes transfer pricing regulations that apply to foreign and domestic businesses in the UAE, regardless of whether they are located in the mainland or a free zone.

This article provides an overview of the UAE transfer pricing regulations introduced as a part of the Law.

Arm's Length Principle

Article 34 of the Law states that transactions or arrangements between related parties or connected persons must comply with arm's length standards, meaning the outcome of the transaction must be consistent with what would have been achieved if uncontrolled taxpayers had entered into a similar transaction under similar circumstances.

If the transaction or arrangements between the related parties or connected persons are not in accordance with the arm's length principle, Article 34 of the Law gives the Federal Tax Authorities (FTAs) the power to adjust the taxpayer's taxable income to align with the arm's length principle.

Related Parties

The definition of what constitutes a "related party" is extremely important, as it determines whether the parties to the transaction are regarded as affiliated and thus fall under the ambit of transfer pricing rules. Related parties are defined under Article 35 of the Law. The UAE has a wider and more stringent definition of a related party than the OECD TPG.

The definition of a related party in Article 35 includes any of the following:

1. **Two or more natural persons:** Two or more individuals who are related up to the fourth degree of kinship or affiliation.
2. **A natural person and a juridical person:** A natural person and juridical person would be considered related parties if a natural person, alone or with its related parties, owns more than 50% of the ownership in the juridical person or controls the juridical person, directly or indirectly.
3. **Two or more juridical persons:** Two or more juridical persons would be considered related parties if one of the juridical persons, either alone or together with its related parties, owns more than 50% of the ownership in the other juridical person or controls the other juridical person, directly or indirectly.

Any person, alone or with its related parties, owns more than 50% of the ownership in or controls two or more juridical persons, directly or indirectly.

1. Persons and their permanent establishments or branch
2. Two or more persons are partners in the same unincorporated partnership
3. A person who is a trustee, founder, settlor, and beneficiary of trusts or foundations

For the purpose of ownership, a threshold of 50% is provided in the Law. Furthermore, a person is considered to have "control" if they:

- Possess the ability to exercise 50% or more of another person's voting rights
- Have the power to appoint at least 50% of the Board of Directors of a legal entity
- Are entitled to claim 50% or more of a legal entity's profits
- Can exercise significant influence over a legal entity's affairs and business operations

Connected persons

The Law also provides for the concept of connected persons. A person is considered "connected" to a business if any of the following criteria are met:

- A person is the owner of the business
- A person is a director or officer of the business
- A person is a related party to someone who meets the above criteria

Transfer Pricing Methods

To determine the appropriate arm's-length price for transactions involving related parties or connected persons, Article 34 of the Law offers a selection of established transfer pricing methods that align with the OECD Transfer Pricing Guidelines:

- Comparable Uncontrolled Price (CUP) method
- Resale Price method
- Cost Plus method
- Profit Split method (PSM)
- Transactional Net Margin method (TNMM)

It is also possible for taxpayers to use alternative transfer pricing methods that are not included in this list. However, the taxpayers must maintain proper documentation to demonstrate why this method is suitable for their specific circumstances.

Article 34 does not mandate any specific sequence or order of preference for the selection of the transfer pricing method in determining the arm's length price for inter-company transactions. Instead, taxpayers should carefully consider the nature of their transaction and the specific circumstances of each case to choose the most suitable method.

To choose the most appropriate transfer pricing method or a combination of methods, taxpayers must consider various factors, such as the contractual terms of the transaction, its characteristics, the economic conditions in which it takes place, the functions performed by the related parties, and their business strategies.

Transfer Pricing Documentation Requirements

- Local File and Master File: Article 55 of the Law mandates that taxpayers meeting certain criteria (to be specified) must maintain both the local file and the master file. While the Law does not provide further details on the contents of these files, the Ministry of Finance (MoF) has previously indicated in the Public Consultation Document that the requirements are anticipated to align with OECD guidelines.
- Country-by-Country Reporting: The UAE Ministry of Finance wide 'Cabinet Resolution No. 32 of 2019 on Organizing the Reports Submitted by Multinational Corporations' dated April 30, 2019, introduced the Country-by-Country Reporting (CbCR) for multinational entity groups (MNE) based and operating in the UAE, starting from the financial years that commence on or after January 1, 2019.
- Transfer Pricing Disclosure: Article 55 of the Law states that the taxpayers may be required to provide information on their transactions and arrangements with Related Parties and Connected Persons, in a form specified by the Authority, along with the return of income. This disclosure form must be filed along with the tax return by nine months after the end of the fiscal year. The specifics of what should be included in the TP disclosure form have yet to be specified by the Law and will be announced at a later date.

Transfer Pricing Penalties

- The Law does not provide any specific information about penalties for non-compliance related to transfer pricing requirements. This applies to situations where taxpayers fail to meet contemporaneous transfer pricing documentation requirements or do not adhere to the arm's length principle when calculating their taxable income. The penalties for failing to comply fully or partially or for providing inaccurate compliance information are yet to be specified and are expected to be announced at a later date.

Applicability for Free Trade Zone

- Article 18 of the Law outlines the requirements for a Qualifying Free Zone Person, which includes compliance with Article 34 and 55 of the Law. This indicates that Qualifying Free Zone Person must adhere to the arm's length principle when conducting transactions with related parties and connected persons. Additionally, they must fulfill the transfer pricing documentation requirements as stipulated in the Law.

Advance Pricing Agreement

- The Law states that taxpayers may be eligible to apply for Advance Pricing Agreements (APAs). However, further direction about the form and manner in which it is to be applied is anticipated from the FTA.

Conclusion

- The introduction of Transfer Pricing rules as part of the UAE Corporate Tax Law is a significant development for businesses operating in the UAE, particularly for those engaged in transactions or arrangements with related parties.
- The rules have been introduced to ensure that the prices for transactions or arrangements between related parties are consistent with the arm's length principle and that the taxable income of taxpayers is accurately determined. As a result, the transfer pricing rules under the Law are largely consistent with the OECD Transfer Pricing Guidelines, and the definition of related parties is wider and more stringent than the OECD transfer pricing guidelines.
- This makes it crucial for multinational enterprises having a presence in the UAE to gear up for the preparation of transfer pricing documentation for the financial years starting on or after June 1, 2023. KNAV can assist multinational enterprises in preparing for these regulations and complying with the new Corporate Tax Law.

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