UAE Introduces Transfer Pricing Taxation: Understanding Transfer Pricing - Definition, Evolution, UAE TP Regulations & Guidelines and Implications

What is transfer pricing?

Transfer pricing refers to the pricing of goods, services, or intangible assets exchanged between related entities, such as parent companies, subsidiaries, branches, and affiliates of multinational corporations. The primary objective of transfer pricing taxation is to determine a fair price for these transactions that would exist under normal market conditions as if the entities were independent.

Profits accruing to one entity can be increased by setting high transfer prices to siphon profits from other related entities domiciled in high-tax countries, and low transfer prices to move profits to other related entities located in low-tax jurisdictions. As an example of this, a group that manufactures products in a high tax jurisdiction may decide to sell them at a low profit to its affiliate sales company based in a tax haven jurisdiction. That company would in turn sell the product at an arm's length price and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss for the company manufacturing the products in the high-tax jurisdiction.

To illustrate the above, suppose a company A manufactures goods for 100 and sells them to its related company B in another country for 200, who in turn sells the goods in the open market for 400. Had A sold it directly, it would have made a profit of 300. But by routing it through B, it restricted it to 100, permitting B to appropriate the balance. The transaction between A and B would be arranged and not governed by market forces. The profit of 200 is, thereby, shifted to company B. Such goods are transferred on a price (transfer price) that is arbitrary or dictated (i.e., 200), but not on the market price (i.e., 400).

Evolution of transfer pricing worldwide

The concept of transfer pricing entered the realm of international taxation in 1968 when the United States initially incorporated it into federal tax legislation. Subsequently, numerous European nations, such as France (1973), Germany (1983), and the United Kingdom (1988), followed suit and implemented similar frameworks. During the late 1980s and early 1990s, the majority of developing countries, including notable examples like China and India, maintained relatively closed economies. As a result, the imperative to establish transfer pricing regimes was not perceived as an immediate necessity within these regions.

In the late 1990s and early 2000s, some countries started to open their international trade policies, however, they rapidly developed transfer pricing regimes in an attempt to stem the possibility of Multinational Enterprises (MNEs) shifting profits out of their respective jurisdictions. Accordingly, South Africa (1995), Brazil (1997), China (1998), and India (2002) respectively introduced their transfer pricing regimes.

In December 2022, the United Arab Emirates (UAE) introduced a transfer pricing regime through Federal Decree-Law No. 47 of 2022 on the taxation of Corporations and Businesses (the “Tax Law”), marking a significant development in its tax framework. The implementation of this regime demonstrates the UAE's commitment to enhancing transparency and aligning its tax regulations with international standards.

OECD Transfer Pricing Guidelines

The Organization for Economic Co-operation and Development (OECD), an international organization, published guidelines on Transfer Pricing namely “Transfer Pricing and Multinational Enterprises” in 1979, as MNEs began to engage in aggressive tax planning strategies, often involving the manipulation of transfer prices.

The OECD Transfer Pricing Guidelines were established to address the potential abuse of transfer pricing and ensure that profits are allocated in a manner that reflects the economic substance of transactions. Over time, these guidelines have been regularly updated (1995, 2010, 2017, 2018, and 2020) to address emerging challenges, including those related to the digital economy and concerns about base erosion and profit shifting (BEPS).

The 2017 OECD Transfer Pricing Guidelines recognize that the arm's length standard may not be best suited as MNEs operate in an integrated manner instead of its constituent Associated Enterprises ('AEs') acting and transacting independently.

Moreover, to address the twin challenges of digitalization and globalization, the OECD published its Public Consultation Document (Secretariat's Proposal) under Pillar 1 and Pillar 2 in late 2019 and its Report on the challenges to Pillar 1 and 2 stemming from digitalization in October 2020. The Two-Pillar Solution aims to allocate a portion of the profit of the largest and most profitable MNEs to the market countries under Pillar 1 and subject MNEs to a jurisdiction-level minimum effective tax rate (ETR) of 15% under Pillar 2.

Pillar 1 is a move away from the long-standing and established arm's length principle to a formulary apportionment method by the OECD. Pillar 2 creates an entirely new taxing right for countries that mandate a minimum tax be levied on enterprises.

Applicability of these Pillar 1 or Pillar 2 has certain threshold limits based on turnover and profitability.

The UAE has also given its endorsement to the Pillar 2 (Global Minimum Tax) approach, as an Inclusive Framework member. Accordingly, large multinationals in the UAE would likely be subject to a different tax rate under the UAE corporate tax regime.

Introduction of Corporate Tax Law including Transfer pricing rules in UAE

On 9 December 2022, the UAE Ministry of Finance (MoF) published the Federal Decree-Law No. 47 of 2022, issued on 3 October 2022 on Tax Law to enact a new corporate tax (CT) regime in the UAE. The New CT regime is effective for financial years starting on or after 1 June 2023 with a headline rate of 9%.

In addition, the MoF, on 27 April 2023, released the Ministerial Decision No. 97 of 2023 containing the requirement for maintaining transfer pricing documentation; containing the conditions for maintaining a Master File and Local File in compliance with the requirements under the Tax Law.

On 23 October 2023, the UAE Federal Tax Authority (FTA) issued a comprehensive Transfer Pricing Guide ("TP Guide"), bringing much-needed clarity for businesses on the application of the arm's length principle.

We have provided a brief overview of the Transfer Pricing (TP) provisions in the Tax Law:

<u>Arm's-length Principle ('ALP')</u>

UAE TP provisions are in **line** with the OECD TP Guidelines: –

- To determine taxable income, transactions and arrangements with Related Parties (RPs) and Connected Persons (CPs) requires compliance with the arm's-length principle. Definition of RPs and CPs are provided in the subsequent paras.
- Further, any transaction or arrangement between an entity's exempt activity from CT and its non-exempt activity from CT will also need to comply with the ALP.
- The Law considers a transaction or arrangement with an RP or CP to have met the arm's-length principle if the outcome of such transaction is consistent with the outcome that would have been realized if the parties to the same transaction were not related or otherwise connected.
- Taxable persons will need to determine arm's-length prices using one or a combination of the following internationally recognized TP methods:
  - Comparable Uncontrolled Price method
  - Resale Price method
  - Cost Plus method
  - Transactional Net Margin method
  - Transactional Profit Split method
- A taxable person may apply a TP method other than those listed above if the taxable person can reliably demonstrate that the above methods cannot be reasonably applied. Further, it is important to note that the UAE TP rules do not specify any particular

order of preference for determining which TP method to apply.

In cases where the outcome of a transaction or arrangement between RPs does not meet the arm's-length standard, the FTA may adjust a person's taxable income accordingly to achieve the arm's-length result that appropriately reflects the facts and circumstances of the transaction or arrangement. In such cases, corresponding adjustments to the other jurisdiction/other entity may also be available.

Related Parties (RPs)

As the transactions between RPs/ CPs are required to be at arm's length, we have provided a brief overview of RPs below -

As per the Tax Law, the following different rules apply for determining whether parties involved in a transaction are considered "Related Parties" –

- Two or more individuals related to the fourth degree of kinship (in the case of natural persons) or affiliation, including by birth, marriage, adoption, or guardianship.
- An individual and a legal entity where alone, or together with a related party, the individual directly or indirectly owns a 50% or greater share in, or controls, the legal entity.
- Two or more legal entities where one legal entity alone, or together with a related party, directly or indirectly owns a 50% or greater share in or controls, the other legal entity.
- Two or more legal entities if a taxpayer alone, or with a related party, directly or indirectly owns a 50% share of each or controls them (common control or ownership).
- A taxpayer and its branch or permanent establishment.
- Partners in the same unincorporated partnership.

For purposes of the Tax Law, the term "control" can be broadly categorized as:

- Having a 50% or greater share in the voting rights of another legal person.
- Being able to determine the constitution of 50% or more of the Board of Directors of a legal person.
- Being entitled to 50% or more of the profits of a legal person.
- Having the ability to exert significant influence over the affairs and business operations of a legal person.

Connected Persons ('CPs')

A person is construed to be "Connected" to a business if the person meets at least one of the following conditions:

- Is an owner of the business.
- A director or an officer in the business.
- A related party of any of the above (i.e., a relative within the fourth degree of kinship or affiliation).

Documentation requirement

TP documentation requirement by Tax Law has been provided below:

Documentation	Guidance & Requirement
Disclosure Form (Article 55(1) of Tax Law	UAE Businesses may need to file a disclosure together with their tax return, no later than 9 months after the end of the financial year. It includes information relating to the broad category of transactions and arrangements, the nature and value of the transaction, details of related parties, and TP arrangements.

Master File & Local File (Article 55(2) of Tax Law	Master file contains high-level information about the MNE's business, transfer pricing policies, global supply chain, and agreements with tax authorities in a single document available to all tax authorities where the MNE has operations. The local file contains detailed information about the local business, including related party payments and receipts for products, services, royalties, interest, etc. The guidance provides that a taxable person must maintain a Local file and a Master file if during the relevant tax period: ▪ The taxable person is a constituent entity with annual consolidated group revenues exceeding AED 3.15 billion; or ▪ The taxable person's revenues exceed AED 200 million The local file must be submitted to the UAE FTA within 30 days following a request. Similarly, the FTA may request taxpayers to provide additional supporting information within 30 days of a request.
Country by Country reporting (CbCR) (Cabinet Resolution No 44 of 2020	CbCR is a standardized report that includes aggregate tax jurisdiction information relating to the global allocation of income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE Group operates. The CbCR requirements apply to MNE Groups headquartered in the UAE with consolidated Group revenue equal to or above AED 3.15 billion (approximately EUR 750 million) during the Fiscal Year immediately preceding the reporting Fiscal Year. The Ultimate Parent Entity will be required to submit a CbCR notification in respect of each reporting Fiscal Year. The CbCR notification needs to be submitted no later than the last day of the Fiscal Year and it informs the FTA that the Ultimate Parent Entity is the reporting Entity which will file the CbCR. The Ultimate Parent Entity is also required to file the CbCR within 12 months from the last day of each reporting year of the MNE Group in the UAE.
Advance pricing agreements (APAs) (Article 58 of Tax Law)	The Law states that UAE businesses may be able to apply for APAs.

<u>TP considerations for free zones</u>

The Law introduces the concept of "Qualifying Free Zone Persons" (QFZP), which is broadly defined as a company or branch registered in a free zone that:

- Maintains adequate substance in the UAE
- Derives qualifying income (to be specified through a Ministerial Decision)
- Satisfies TP requirements
- Meets any other conditions to be prescribed through a Ministerial Decision

A QFZP is eligible to benefit from a 0% CT rate on its qualifying income. However, the QFZP will be required to comply with the arm's length principle and prepare and maintain appropriate TP documentation.

<u>Consequences of non-compliance with TP documentation requirements</u>

UAE businesses failing to adhere to the TP requirements may face the risk of:

- Potential TP adjustments by the FTA which, in turn, may lead to an increase in the tax base of the UAE business
- Potential loss of 0% CT rate applicable to QFZP businesses
- Potential penalties for noncompliance or partial/inaccurate compliance (Expected to be announced in due course)

However, FTA allow the corresponding adjustment to the taxable Income of the RPs that is on the other side of the transaction or arrangement to achieve tax neutrality. Hence, reducing the administrative burden of the taxpayer by directly adjusting the tax liability of the corresponding RP.

Where a TP adjustment in a foreign country for a transaction involving a UAE entity, such UAE entity can make an application to the FTA to make a corresponding adjustment to its taxable income to eliminate/minimize the risk of double taxation.

The Tax Law includes general anti-abuse rules (GAAR) intended to disregard transactions or arrangements undertaken with the main purpose of obtaining a corporate tax advantage.

UAE Transfer Pricing Guide dated 23 October 2023

The TP Guide provides insights and practical guidance to taxpayers on the Transfer Pricing (TP) rules and regulations per the Tax Law.

The TP Guide offers insights and illustrative examples on various aspects of the UAE TP regime, such as the application of the arm's length principle, Transfer Pricing Documentation, considerations for specific transactions like financial transactions, intra-group services, intangibles, and cost contribution arrangements, as well as Transfer Pricing audits and risk assessments. The UAE TP Guide takes into consideration the guidance provided by the OECD TP Guidelines 2022.

As such, in relation the TP, UAE taxpayers should rely primarily on the Tax Law, Ministerial Decision No. 97 of 2023, Cabinet Resolution No. 44 of 2020, and the TP Guide. To the extent any aspect/issue is not covered, UAE taxpayers are encouraged to refer to the OECD TP Guidelines. Although the TP Guide is not a legally binding document, it will be the primary source of guidance for TP-related matters going forward and can be used as an indication of how the FTA will consider the regime.

We have provided the key highlights from the TP Guide below -

<u>Related Parties and Control</u>

TP Guidelines provide examples of 'control through significant influence' being exercised by way of the following arrangements to identify the relationship between entities in addition to the definition provided above:

- Debt constituting 50% of the total capital of the borrower;
- Royalty agreement entitling 50% of profits;
- Shareholders play a key role in decision-making, despite the shareholding being less than 50%

<u>Application of Arm's Length Principle ('ALP')</u>

The TP Guide provides for three key steps while applying the ALP for controlled transactions:

<u>Step 1</u> – Identify RPs, CPs, relevant transactions, and arrangements and perform a comparability analysis accordingly.
<u>Step 2</u> – Selection of the most appropriate TP method.
<u>Step 3</u> – Determination of arm's length price.

<u>Functions, Assets and Risk analysis ('FAR Analysis'), Benchmarking requirement and TP methods</u>

Concerning undertaking a comparability analysis, the TP Guide emphasizes the importance of conducting a detailed FAR analysis, to accurately delineate the controlled transactions. It also provides 6-step framework to analyze the risk in a controlled transaction

<u>Step 1:</u> Identify economically significant risks with specificity.
<u>Step 2:</u> Determine the contractual assumption of risks by RP based on the terms of the underlying intercompany agreement(s).
<u>Step 3:</u> Undertake a functional analysis to determine how the RP in the controlled transaction operates in relation to the assumption and management of the economically significant risks.
<u>Step 4:</u> Determine whether the contractual assumption of risk is consistent with the conduct of the RP, by assessing whether:

i) the RPs operate in line with the relevant contractual terms; and

ii) the RP assuming the risk [contractually] exercises control and has the financial capacity to assume the risk.

Step 5: Allocate the risk by control and financial capacity (i.e., Step 4(ii)) *[step 5 will only be applicable if the answer to step 4 is no]*

Step 6: Determine the Arm's Length Price for the Controlled Transaction, taking into account the financial and other consequences of risk assumption, as appropriately allocated, compensating for risk management functions

The TP Guide also provides practical guidance with respect to undertaking a FAR analysis and the steps involved in applying the various TP methods including examples.

We have provided some key aspects related to TP methods and benchmarking requirements:

- Number of TP Methods: TP Law provides for five approved methods to determine the arm's length result of transactions, along with the use of a method, other than the approved methods.

- Combination of TP Method – In specific cases, two or more methods is also permissible to justify arm's length price. A specific example using RPM as a main method and TNMM as a corroborative analysis for one transaction is provided in the TP Guidelines.

- Method preference: No order of preference has been defined. However, other method can be used only if none of the five approved methods seem appropriate.

- Transaction by transaction vs. aggregate/combined transaction approach: A transaction by transaction approach is preferred over an aggregate/ combined transaction approach. Company-wide approach can be used either for inter-linked transactions or to corroborate the primary approach.

- Local vs. regional comparables: Order for identifying comparables must be followed by the Taxpayer i.e., Domestic, Regional (Middle East) and then Foreign comparables), subject to necessary adjustments to account for geographic and other differences.

- Multiple-year data: Multiple-year analysis for comparable companies is acceptable (preferably three years). While using three-year data, at least two years' data should be available in order to accept a comparison.

- Range: The interquartile range *(i.e. 25th to 75th percentile)* is considered appropriate for arriving at the Arm's Length Price. While determining the Arm's Length Price, the functional profile of the Taxpayer/ controlled transaction needs to be considered, in order to arrive at the appropriate data point in the aforesaid range.

- Frequency of updating the search of comparables: It is recommended to perform the comparability analysis on a three years recurring basis if there is no change in conditions and circumstances of the Taxpayer and its controlled transactions. However, a financial update of the comparability analysis would have to be performed on an annual basis.

- Comparability adjustments: Adjustments with respect to accounting consistency, segmentation of financial data, working capital, and FAR are allowed to adjust the potential comparable for accuracy & reliability purposes.

Special Considerations for Specific Cases

TP Guide provides detailed guidance with respect to certain specific categories of transactions:

- Financial transactions: It includes treasury functions, intra-group loans, cash pooling, hedging, guarantees, captive insurance. Guidance in relation to preferred TP method, the factors to be considered while conducting benchmarking (e.g., issue date, currency, tenor, country and credit rating of the borrower, implicit support – if any, interest rate type, industry, pre-payment option, etc.) and the steps for determining the arm's length price have been provided.

- Intra group services: It often includes services typically available externally from third parties but performed internally by one or more group members for the benefit of other group members.

The TP Guide provides comprehensive guidance, largely in line with Chapter VII of the OECD TP Guidelines. The analysis of TP considerations for such intra-group services involves two main areas:

- Whether intra-group services have been provided
- Whether the charge for the intra-group service is in accordance with the arm's length principle

The TP Guide emphasizes the importance of conducting the "benefits test" for all services, which primarily aims to determine whether a particular activity contributes economic or commercial value to a specific member within the group to enhance or maintain its business position.

An obligation to pay for an intra-group service arises only where the benefits test is satisfied, which is determined by evaluating whether independent parties in comparable circumstances would have been willing to pay for the activity if performed by an independent service provider or would have performed the activity in-house.

The TP Guide elaborates on the various aspects required to be considered like shareholder activities, treatment of pass-through cost/reimbursement of expenses, duplication of activities, incidental benefits and use of appropriate allocation keys, etc. to arrive at the cost base.

Finally, to determine the arm's length charge, the service provider should apply a markup to all costs that are not pass-through in nature. The markup should be determined using comparable data.

The TP Guide also prescribes a Safe Harbour margin of 5% with regard to arriving at the arm's length compensation for low-value-adding intra-group services.

- <u>Intangibles</u>: Intangibles are defined as something that is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities. The most crucial step while analyzing transaction involving intangibles is to identify the entity performing the Development, Enhancement, Maintenance, Protection, and Exploitation ('DEMPE') of intangibles along with distinguishing its legal owner from the economic owner.

  The TP Guide provides a six-step approach while benchmarking the transactions involving intangibles. Further, in specific circumstances, when none of the approved methods can be applied, the taxpayers have been provided an option to choose an alternate method other than the prescribed TP method like market appraisal, or valuation reports, especially when it's a unique or one-off transaction.

- <u>Cost contribution arrangements ('CCAs')</u>: The objective of CCAs is to share the contributions and risks of joint projects involving the development, production, or acquisition of intangible or tangible assets, or the performance of services, with the anticipated benefits derived from their contributions shared equitably among the parties.

  To benchmark CCAs, the TP Guide highlights that the most crucial step is to calculate the value of each participant's contribution to the joint activity and finally to determine whether the allocation of CCA contributions aligns with the expected benefits.

- <u>Business Restructuring</u>: It refers to the reorganization of the commercial and financial relations between RPs or CPs including termination or substantial renegotiation of existing arrangements. It often involves a change in the functional characterization of the entity(ies), transfer of something of value (tangible/intangible assets or a going concern) typically accompanied by a reallocation of the profit potential for various commercial reasons. Key consideration is provided below:
  - To benchmark such transactions, an understanding of the commercial and financial relation between the entities involved before and after the business restructuring is important, coupled with the expected benefits that ought to flow as a result of the restructuring exercise.
  - Justifying the commercial sense of restructuring by determining options realistically available to RPs

- and CPs; since in an arm's length scenario, persons acting at arm's length would only enter into a transaction if it does not make them worse off than their next best option.
- Sound commercial reasons behind restructuring may not necessarily mean that it is arm's length from the perspective of each of the restructured entities.

▪ Permanent Establishment ('PE'): For Transfer Pricing purposes, a PE is treated as a separate and independent entity (from its parent entity) and thus, transactions between RPs or CPs with a PE need to comply with ALP. Benchmarking a PE transaction involves undertaking a thorough FAR analysis to identify the activities performed by the PE vs. the parent, to determine the compensation/ profits attributable to the PE.

▪ Group synergies: The TP Guide touches upon the topic of group synergies, which can arise from being part of a group where entities may benefit from interactions or synergies between each other. Synergies can lead to benefits for the Group as a whole, and it is essential to determine whether these benefits are attributable to passive association or active synergies resulting from concerted action of group members. In cases where material synergies can be allocated to group members by way of advantages or disadvantages, any resulting benefit or detriment should be allocated between members commensurate with their role in generating the synergy on an arm's length basis supported through documentation.

▪ Inter-company balances: Regarding cash/ bank settlement between related parties it has been clarified that amounts remaining outstanding beyond a reasonable period could result in the re-characterization of such credit into an advancement of loan. Such a transaction would be subjected to TP provisions and would warrant an arm's length interest rate to be levied.

Transfer Pricing audit and risk assessment

While undertaking the TP analysis, the burden of proof for maintaining adequate supporting documentation and justifying the arm's length nature of each controlled transaction falls upon the Taxpayer

While undertaking the TP analysis, the taxpayers have the option to make adjustments to their Transfer Price throughout the Tax period up to the date of filing the Tax return. After submitting the Tax return, only adjustments increasing the profit of the Taxpayer is allowed by the FTA. Any adjustment resulting in a decrease in the profit of the Taxpayer may be performed only by the FTA during the audit process.

The FTA has the option to make necessary adjustments to the Transfer Price, in case the same does not align with the ALP. The FTA also has the option to disregard the controlled transaction and replace it with an alternate transaction.

Implications

The above TP rules have significant implications for UAE businesses. Further, the TP Guide is a comprehensive document and provides clarity on many operational aspects of TP provisions in the UAE. Businesses should therefore begin to evaluate potential implications on their operations, which may include the following aspects:

▪ Applicability of the TP rules such as identification of transactions that the business is carrying out with any RPs and/or CPs.
▪ Pricing of relevant transactions to see if any changes are required to align them with the arm's-length standard/market price.
▪ Impact of changes in the pricing of goods and services on the supplier company and recipient company.
▪ Efficient management of the additional compliance requirements introduced by these rules.
▪ Alignment of existing TP policies and documentation, if any, with the newly introduced TP rules.
▪ Impact on historical positions adopted concerning Economic Substance Regulations ('ESR').

The QFZP is required to comply with the ALP and prepare & maintain appropriate TP documentation to be eligible/continue to avail the 0% CT rate.