vstn Consultancy

UAE Transfer Pricing

Key Action points for Businesses

November 2023

Introduction

UAE Corporate Tax ("CT") regime was introduced w.e.f 01 June 2023. However, most of the businesses - following the calendar year, this regime would kick off from 1st January 2024.

This alert is intended to provide businesses with head start on what they need to consider, evaluate and factor to determine the applicability of the CT Regime & Rates, with primary focus on Transfer Pricing requirements.

Applicability of Corporate Tax Regime

- ► Scope of Taxation and Tax rate
- ► Compliance Requirements

Pragmatic Approach for Transfer Pricing

- Step 1- Identify Related Parties (RP) / Connected Persons (CP)
- Step 2- Identify RP Transactions
- Step 3- Substantiating Arm's Length Price

Other Key Aspects

- ► TP Documentation Requirements
- ► Key Transactions
- ► Tax Audit

Applicability of Corporate Tax Regime

Scope of Taxation and Tax rate

- **Scope of Tax**
  - Corporate tax shall be imposed on a taxable person whether resident or non-resident.
- **Tax Rate**
  - Tax rate needs to be determined with respect to each business activity.

Tax Rate	Taxable Person
0%	• Taxable income upto AED 375,000 • Qualifying income of free zone
9%	• Where taxable income is more than AED 375,000 • 9% on taxable income that does not meet the qualifying income definition

  - Entities opting for small business relief are treated as having no taxable income for the tax period.

Compliance Requirements

1. Mandatory for taxable persons[1] to meet CT compliance requirements with respect to registration, computation of taxable income, filing of tax returns and maintenance of records. However, in case of entities opting for small business relief, they have the leverage of:-
   - filing simplified tax returns;
   - no obligation to compute taxable income;
   - reduced record keeping ;
   - no requirement to maintain Transfer Pricing documentation; and
   - preparing financials using cash basis of accounting

Pragmatic Approach for Transfer Pricing

Step 1- Identify Related Parties (RP) / Connected Persons (CP)

► Identify the RP/CP based on the Ownership and Control, Kinship (in case of natural person) and significant influence

[1] Exempt entities (referred to in Article 4) are not subject to any compliance requirements under CT Law

- ► Group shareholding structure maybe the starting point for such analysis however parties falling under the significant influence category need to be separately identified (e.g. based on debt, authority to make strategic decisions etc.).
- ► In case of KMP, organisation chart of the Company may be used for identification.
- ► One challenge in case of connected persons maybe to identify 'officers' as this term is not defined. This needs to be determined independently for every company depending on their business circumstance.

Step 2- Identify Related Party Transactions

1. **Transactions:** Related party transactions include:
   a. the supply or transfer of tangible goods,
   b. provision and receipt of services,
   c. funding and other financial transactions,
   d. commercial exploitation of intangible assets such as patents, brands and know-how,
   e. Intra group transactions,
   f. Cost contribution arrangements,
   g. Business Restructuring,
   h. Reimbursements.
2. **Entities** - The above mentioned transactions can be between:
   a. PEs including foreign PEs,
   b. Two Free Zone entities,
   c. Two mainland entities,
   d. Mainland entity and Free Zone entity,
   e. Trustee, founder, settlor or beneficiary of a trust or foundation and the trust or foundation, including the trust's or foundation's Related Parties,
   f. Partner in an unincorporated partnership and related parties of such partner,
   g. Entity and connected persons.
3. **Not visible (hidden) transactions**- In certain cases though services maybe availed there may be no cross charge for the same, for eg. shared employees, deputation of employees, interest free loans / guarantees, head office management charges. All business facts need to be completely evaluated to identify such invisible transactions.

Step 3- Substantiating Arm's Length Price

Every transaction with related party and connected persons need to be tested for Arm's length Principle and thresholds are not applicable. Following are key points one has to bear in mind while justifying the arm's length nature of RP transactions:

1. Granular analysis of the transaction through FAR analysis/ Transactional Analysis.
2. Characterisation of the Entities, which could be ranging from limited risk bearing to entrepreneur manufacturer/ distributor/ service provider.
3. Selection of Tested party (which is the least complex entity) considering the FAR profile. Tested Party can be local or a foreign entity. Price based methods (e.g. CUP, Other Method) do not require selection of Tested Party.

4. Selection of MAM (most appropriate transfer pricing method)
    a. No hierarchy of methods,
    b. Combination of methods can be used,
    c. TP Methods – Comparable Uncontrolled Price Method (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM), Transactional Net Margin Method (TNMM), Other Transfer Pricing Method,
    d. Internal comparability assumes prominence before proceeding to external comparables,
    e. Transaction testing preferred over entity approach using TNMM.
5. PLI
    a. Can be cost based, sales based, asset based.
6. Search Process
    a. Prescribes either deductive (drilled down from the universe of companies) or additive approach (Go back from the probable list of comparables),
    b. No preference to any specific commercial database. However at the time of audit the FTA may request access to the database in which the search has been carried out,
    c. Comparables- First preference towards local comparables, in the absence of the same, one could look at regional/ global comparables.
7. Arm's Length Range
    a. Any point within the interquartile range (25^{th} to 75^{th} Percentile) to be considered at arm's length. Comparability adjustments such working capital adjustments maybe provided.
    b. However, in case where the tested party performs more significant functions then the expectation is for it to be remunerated closer to the upper quartile and vice versa.

Other Key Aspects

TP Documentation Requirements

There 5 specific documentation requirements that are required to be complied with depending on applicability.

1. **Disclosure form** (Applicability, format to be announced by FTA)
    a. May not apply to all entities,
    b. Materiality thresholds yet to be prescribed.
    c. Needs to be filed with FTA
2. **Local File**
    a. Contemporaneous requirement,
    b. Can be prepared either at the time of transaction (price setting approach) or at the end of the tax period (outcome testing approach)
    c. Applicability of threshold
    d. Exempt for entities claiming SBR (Small Business Relief),
    e. Contents similar to OECD TP Guidelines,
    f. Needs to be prepared every 3 years if no change in facts, however year on year margin update required for comparables and tested party,
    g. Cross referencing of certain sections with Master File permitted.

3. **Master File**
    a. Thresholds prescribed,
    b. Contents follows the requirement under the OECD TP Guidelines,
    c. Required to be prepared for each tax year,
4. **Country-by- Country Reporting (CbCR)**
    a. Already in place from April 2019
    b. Applies to businesses which are part of the MNE Group headquartered in UAE
    c. Consolidated Revenue Thresholds prescribed,
    d. Ultimate Parent Entity required to submit a CbCR,
    e. If a company is a constituent entity of a foreign MNE group which is subject to CbCR requirements then it shall be required to file a notification with the FTA.
5. **Additional information**
    a. Contracts / agreements to be maintained based on materiality threshold,
    b. Invoices, work papers, email and correspondences justifying the decisions taken to ensure Arm's length
    c. Any other documentation that maybe required to justify Arm's length price (ALP) when called for by FTA.

Key transactions

Some of the common key transactions and their TP considerations is captured in this section:

- **KMP**
  Compensation to Key Managerial Personnel (KMP) exists for all Companies and hence is of paramount importance. TP Aspects one has to bear in mind w.r.t. KMP compensation include:
    - Contract (Job description) Vs Conduct (Role) to be documented.
    - Internal appraisal documents (such as KRA, KPI) maybe leveraged while carrying out ALP analysis.
    - Adopt a practical approach to separately test the transaction based on alternatives.
    - Testing of the margins of the Company at net level (through use of TNMM by aggregating all transactions including KMP payments) may not be the right way to test the transaction.
    - TP exercise can be considered as a cap for the managerial remuneration and should not be a substitute for business considerations such as intelligence on pay-scale prevalent in the industry, existing compensation.
    - There may be scenarios where promoters are KMP as well as, shareholding activities and strategic activities for business will have to be delineated, as shareholding activities will not require separate compensation.

- **Intangible/ Intellectual Property (IP)**
    - Identify marketing intangibles and technology intangibles in the group
    - Detailed DEMPE (Development, Enhancement, Maintenance, Protection, exploitation) analysis carried by various entities towards the IP
    - Return for intangibles- running royalty/ lumpsum
    - Use of appropriate methods- CUP/ Other Method

- **Intra Group Loans**
  - Identify intra group loan transactions including interest free loans
  - Evaluate Terms of loan for e.g.- Secured Loans, Tenure, Credit Rating, country of the borrower, currency, interest rate type, prepayment option etc. influence the pricing
  - Carry out appropriate adjustments such as tenor adjustments
  - Use of appropriate comparable loan agreements to justify ALP

- **Guarantee**
  - Identify financial guarantee transactions including free of cost guarantees
  - Evaluate appropriate pricing approaches for guarantee such as interest saving approach. Few other approaches as provided in OECD can also be evaluated such as CUP, cost approach, valuation of expected loss approach, capital support method.

- **Cash Pooling**
  - Good approach to manage liquidity-. Regulatory environment in various countries of the group to be checked before implementing for the group as a whole
  - Two important considerations- every cash pool member should both borrow and lend and the time period should be short term
  - Can be notional or physical cash pooling arrangement
  - Compensation to the cash pool leader to be based on functions performed
  - The savings through cash pooling can be allocated to the cash pool participants based on their debit/ credit positions

- **Intra Group Services (IGS)**
  - Documenting "Need" for the services and "Benefit" arising from rendering of such service.
  - Exclusion of shareholder cost.
  - Eliminate duplicative activities and direct cost identifiable to any other specific entity.
  - Justification of mark-up. Leveraging safe harbour for Low value adding services viz., compensation for such services at cost +5%. By definition, Low value adding services rendered do not pertain to any core business activity of the group.
  - Consistency in the allocation of costs among group entities through appropriate allocation keys
  - Routine treasury functions identified may be remunerated similar to IGS

- **Business Restructuring**
  - Reorganisation of commercial and financial relationships both domestic and cross border
  - Some examples of restructuring would be conversion of full fledged manufacturers/distributors to contract manufacturers/limited risk distributors, transfer of intangibles
  - This can be driven by business reasons but should be carried out at ALP. Compensation (exit charge) for the business restructuring may be warranted.
  - Valuation techniques can be adopted to arrive at the arm's length compensation for such restructuring
  - Post restructuring also the transactions should be conducted at arm's length

  - Impact of any restructuring in light of GAAR provisions should be evaluated
- **Permanent Establishments (PE)**
  - Separate/distinct entity approach to be adopted
  - Identification of functions of the PE along with the allocation of risks and attribution of economic ownership of the assets
  - Attribute Profits to PE by adopting the Authorised OECD Approach

Tax Audit

- Onus is on the tax payer to demonstrate ALP.
- FTA can call for additional documents to justify ALP
- FTA can disregard the transaction and recharacterize the transaction
- In case of any adjustments to ALP, taxpayer can claim corresponding cross border adjustment invoking MAP.
- Corresponding adjustments in case of adjustments between domestic entities is granted.
- After submitting the Tax Return, one can make transfer pricing adjustments if it increases the profit or decreases the loss. The reverse situation is also possible after complying with FTA Procedures.
- Taxpayer can seek clarification on any legal position from the FTA
- Detailed guidance on APA is awaited.

Way Forward

While Businesses in UAE, especially with Financial Years starting 01 January 2024, are preparing for Corporate Tax regulations, being transfer pricing ready will ensure smooth implementation of corporate tax laws in respective business environment. Identifying related parties and related party transactions are the first key transfer pricing considerations, based on which determination / substantiation of arm's length price follow. Further as connected persons have been included under the purview of transfer pricing, transfer pricing compliance will be applicable for all businesses.

Ensuring a robust pricing setting has been undertaken is the cornerstone for a business to substantiate the arm's length nature of payments with its related parties before the tax authorities.

Since transitional positions apply, Companies need to recheck whether the transactions are at arm's length and in case of any deviation, they need to ensure that the suitable year end adjustments are made before book closure for 2023 so that the closing and subsequent opening balances in the books reflect arm's length pricing.

About us

VSTN Consultancy Private Ltd is a boutique Transfer pricing firm with extensive expertise in the field of international taxation and transfer pricing.

Our offering spans the end-to-end Transfer Pricing value chain, including design of intercompany policy and drafting of Interco agreement, ensuring effective implementation of the Transfer Pricing policy, year-end documentation and certification, BEPS related compliances (including advisory, Masterfile, Country by Country report), Global Documentation, safe harbour filing, audit defense before all forums and dispute prevention mechanisms such as Advance Pricing agreement.

We are structured as an inverse pyramid where leadership get involved in all client matters, enabling clients to receive the highest quality of service.

Being a specialized firm, we offer advice that is independent of an audit practice, and deliver it with an uncompromising integrity.

Our expert team bring in cumulative experience of over five decades in the transfer pricing space with Big4s spanning clients, industries and have cutting edge knowledge and capabilities in handling complex TP engagements.