Certificate Course on UAE Corporate Tax

BACKGROUND MATERIAL

Direct Taxes Committee

The Institute of Chartered Accountants of India

(*Set up by an Act of Parliament*)

New Delhi

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Foreword

In this era of borderless trade of goods and services, and also in view of presence of about 30000 members in global jurisdictions, the need to keep chartered accountants updated on various regulatory developments beyond the borders has also become important. Thus, considering the fact that the Ministry of Finance, United Arab Emirates (UAE) has published Federal Decree-Law No. 47 of 2022 providing the legislative framework for corporate tax on business profits in the UAE, the Direct Taxes Committee (DTC) of ICAI with the approval of Council decided to conduct Certificate course on UAE Corporate Tax (UAE CT) for our members in UAE through the Overseas UAE office and UAE Chapters in physical and online mode. This course will benefit our professionals in industry as well in practice to acquire specialized knowledge in this area and take the profession to newer heights. Members may recall that earlier in the year 2017, we have launched Certificate Course on UAE VAT also which is very well attended.

I am happy to note that this background material has been developed specifically for the UAE Corporate Tax Certificate course and provides a comprehensive guidance for understanding and navigating the world of corporate tax in the UAE. Notably, this publication addresses the unique challenges and opportunities presented by the UAE's tax system, including its emphasis on transparency and compliance. The insights and information provided through this publication will be valuable in helping oneself through the intricacies of UAE corporate tax.

I appreciate the efforts of CA. Sanjay Kumar Agarwal, Chairman, CA. Piyush S. Chhajed, Vice-Chairman and other members of the Direct Taxes Committee of ICAI for development and release of this publication.

I am quite hopeful that this publication will serve as a valuable resource for all the members and other stakeholders in better clarity of corporate taxation system in the UAE.

Date: 01-05-2023 **CA. Aniket Sunil Talati**

Place: New Delhi **President, ICAI**

Preface

In recent years, the United Arab Emirates (UAE) has emerged as a global business hub and a preferred destination for foreign investments. To help the UAE achieve its strategic objectives and accelerate its development and transformation, the UAE Government has introduced various tax reforms, including the implementation of corporate taxation. To provide comprehensive knowledge and understanding of UAE corporate tax and its implications on international taxation, the Direct Taxes Committee of ICAI (Committee on International Taxation now merged with Direct Taxes Committee) thought it fit to recommend to the Central Council of ICAI which decided to allow Overseas UAE office and UAE Chapters to conduct the Certificate course on UAE Corporate Tax (UAE CT) for its members in UAE. Further the Committee is allowed to conduct the course through online mode.

To supplement the Course, this publication namely *"Background Material for Certificate Course on UAE Corporate Tax"* serves as a handy tool to assist the CA fraternity in discharging their duties in respect of UAE Corporate Tax in the most efficient manner. This Background material covers various aspects of taxation such as taxable income, expense deduction, taxable persons, permanent establishment, residential status, computation of taxable income, Person's Not Covered by UAE CT, Taxation of Free Zone Persons (FZP), group taxation, corporate reorganizations and administrative procedure. Each chapter of this publication has been prepared and reviewed by proficient tax professionals to ensure greater efficacy and relevance to the UAE corporate tax system.

The purpose of this publication is to provide a thorough understanding of UAE corporate tax and its implications on international taxation. We hope that this publication will provide valuable insights and augment the knowledge of our members all across the world. It will also guide them navigate through the tax landscape in the UAE.

We are sincerely thankful to CA. Aniket Sunil Talati, President, ICAI and CA. Ranjeet Kumar Agarwal, Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

We are pleased to place on record our sincere gratitude to all the contributors who have helped in giving shape to this publication possible in such a short span of time. We are sure that this effort of Direct Taxes Committee of ICAI would go a long way in assisting our members in making utmost compliance of the new provisions.

Place: Delhi **CA. Sanjay K. Agarwal**

Date: 01.05.2023 **Chairman, Direct Taxes Committee of ICAI**

Message from Chairman, Dubai Chapter, ICAI

The UAE is home to thousands of members of ICAI and the publication of background material, coinciding with the introduction of Corporate Tax in UAE, will go a long way in meeting the needs of our members and stakeholders in the country.

The introduction of Corporate Tax is intended to help the UAE achieve its strategic objectives and accelerate its development and transformation.

The certainty of a competitive Corporate Tax regime that adheres to international standards, together with the UAE's extensive network of double tax treaties, will cement the UAE's position as a leading jurisdiction for business and investment.

The hardwork of contributors of this background material, over past several months are coming to fructification, wherein the feedback from readers of this background material, will lay a foundation to continuously improve and make our members aware of developments and experiences in the field of UAE Corporate Tax and International Taxation.

The publication of this material is a landmark progress and as we continue with various initiatives for making our members aware of the developments, this publication will become an important resource to continue with our work, for supporting our members and stakeholders.

With deep gratitude to ICAI leadership, Central Council Members, Direct Taxes Committee (including CITAX merged in 2023-24) under leadership of Chairman and Vice Chairman, contributors from India and UAE and all team members, we eagerly look forward to this background material, making a big difference in our lives.

CA. Harikishan Rankawat

Chairman, Dubai Chapter, ICAI

Message from Chairman, Abu Dhabi Chapter, ICAI

This background material provides an in-depth analysis of the Corporate Tax Law, including its scope, applicability, and compliance requirements. It also discusses the tax rates, exemptions, and penalties for non-compliance. The material is a comprehensive guide that will serve as an excellent resource for businesses operating in the UAE, particularly those in the accounting and financial sectors.

The introduction of the Corporate Tax Law is a significant development for the UAE, aimed at achieving its strategic objectives and accelerating its development and transformation. The UAE's extensive network of double tax treaties further strengthens its position as a leading jurisdiction for business and investment. The Corporate Tax Law will not only contribute to the growth of the UAE economy but also provide a more stable and transparent business environment for foreign investors.

I believe that this material will be of immense value to all our readers, helping them navigate the Corporate Tax Law and remain compliant with the regulations. I would like to express my gratitude to the Direct Taxes Committee (including CITAX merged in 2023-24) and Overseas Office of ICAI in Dubai, for their diligent efforts in producing this material.

I thank everyone who contributed to the development of this material, and I encourage all Chartered Accountants and readers to make full use of this valuable resource.

CA. John George

Chairman, Abu Dhabi Chapter, ICAI

Message from Chairman, Ras Al Khaimah Chapter, ICAI

I am very pleased to note that ICAI is publishing material on UAE Corporate Tax. The UAE has been through a series of tax reforms in the last few years to align itself with international markets and diversify its revenue.

The Institute has been very active in facilitating professional development and providing a platform for networking to professionals. CA Professionals have been recognized for their trust, reliability, and competence in a wide range of roles as CEOs, CFOs, Auditors, and so on in Government entities, industries, and service verticals, emerging as a contributor to the economy of UAE. The increasing ratio of young members renders a competitive advantage to adapt technology at a relatively rapid phase.

I would like to express my gratitude to all the ICAI Members for their contribution to compiling valuable information for the preparation of this publication.

CA. Pramod K. Chand

Chairman, Ras Al Khaimah Chapter, ICAI

Message from Chairman, Fujairah Chapter, ICAI

UAE and India have this unique synergy where they share resources both ways for nation building. On the strength of this partnership and with the introduction of corporate tax, ICAI – the second largest accounting body in the world and India's statutory body – stands firmly with UAE and its people.

We thank ICAI for laying the foundation for the detailed study and lucid explanation with this publication, which will help not just our members, but also every reader in society, to adopt to the new environment comfortably, overcome its challenges seamlessly and serve as a lasting guide for years to come.

CA. Dhawal G. Nandedkar

Chairman, Fujairah Chapter, ICAI

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The Direct Taxes Committee (DTC) of ICAI acknowledges the contribution made by the following members to develop the publication namely "*Background Material for Certificate course on UAE Corporate Tax*". DTC of ICAI places on record its gratitude for their contribution in enrichment of knowledge of the members:

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Chapter 1

An Overview of UAE Corporate Tax and International Taxation

This chapter covers the following:

- **Background and rationale of introducing Corporate Tax (CT) in UAE**
- **Basis of Taxation - Source and Residence Rules- Double Taxation**
- **Model Tax Conventions on Double Tax Avoidance - Brief introduction of Articles**

1. Background and rationale of introducing CT in UAE1[1]

Over the past few years, the UAE has taken significant steps to enhance tax transparency and facilitate the exchange of information for tax purposes by bringing its domestic tax rules in line with international standards.

Many of the changes in the UAE were driven by the Organization for Economic Cooperation and Development's ('**OECD**'), Base Erosion Profit Shifting ('**BEPS**') project which seeks to tackle international tax avoidance and address gaps in existing tax rules that allow the profits of multinational companies to be artificially shifted from high tax jurisdictions to low or no tax environments where little or no economic activity takes place.

A 15-point BEPS Action Plan was developed by the OECD in partnership with the G20 countries in 2013.

- The UAE already has a wide tax treaty network with over 90+ double taxation treaties in place with other countries. These treaties seek to eliminate double taxation and facilitate the exchange of tax information on a bilateral basis.
- The UAE implemented the Common Reporting Standard for the automatic exchange amongst tax authorities of financial account information of foreign tax residents. UAE signed the OECD Convention on Mutual Administrative Assistance in Tax Matters in April 2017 and ratified the same in April 2018.
- The UAE became a BEPS inclusive member in May 2018, together with more than 135 other countries, committing to the implementation of four minimum BEPS standards, namely countering harmful practices (Action 5), countering treaty abuse (Action 6), transfer pricing documentation and country-by-country reporting (Action 13) and improving dispute resolution mechanisms (Action 14).

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[1] https://www.tamimi.com/law-update-articles/the-introduction-of-corporate-tax-in-the-uae-myth-or-reality/

- In July 2018, the UAE signed and subsequently ratified the Multilateral Competent Authority Agreement to complete the implementation of the Common Reporting Standard and to facilitate compliance with various BEPS transparency measures including the exchange of country-by-country reports under BEPS Action 13.
- In line with its commitments as a BEPS inclusive member, the UAE has taken various measures to implement the minimum BEPS standards. The UAE signed up to the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in June 2018 (also known as the "multilateral instrument") allowing the UAE to modify existing double tax treaties without the need for protracted bilateral negotiation.
- The UAE also issued initial substance regulations and a cabinet resolution on country-by-country reporting with effect from April 2019.
- The Government of UAE announced on 31st January 2022 that UAE would be promulgating legislation for levying Federal Corporate Tax (CT) on business profits and the same shall be effective for the tax period commencing on or after 1st June 2023.
- As a part of the implementation process of the CT, the UAE Government initially released Public Consultation Document on 28th April 2022 and thereafter promulgated the Corporate Tax law vide Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses issued on 9th December,2022.

Objectives of introducing CT as per the UAE Ministry of Finance:

By introducing the CT, the UAE aims to:

- Cement its position as a leading global hub for business and investment.
- Accelerate its development and transformation to achieve its strategic objectives.
- Reaffirm its commitment to meeting international standards for tax transparency and preventing harmful tax practices.

2. Basis of Taxation - Source and Residence Rules - Double Taxation

Globalization increased interaction among nations through trade, investment and movement of people. Companies and individuals move to other countries and create income. Here, there is a vital question, in which country he/it has to give taxes?

When a company or individual from country A gets income in country B, which country has the right to tax such income is an area of controversy. Economic borders may have eroded due to globalization, but tax power of countries remains the same. Similarly, every country would like to tax an income if it is related with that country.

To solve this problem, there are two principles to guide taxation.

- Residence based taxation and
- Source based taxation.

2.1 Residence based taxation

Resident based taxation instructs that, the country can tax persons if they are residents or domiciled in the country, regardless of the source of income. In the case companies, the place of incorporation or registration of the entity or the place where its place of effective management is located is its place of residence.

In the case of income tax, individuals/companies have to pay taxes for their global income. Therefore, the principle of residence-based taxation of income envisages the taxation of global income.

2.2 Source based taxation

In the case of source-based taxation principle, importance is to the source (country) where income is generated. There are individuals/entities whose "residence" is in one country, but their business is actually carried on in another country and their income is earned in the latter country. In such cases, the principle of residence-based taxation would be inappropriate. Therefore, there is a view that the country which provides the opportunity and facilities to generate income or profits should also have the right to tax the same.

Primary problems in residence and source-based rules of taxation and which method to adopt

Theoretically, imagine a world in which all countries adopted either pure residence jurisdiction or pure source jurisdiction.

Economists would favour residence jurisdiction, because they consider the source of income to be hard to pin down (income often has more than one source), and because they think residence jurisdiction promotes economic efficiency, since the decision where to invest should be unaffected by the tax rate.

However, pure residence taxation may be unrealistic, for three reasons as given below.

- Countries are unlikely to give up the right to collect tax from foreigners doing business within their economy.
- Wholly residence-based taxation would reduce revenues in poor developing countries, who rely heavily on source-based taxation, in favour of the rich developed countries where investors reside. Residence taxation may be much easier to evade or avoid, by channeling international investments through tax.
- Strong protection of bank confidentiality and other secrecy provisions in heavens makes it hard for the residence country to get the information about its resident 's foreign source income.

Pure Source based taxation enables investors to play countries off against each other to obtain lowest source-based tax rate. It also provides for problems of determining the source of income and of combating abusive transfer pricing (i.e., shifting of profits artificially for a tax advantage).

Double taxation

When the same income is taxed more than once, it creates double taxation. This may be due to when a person is taxed in more than one country for the same income which he had earned, leads to double taxation.

For example, if country A and country B both tax income at a rate of 30% and 20% respectively, and a resident of A derives USD 100 of income from a source within B, that income could first be taxed by B at 20% (paying USD 20 in taxes) at source, and the same income of USD 100 units could be taxed by A at 30% (paying taxes of USD 30) on the basis of residence jurisdiction. So, the taxpayer would be left with only (100-20-30) = USD 50, paying an effective tax rate of 50%.

The double taxation can be eliminated or reduced by completely exempting the income derived from foreign sources from residence taxes. But this could encourage business or investors to go abroad to countries where tax rates are lower than at home.

Countries enter into Double Taxation Avoidance Agreements (**DTAA**) with other countries to resolve double taxation issue so as to ease out the tax burden of their taxpayers. This relief for taxes paid in foreign country is given to taxpayer while taxing the same income in the other country and is termed as Foreign Tax Credit (**FTC**).

There are two methods of granting relief under Double Taxation Avoidance Agreement.

(i) **Exemption method** - A particular income is taxed in one of both countries and exempted in the other

(ii) **Tax Credit method** - The income is taxed in both the countries as per the treaty and the country of residence will allow the tax credit / reduction for the tax charged in the source country.

The UAE has 90+ agreements in place with other nations to avoid double taxation on investments overseas.

The agreements on the Avoidance of Double Taxation are aimed to:

- promote the country's development goals and diversify its sources of national income.
- eliminate double taxation as well as additional, indirect taxes and taxes evasion.
- eliminate any obstacles related to cross-border trade and investment flows.
- provide protection to taxpayers from double taxation, whether direct or indirect
- promote the exchange of goods and services and the free movement of capital.

3. Model Tax Conventions on Double Tax Avoidance - Brief introduction of Articles

3.1 Overall preview of the model convention

Many organizations come up with their own model laws in this regard which can be used by countries to base their tax treaties with each other. The two most popular ones are the OECD and the UN model tax conventions which have been used by many countries to design treaties amongst themselves.

The basic premise behind having tax treatise is to choose the extent to which one country is ready to forego some of its taxing rights in order to address concerns of double taxation, tax evasion and for promoting investment and business.

There are two main ways in which income or profits from international transactions are taxed by countries. First, by asserting the right to tax the source of the income by the country where it originates and the second is by asserting the right to tax the resident whom the income accrues to by the country where the resident is situated.

There exists a third assertion which is mostly used only by the USA and originates in its own Model Tax Treaty by the US Treasury Department is the assertion on the basis of Citizenship. However, this is not a very widely accepted position apart from the USA which also applies it with various qualifications in practice. Therefore, we will only consider the two main principles stated earlier.

In the absence of any tax treaty, the first problem is that both countries might end up taxing the income due to conflicting assertions. The second possibility is that the source country where the income is generating will always be successful in taxing the income first before it can be repatriated thus the resident country will always be at a loss if it wants to continue to promote cross border trade and expansion of business. Added to it a country like USA which also taxes based on citizenship, although rare, could complicate matters further. Another, problem that arises sometimes is the way different countries define residency of an entity for the purpose of taxation. This is especially of significance where multinational corporations are involved which are sometimes incorporated in one jurisdiction while they are organized in another or carry on their effective management form another jurisdiction. This is one of the main issues that various model tax treaties have tried to address in the Permanent Establishment topic.

Due to all the above reasons a good bilateral tax framework is necessary for avoiding any confusion as to conflicting definitions by states. Thus it is very necessary to have a good tax treaty for coordination. Once establishing the necessity for a tax treaty as the first consideration, the logical next consideration is which country needs to relent its rights to what extent as to not be very adversely affected by foregoing taxation rights at the expense of promoting business. This is the core of treaty negotiations and choice of a model tax convention as the correct basis for negotiations.

3.2 Types of DTAAs

DTAA's can be of two types:

1. Comprehensive.
2. Limited

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time a treaty covers wealth tax, gift tax, surtax. Etc. too.

Limited DTAAs are those which are limited to certain types of incomes only.

3.3 Language used by Treaties.

Tax Treaties employ standard international language and standard terms. This is done in order to understand and interpret the same term in the same manner by both assessee as well as revenue. Language employed is technical and stereotyped.

Some of the key terms are explained below:

(i) *Contracting State* - country which enters into Treaty.

(ii) *State of Residence* - Country where a person resides.

(iii) *State of Source* - Country where income arises.

(iv) *Enterprise of a Contracting State* - Any taxable unit (including individuals of a Contracting State)

(v) *Permanent Establishment* – A fixed base/presence of an enterprise in the state of Source (usually a branch of a foreign company and in some cases wholly – owned subsidiaries as well)

(vi) *Income arising in Contracting state* – Income arising in a State of a source.

One has to read the treaty carefully in order to understand its provisions in their proper perspective. The best way to understand the DTAA is to compare it with an agreement of partnership between two persons. In partnership, the words used are "*the party of the first part*" and in the DTAA, the words used are "*the other contracting state*". One can also replace the words" *Contracting States*" by names of the respective countries and read the DTAA again, for better understanding.

In general terms, the Articles of a convention can be divided into six groups for the purpose of analysis:

1. **Scope Provisions:** These include Article 1 (Personal scope), 2 (Taxes covered), 30 (Entry into force) and 31 (Termination). These provisions determine the persons, taxes and time period covered by a treaty.

2. **Definition provisions:** These include Article 3 (General Definitions), 4(Residence) and 5 (Permanent Establishment) as well as the definitions of terms in some of the substantive provisions (e.g. the definition of "immovable property" in Article 6(2)).

3. **Substantive Provisions:** These are the Articles between Article 6 and 22 which apply to particular categories of income, capital gains or capital and allocate taxing jurisdiction between the two Contracting States.

4. **Provisions for elimination of double taxation:** This is primarily Article 23. Article 25(Mutual Agreement) could also be placed in this category.

5. **Anti-avoidance provisions:** These include Article 9 (Associated Enterprises) and 26 (Exchange of information).

6. **Miscellaneous Provisions:** This final category includes Articles such as 24 (Non-Discrimination), 28 (Diplomats) and 29 (Territorial Extension).

Article No.	Heading	Content
1	Scope of the Convention	To whom applicable?
2	Taxes covered	Specific taxes covered
3	General definition	Persons, company enterprises, international traffic, competent authority
4	Resident	'Residence' of a contracting state who can access treaty
5	Permanent Establishment	What constitutes PE? What does not constitute PE?
6	Income from immovable property	Immovable property and income there from
7	Business Profits	Determination and taxation of profits arising from business carried on through PE.
8	Shipping, inland waterways & air transport	Place of deemed accrual of profits arising from activities and mode of taxation thereon
9	Associated Enterprises	Enterprises under common management and taxation of profits owing to close connection (other than transactions of arm's length nature)
10	Dividend	Definition and taxation of dividends; Concessional rate of tax in certain situations.
11	Interest	Definition and taxation of interest; Concessional rate of tax in certain situations; Taxation of

Article No.	Heading	Content
		interest paid in excess of reasonable rate, on account of special relationship.
12	Royalties	Definition of Royalties- what it includes and covers, and its taxation; Treatment of excessive payment of royalties due to special relationship; Country where taxable.
13	Capital Gains	Definition- Taxation aspect; Concessional rates/exemption from tax if any; Country where taxable.
14	Independent Personal Services	Types of services covered; Country where taxable.
15	Dependent Personal Services	Definition and Country where taxable.
16	Directors Fees and Remuneration	Definition and mode of Country where taxable.
17	Income earned by entertainer and athletes	Types of activities covered; Mode of Country where taxable.
18	Pension and social security payments	Country where taxable.
19	Remuneration and pensions in respect of government services	Types of remuneration and Country where taxable.
20	Payment received by students and apprentices	Taxation / Exemption of payments received by student and apprentices.
21	Other Income	Residual Article to cover income not covered under other 'Articles', mode of taxation and country where taxable.
22	Capital (Tax on wealth)	Definition – made – and country where taxable.
23	Method of elimination	Exemption Method / Credit Method
24	Non-Discrimination	(Equitable) Basis of taxing Nationals and citizens of foreign state
25	Mutual Agreement Procedure	Where taxation is not as per provisions of the convention, a 'person' may present his case to Competent Authorities of respective states and procedure in such cases.

Article No.	Heading	Content
26	Exchange of Information	Competent Authorities to exchange information for carrying out provisions of the convention and methodology.
27	Assistance in collection of taxes	NA
28	Diplomatic agents and Consular corps (Officers)	Privileges of this category to remain unaffected.
29	Territorial Extension	
30	Entry into force	Effective date from which convention comes into force; Assessment year from which it comes into force.
31	Termination	Time – Notice period – Mode.

Chapter 2

Taxable Income, Expense Deduction and Taxable Person

This chapter covers the following:

- **Taxable income and Tax (UAE CT)**
- **Expense deduction (UAE CT)**
- **Taxable person**

Introduction

To cement UAE's position as an international hub for businesses and investments, on 9th December 2022, the UAE Ministry of Finance ('MoF') officially introduced a Corporate Tax ('CT') law under a Federal Decree -Law No. 47 ('The Decree Law') of 2022 on Taxation of Corporations and Businesses ('CT Regime'). The new CT regime shall become applicable from 1 June 2023. With this introduction, UAE aims to reaffirm its commitment to meet international standards for tax transparency and to prevent harmful tax practices. Here, in this chapter the definition of Income and related attributes along with rate of tax has discussed.

1. Taxable income and Tax (UAE CT)

1.1 What is Income?

Income refers to money – cash or cash-equivalents – coming in either for work done, interest or profit from capital invested, or rent from a property or land that is let. When it comes from work it is referred to as either a wage or a salary.

It is any money received by a worker, company, investor, charity, organization or the economy. It is also known as earnings.

In accounting, it is an excess of revenue over expenses for a specific accounting period – also referred to as gross profit or earnings. It can also refer to how much total assets increased in value by during an accounting period.

Income has a range of meanings

The term has several different meanings, depending on the situation and whether it refers to an individual, company, household, or national economy. It is the consumption and savings opportunity gained by an entity within a specific timeframe – nearly always expressed in monetary terms.

For individuals and households, however, it is the sum of all the wages, salaries, profits, interest payments, rents and other forms of earnings received – in every case, over a specific period.

1.2 Taxable Income

Corporate Tax shall be imposed on a Taxable Person at the rates determined under this Decree-Law. A Taxable Person either a Resident Person or a Non-Resident Person ***(detailed discussion in other chapter of the module)***

Taxable income is the portion of your gross income used to calculate how much tax you owe in a given tax year.

Article 1 of UAE CT Law define the term 'Taxable Income' stated below:

" *The income that is subject to Corporate Tax under this Decree-Law."*

Chapter Six of this Decree-Law deals with the Calculating Taxable Income, hereunder Article 20 defines the general rules on determining the taxable income on which Corporate Tax to be calculated and paid.

Article 20 of UAE CT Law states:

"1. The Taxable Income of each Taxable Person shall be determined separately, on the basis of adequate, standalone financial statements prepared for financial reporting purposes in accordance with accounting standards accepted in the State.

2. The Taxable Income for a Tax Period shall be the Accounting Income for that period, and to the extent applicable, adjusted for the following:

a. Any unrealised gain or loss under Clause 3 of this Article.

b. Exempt Income as specified in Chapter Seven of this Decree-Law.

c. Reliefs as specified in Chapter Eight of this Decree-Law.

d. Deductions as specified in Chapter Nine of this Decree-Law.

e. Transactions with Related Parties and Connected Persons as specified in Chapter Ten of this Decree-Law.

f. Tax Loss relief as specified in Chapter Eleven of this Decree-Law.

g. Any incentives or special reliefs for a Qualifying Business Activity as specified in a decision issued by the Cabinet at the suggestion of the Minister.

h. Any income or expenditure that has not otherwise been taken into account in determining the Taxable Income under the provisions of this Decree-Law as may be specified in a decision issued by the Cabinet at the suggestion of the Minister.

i. Any other adjustments as may be specified by the Minister.

3. *For the purposes of calculating the Taxable Income for the relevant Tax Period, and subject to any conditions that the Minister may prescribe, a Taxable Person that prepares financial statements on an accrual basis may elect to take into account gains and losses on a realisation basis in relation to:*

   a. *all assets and liabilities that are subject to fair value or impairment accounting under the applicable accounting standards; or*

   b. *all assets and liabilities held on capital account at the end of a Tax Period, whilst taking into account any unrealised gain or loss that arises in connection with assets and liabilities held on revenue account at the end of that period.*

4. *For the purposes of paragraph (b) of Clause 3 of this Article:*

   a. *"Assets held on capital account" refers to assets that the Person does not trade, assets that are eligible for depreciation, or assets treated under applicable accounting standards as property, plant and equipment, investment property, intangible assets, or other non-current assets.*

   b. *"Liabilities held on capital account" refers to liabilities, the incurring of which does not give rise to deductible expenditure under Chapter Nine of this Decree Law, or liabilities treated under applicable accounting standards as non-current liabilities.*

   c. *"Assets and liabilities held on revenue account" refers to assets and liabilities other than those held on a capital account.*

   d. *An "unrealised gain or loss" includes an unrealised foreign exchange gain or loss.*

5. *Notwithstanding Clauses 1 and 3 of this Article, the Minister may prescribe any of the following for the purposes of this Decree-Law:*

   a. *The circumstances and conditions under which a Person may prepare financial statements using the cash basis of accounting.*

   b. *Any adjustments to the accounting standards to be applied for the purposes of determining the Taxable Income for a Tax Period.*

   c. *A different basis for determining the Taxable Income of a Qualifying Business Activity.*

6. *Subject to any conditions prescribed under Clause 5 of this Article, a Taxable Person can make an application to the Authority to change its method of accounting from cash basis to accrual basis from the commencement of the Tax Period in which the application is made or from the commencement of a future Tax Period.*

7. *In the case of any conflict between the provisions of this Decree-Law and the applicable accounting standards, the provisions of this Decree-Law shall prevail to that extent."*

In simpler terms, it can be said that, the Taxable Income of each Taxable Person shall be determined separately on the basis of adequate, standalone financial statements prepared in accordance with accounting standards accepted in the State, after making adjustment for certain specified items namely Unrealised Gain or Loss, Exempt Income, Reliefs, Incentives Deduction, Tax losses, Transactions with Related Parties and Connected Person and Unrecorded Income or Expenditure.

1.2.1 Exclusions from Taxable Income

The main focus of UAE CT Law is to tax the income which is earned by Business or Business Activities in UAE. Business or Business Activities can be takes place by individual in the form of sole proprietor, partnership or any other form. In conclusion, income earned from the business is to be taxable. Employment income real estate income, income from savings and other income earned by individuals in their personal capacity would not taxable. Also dividends, capital gains and other investment returns earned by foreign investors would also outside the purview of Corporate Tax.

1.2.2 Capital gains and other capital receipts in terms of taxability (vs. Revenue receipts)

In line with many other countries and leading international financial centres, a UAE corporate shareholder will generally be exempt from CT on dividends received, and capital gains earned from the sale of shares of a subsidiary company. The purpose of this so-called participation exemption is to avoid double taxation of corporate profits, first when they are earned by the subsidiary company and second when the profits are distributed to, or the shares in the subsidiary company are sold by, the UAE shareholder company. Capital gains from the sale of shares in both UAE and foreign companies are exempt from CT, provided certain conditions are met.

1.2.3 Rules relating to income exempt from taxation

Domestic and cross border payments of interest, dividends, royalties and other payments will not attract withholding tax in UAE and foreign tax credits will be available for taxation incurred by UAE business on income earned outside the UAE.

1.3 Rate of Corporate Tax

Chapter Two of UAE CT Law deals with the Imposition of Corporate Tax (Article 2) and Applicable rates (Article 3).

Article 2 of UAE CT Law states:

"Corporate Tax shall be imposed on Taxable Income, at the rates determined under this Decree-Law, and payable to the Authority under this Decree-Law and the Tax Procedures Law."

Article 3 of UAE CT Law states:

"1. Corporate Tax shall be imposed on the Taxable Income at the following rates:

   a. *0% (zero percent) on the portion of the Taxable Income not exceeding the amount specified in a decision issued by the Cabinet at the suggestion of the Minister.*

   b. *9% (nine percent) on Taxable Income that exceeds the amount specified in a decision issued by the Cabinet at the suggestion of the Minister.*

2. *Corporate Tax shall be imposed on a Qualifying Free Zone Person at the following rates:*

   a. *0% (zero percent) on Qualifying Income.*

   b. *9% (nine percent) on Taxable Income that is not Qualifying Income under Article 18 of this Decree-Law and any decision issued by the Cabinet at the suggestion of the Minister in respect thereof."*

In simpler terms,

Corporate Tax shall be imposed on Taxable Income derived by Taxable Person, at the following rates, and payable to the Authority under this Decree-Law.

Taxpayer	Applicable CT rate
Individuals and juridical Persons	0% for taxable income up to and including AED 375,000* 9% for taxable income exceeding AED 375,000* **this amount confirmed in a Cabinet Decision 116 of 2022 on the Applicable Taxable Income Threshold for Corporate Tax.*
Qualifying Free Zone Persons**	0% on qualifying income 9% on taxable income that does not meet the qualifying income definition

*****Chapter Five** of UAE CT deals with Free Zone Person, wherein **Article 18** defines who can be termed as Qualifying Free Zone Person and **Article 19** states that Qualifying Free Zone Person can make an election to be subject to Corporate Tax at the rates specified under this Decree-Law.* ***(detailed discussion in other chapter of module)***

A Qualifying Free Zone Person is a Free Zone Person where all of the specified conditions are met:

- *Maintains adequate substance in the State.*
- *Derives Qualifying Income*
- *Has not elected to Corporate Tax*
- *Complies with the Article of “Arm’s Length Price” and “Transfer Pricing Documentation”*
- *Any such other conditions as may be prescribed*

A Qualifying Free Zone Person that feels to meet any of the specified condition under this article at any particular time during a Tax Period shall cease to be a Qualifying Free Zone Person from the beginning of that Tax Period.

Illustration:

If a business has earned taxable income of AED 500,000 in a given financial year, what will be the UAE CT amount payable?

The CT liability will be calculated as follows:

- Taxable income of AED 0 - AED 375,000 at 0% = AED 0
- Portion of taxable income exceeding AED 375,000 (i.e. AED 500,000 - AED 375,000 = AED 125,000) at 9% = AED 11,250

The UAE CT liability for the year will be AED 0 + AED 11,250 = AED 11,250

1.4 Taxable Year

UAE Corporate Tax will become effective for financial years starting on or after 1 June 2023. Article 57 (Tax Period) of UAE CT Law states that, A Taxable Person’s Tax Period is the Financial Year (Gregorian calendar year, or the twelve-month period) or part thereof for which a Tax Return is required to be filed.

Article 58 (Change of Tax Period) of UAE CT Law states that, A Taxable Person can make an application to the Authority to change the start and end date of its Tax Period, or use a different Tax Period, subject to conditions to be set by the Authority.

1.5 Manner of Payment of Tax & Filing of Tax Return

Article 53 (Tax Returns) of UAE CT Law states that, A Taxable Person must file a Tax Return, as applicable, to the Authority in the form and manner prescribed by the Authority no later than nine months from the end of the relevant Tax Period, or by such other date as directed by the Authority.

Illustrative timetable for CT filing and payment deadlines:

Financial year end	30 June	31 December	31 March
First tax period	1 Jul 2023- 30 Jun 2024	1 Jan 2024-31 Dec 2024	1 Apr 2024- 31 Mar 2025
CT return must be filed, and CT payment made, within nine months of the tax period			
Filing & payment due date	31 Mar 2025	30 Sept 2025	31 Dec 2025

2. Expense deduction (UAE CT)

The calculation of taxable income will largely follow accounting rules, but the UAE Corporate Tax regime will disallow or restrict the deduction of certain specific expenses. This is to ensure that relief can only be obtained for expenses incurred for the purpose of generating taxable income, and to address possible situations of abuse or excessive deductions.

Non-deductible expenses and interest capping rules have been introduced to ensure that relief can only be obtained for expenses incurred for the purpose of generating taxable income.

2.1 Deductible Expenditure (Article 28)

There are certain expenses that are incurred solely and exclusively for business activities which are not of capital nature and are deductible in the Tax Period in which they are incurred. This includes- any expenditure used to generate Taxable income or a share of an expenditure calculated on fair and reasonable basis, but does not include, expenditure not incurred in connection with Taxable Person's business, cost incurred in exempt income, losses not connected to Taxable Person's business or as per the Minister's recommendation.

2.2 Interest Expenditure (Article 29, 30 & 31)

The limitation of the deductibility of the net interest expense (i.e. interest expenses incurred (including amount of net interest expenditure) less interest income in line with OECD's interest limitation rules proposed by Action 4 of OECD's BEPS project). The objective is to prevent tax arbitrage opportunities for erosion of the UAE CT base. The CT Law provides that net interest expense up to 30% of business' EBITDA (adjusted by excluding Exempt Income) could be deductible. To reduce the administrative burden, it also provides for a safe harbour/de-minimis threshold to be specified by a Cabinet Decision which can be deducted irrespective of the interest deductibility limit based on the EBITDA rule. It further states that interest capping rules will not apply to banks, insurance businesses and certain other regulated financial service entities. Also, interest capping rules will not apply to Business carried on by natural persons/individuals or any other Person that may be determined by a UAE Cabinet Decision The net interest expense amount disallowed for deduction under the interest capping rules could be carried forward and deducted in the subsequent ten Tax Periods. In addition to the general interest limitation rule set out above, no interest deduction will be allowed if the loan was obtained, directly or indirectly, from a related party for the following transaction with the related parties and loan was not attracted to gain a UAE CT advantage (i.e. lender is subject CT in the UAE or a tax of a similar character under applicable legislation of foreign jurisdiction at a rate not less than 9%):

- dividends/profit distribution;
- redemption, repurchase, reduction or return of share capital;
- capital contribution; or
- acquisition of ownership interest in a legal entity, who is or becomes a related party following acquisition.

2.3 Entertainment Expenditure (Article 32)

Deduction of 50% is allowed of the expenditure incurred such as meals, accommodation, transportation, admission fees, facilities and equipment in entertainment, amusement or recreation of client, shareholder, supplier, or other business partners.

2.4 Non-deductible expenditure (Article 33)

The UAE CT does not allow any deduction for penalties paid, bribes or illicit payments, UAE CT or tax imposed on income outside UAE, UAE VAT recoverable or donations paid to unapproved charities.

3. Taxable Person

The UAE CT regime will be implemented without a parallel tax on the income of natural persons, namely individuals. In order to level the playing field between incorporated businesses and unincorporated businesses owned by individuals, as per Article 11 of UAE CT will also apply to natural persons engaged in a business or commercial activity in the UAE. This will include sole establishments or proprietorships and individual partners in an unincorporated partnership that conducts business in the UAE. Similar approaches are taken in other jurisdictions without parallel taxes on personal income from a business.

As per the Public Consultation Document, whether an individual is engaged in a business that is subject to UAE CT would generally depend on whether the activity requires the individual to obtain a commercial licence or equivalent permit from the relevant competent authority (e.g., the relevant Department of Economic Development or registration authority of a Free Zone) in the UAE.

Employment income and other personal income earned by UAE and foreign individuals such as dividends, rental receipts from UAE real estate investments, and other investment income will not be within the scope of the proposed UAE CT regime. The same treatment is intended to apply where UAE real estate and other investments are held through a private or family trust on behalf of beneficiaries that are natural persons.

In UAE, *legal persons* include Limited Liability Companies, Private Shareholding Companies, Public Joint Stock Companies, and other entities established under the laws of the UAE that have separate legal personality. As per the UAE Federal Law decree, Article 11 states that a Taxable Person shall be either a 'Resident Person' or a 'Non-Resident Person'. Further *Resident person includes:*

a) juridical person that is incorporated or otherwise established or recognized under the applicable legislation of the State, including a Free Zone Person,

b) a juridical person that is incorporated or otherwise established or recognized under the applicable legislation of a foreign jurisdiction that is effectively managed and controlled in the State,

c) a natural person who conducts a Business or Business Activity in the State and any other Person as may be determined in a decision issued by the Cabinet at the suggestion of the Minister.

For the application of UAE CT Law, *legal persons incorporated in a foreign jurisdiction* that are effectively managed and controlled in the UAE will be treated as if they were UAE incorporated entities. Limited and general partnerships and other unincorporated joint ventures and associations of persons will be treated as *'transparent'* for UAE CT Law purposes. This means that they will not be taxpayers in their own right, but their income will instead 'flow through' and be taxed in the hands of the partners or members only. This flow-through treatment is widely recognised and accepted internationally, and also ensures tax neutrality for investors in collective investment funds that are often structured as limited partnerships. Investing in and through unincorporated partnerships in a cross-border context can create difficulties and unintended tax consequences where one country treats the partnership as a transparent entity, and the other country taxes the partnership as if it were a company. To align the tax treatment of partnerships in a cross-border context, the UAE CT treatment of foreign unincorporated partnerships would generally follow the tax treatment of the partnership in the respective foreign jurisdiction. Limited liability partnerships, partnerships limited by shares and other types of partnerships where none of the partners have unlimited liability for the partnership's obligations or other partners' actions will be subject to UAE CT in the same manner as a UAE company.

Chapter 3
Permanent Establishment (PE)

This chapter covers the following:

- **Article 14 of the Federal Decree Law**
- **The concept**
- **Types of PE**
- **Fixed Place PE**
- **Place of business**
- **Place of business test**
- **Power of disposition test**
- **Place of business must be fixed – location/permanence test**
- **Business activity/business connection test**
- **Components of PE**
- **Article 5(4) of OECD Model**
- **Agency PE**

There are two types of taxation system prevalent globally i.e., residence-based taxation and source-based taxation. Under the residence-based taxation, the enterprise is tax in respect of its worldwide income by the state of its residence. The residence-based taxation has been dealt with in the previous chapter. This chapter covers the concept and taxation as per the source rule. To determine the source in a UAE, the enterprise should have permanent establishment in UAE. This means the PE concept needs to be tested only when the enterprise is non-resident of UAE. In UAE CT, the taxation is based on both residency and source of an enterprise in UAE. Para 4.2 of consultation paper deals with a taxation of Non-residents. Non-residents will be subject to UAE CT on:

A. Taxable income from their PE in the UAE; and

B. Income which is sourced in the UAE.

The concept of PE is an important principle of international tax law used in CT regime across the world. The main purpose of the PE concept is to determine, if and when an enterprise has established sufficient presence in UAE to warrant the detect taxation of the business profits of the company in UAE. Generally, a country only has the right to tax the business profits of a foreign company if that company has a PE in UAE. The concept of PE under UAE CT regime has been designed on the basis of the OECD Model Tax Convention (OECD MTC). Besides, The UAE CT Law also covers "a*n installation or structure for the exploration of renewable or* *non-renewable natural resources"* for determining fixed or permanent place in the State. Article 5 of OECD Model Tax Convention (MTC) sets out internationally recognised principles for determining what constitute PE. Article 7 of the OECD MTC mandates that existence of a PE in a jurisdiction is pre-requisite for the purpose of taxation of business profit of an enterprise of another jurisdiction in that jurisdiction.

Article 14 of the Federal Decree Law

Clause 1 of Article 14 of the Federal Decree Law, a non-resident person has a permanent establishment in UAE in any of the following instances:

a. Where it has a fixed or permanent place in the state through which the business of the non-resident person, or any part thereof, is conducted.

b. Where the person has and habitually exercises an authority to conduct business or business activity in the state on behalf of the Non Resident (NR) person.

c. Where it has any other form of nexus in the state as specified in a decision issued by the cabinet at the suggestion of the minister.

Clause 2: For the purposes of paragraph (a) of Clause 1 of this Article, a fixed or permanent place in the State includes:

a. A place of management where management and commercial decisions that are necessary for the conduct of the Business are, in substance, made.

b. A branch.

c. An office.

d. A factory.

e. A workshop.

f. Land, buildings and other real property.

g. An installation or structure for the exploration of renewable or non-renewable natural resources.

h. A mine, an oil or gas well, a quarry or any other place of extraction of natural resources, including vessels and structures used for the extraction of such resources.

i. A building site, a construction project, or place of assembly or installation, or supervisory activities in connection therewith, but only if such site, project or activities, whether separately or together with other sites, projects or activities, last more than (6) six months, including connected activities that are conducted at the site or project by one or more Related Parties of the Non-Resident Person.

Clause 3: Notwithstanding Clauses 1 and 2 of this Article, a fixed or permanent place in the State shall not be considered a Permanent Establishment of a Non-Resident Person if it is used solely for any of the following purposes:

a. Storing, displaying or delivering of goods or merchandise belonging to that Person.

b. Keeping a stock of goods or merchandise belonging to that Person for the sole purpose of processing by another Person.

c. Purchasing goods or merchandise or collecting information for the Non-Resident Person.

d. Conducting any other activity of a preparatory or auxiliary nature for the Non-Resident Person.

e. Conducting any combination of activities mentioned in paragraphs (a), (b), (c) and (d) of Clause 3 of this Article, provided that the overall activity is of a preparatory or auxiliary nature.

Clause 4: Clause 3 of this Article shall not apply to a fixed or permanent place in the State that is used or maintained by a Non-Resident Person if the same Non-Resident Person or its Related Party carries on a Business or Business Activity at the same place or at another place in the State where all of the following conditions are met:

a. Where the same place or the other place constitutes a Permanent Establishment of the Non-Resident Person or its Related Party.

b. The overall activity resulting from the combination of the activities carried out by the Non-Resident Person and its Related Party at the same place or at the two places is not of a preparatory or auxiliary nature and together would form a cohesive Business operation, had the activities not been fragmented.

Clause 5: For the purposes of paragraph (b) of Clause 1 of this Article, a Person shall be considered as having and habitually exercising an authority to conduct a Business or Business Activity in the State on behalf of a Non-Resident Person if any of the following conditions are met:

a. The Person habitually concludes contracts on behalf of the Non-Resident Person.

b. The Person habitually negotiates contracts that are concluded by the Non-Resident Person without the need for material modification by the Non-Resident Person.

Clause 6: The provisions of Paragraph (b) of Clause 1 of this Article shall not apply where the Person conducts a Business or Business Activity in the State as an independent agent and acts for the Non-Resident Person in the ordinary course of that Business or Business Activity, unless the Person acts exclusively or almost exclusively on behalf of the Non-Resident Person, or where that Person cannot be considered legally or economically independent from the Non-Resident Person.

Clause 7: For the purposes of Clause 3 of this Article, the Minister may prescribe the conditions under which the mere presence of a natural person in the State does not create a Permanent Establishment for a Non-Resident Person in any of the following instances:

a. Where such presence is a consequence of a temporary and exceptional situation.

b. Where the natural person is employed by the Non-Resident Person, and all of the following conditions are met:

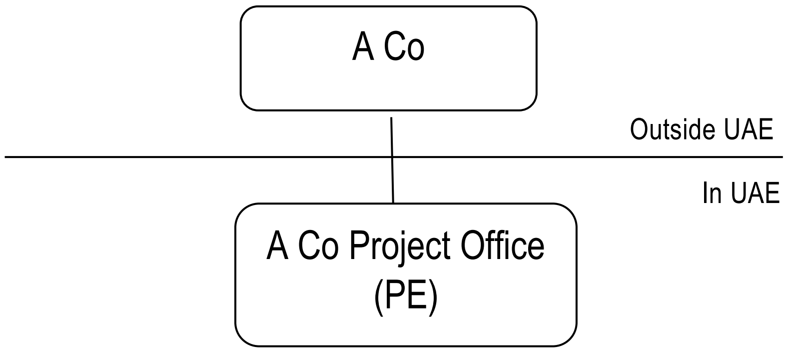
   1) The activities being conducted in the State by the natural person are not part of the core income-generating activities of the Non-Resident Person or its Related Parties.

   2) The Non-Resident Person does not derive State Sourced Income.

Threadbare discussion on Article 14 is given in the subsequent part of this chapter.

The concept

The commonly used term to describe form of taxable presence of an enterprise in a foreign state could be a "branch office", "liaison office", "project office". While the branch office, project office or liaison office are the extension of the foreign enterprise in a source contracting state, only branch office and project office of the foreign enterprise are allowed to and actually carry out the business activities in the source state. These forms of business presence constitute PE of a foreign enterprise in the source state. The other examples can be subsidiary company of a foreign enterprise.

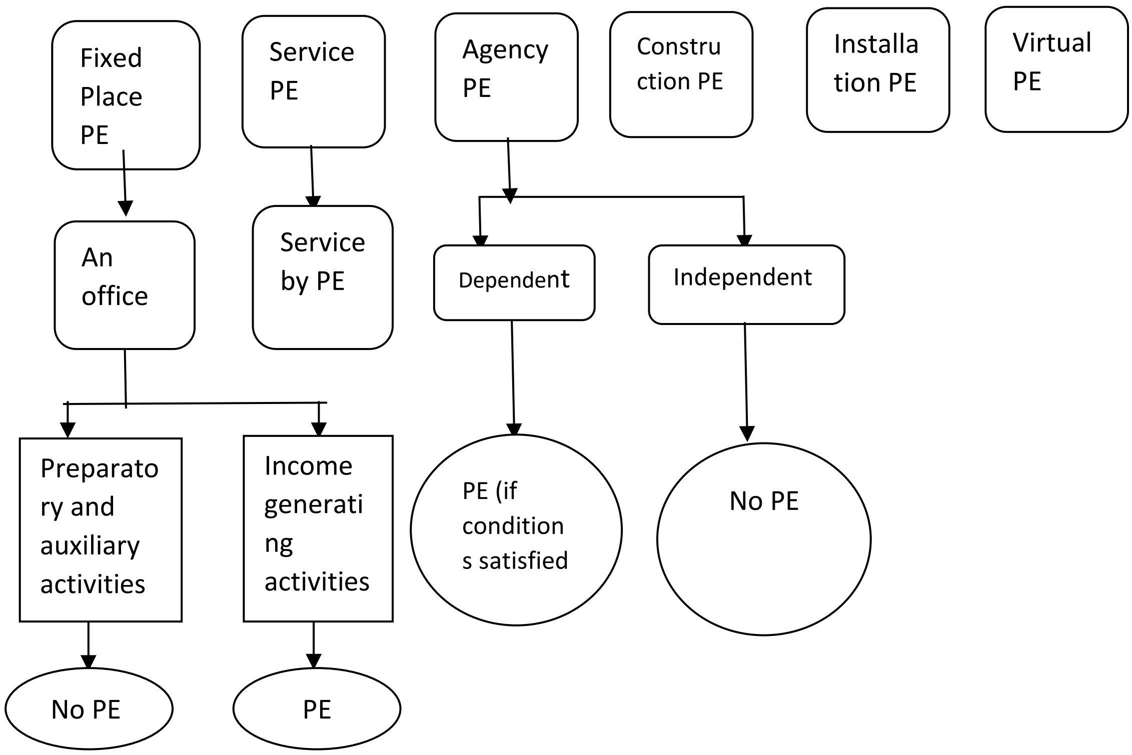


The concept of 'Permanent Establishment' (PE) is used in tax treaties principally for the purpose of determining the right of the source country to tax business profits of a foreign enterprise (FE). Typically, under tax treaties, business profits of a FE can be taxed in the source country only if the FE carries on business in the source country through a PE situated therein. Once it is determined that a FE has a PE in the source country, the amount of profits on which the PE is taxable would depend on the extent of profits that are attributable to the PE in accordance with the attribution principles advocated under a particular tax treaty. Therefore, the concept of PE assumes significance in determining whether a FE is taxable in the source country or not, with respect to its business profits. Assuming there is tax treaty between Country of Source (COS) and the Country of Residence (COR). The profit attributable to the business activities carries out through the PE of A Co may be taxable in COS according to the law of COS. The income of PE is taxable in COR which causes double taxation. In order to reduce double taxation, normally COR will grant a credit to A Co.

Types of PE

Article 5 of the OECD MTC and tax treaties define Permanent Establishment to include various forms of PE like fixed place PE, construction PE, installation PE, Agency PE and Service PE etc. The type of PE depends upon the establishment of such PE and the activity such PE is carrying on. If such PE is carrying in its business from the fixed place, then it is said fixed place PE. If the oil exploration machine is installed for the purpose of exploration of oil in the oil rig, it is said equipment PE. Similarly, if the FE is in UAE for construction of any bridge or railway project, it is said to be construction PE.

Types of PE



Fixed Place PE

Paragraph 1 of Article 14 gives a general definition of the term "permanent establishment" which brings out its essential characteristics of a permanent establishment in the sense of the Convention, i.e., a distinct "situs", a "fixed place of business". The paragraph defines the term "permanent establishment" as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

a. the existence of a "place of business", i.e., a facility such as premises or, in certain instances, machinery or equipment.

b. this place of business must be "fixed", i.e., it must be established at a distinct place with a certain degree of permanence.

c. the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

It is also important to note that the way in which business is carried on evolves over the years so that the facts and arrangements applicable at one point in time may no longer be relevant after a change in the way that the business activities are carried on in a given State. Clearly, whether or not a permanent establishment exists in a State during a given period must be determined on the basis of the circumstances applicable during that period and not those applicable during a past or future period, such as a period preceding the adoption of new arrangements that modified the way in which business is carried on.

Clause 1(c) of Article 14 of Federal Decree Law is deviation from the OECD model convention and the position of law is also depending on certain circular or notification to be issued. This clause gives power to Federal Tax Authority to issue notification or circular to determine that when an enterprise is said to be fixed place PE in UAE.(Any form of Nexus in the state)

Place of business

The paragraph starts with fixed place of business, i.e. there must be a place of business. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again, the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises, or a part thereof owned by the other enterprise.

However, as per the Public Consultation Document issued by the Ministry of Finance, UAE (released on 28th April, 2022), the activity threshold that will trigger a PE for a foreign company in the UAE will be determined by the following two main tests:

- Fixed place of business test
- Dependent agent test

Article 5(1) contains the basic rule for PE. A PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Under Article 5(1) of the OECD model convention, present in virtually all DTAAs, a PE is said to be constituted when a fixed place of business (POB) exists, through which the business of a foreign enterprise (FE) is wholly or partly carried on. This is popularly referred to as 'base rule PE' or 'fixed place PE' or '**fixed PE'**. Based on various commentaries, a number of conditions must be satisfied in order to constitute a fixed PE, namely:

- There must be a POB i.e. a facility such as premises or in certain instances, machinery or equipment ("place of business test");
- The POB must be fixed i.e. must be established at a distinct place with certain degree of permanence; ("permanence test");
- There must be certain right of use of the POB i.e. place should be at disposal of FE ("right of use/ disposal test");
- The activities performed through the POB must be a business activity for the FE and such activities should constitute the "core activities" ("business activity test").

Place of business test

"Place of business" test

This test requires that in order to constitute a PE, the foreign enterprise should have a "place of business". The term "place of business" is not defined. A "place", though normally "a particular portion of space", must be read in light of it being used to define an "establishment". A "place of business" means all the tangible assets (e.g., premises, facilities, machinery or equipment, or installations) which are used for carrying on the business, whether or not they are exclusively used for business purpose. In marginal cases, one tangible asset may be sufficient. The nature of the fixed place of business is very much that of a physical location, that is, one must be able to point to a physical location through which the business is carried on. The term "place" is wide enough to cover a large geographical area. Hence even a hawker paddling his wares on a particular street can be said to have his place of business on that street.

Illustrations: Place of business

- An office of any size.
- A depot for storing imported goods.
- A fully equipped diving support/fishing vessel
- A computer server.
- A facility for berthing at a port in Source State which is guaranteed for foreign ships provided on a time charter.
- Residential premises, if used for carrying out business activities.
- A motor racing circuit.
- Lockable space for storing tools and equipment within a stadium and lighting facilities.

- Vessels engaged in seismic surveys on the high seas in connection with the exploration of mineral oil/ natural resources.

Power of disposition test

"Power of disposition" test

The place of business should be at the disposal of the foreign enterprise for the purposes of its business activities. Some right or domain or control to use a place is required for having a PE. Such place of business may be owned or rented or may also be situated in business facility of another entity. The premise must be at the disposition of the enterprise. However, such power need not be a legal right to use a place and an illegally occupied place could also constitute a PE if the enterprise has some domain or control to use it. At the same time, no PE exists merely because an enterprise is present at a particular place if that place is not at the disposal of the enterprise, or that the presence is very limited. There should be some evidence to indicate that whenever any employee of the foreign enterprise comes to Source state, he should be able to walk into the business premises and occupy a space or a table. The onus is upon the Revenue to prove these facts to establish existence of PE.

Illustrations

- A salesman who visits his customer's office in Source State to collect orders does not have the office at his disposal merely on account of his visits and hence, his employer does not have a PE. However, there could be a PE if the foreign enterprise has an office at his disposal together with telephone and telex, where its employees work.
- A website hosted on the computer server of an internet service provider does not result in the server being at the disposal of the enterprise (say "W") owning the website, even if W can choose the particular server on which its website should be hosted. If, however, W leases and operates the server on which its website is hosted, such server is at its disposal.
- Intermittent or incidental use of home of employee does not meet disposal test. Example- A cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State. The FE did not require that the home be used for its business activities.
- Plant that is owned and used exclusively by a supplier or contract manufacturer will not be considered as at the disposal of an enterprise that will receive and use the goods produced at that plant.
- Road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that the enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

Purpose of use of premises

Use of the premises should create an impression in the minds of the business customers of the foreign enterprise in Source State, that the office of the group company can be viewed as a projection of foreign enterprise's activities in Source state.

Place of business must be fixed – location/permanence test

Place of business must be fixed

Definition of "fixed"

The concept of "fixed" has two aspects: that of space (location test) as well as that of time (permanence test).

"Location" Test

(a) Specific situs

The "location test" requires the place of business to be located at a "single place". Such place could be:

- a specific place or a distinct place within Source State (that is, it should have a specific situs); or
- moving within a specific geographical point or area or location".

If a FE does not operate in Source State at a distinct place, then it does not constitute a PE, even if it operates for a long duration in the State.

(b) Specific place

The place of business should be a specific place within Source state. It is not necessary that the equipment constituting the place of business has to be affixed to the ground; it is enough that the equipment remains at a particular site. The possibility of it being moved is irrelevant; what is important is whether it is, in fact, moved.

(c) Existence of "geographical" and "commercial" coherence

The expression "fixed place" does not necessitate that the place of business should be stationary and not moving. It involves identifying a "definite place" as the place from which a business is carried on. It is necessary that 'there should be both "geographical" and "commercial" coherence. Thus, an area cannot be regarded as a single place of business, if:

(i) the activities are carried on within a limited geographical area but there is no "commercial coherence'": or,

(ii) it constitutes a coherent commercial whole but lacks "geographical coherence"

"Permanence" Test

(a) Meaning of "permanence"

The use of the word "permanent" itself suggests that a PE can exist only if the place of business has a certain degree of permanency. The activity need not be "permanent" in the sense of everlasting eternally in nature or without interruptions. Permanence of the place has to be gauged only for as much time as the business requires.

At the same time, the expression "fixed" contains, in itself, the indication of a reasonable period for the existence of the place of business and in order to constitute a PE, the presence in UAE must be more than merely temporary or transitory.

For instance, an overseas supplier, who merely sells equipment to a UAE buyer and sends its expert engineer to UAE to supervise erection of the equipment for a short period, does not have a fixed place of business since it does not give rise to any establishment in UAE of a permanent or enduring nature either wholly or substantially which would amount to a virtual projection of the supplier in UAE.

(b) Intended permanence/actual conduct

The term "fixed" and the condition of "permanence" implicit therein should be construed by intent as well as conduct.

(c) Duration

OECD commentary does not make reference to any minimum period for which a PE should be in existence in Source State. Often, six-month is regarded as the threshold for the duration test. PE may emerge even if place of business exists for a short period of time in certain circumstances e.g. in case of recurrent activities. However, an isolated activity cannot result in a fixed PE as the ingredients of regularity, continuity and repetitiveness are essentially missing in such cases.

(d) Calculation of time threshold

(i) Commencement of a PE: A PE comes into existence as soon as a foreign enterprise begins to carry on its business through a fixed place of business. For this purpose:

- The business is regarded to have commenced once the foreign enterprise is "prepared" at the place of business for its activities in the State.
- The period of time during which the place of business is being set up in Source State should not be considered, if this activity is substantially different from the activity which is intended to be carried on from the place of business in the Source State.

(ii) Cessation of PE: A PE ceases to exist when the business is no longer "carried on through a fixed place of business or the fixed place is disposed of. It is important to note, however, that since a PE of the non-resident is essential for only taxation of attributable business profits of such non-resident, if any, non-business income say capital gains income resulting from disposal of assets by the PE, may continue to be taxed in UAE, even after cessation of the PE.

Business activity/business connection test

The business of a foreign enterprise must be carried on ("business activity test") wholly or partially through a fixed place of business ("business connection test"). It may be carried on in UAE:

- pursuant to the physical presence of the entrepreneur himself, or his personnel (e.g., employees, dependent agents'", etc); or
- through automatic equipment (e.g., vending machines, computer, etc) when the foreign enterprise operates and maintains such equipment'. Human intervention may not be necessary for existence of a PE.

► **"Through which"**

The word "through" has a wide meaning. It includes: (a) a situation where business activities are carried on "in" a fixed place of business; or (b) a place where business is not literally carried on "in" a place (e.g., a road construction site). The word "through" is used to be consistent with the language of Article 7(1) which refers to a foreign enterprise carrying on a business and making profits through a PE in Source State.

The fact that a foreign entity (A) derives economic benefit on account of activities of another entity (B) at a place of business in UAE, does not mean that A carries on its business "through" that location. To illustrate, if A procures management services from B, A does not have a PE in UAE if B is carrying on its business in UAE by using its own personnel. An exception could be a case where the management services and the relations between A and B are such that A can be construed to be carrying on its own business through the medium of such services rendered by B.

► **Agent**

In certain situations, the business of a foreign principal may be carried on by its agent in Source State. Having regard to this, if the agent works at a fixed place of business and carries on the business of the foreign enterprise in Source State, say UAE, a fixed place PE could be constituted in UAE. However, it may be noted that whether a PE may be constituted in a situation where the premises of such agent are not at disposal of the foreign enterprise, is a debatable aspect. For instance, a legally independent agent, whose place of business may not be at the disposal of the foreign enterprise, might still constitute a PE of the foreign enterprise, if the courts conclude such agent to be economically dependent on such foreign enterprise.

The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). These personnel include employees and other persons receiving instructions from the enterprise (e.g., dependent agents).

► **Business "carried on"**

The expression "carries" denotes "actual carrying on of business" and does not cover a "would have carried on" situation. If the fixed place of business is leased to another enterprise, normally it will only serve the activities of the lessee's enterprise instead of the lessors; in general, the lessor's permanent establishment ceases to exist, except where he continues to carry on a business activity of his own through the fixed place of business.

Components of PE

As per Article 5(2) of OECD MC, a fixed place of business will include *interalia* a place of management, a branch, an office (including a temporary field office or an employee's home office), a factory, a workshop, real property, and a building site where activities are carried on for over 6 (six) months. Installations and structures used in the exploration of natural resources, as well as mines, oil or gas wells, quarries and other places of extraction of natural resources will also be considered PEs.

► **Place of management**

The expression "management" in Article 5(2)(a) of the OECD Model Convention refers to the management of the foreign enterprise itself, and not of another entity and hence, a foreign entity/ enterprise does not have a PE, when it seconds an employee to its subsidiary in UAE in order to manage the subsidiary.

A "place of management" could be situated in residential premises. The term has to be interpreted widely.

► **Branch**

A "branch" is "a division; a sub-division; department; a component portion of an organisation. It is a projection of an entity and depicts management and control of the entity over it. By itself, on account of its ("branch") meaning and statutory definitions, one associate company of a group of companies cannot be regarded as a "branch" of another company.

► **Office**

An "office" is mentioned, as such, for correspondence purposes. Unless defined otherwise in the domestic law of UAE, the term "office" would include a "place of management.

"Office" means a room, a set of rooms or building where the business of a commercial or industrial organisation or a professional person is conducted-". Thus, the term would include all types of offices including:

- A "management office" performing supervisory and coordinating functions.
- Depending upon the facts, a project office" or liaison office or even a recruitment office of a labour contractor for recruiting labourers"; could also constitute an "office".

► **Factory**

A factory would obviously be a permanent establishment of the foreign enterprise in UAE.

► **Workshop**

A contractor does not have a "workshop" on an oil rig when it merely provides personnel for manning, operation management of such rig.

► **Installation for extraction or exploitation of natural resources**

The provision does not cover all installations but only those used for exploration or exploitation of natural resources.

► **a building site where activities are carried on for over 6 (six) months**

where an office or workshop is used for a number of construction projects, then, even if none of these projects continues for more than six months, it (office/workshop) may still be considered as a PE under Article 5(2) of OECD MC if the office satisfies the conditions of Article 5.

Splitting up of contracts to avoid PE in the context of building / construction sites or installation project

BEPS Action Plan 7 also addresses the issue of splitting up of contracts between group entities to dodge the prescribed time threshold under Article 5(3) of the OECD Model Tax Convention to avoid constitution of a PE for building sites and construction / installation projects. The Action Plan notes that multinational enterprises typically split up a single project that may be connected both commercially and geographically into several parts through allocation of activities to different entities within the group. The duration of these individual activities is generally restricted / planned to be lower that the recommended time threshold, such that the constitution of PE in a source state is avoided. In this backdrop, the Action Plan recommends that this form of artificial avoidance by way of splitting up a single project may be addressed either through the principal purpose test rules (as per Action Plan 6) or following certain test guidelines as per Action Plan 7. Briefly, BEPS Action Plan 7 recommends the following guidelines to determine whether the time threshold recommended under Article 5(3) has been breached:

- Determine the total duration of the activities undertaken by the enterprise as a whole
- Determine the duration of connected and commercially coherent activities which may have been split / segregated geographically
- The aggregates of (i) and (ii) may help in determining possible breach of the time threshold.

Determination of whether and how certain activities are connected would depend on the facts and circumstances of the case. Certain factors which may be relevant for this determination include:

- Whether the contracts involving the different activities were concluded with the same person

- Whether there are separate or additional contracts for various activities leading to the final outcome of the project
- Whether the above activities / contracts are logically / sequentially linked to form a united whole
- Whether the same personnel are executing the various activities / contracts as part of an integrated project

► **Technical discussions on Home office as PE**

There cannot be a presumption that home office of an employee is at the disposal of the employer. Even though a part of the business of a FE may be carried on at the individual's home office that should not lead to the automatic conclusion that that location is at the disposal of that FE. There needs to be clear evidences to prove disposal with employer.

Following discussion indicates the circumstances/ evidences where home office can be seen at the disposal of the employer -

New para 18 and 19 inserted in **2017 OECD Commentary** explaining when home office can be a PE.

Disposal is said to be met in the following circumstances -

- Home office used on a **continuous basis** for carrying on business activities for an enterprise and it is clear from the facts and circumstances that **the enterprise has required the individual to use that location to carry on the enterprise's business** (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office).
- Example - A non-resident consultant who is present for an **extended period** in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise

From the above it is clear that for satisfying the disposal test, the home office should be used on a regular and continuous basis, and the FE should have required the employee to use that location to carry on the FE's business.

Disposal met in the following circumstances-

- Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise.
- Where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a continuous basis during an extended period of time.

► **Duration of six months**

If a building site or a project does not last for more than six months, then it does not constitute a PE, and if there exists within it an office or other places like factory, workshop etc as discussed above, such places also do not constitute a PE.

At the same time, where an office or workshop is used for a number of construction projects, then, even if none of these projects continues for more than six months, it (office/workshop) may still be considered as a PE, if the office satisfies the four tests discussed above.

► **"Threshold time limit" applies to each individual site or project**

The "six-month test" applies to each site or project except where such sites or projects form a coherent whole commercially and geographically. Hence, time spent on unconnected sites or projects is to be ignored. Specific language of the tax treaty under consideration needs to be examined.

► **Commercial and geographic coherence**

A series of contracts undertaken by a contractor that are interdependent both commercially and geographically are to be treated as a single unit for the purpose of applying the threshold test of "six months". Thus, a building site based on several contracts should be regarded as a "single unit" if it forms a "coherent whole" commercially and geographically. To illustrate, the construction of a housing colony is a "single unit" even if each house is constructed for different customers".

► **Abuse of "threshold time limit"**

Domestic anti-avoidance legislative or judicial rules of UAE may be applied to prevent schemes for artificially avoiding the six months threshold.

► **Determination of "six-month threshold"**

(a) Tenure

Tenure of a contract can be ascertained from the contract, invoice etc. for determining the date of commencement or completion of a contract. Besides, independent confirmation/certificate by the contractor, terms of contract, audited financial statements, correspondence with contractor, no-objection certificate granted by income-tax department to facilitate remittance, date of closure of project office etc. may be relevant. The onus is upon the Revenue to prove that the "time threshold" is exceeded.

(b) Commencement of PE

According to one view, a site in source state exists from the date on which a contractor begins his preparatory work e.g., when he begins a planning office, etc. However, according to the other view, the "six-month threshold" commences from the date when the work physically begins in the Source State.

(c) Cessation of PE

A PE continues as long as the site, project or supervisory activities continue and it ceases to exist when: (a) the work at a site or of a project or the supervisory activity is completed or permanently abandoned; or, (b) the foreign enterprise ends its business activities in the Source State. A PE for a dredging contract ceases only when the dredger is completely demobilised; it does not cease from the date of completion of the dredging activity or on closure of "project office". Seasonal or temporary interruptions of operations (e.g., on account of bad weather, lack of raw materials or labour problems) cannot be regarded as a closure and such period should be included in determining the life of a site, although the concept of "temporary" may often be vague.

(d) Time spent by sub-contractor

The expression "permanent establishment" in Article 5(3)(a) of the OECD Model Convention is defined with reference to an enterprise in relation to such enterprise's presence in site or involvement in project or supervisory activities. Hence, if a foreign enterprise (main contractor) sub-contracts to a sub-contractor all or part of its work in a Source state in relation to such site or project or activities, the time spent by the subcontractor must be considered as time spent by the main enterprise in Source state; further, if a sub-contractor is on a site intermittently, time is measured from the first day the sub-contractor is on the site until the last day (i.e., intervening days when the sub-contractor is not on the site, are counted).

Article 5(4) of OECD Model

Article 5(4) of the OECD Model reads as follows:

"Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:

(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

Model Commentaries state that the purpose of Article 5(4) is to prevent a foreign enterprise from being taxed in Source State, if it carries on activities of a purely preparatory or auxiliary character in Source State; such activities in Source State may be productive, but are so remote from the actual realisation of profits that it is difficult to allocate any profit to Source State, or that it is only possible to attribute insubstantial profits to Source state.

Co-relation with Article 5(1)

Article 5(4) lists a number of business activities which are exceptions to the general definition laid down in Article 5(1); such exceptions are absolute notwithstanding that a particular activity otherwise satisfies the tests of a PE under Article 5(1).

Article 5(5) in relation to 5(4)

Article 5(4) starts with the words "Notwithstanding the preceding provisions of this Article" and consequently, overrides only Article 5(1) to Article 5(3). However, in view of the specific exclusion in Article 5(5)(a), provision under Article 5(5)(a) is subject to provision under Article 5(4).

Activities only "for the enterprise"

Article 5(4) uses the expressions "belonging to the enterprise" or "for the enterprise". Hence, a fixed place of business mentioned in Article 5(4) does not constitute a PE only if its activities in Source State are performed "on behalf of" or for the enterprise to which it belongs. However, a PE exists if such activities are also carried on behalf of other enterprises or if the activities are aimed at directly benefitting a third party as well.

Only exempted activities should be carried on

Having regard to the use of the word "solely" in Article 5(4), a fixed place of business mentioned in Article 5(4) does not constitute a PE if its activities in Source State are only restricted to activities specified therein. However, if a fixed place of business is used for "exception activities" (e.g. for storage or display of goods or merchandise) and also for other activities (eg, sales), it would not be eligible for the exemption and would be regarded as a "single PE" taxable in respect of both types of activities.

Disposal of movable property

Once a fixed place of business is deemed not to be a PE under Article 5(4), then the profits arising out of such activity as stated in Article 5(4) is also exempt. Thus, profit on the disposal of the stock-in-trade on termination of the enterprise's preparatory or auxiliary activity in Source State is also covered by the exception in Article 5(4) and, profits on the sale of products displayed in a fair or exhibition in Source State and sold at the termination of the fair, are not taxable in Source State.

Advertising activity

There is no PE in UAE when a fixed place of business engages solely in promotional advertising for the goods manufactured by the foreign enterprise.

"For the enterprise"

In terms of Article 5(4)(e), a fixed place of business in Source State has to be maintained "for the enterprise" and hence, if it renders services not only to its enterprise but also to other enterprises, it does not fall within the exception to Article 5(4).

Article 5(4)(f) of the OECD Model

Article 5(4)(f) provides that where a fixed place of business combines any of the activities mentioned in sub-paragraphs (a) to (e) then, as long as the combined effect of the overall activity of such fixed place of business is preparatory or auxiliary, a PE should not be deemed to exist. One of the key recommendations by OECD in its BEPS Action Plan 7 report towards countering artificial avoidance of PE status, is to restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or of auxiliary nature and for ensuring that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations.

Article 5(4)(f) should not be interpreted rigidly and ought to be considered in the light of facts and circumstances. However, as may be clear from the above recommendation by OECD in its BEPS Action Plan 7 report, an enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each part is merely engaged in a preparatory or auxiliary activity.

Article 5(5) of OECD Model Convention

As per Article 5(5) of OECD Model Convention-

"*Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*

(a) in the name of the enterprise, or

(b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

(c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph"

Agency PE

This is another important concept of taxation of FE where the FE does not have a fixed place in UAE. In this case, the agent who plays the principal role in conclusion of contract and it is necessary that the agent should act "on behalf" of a FE in the source state. An agent is one who works for another in accordance with his authority while dealing with the third parties or who canvasses for his principal. He may be a person who is responsible for, or can act or enforce anything on behalf of, his principal. The agent is different from contractor or sub-contractor. In order to determine the existence of principal agency relationship, the substance or agreement has to be looked into rather that looking into form.

Article 5(5) refers to a person without any qualification. As such, a dependent agent could be:

a. Any entity, including individual or companies; or,

b. Employee of the FE, or non-employees; or,

c. Resident of source state or non-residents.

What is defined as a dependent agent PE is not the dependent agent per se, but it is by virtue of FE having a dependent agent that the enterprise is deemed to have a PE.

Article 5(5) of the OECD MTC say *"Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph

Paraphrasing, Article 5(5), a PE is constituted for another person if the following conditions are satisfied:

- there is a person;
- he is acting on behalf of an enterprise;
- he is acting in Source State;

- he is not an independent agent to whom Article 5(6) applies,
- other conditions of art 5(5) are satisfied
- Has an authority to conclude contracts in a contracting state
- Habitually exercises such authority in contracting state in name of NR
- activities are not limited to those mentioned in Article 5(4)

Proceeds on the basis that only persons habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise, can lead to a permanent establishment for the enterprise.

Authority to conclude contracts

Person said to have authority to conclude contracts if, he/she:

- Has sufficient authority to bind NR and decide final terms
- Can act independently, without control from the principal NR
- Is authorized to negotiate all elements and details of a contract
- Where approval of contract by the NR is a mere formality

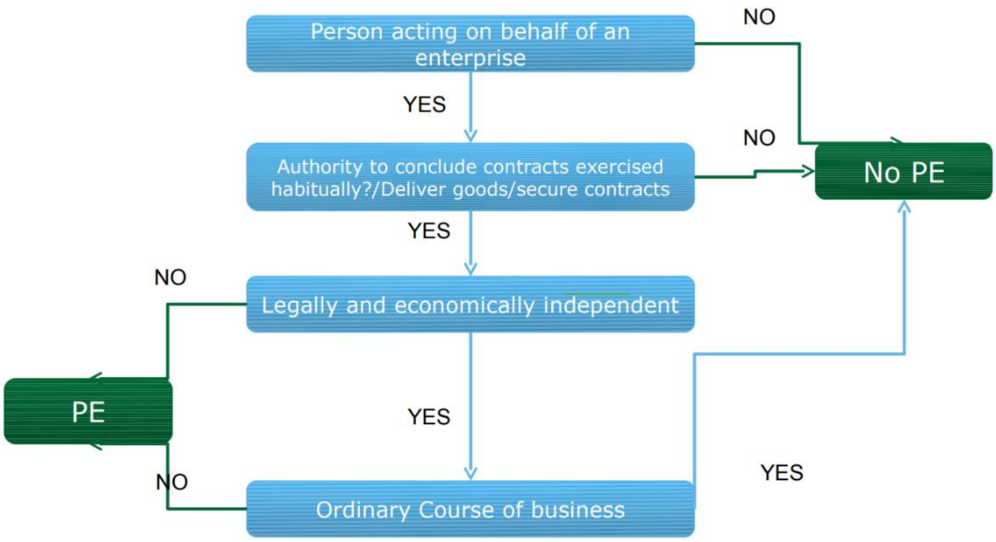
OECD Position on authority to conclude contracts

- Agent is required to conclude contracts relating to operations which constitute business proper of the NR
- Participation / attendance in mere negotiations of contracts not sufficient to trigger dependent agent PE.

Article 5(5) of the OECD Model :

Article 5(5) refers to "Agency PE". It contains a deemed inclusion clause" and commences with a non-obstante clause overriding Article 5(1)/(2). Accordingly, a foreign enterprise may be treated as having an Agency PE in UAE even though it may not satisfy all the tests in Article 5(1) (such as not having a fixed place of business at its disposal in Source State within the meaning of Article 5(1) and 5(2), or not satisfying the time threshold (of six/twelve months).

Agency PE- Summary



Independent agent

Article 5(6) of the OECD MTC says, *"Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise."*

Paraphrasing Article 5(6), a person will not constitute a PE of another person ("principal") if:

- such person is a broker, general commission agent or any other agent ("agent").
- he acts in the ordinary course of his business.
- he is independent of his principal.
- his activities are such which could not be considered as devoted exclusively or almost exclusively on behalf of his principal; and
- conditions made or imposed between him and the principal in their commercial and financial relationship do not differ from those which would have been otherwise made between independent enterprises.

An agent of independent status needs to be independent both legally and economically.

The same rules and principles of agency PE will apply to determine whether the Free Zone person has a PE in mainland UAE.

Investment Manager Exemption (Article 15):

Article 15 of the Decree Law states:

For the purposes of Clause 6 of Article 14 of this Decree-Law, an Investment Manager shall be considered an independent agent when acting on behalf of a Non-Resident Person, where all of the following conditions are met:

a. *The Investment Manager is engaged in the business of providing investment management or brokerage services.*

b. *The Investment Manager is subject to the regulatory oversight of the competent authority in the State.*

c. *The transactions are carried out in the ordinary course of the Investment Manager's Business.*

d. *The Investment Manager acts in relation to the transactions in an independent capacity.*

e. *The Investment Manager transacts on an arm's length basis with the Non-Resident Person and receives due compensation for the provision of services.*

f. *The Investment Manager is not the Non-Resident Person's representative in the State in relation to any other income or transaction that is subject to Corporate Tax for the same Tax Period.*

g. *Any such other conditions as may be prescribed in a decision issued by the Cabinet at the suggestion of the Minister.*

2. For the purposes of Clause 1 of this Article, "transactions" means any of the following:

a. *Transactions in commodities, real property, bonds, shares, derivatives or securities of any other description.*

b. *Transactions of buying or selling any foreign currency or placement of funds at interest.*

c. *Such other transactions permissible to be carried out by the Investment Manager on behalf of a Non-Resident Person under the applicable legislation of the State.*

Article 1 of the Decree Law define the term Investment Manager as:

A Person who provides brokerage or investment management services that is subject to the regulatory oversight of the competent authority in the State.

In simple terms, An Investment Manager shall be considered an independent agent when acting on behalf of a Non-Resident Person, where all of the specified conditions are met:

- Engaged in the business of providing Investment management and brokerage services under the supervision of competent Authority

- The transactions are carried out in the ordinary course in an Independent Capacity on an Arm's Length Price and receives due compensation for the provision of service.
- The Investment Manager does not act as a representative of the Non-Resident Person.
- Any such other conditions as may be prescribed.

Further, clause 2 of Article 15 also define the term 'transaction' which means any of the following:

- Transactions takes place in commodities, real property, bonds, shares, derivatives or securities of any other description.
- Transactions of buying or selling any foreign currency or placement of funds at interest.
- Such other transactions permissible to be carried out by the Investment Manager on behalf of a Non-Resident Person under the applicable legislation of the State.

UAE's Presence as Investment and Wealth Management Centre

Considering the UAE's position as a leading investment and wealth management centre, the UAE CT regime will allow regulated UAE investment managers to provide discretionary investment management services to foreign customers without triggering a UAE PE of the foreign investor or the foreign investment fund. This exemption will be subject to conditions that are comparable to similar regimes in leading financial centres.

UAE sourced income and applicable tax rate:

UAE sourced income earned by foreign person that does not have a PE in UAE, will be subject to withholding tax at the rate of 0% (zero percent).

The income shall generally be considered as UAE sourced if the income is earned from a UAE resident person, if the payment is attributed to a PE in the UAE of a foreign company, or if the income is derived from activities or contracts performed in the UAE, assets located in the UAE, or rights used in the economic purposes in the UAE.

The same principles will be applied to determine if a free zone person earns income from a source in mainland UAE.

Effective Management

Place of Effective Management (POEM) is a concept used to determine the tax residency of a company. It is a set of rules used by tax authorities to determine whether a company should be taxed in a particular country based on the location of its effective management.

Concept of Substance over form

Any determination of the POEM will depend upon the facts and circumstances of a given case. The POEM concept is one of substance over form. It may be noted that an entity may have more than one place of management, but it can have only one place of effective management at any point of time. Since "residence" is to be determined for each year, POEM will also be required to be determined on year to year basis.

Place of Effective Management:

Updated Article 4(3) of the OECD Model Convention states that:

"Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the ***Contracting States shall endeavor to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention****, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.* ***In the absence of such agreement****,* ***such person shall not be entitled to any relief or exemption from tax*** *provided by this Convention* ***except to the extent and in such manner as may be agreed upon by the competent authorities*** *of the Contracting States".*

Therefore, now the determination of residency is to be done by the Competent Authorities by mutual agreement having regard to its place of effective management, place of incorporated / constitution and any other relevant factors.

The **OECD (Organization for Economic Cooperation and Development) Commentary** on Article 4 states that effective management **"refers to the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.** All relevant facts and circumstances must be examined to determine the place of effective management.

The **United Nations (UN) model** of POEM is another framework used to determine the tax residency of a company for tax purposes.

Under the **UN Model**, Article 4(3) provides that in case of dual residency, a company is considered a resident of a country in which its place of effective management is situated.

Some of the guiding principles which may be considered for determining the POEM are as follows:

a) **The location where a company's Board regularly meets and makes strategic decisions.**

This location may be the place of effective management of a company provided, the Board –

(i) retains and exercises its authority to govern the company; and

(ii) does, in substance, make the key management and commercial decisions necessary for the conduct of the company's 'business as a whole'.

It may be mentioned that mere formal holding of board meetings at a place would by itself is not conclusive for determination of POEM being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held then such other place would be relevant for POEM.

As an example this may be the case where the board meetings are held in a location distinct from the place where head office of the company is located, or such location is unconnected with the place where the predominant activity of the company is being carried out.

b) Where the chief executive officer and other senior executives usually carry on their activities

If a Board has de facto delegated the authority to make the key management and commercial decisions for the company to the senior management or any other person including a shareholder, promoter, strategic or legal or financial advisor etc. and does nothing more than routinely ratifying the decisions that have been made, the company's place of effective management will ordinarily be the place where these senior managers or the other person make those decisions.

c) Place where the senior day-to-day management of the person is carried on.

It may be clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM. The operational decisions relate to the oversight of the day-to-day business operations and activities of a company whereas the key management and commercial decisions are concerned with broader strategic and policy decision. For example, a decision to open a major new manufacturing facility or to discontinue a major product line would be examples of key commercial decisions affecting the company's business as a whole. By contrast, decisions by the plant manager appointed by senior management to run that facility, concerning repairs and maintenance, the implementation of company-wide quality controls and human resources policies, would be examples of routine operational decisions. In certain situations, it may happen that the person responsible for operational decision is the same person who is responsible for the key management and commercial decision. In such cases it will be necessary to distinguish the two types of decisions and thereafter assess the location where the key management and commercial decisions are taken.

If the above factors do not lead to clear identification of POEM, then the final guidelines provide that following secondary factors may be considered:

- Place where main and substantial activity of the company is carried out; or
- Place where the accounting records of the company are kept.

d) Location of a company's head office.

The location of a company's head office will be a very important factor in the determination of the company's place of effective management because it often represents the place where key company decisions are made. The following points need to be considered for determining the location of the head office of the company: -

If the company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal place of business or headquarters, then that location is the place where head office is located.

If the company is more decentralized (for example where various members of senior management may operate, from time to time, at offices located in the various countries) then the company's head office would be the location where these senior managers,-

(i) are primarily or predominantly based; or

(ii) normally return to following travel to other locations; or

(iii) meet when formulating or deciding key strategies and policies for the company as a whole.

Members of the senior management may operate from different locations on a more or less permanent basis and the members may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situation the head office would normally be the location, if any, where the highest level of management (for example, the Managing Director and Financial Director) and their direct support staff are located.

In situations where the senior management is so decentralized that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office would not be of much relevance in determining that company's place of effective management.

e) Location of the registered office

Needless to mention that the registered office of the company is always to be considered for determining its place of effective management i.e. which country's laws govern the legal status of the company.

f) Where its accounting records are kept

Accounting record database of the company is also relevant for determining its Place of effective management, it demonstrates that the country in which accounting record is kept is vital as a central point of management and administration.

g) Use of modern technology

The use of modern technology impacts the place of effective management in many ways. It is no longer necessary for the person taking the decision to be physically present at a particular location. Therefore, the physical location of a board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases the place where the directors or the people taking the decisions or the majority of them usually reside may also be a relevant factor.

It needs to be emphasized that the determination of POEM is to be based on all relevant facts related to the management and control of the company and is not to be determined on the basis of isolated facts that by itself do not establish effective management,

Key International Jurisprudence

International jurisprudence has provided further guidance on the meaning of effective management.

- **De Beers Consolidated Mines (Swiss Federal Supreme Court)-** held that the POEM of a company should be determined by considering all relevant factors, including the location of its board of directors, the place where its strategic decisions are made, and the place where its financial and administrative decisions are taken. The Court also held that the location of a company's head office is not necessarily determinative of its POEM.

- **Ishikawajima-Harima (Singapore High Court)-** Harima case involved a Japanese engineering company that set up a subsidiary in Singapore to serve as a holding company for its overseas operations. Subsidiary received tax-free dividends from the company's overseas subsidiaries and repatriated them to Japan.

  Singapore High Court, which held that **the subsidiary had its POEM in Japan**, as its board of directors merely acted as a "rubber stamp" for decisions made by IHI's management team in Japan. The Court also held that the subsidiary's separate legal status did not necessarily determine its POEM.

- **Trevor Smallwood Trust - [2010] EWCA Civ 778 (UK)-** One has to look at the place from where the real top level of management or realistic, positive management of the taxpayer, a trust, was exercised.

- **Wensleydale's Settlement Trustees V. Inland Revenue Commissioners** - [1996] STC 241 (UK)- 'Effective' implies realistic, positive management. The PoEM is where the shots are called, to adopt a vivid transatlantic colloquialism.

- **Laerstate BV v. The Comm. Of Her Majesty's Revenue and Customs** – SC 3032/07 (UK)- One needs to consider, whether a director acted on another person's wishes or instructions without truly considering the merit of those wishes or instructions; or whether the director considered the wishes or instructions but still made the decision while in possession of the minimum information required to decide.

- **Switzerland Case - 2C-1086/2012, 2C-1087/2012**- The PoEM would be where the economic and effective center of a company is located. The decisive factor is thus the management of daily business activities within the company's purpose; the place of board meetings or the general assembly is to be disregarded.

Different countries have adopted different approaches for determining the place of effective management (POEM) of a company. Some of these approaches include:

Country	Tax Residency based on POEM
Russia	New law (Law No. 376- FZ) amends the definition of tax residency for foreign companies. The amendment provides that tax residency for foreign companies is to be based on the **place of effective management** of such companies. A foreign company will be deemed to be resident in Russia if any of the following requirements are met: - • Majority of the board of directors' meetings are held in Russia. • Executive management of the company is regularly exercised in Russia; or • the key corporate officials (i.e., the persons in charge of strategic planning, of management and of control of the foreign company) perform their actual daily management activities in Russia. Auxiliary criteria apply by default when it is impossible to recognize a foreign company as a tax resident by using the key criteria above. The list of auxiliary criteria notably includes: • Preparation of accounting and financial statements in Russia. • Operational personnel management is conducted from Russia. • Books and records are kept in Russia. • Certain activities including budgeting, preparation of consolidated statements, and • adoption of group standards and policies will not be considered sufficient to result in a Russian tax residency status, even if they are carried out in Russia.
Colombia	Colombia's Ministry of Finance and Public Credit has issued Decree 3028 (27 December 2013), regulating the concept of effective place of management for companies and foreign entities. Article 12-1 of the Tax Statute, incorporated in Colombia by Law 1607 of 2012, defines "effective place of management" as: • The place in which the company does business and necessary management decisions to carry out the company's activities.

	• To determine the effective place of management, all the relevant facts. and circumstances should be considered, especially those related to the places in which the senior executives and administrators of the company or entity usually exercise their responsibilities and carry out the company or entity's upper management daily activities
India	The Finance Bill, 2015 introduced the concept of POEM for determination of residence of companies. Earlier the word used in the Act were control and management of its affairs is situated wholly in India. The process of determination of POEM would be primarily based on the fact as to whether company is engaged in active business outside India. A company shall be said to be engaged in 'active business outside India. — if passive income is not more than 50% of its total income, and — less than 50% of its total asset are situated in India; and — less than 50% of total number of employees are situated in India or are resident in India; and — The payroll expenses incurred on such employees is less than 50% of its total payroll expenditure. *In case of Companies engaged in Active Business outside India* POEM of a company shall be presumed to be outside India if the majority of the board meeting are held outside India. However, in case the Board is not exercising its powers of management and such powers are being exercised by either the holding company or any other person, resident in India, then POEM shall be in India. *In case Companies not engaged in active business outside India* — **First stage**: Identifying the person(s) who make the key management and commercial decisions for the conduct of the company as a whole. — **Second stage**: Determine the place where these decisions are, in fact, being made.
United Kingdom	Entities incorporated in UK or Centrally Managed and Controlled in UK. As per ITH348, — PoEM is generally understood to be the place where the Head Office is: the Head Office in the sense of - not the registered office - but the central directing source. The place where one would expect to find the finance director, for example, the sales director and, if there is one, the managing director. The company records would normally be found there together with the senior administrative staff. — Nevertheless it is not that easy to divorce effective management from central management and control and in the vast majority of cases they will be located in the same place.

Australia	Incorporation or carries on business in Australia, central management and control or voting power in Australia — In case of Dual residency, the assesses are treated as resident in Australia. Government has announced that legislation will be introduced which will treat such companies as non-resident for domestic tax purposes
China	An entity established, incorporated in China or their PoEM is in China will be resident in China. Effective management is factual and effective exercise of the entire management and control over production and business operations, human resources, financial and property aspects of the entity. State Administration for Tax (SAT) has issued Notice no. 82 which provides guidance on PoEM in China. i) Article 1 defines a “Chinese-controlled offshore incorporated enterprise” as an enterprise that is incorporated under the laws of a foreign country or territory and has a domestic (i.e. a Chinese) enterprise or enterprise group as its primary controlling shareholder. ii) Article 2 provides that a Chinese-controlled offshore incorporated enterprise will be regarded as a Chinese tax resident by virtue of having a place of effective management and control in China and it will be subject to EIT on its worldwide income if all of the following conditions are satisfied: • The senior management personnel responsible for the day-to-day production and operation of the Company is located primarily inside China and their management duties are performed primarily inside China; • Decisions relating to the enterprise's financial and human resource matters are made or are subject to approval by organizations or personnel in China; • The enterprise's primary assets, accounting books and records, company seals, board and shareholder meeting resolutions are located or maintained in China; and • 50% or more of voting board members or senior executives habitually reside in China. iii) Article 3 further provides that the substance-over-form principle will be applied in determining the place of effective management and control.

Chapter 4
Taxation of Partnership

This chapter covers the following:

- **Understanding various approaches followed internationally, for taxation of partnership – Fiscally transparent vs. Separate entity**
- **Possibilities of double non-taxation – OECD Action Plan**
- **Approach under UAE CT**
- **Potential challenges**

1. Understanding various approaches followed internationally, for taxation of partnership – Fiscally transparent vs. Separate entity

A '*partnership*' in its simplest form may be defined as an agreement or understanding, between two or more parties, where the parties agree to operate in a manner which furthers their mutual interests. The parties to such agreement of partnership are termed as 'partners' of the partnership. Such agreements for partnership may be oral or written, depending upon the laws of the country under which the partnership is organized.

Another way to define partnerships is as a relationship existing between two or more persons who join to carry on a specific purpose like trade, business etc.

Most countries recognize at least two forms of partnership: the general partnership, in which the partners are jointly liable for the debts of the firm, and the limited partnership, in which the liability of some of the partners is limited. In a number of countries, there are more than two forms of partnership, and the tax treatment may vary according to the particular form.

In some legal systems, partnerships have legal personality, while in others they do not. The term "*partnership*" is used not as a term that corresponds precisely to a concept in the legal system of all countries, but as a general one that encompasses a variety of legal forms. This variety and the differences in treatment under civil law, in particular whether the partnership is considered a legal person, make it difficult to generalize about partnerships. To some extent, differences in tax treatment from one country to another may also have been influenced by differences in civil law.

The term *'Fiscally Transparent Entities'* ('FTEs') are entities wherein the owners and investors are taxed for the income earned by the entities and not the entities themselves. The income flows through to the investors and owners of the entities. These entities are considered as non-entities for tax purposes because all the burden of taxation is borne by its owners and investors. Common forms of FTEs are partnerships, Limited Partnerships and LLPs

Partnerships as Taxable Entities

The absence of legal personality of partnerships in many countries may have facilitated transparent treatment for tax purposes, although the fact that a partnership is or is not categorized as a legal person is not necessarily determinative of its tax status. Different approaches are possible. In several countries, partnerships are considered legal persons but are not treated as taxable persons. Belgium, Spain, and many Latin American countries treat as taxable persons those forms of partnership that are legal persons, except for specified cases where a fiscal transparency regime applies. In common law countries, partnerships generally are not considered legal persons and are not taxed as corporations, although some partnerships that are considered to resemble corporations are taxed as corporations rather than as partnerships, even though they are not legal persons. In Indonesia, partnerships are taxed as separate entities even though they have no legal personality.

In recent years, the civil and commercial laws of many transition countries have undergone changes under which the legal status of various kinds of business entities has been defined or redefined; the tax treatment of such entities has also been in a state of flux. The different patterns that have emerged can be illustrated with some examples. In Kazakhstan and Romania, all legal persons (including partnerships) are subject to income tax as separate entities. In Latvia, the enterprise income tax applies to all enterprises, which are defined according to registration requirements, except that partnerships are taxed on a flow-through basis and physical persons and *"individual enterprises"* that are not required to submit annual reports under commercial law are taxed on a flow-through basis to the owner. Individual enterprises that are required to submit annual reports are therefore taxed as entities even if they are not legal persons. Similarly, in China, all enterprises are subjected to enterprise income tax as separate entities regardless of whether a given entity is a legal person. In Estonia, the entity-level tax applies to legal persons. General and limited partnerships are taxed under the entity-level tax, except that general partnerships consisting of no more than ten partners who are all resident physical persons are taxed on a flowthrough basis. Taxing partnerships as entities has the advantage of administrative simplicity, as it is generally easier to collect tax from a single entity than from the individual participants. Income tax returns of partners who are physical persons are kept simple, as they do not include income received through the entity, and complicated rules for the taxation of flowthrough entities can be largely avoided. A further advantage of taxing partnerships as entities is that it avoids discrimination between different forms of business organization and eliminates "*entity shopping*." However, the disadvantage is that the income will then normally be taxed at a flat rate rather than at the marginal rates applicable to the individual partners.

2. Possibilities of double non-taxation – OECD Action Plan

As noted earlier, the basic issue faced while ascertaining taxation of partnerships is that the same entity may be viewed and treated differently by the country of its residence and the Source State for the purposes of granting Treaty benefits.

For the purposes of applying a Treaty, the key question that arises from such variation of understanding is whether a partnership is a resident for the purposes of a Treaty, or not. The same question is analyzed below in the context of the OECD Model Tax Convention ("Convention").

In 1963, the OECD published a draft model double taxation agreement, or the Convention, and a Commentary on each Article in the Convention, which was intended to form the basis of double taxation agreements between member countries, including the United Kingdom. Since then, new editions of the Convention have been published and updated periodically. Article 1 of the Convention provides that the Convention shall apply to persons who are 'residents of one or both of the contracting States' i.e. the States which are the parties to the Treaty. Further, Article 3 of the Convention states that the term 'person' includes an individual, a company and any other body of persons. Therefore, for a partnership to avail the benefits of the Convention, is required to be treated as a person as defined under Article 3 of the Convention. Further, Article 4 of the Convention provides that a person is considered as a resident of a contracting state where such person is 'liable to tax' therein by reason of his domicile, residence, place of management or any other criteria of similar nature, and includes that State and any political sub-division or local authority thereof. Hence, a fiscally transparent entity may be treated as not liable to tax in a contracting State and be denied being treated as a resident of that State. The answer to the question as to whether a given entity is 'liable to tax' for the purposes of Article 4 of the Convention itself depends upon the manner in which it is perceived by a country. In specific reference to partnerships, the source State may apply its own laws in order to ascertain the classification of the concerned entity.

Additionally, the laws of one State may provide for taxation of the income of a partnership at the level of the partnership itself, but the other State may choose to tax the income of a partnership in the hands of its partners. In both cases, there exists a possibility of either double taxation or double non-taxation in respect of the income of such partnership. This issue gets further complicated in a triangular situation, where the partners of a partnership are residents of jurisdiction separate from the jurisdiction in which the partnership is organized, due to the different tax treatments of partnerships under the laws of each jurisdiction.

In order to address the above issues such as the one mentioned above, the OECD released a report in 1999 called 'The Application of the OECD Model Convention to Partnerships' ("the Report")[1]. The Report contains a comprehensive analysis of a wide variety of possible fact situations which may be faced in taxation of partnership dealing with both bilateral and triangular situations. The Report also suggests solutions to such issues. A few of the various factual scenarios analyzed by the Committee in the Report are summarized herein subsequently.

As noted above, Article 1 of the Convention clearly restricts its benefit to only such persons who are residents of at least one of the contracting States. Therefore, in order to obtain the benefits of [1]the Convention, two criteria must be fulfilled:

a) The partnership must be considered a *'person'* under Article 3 of the Convention which includes an individual, a company and the other body corporate; and

b) The partnership must be considered a '*resident of a contracting State'* under Article 4 of the Convention i.e. a person who is liable to tax therein by reason of his domicile, residence, place of management or any other criteria of similar nature.

As regards the first criterion, it has been conceded in the Report that the definition of *'person'* provided under Article 3 is not exhaustive as it overtly includes only individuals, companies and other '*bodies of persons'*. Although the scope of the terms *'company'* and 'body of persons' are much broader than what the literal sense suggests, and though many countries include partnerships within one of these categories, the fact that a partnership has not been expressly included within the definition of 'person' has created a lack of uniformity and clarity. Accordingly, the Report, for the sake of absolute certainty, concluded that partnerships were to be specifically included within the ambit of Article 3 and that paragraph 2, of the OECD Model Commentary on the Convention ("Commentary") on Article 3, be amended to include the following:

"Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons."

[Emphasis Supplied]

As regards the second criterion, the Report analyses the expression '*liable to tax'*, as contained in Article 4 of the Convention vis-a-vis the case of partnerships. As per Article 4, a person is considered a resident of a contracting State only if it is 'liable to tax' in that State. The Report states that while certain jurisdictions tax income earned by the partnership at an entity level, others tax income earned by a partnership in the hands of its partners; in which case, effectively, the partnership is 'fiscally transparent' and thus cannot be said to be *'liable to tax'* under Article 4. The Report, in this regard, finally concludes that if the jurisdiction where the partnership is organised treats it as fiscally transparent, the partnership cannot be entitled to benefits under the Convention.

The Report examines two common approaches to taxation of partnerships adopted by its member countries. It observes that in many countries, the tax laws provide that income derived by a partnership, from a particular source must be computed at the partnership level, as if the

[1] The Application of the OECD Model Tax Convention to Partnerships, (Paris: OECD, 1999), Issues in International Taxation, No. 6.

partnership were a distinct taxpayer. Each partner is then allocated his share of that income which retains its character and is added to his income for purposes of determining his taxable income. Further, the taxable income of the partner, including his share of the partnership's income, is then reduced by the personal allowances and deductions to which he is entitled and tax is then determined, assessed and paid at the partner's level.

In such cases, it is clear that the partnership is not itself liable to tax. As opposed to this approach, in certain other countries, the income and the tax payable is computed in a similar way, but the tax payable by the partners is then aggregated at the level of the partnership, which is then assessed for the total amount of the tax. To that extent, the Report states that in such cases, the assessment of the tax in the hands of the partnership is a collection technique that does not change the fact that the tax payable on the income of the partnership is determined at each partner's level taking into account the other income of that partner, the personal allowances to which he is entitled and the tax rate applicable to him (which may vary depending on his total income or his nature). In such cases also, the partnership is not liable to tax. Analysing the common tax treatments of partnerships, the Committee agreed that for purposes of determining whether a partnership is liable to tax, the real question is whether the amount of tax payable on the partnership income is determined in relation to the personal characteristics of the partners (i.e. considering whether the partners are taxable or not, what other income they have, what are the personal allowances to which they are entitled and what is the tax rate applicable to them). If the answer to that question is yes, then the partnership should not itself be considered to be liable to tax. The fact that the income is computed at the level of the partnership before being allocated to the partners, that the tax is technically paid by the partnership or that it is assessed on the partnership as described in the preceding above will not change that result. This conclusion of the Report is extremely important since it actually serves as a test for determination of entitlement to benefits of the Convention as far as OECD's viewpoint is concerned.

Another important conclusion arrived at in the Report pertaining to partners' entitlement to the benefits of the Convention. It was concluded that whenever a fiscally transparent partnership loses entitlement to benefits under the Convention as detailed above, the individual partners would be eligible to claim benefits in respect of the share of their partnership income that is liable to tax owing to such transparency, and such income would retain the nature and source that it had in the hands of the partnership for tax purposes. The most important conclusion arrived at in the report is that transparency for tax purposes is to be decided by the country of residence and the source country must adhere to such determination. The Report emphasizes that the source State, in applying the Convention where partnerships are involved, should take into account the way in which an item of income is treated in the resident State of the taxpayer claiming the benefit of the convention i.e. the Source State should take into account whether the resident State treats the partnership as transparent or opaque.

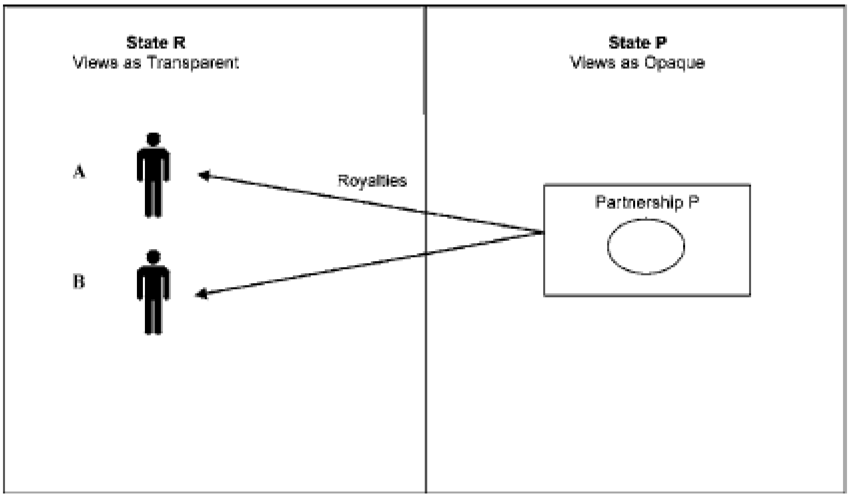
Clearly, in itself, the Report serves as a source of jurisprudence on cross border taxation of partnerships. The OECD's view with regard to application of the Convention to partnerships has generally been accepted by many academicians and jurists on the grounds that Article 4 clearly provides against grant of Treaty benefits to a partnership that is not 'liable to tax' in its country of organization. Since the aim of the Convention is to avoid double taxation of income, when a fiscally transparent partnership does not qualify for Treaty benefits, for the reason that its income is taxed at the level of the individual partners, it is regarded sufficient that the partners are given Treaty benefits with regard to their individual share of such income.

Eminent author Philip Baker has analysed the application of the Report, referring to certain important case laws which were in harmony with the conclusions arrived by the OECD in the Report. He referred to the decision of the French Conseil d'Etat in SA Diebold Courtage, which concerned taxation of rental payments by a French Company to a Dutch limited partnership under an agreement for the sale and leaseback. The partners of the Dutch partnership were both companies resident in the Netherlands. The Conseil d'Etat referred to the tax treatment of the partnership under Dutch tax law and concluded that since partnership was fiscally transparent under Dutch tax laws, it could not be treated as a resident of the Netherlands for the purposes of the Netherlands-France Treaty.

The Conseil d'Etat also held that rental income was to be treated as paid to the two partners of the Dutch partnership, who were also residents of the Netherlands, and could benefit from the Treaty. Clearly, the approach of the Conseil d'Etat is in consonance with the conclusions arrived at in the Report since it essentially applied the laws of the resident State, i.e. Netherlands, in refusing Treaty benefits to the Dutch partnership. Further, in the same manner as suggested in the Report, the Conseil d'Etat granted the benefit to the partners of the Dutch partnership who coincidentally were residents of Netherlands.

An important criticism faced by the OECD approach comes from Michael Lang as to the extension of Convention benefits beyond the purview of Article 1. A partnership needs to be a 'person' under Article 3 and 'resident' under Article 4 because the Report proceeded on the basis that Article 1 provides for benefits under the Convention. Lang has argued that Article 1 is not the basis of Treaty benefits and that the Convention applies even when a person is not 'liable to tax' in its resident jurisdiction. His argument is along different lines and is based on the premise that since the Convention in itself does not put de facto taxation as a prerogative for taxation, the association of the 'liable to tax' test to Treaty benefits is not proper. Hence, since 'liable to tax' does not mean 'subject to tax', it cannot be considered an unconditional requirement. Thus, he argues that a transparent partnership can claim benefits under the Convention. This argument can be contested by pointing out the distinction between the expressions 'liable to tax' and 'subject to tax'. While the latter considers whether the tax has been exercised in effect i.e. de facto taxation has occurred, the former merely implies the legal obligation to pay tax. Although the Convention does not provide for a general 'subject to tax' or de facto taxation requirement as pointed out in paragraph 34 of the Commentary to Article 23, there is no implication that Treaty benefits are to be conferred when there is no legal obligation or liability to pay tax in the resident state. One very important scenario that the Report has failed to deal with is a case where a country gives the partnership intermediate status i.e. partly transparent and partly opaque. This is seen in the French tax treatment of limited partnerships which is complex and involves taxation at both the entity level and the partner level. A limited partnership (which has not opted to be taxed as a corporation) is taxed at two levels i.e. it is fiscally transparent as far as the profits accruing to the general partners are concerned while the profits accruing to the limited partners are taxed at the entity level by holding such profits as taxable income of the entity. Consequently, France has reserved its position with regards to this conclusion of the Report. As per the rationale used in the Report, experts have opined that the only logical position in such cases would be to recognize the partnership as a resident to the extent that it is liable to tax. Therefore, in case of a French limited partnership, benefits under the Convention would be accorded to the limited partners with regard to their share in the income earned by the partnership since the partnership is taxable with respect to them.

The Report itself is not oblivious of the absurdities caused due to the OECD's viewpoint that the Source State while taxing cross border partnerships should refer to the tax treatment of the partnership in its home jurisdiction. Example 17 of the Report discusses a case where the P is a partnership established in State P. A and B are P's partners who reside in State R. State P treats P as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State P that is not attributable to a permanent establishment in that state.



In this example, State P would, under its domestic law, impose tax on the royalties in the hands of the partnership. From its perspective, P is a resident taxpayer and as such liable to tax on its income arising in State P. Thus, Article 12 of the Convention would not apply since the royalties arise in State P and are paid to a resident of State P. However, because State R allocates the income to partners A and B, they are also liable to tax on the royalties in State R as residents.

In this situation, it would be difficult to justify the application of the principles of taxation of State R by the State P since the taxation of the partnership is entirely an internal affair of State P. The Report recognised the absurdity in this approach and the majority of the Committee was of the view that it should not be applied in the given scenario.

The Report and the OECD's approach, to the extent it provides that the Source State while taxing cross border partnerships should refer to the tax treatment of the partnership in its home jurisdiction, has also been criticized on the grounds of Article 3(2) of the Convention which provides that unless the context otherwise requires, terms not defined in the Convention shall have the meaning that they have under domestic law of the contracting State that applies the Convention. Some eminent jurists have argued that since a partnership is not included in the definition of 'person' as contained in Article 3 of the Convention, Article 3(2) of the Convention implies that each contracting state could decide independently whether or not a partnership was transparent as per their domestic law. Since the determination by the residence state binds the Source State under the OECD approach, they argue that this would entail a teleological interpretation.

The above criticism has been answered through the interpretation given to the expression "unless the context otherwise requires" of Article 3(2) of the Convention by experts such as Michael Lang whereby they believed that the term 'context' should include all available historical, systematic and teleological aspects which are important. It is of course possible that in the light of such arguments a country may disregard the approach adopted by the OECD and in consideration of Article 3(2) of the Convention choose to apply its own laws to decide upon the classification of partnerships. It would thus be helpful, if the Report had justified adopting this approach in greater detail.

3. Approach under UAE CT

In UAE Federal Decree law, the term unincorporated partnership is defined under Article 1 as under:

> *"A relationship established by contract between two Persons or more, such as a partnership or trust or any other similar association of Persons, in accordance with the applicable legislation of the State."*

Considering the above definition, we can conclude that an unincorporated partnership is merely a contract between the parties in accordance with the legislation of the UAE and has no legal personality, while the incorporate partnership has legal status.

Incorporated partnerships include limited liability partnerships, partnerships limited by shares and other types of partnerships where none of the partners have unlimited liability for the partnership's obligations or other partners' actions. Such partnerships are subject to Corporate Tax in the same manner as a corporate entity

The below is the extract of Article 16 of the UAE Federal Law Decree which deals with Partners in an Unincorporated Partnership

"1. Unless an application is made under Clause 8 of this Article, and subject to any conditions the Minister may prescribe, an Unincorporated Partnership shall not be considered a Taxable Person in its own right, and Persons conducting a Business as an Unincorporated Partnership shall be treated as individual Taxable Persons for the purposes of this Decree-Law.

2. Where Clause 1 of this Article applies, a Person who is a partner in an Unincorporated Partnership shall be treated as:

a. Conducting the Business of the Unincorporated Partnership.

b. Having a status, intention, and purpose of the Unincorporated Partnership.

c. Holding assets that the Unincorporated Partnership holds.

d. Being party to any arrangement to which the Unincorporated Partnership is a party.

3. For the purposes of Clause 1 of this Article, the assets, liabilities, income and expenditure of the Unincorporated Partnership shall be allocated to each partner in proportion to their distributive share in that Unincorporated Partnership, or in the manner prescribed by the Authority where the distributive share of a partner cannot be identified.

4. The Taxable Income of a partner in an Unincorporated Partnership shall take into account the following:

a. Expenditure incurred directly by the partner in conducting the Business of the Unincorporated Partnership.

b. Interest expenditure incurred by the partner in relation to contributions made to the capital account of the Unincorporated Partnership.

5. Interest paid by an Unincorporated Partnership to a partner on their capital account shall be treated as an allocation of income to the partner and is therefore not a deductible expenditure for calculating the Taxable Income of the partner in the Unincorporated Partnership.

6. For the purposes of calculating and settling the Corporate Tax Payable of a partner in an Unincorporated Partnership under Chapter Thirteen of this Decree-Law, any foreign tax incurred by the Unincorporated Partnership shall be allocated as a Foreign Tax Credit to each partner in proportion to their distributive share in the Unincorporated Partnership.

7. A Foreign Partnership shall be treated as an Unincorporated Partnership for the purposes of this Decree-Law where all of the following conditions are met:

a. The Foreign Partnership is not subject to tax under the laws of the foreign jurisdiction.

b. *Each partner in the Foreign Partnership is individually subject to tax with regards to their distributive share of any income of the Foreign Partnership as and when the income is received by or accrued to the Foreign Partnership.*

c. *Any other conditions as may be prescribed by the Minister.*

8. *The partners in an Unincorporated Partnership can make an application to the Authority for the Unincorporated Partnership to be treated as a Taxable Person.*

9. *Where an application under Clause 8 of this Article is approved:*

   a. *The provisions of Clauses 1 to 6 of this Article shall no longer apply to the partners in the Unincorporated Partnership in respect of the Business conducted by the Unincorporated Partnership.*

   b. *Each partner in the Unincorporated Partnership shall remain jointly and severally liable for the Corporate Tax Payable by the Unincorporated Partnership for those Tax Periods when they are partners in the Unincorporated Partnership.*

   c. *One partner in the Unincorporated Partnership shall be appointed as the partner responsible for any obligations and proceedings in relation to this Decree-Law on behalf of the Unincorporated Partnership.*

10. *Where the application under Clause 8 of this Article is approved, the Unincorporated Partnership shall be treated as a Taxable Person effective from the commencement of the Tax Period in which the application is made, or from the commencement of a future Tax Period, or any other date determined by the Authority"*

Article 16(1) of the law requires that an unincorporated partnership itself shall not be considered a taxable person but the partners conducting the business as an unincorporated partnership shall be treated as taxable persons. Such unincorporated partnerships with no legal personality are called "transparent", and the income of such partnerships is taxable in the hands of the partners in their respective share of income.

The unincorporated partnership's assets, business, intention, purpose, and arrangement shall be treated as partners' assets, business, intention, purpose, and arrangement. The unincorporated partnership's assets, liabilities, income and expenditure shall be allocated to each partner in proportion to their share or in the proportion determined by the Federal Tax Authority where each partner's share cannot be identified. Interest expense on contributions in the capital account by each partner and any other expense directly related to the business of the partnership will be allowed as allowable expenses to each partner. Interest received on the partner's capital account shall be treated as an allocation of income instead of allowable expense to the partners. Any foreign tax incurred by the unincorporated partnership shall be allocated as a foreign tax credit to each partner in proportion to their share.

For example, X and Y are in a partnership, and the partnership has made a profit of Dh100,000 in a tax period. It was agreed that X would take 75 per cent of the profit while Y would take 25 per cent. So, Dh75,000 will be taxable in the hands of X, and Dh25,000 will be taxable in the hands of Y after adjusting interest and other expenses directly related to the partnership.

Partners can apply to the Federal Tax Authority for the unincorporated partnership to be treated as a taxable person, and if approved, the partnership shall be treated like a juridical person. After approval, each partner shall remain jointly and severally liable for the corporate tax payable to the Federal Tax Authority. One partner shall be appointed as responsible for any obligations and proceedings related to the partnership. The status of an unincorporated partnership as a taxable person shall be effective from the beginning of the tax period in which the application was made, or any future tax period or any other period approved by the Federal Tax Authority.

Even if not applied by the partners, the Federal Tax Authority may require the unincorporated partnership to register for corporate tax and obtain a tax registration number. The Federal Tax Authority may request a partner in an unincorporated partnership to provide financial statements; if required, an unincorporated partnership shall be required to provide.

Where there is an incorporated partnership, and the liability of any of the partners is not unlimited (means all members have limited liability, or we can say that it is a limited liability partnership like a partnership limited by shares), such partnership shall be treated like a juridical person, and we know, the worldwide of income of the juridical resident person is subject to tax. In case there is an incorporated partnership, where the liability of any of the partners is unlimited, it will be treated like an unincorporated partnership.

4. Potential challenges

Investing in and through unincorporated partnerships in a cross-border context can create difficulties and unintended tax consequences where one country treats the partnership as a transparent entity, and the other country taxes the partnership as if it were a company. To align the tax treatment of partnerships in a cross-border context, the UAE CT treatment of foreign unincorporated partnerships would generally follow the tax treatment of the partnership in the respective foreign jurisdiction.

Chapter 5

Persons not covered by UAE CT

This chapter covers the following:

- **Exempt Persons**
- **Federal and Emirate Governments**
- **Government Controlled Entity**
- **Extractive Business**
- **Non-Extractive Natural Resource Business**
- **Qualifying Public Benefit Entity**
- **Qualifying Investment Fund**
- **Taxation of Oil and Gas companies – Concession agreements**
- **Present provisions for taxation of branches of foreign banks**
- **Private or family trust holding**

1. Exempt Persons

According to Article 4 of the Decree Law the following persons shall be exempt from Corporate Tax:

a) A Government Entity

b) A Government controlled entity

c) A person engaged in the Extractive Business, that meets the conditions of Article 7 of this Decree Law

d) A person engaged in a Non-Extractive Natural Resource Business, that meets the conditions of Article 8 of this Decree Law

e) A qualifying Public Benefit Entity under Article 9 of this Decree Law

f) A qualifying Investment fund under Article 10 of this Decree Law

g) A public pension or social security fund or a private pension or social security fund that is subject to regulatory oversight of the competent authority in the State and that meets any other conditions that may be prescribed by the Minister

h) A juridical person incorporated in the State that is wholly owned and controlled by an Exempt Person specified in paragraphs (a), (b), (f) and (g) of Clause 1 of Article 4 and conducts any of the following:

(i) Undertakes part or whole of the activity of the Exempt Person

(ii) Is engaged exclusively in holding assets or investing funds for the benefit of the Exempt Person

(iii) Only carries out activities that are ancillary to those carried out by the Exempt Person

i) Any other person as may be determined in a decision issued by the cabinet at the suggestion of the Minister.

A Person under paragraphs (a), (b), (c) and (d) that is a Taxable Person insofar as it relates to any Business or Business Activity under Articles 5, 6, 7 or 8 of this Decree-Law, respectively, shall be treated as an Exempt Person for the purposes of Articles 26, 27, 38 and 40 of this Decree-Law. (Transfer within qualifying group, Business restructuring, Transfer of Tax Loss, Tax Group)

Persons specified in paragraphs (f), (g), (h) and (i) of Clause 1 of this Article, as applicable, are required to apply to the Authority to be exempt from Corporate Tax in the form and manner and within the timeline prescribed by the Authority in this regard. (*The concept of* Automatically *exempt, Exempted after they fulfill certain conditions or if they are notified to the Ministry of Finance, Exempt if listed in a Cabinet Decision, Exempt if applied to and approved by the Federal Tax Authority (and subject to meeting certain conditions)*

The exemption from Corporate Tax under paragraphs (f), (g), (h) and (i) of Clause 1 of this Article, as applicable, shall be effective from the beginning of the Tax Period specified in the application, or any other date determined by the Authority.

In the event that the Exempt Person failed to meet any of the conditions under the relevant provisions of this Decree-Law at any particular time during a Tax Period, such Person shall cease to be an Exempt Person for the purposes of this Decree-Law from the beginning of that Tax Period.

For the purposes of Clause 5 of this Article, the Minister may prescribe the conditions under which a Person may continue to be an Exempt Person, or cease to be an Exempt Person from a different date, in any of the following instances:

a. Failure to meet the conditions is the result of the liquidation or termination of the Person.

b. Failure to meet the conditions is of a temporary nature and will be promptly rectified, and appropriate procedures are in place to monitor compliance with the relevant conditions of this Decree-Law.

c. Any other instances as may be prescribed by the Minister.

2. Federal And Emirate Governments

Article 1 of the Decree Law provides the definition of Government Entity is as follows:

> *"The Federal Government, Local Governments, ministries, government departments, government agencies, authorities and public institutions of the Federal Government or Local Governments."*

According to Article 5 of the Decree Law a Government Entity shall be exempt from Corporate Tax and the provisions of this Decree Law shall not apply to it. However, a Government Entity shall be subject to the provisions of this Decree Law if it conducts a Business or Business Activity under a License issued by a Licensing Authority.

It is important to note that the Federal and Emirate Governments and their Departments, various authorities and other public institutions which are carrying out sovereign activities will be exempt from the application of UAE Corporate Tax. This is mainly because the sovereign activities are activities which can be performed only by the Government and the performance of such sovereign activities are purely in the public interest and not with a motive to generate profits. In view of this the Government activities are clearly exempt from the application of UAE Corporate Tax.

However, if the Government entity is involved in any Business or Business Activity, then the business activity that is carried out by the Government Entity will then be subject to Corporate Tax. The business activity conducted by a Government Entity shall be treated as an independent business and the Government Entity shall keep separate financial statements for such activity. The Government Entity shall calculate the taxable income for such business activity for each tax period in accordance with the provisions of this Decree Law.

Any transactions between the business activity and other activities of the Government shall be treated as Related Party transaction and such transactions should comply with the Article 34 of this Decree Law as regards the Arm's Length Principle. A Government entity may apply to the authority to treat all its businesses and business activities as a single Taxable Person for the purposes of this Decree Law.

3. Government Controlled Entity

Article 1 of the Decree Law provides the definition of Government Controlled Entity is as follows.

> *"Any juridical person, directly or indirectly wholly owned and controlled by a Government Entity, as specified in a decision issued by the Cabinet at the suggestion of the Minister."*

According to Article 6 of the Decree Law a Government-controlled entity shall be exempt from Corporate Tax and the provisions of this Decree Law shall not apply to it.

Any entity which is registered as a Company in the UAE and is 100% owned by the Government with the sole purpose of carrying out a sovereign or mandated activity then such company will not be attracted under the scope of the Corporate Tax in the UAE. The purpose of the company and its main objectives should be either a sovereign activity or a mandated activity as listed in a Cabinet Decision.

In the previous category the Government Company which is engaged in a commercial activity is clearly brought under the scope of Corporate Tax. However, under this category it is clear that a 100% government owned company will be exempt from Corporate Tax if it is carrying out a sovereign or mandated activity.

To understand the above, the first thing to be observed is what are the activities said to be mandated activities. This has been defined in Article 1 of the Decree Law as under:

> *"Any activity conducted by a Government Controlled Entity in accordance with the legal instrument establishing or regulating the entity, that is specified in a decision issued by the Cabinet at the suggestion of the Minister."*

It is pertinent to note that such mandated activity could be commercial in nature or could be in competition with the private sector. However, since such mandated activity is carried out by the company as per the Cabinet Decision it is being exempt from Corporate Tax as it is considered as an activity of National Importance and significance.

The sovereign or mandated activity are essentially an extension of the Government with the relevant activity segregated from those of the Government for management and accountability purposes. Accordingly, these companies will be outside the scope of the UAE Corporate Tax in so far as the sovereign or mandated activity is concerned.

A Government Controlled Entity shall be subject to provisions of this Decree Law if it conducts a business or business activity that is not its mandated activities. Such activity which is not the mandated activity will be treated as an independent business and the Government Controlled Entity shall keep financial statements for this business separately from the mandated activity.

The Government Controlled Entity shall calculate the Taxable income for its business or business activity that is not its mandated activity independently for each tax period in accordance with the provisions of this Decree law. Any transactions between the business activity and mandated activity of the Government Controlled Entity shall be treated as Related Party transaction and such transactions should comply with the Article 34 of this Decree Law as regards the Arm's Length Principle.

4. Extractive Business

According to Article 7 of the Decree Law a person shall be exempt from Corporate Tax and the provisions of this Decree Law shall not apply to its Extractive Business where all of the following conditions are met:

a) The Person directly or indirectly holds or has an interest in a right, concession or Licence issued by a Local Government to undertake its Extractive Business.

b) The Person is effectively subject to tax under the applicable legislation of an Emirate in accordance with the provisions of Clause 6 of this Article.

c) The Person has made a notification to the Ministry in the form and manner agreed with the Local Government.

If a Person that meets the conditions of Clause 1 of this Article derives income from both an Extractive Business and any other business that is within the scope of this Decree-Law, the following shall apply:

a) The income derived from the Extractive Business shall be calculated and taxed according to the applicable legislation of the Emirate.

b) The income derived from the other business shall be subject to the provisions of this Decree-Law, unless that other business meets the conditions to be exempt from Corporate Tax under Article 8 of this Decree-Law as non-extractive natural resource business.

For the purposes of Clause 2 of this Article, a Person shall not be considered to derive income from any other business where such other business is ancillary or incidental to that Person's Extractive Business and the Revenue of such other Business in a Tax Period does not exceed 5% (five percent) of the total Revenue of that Person in the same Tax Period.

For the purposes of calculating the Taxable Income of the Person's other Business, the following shall apply:

a) The other Business shall be treated as an independent business, and financial statements shall be kept for this Business separately from the Extractive Business.

b) Any common expenditure shared between the Extractive Business and the other Business of the Person shall be apportioned in proportion to their Revenue in the Tax Period, unless such expenditure is taken into account in different proportions for the purposes of calculating the tax payable by the Person under the applicable legislation of the relevant Emirate in respect of its Extractive Business, in which case the expenditure will be apportioned in the latter proportion.

c) The Person shall calculate the Taxable Income for its other business independently for each Tax Period in accordance with the provisions of this Decree-Law.

Transactions between the Extractive Business and the other business of the same Person shall be considered Related Party transactions subject to the provisions of Article 34 of this Decree-Law, unless such other business is exempt from Corporate Tax under Article 8 of this Decree-Law.

A Person shall be considered effectively subject to tax under the applicable legislation of the Emirate for the purposes of this Article if the Local Government imposes a tax on income or profits, a royalty or revenue tax, or any other form of tax, charge, or levy in respect of such Person's Extractive Business.

The exemption under this Article shall not apply to contractors, subcontractors, suppliers or any other Person used or contemplated to be used in any part of the performance of the Extractive Business that does not in its own right meet the conditions to be exempt from Corporate Tax under this Article or Article 8 of this Decree-Law.

> The definition of Extractive Business as provide by the UAE Federal Decree-Law "*The Business or Business Activity of exploring, extracting, removing, or otherwise producing and exploiting the Natural Resources of the State or any interest therein as determined by the Minister.*"

As seen from the above, Extractive Businesses is referred to a business that is concerned with the extraction of unprocessed raw materials from Earth. It requires sophisticated machinery and complex processes for extracting, refining, and filtering natural resources.

5. Non-Extractive Natural Resource Business

According to Article 8 of the Decree Law a person shall be exempt from Corporate Tax and the provisions of this Decree Law shall not apply to its Non-Extractive Natural Resource Business where all of the following conditions are met:

a) The Person directly or indirectly holds or has an interest in a right, concession or Licence issued by a Local Government to undertake its Non-Extractive Natural Resource Business in the State.

b) The person's income from its non-extractive natural resource business is derived solely from persons that undertake a business or business activity.

c) The Person is effectively subject to tax under the applicable legislation of an Emirate in accordance with the provisions of Clause 6 of this Article.

d) The Person has made a notification to the Ministry in the form and manner agreed with the Local Government.

If a Person that meets the conditions of Clause 1 of this Article derives income from both a Non-Extractive Natural Resource Business and any other business that is within the scope of this Decree-Law, the following shall apply:

a) The income derived from the Extractive Business shall be calculated and taxed according to the applicable legislation of the Emirate.

b) The income derived from the other business shall be subject to the provisions of this Decree-Law, unless that other business meets the conditions to be exempt from Corporate Tax under Article 7 of this Decree-Law as Extractive Business.

For the purposes of Clause 2 of this Article, a Person shall not be considered to derive income from any other business where such other business is ancillary or incidental to that Person's Non-Extractive Natural Resource Business and the Revenue of such other Business in a Tax Period does not exceed 5% (five percent) of the total Revenue of that Person in the same Tax Period.

For the purposes of calculating the Taxable Income of the Person's other Business, the following shall apply:

a) The other Business shall be treated as an independent business, and financial statements shall be kept for this Business separately from the Non-Extractive Natural Resource Business.

b) Any common expenditure shared between the Non-Extractive Natural Resource Business and the other Business of the Person shall be apportioned in proportion to their Revenue in the Tax Period, unless such expenditure is taken into account in different proportions for the purposes of calculating the tax payable by the Person under the applicable legislation of the relevant Emirate in respect of its Non-Extractive Natural Resource Business, in which case the expenditure will be apportioned in the latter proportion.

c) The Person shall calculate the Taxable Income for its other business independently for each Tax Period in accordance with the provisions of this Decree-Law.

Transactions between the Non-Extractive Natural Resource Business and the other business of the same Person shall be considered Related Party transactions subject to the provisions of Article 34 of this Decree-Law, unless such other business is exempt from Corporate Tax under Article 7 of this Decree-Law.

A Person shall be considered effectively subject to tax under the applicable legislation of the Emirate for the purposes of this Article if the Local Government imposes a tax on income or profits, a royalty or revenue tax, or any other form of tax, charge or levy in respect of such Person's Non-Extractive Natural Resource Business.

The exemption under this Article shall not apply to contractors, subcontractors, suppliers or any other Person used or contemplated to be used in any part of the performance of the Non-Extractive Natural Resource Business that does not in its own right meet the conditions to be exempt from Corporate Tax under this Article or Article 7 of this Decree-Law.

Oil, Natural Gas, Water, Minerals, Salt, Deposits of Sand and rocks are the primary natural resources in the UAE. The extraction and exploitation of these natural resources makes up a significant part of the UAE Economy.

The Natural Resources are owned by the respective Emirate where they are found and hence the income from the extraction and exploitation of the natural resources is directly earned by the respective Emirate, viz., Abu Dhabi or Dubai or Sharjah or Fujairah, or Ajman or Umm Al Quwain or Ras Al Khaimah.

The income or royalties and other fiscal levies raised by the Government from the extraction or production of natural resources by private sector companies will be outside the scope of UAE Corporate Tax.

The extraction and exploitation of natural resources is often done by companies that are wholly or partially privately owned under long-term concession agreement entered into with the respective Emirate Government to which the natural resources belong. These concession agreements generally provide that the profits earned by such companies are subject to Emirate Level Taxation. This tax is levied and collected by the respective Emirate which owns the Natural Resources.

The private companies which are holding the concession agreements and paying emirate-level taxation for the extraction and exploitation of natural resources are exempt from the UAE Corporate Tax. Acknowledging the long-term nature of natural resource concession agreements and often significant capital commitments made by the concession holders, the UAE Corporate Tax regime intends to exempt the income earned by companies engaged in the extraction and exploitation of natural resources that are already subject to emirate-level taxation. This exemption is available only to concession holder and is not available for suppliers, contractors or subcontractors used by the concession holder.

The spirit behind this provision is to ensure that there is no double taxation on the same activity. Since the concession holders who are extracting and exploiting the natural resources are already paying tax to the respective emirate in which they are located, there is exemption granted under the UAE Corporate Tax to avoid the taxing of the same activity twice or two different legislations.

6. Qualifying Public Benefit Entity

According to Article 9 of the Decree Law a Qualifying Public Benefit Entity shall be exempt from Corporate Tax where all of the following conditions are met:

a) It is established and operated for any of the following:

   i. Exclusively for religious, charitable, scientific, artistic, cultural, athletic, educational, healthcare, environmental, humanitarian, animal protection or other similar purposes.

   ii. As a professional entity, chamber of commerce, or a similar entity operated exclusively for the promotion of social welfare or public benefit.

b) It does not conduct a Business or Business Activity, except for such activities that directly relate to or are aimed at fulfilling the purpose for which the entity was established.

c) Its income or assets are used exclusively in the furtherance of the purpose for which it was established, or for the payment of any associated necessary and reasonable expenditure incurred.

d) No part of its income or assets is payable to, or otherwise available, for the personal benefit of any shareholder, member, trustee, founder or settlor that is not itself a Qualifying Public Benefit Entity, Government Entity or Government Controlled Entity.

e) Any other conditions as may be prescribed in a decision issued by the Cabinet at the suggestion of the Minister.

The exemption under Clause 1 of this Article shall be effective from the beginning of the Tax Period in which the Qualifying Public Benefit Entity is listed in the Cabinet decision issued at the suggestion of the Minister or any other date determined by the Minister.

For the purposes of monitoring the continued compliance by a Qualifying Public Benefit Entity with the conditions of Clause 1 of this Article, the Authority may request any relevant information or records from the Qualifying Public Benefit Entity within the timeline specified by the Authority.

The Charities and other Public Benefit Organisations that are listed in a cabinet decision are mainly existing for a noble cause which could relate to promotion of religion, culture, education, public welfare, etc. The motive behind such charities and Public Benefit Organisations is not commercial in nature and hence they are exempt from the UAE Corporate Tax.

There are many philanthropic and public benefit organisations which are part of the corporate social responsibility, volunteering activity and community service in the UAE. These organisations play an important role by taking responsibility along with the Government for the promotion of social welfare, public benefit, etc.

The organisations which are carrying out social, cultural, religious, charitable or other public benefit activities can apply to the Ministry of Finance to be exempted from the UAE Corporate Tax. If the application is approved the organisation will be listed in the Cabinet Decision to be issued at the request of the Ministry of Finance. The approval is solely at the discretion of the Ministry of Finance. These approved charities and public benefit organisations will need to comply with periodic information reporting obligations throughout their existence.

The Public and regulated private social security and retirement pension funds are created to support the Nationals of UAE. This is a fund mainly created during the active lifespan of the citizens of UAE which can be used to support the individuals and their families when needed particularly during their old age and post retirement phase of life. The Social Security Fund or the Pension Fund does not engage in any commercial activity and is existing only to protect the interests of the beneficiaries of the fund who are primarily the Nationals of UAE and their families. In view of this objective behind the funds it is prudent not to bring them under the scope of Corporate Tax and hence they are exempt from the application of the UAE Corporate Tax subject to the condition that they are under regulatory oversight of the competent authority in the State.

7. Qualifying Investment Fund

According to Article 10 an investment fund may apply to the Authority to be exempt from Corporate Tax as a Qualifying Investment Fund where all of the following conditions are met:

a) The investment fund or the investment fund's manager is subject to the regulatory oversight of a competent authority in the State, or a foreign competent authority recognised for the purposes of this Article.

b) Interests in the investment fund are traded on a Recognised Stock Exchange or are marketed and made available sufficiently widely to investors.

c) The main or principal purpose of the investment fund is not to avoid Corporate Tax.

d) Any other conditions as may be prescribed in a decision issued by Cabinet at the suggestion of the Minister.

For the purpose of monitoring the continued compliance by a Qualifying Investment Fund with the conditions of Clause 1 of this Article, the Authority may request any relevant information or records within the timeline prescribed by the Authority.

The UAE has continued to achieve success and strengthen its position as a leading asset and wealth management hub, and the destination of choice in the region for the financial services sector. The sector is an important pillar of the UAE economy.

An investment fund is an entity whose principal activity is the issuing of investment interests to raise funds or pool investor funds or establish a joint investor fund with the aim of enabling the holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments, in accordance with the applicable legislation.

The UAE offers comprehensive investment fund regimes and fund vehicles that cater to a wide variety of fund manager and investor requirements. The introduction of CT presents an opportunity to further increase confidence from international investors and bolster the UAE's position as the location of choice for investment funds, investment fund managers, and entities used by investment funds to hold their assets or invest their funds.

Investment funds are commonly organized as limited partnerships (as opposed to corporate entities) to ensure tax neutrality for their investors. This tax neutrality follows from the fact that most countries treat limited partnerships as transparent ('flow through') for domestic and international tax purposes, which puts investors in the fund in a similar tax position as if they had invested directly in the underlying assets of the fund, the UAE CT regime intends to treat UAE and foreign investment funds that are structured as unincorporated partnerships as fiscally transparent.

Investment funds that are structured as corporate entities, including Real Estate Investment Trusts, or partnership funds that apply to be treated as a "Taxable Person" for UAE CT purposes in their own right, can apply to the Federal Tax Authority to be exempt from UAE CT subject to meeting certain requirements. For the investment fund exemption, either the investment fund or the manager of the fund is required to be subject to regulatory oversight, not both. If the investment fund manager is a UAE resident, or if it operates in the UAE through a permanent establishment, the investment fund manager will be subject to UAE CT on the income it earns. Wholly-owned UAE investment holding companies and other Special Purposes Vehicles used by an investment fund to deploy capital and hold investments can apply to the Federal Tax Authority to benefit from the UAE CT exemption granted to the investment fund.

8. Taxation of Oil and Gas companies – Concession agreements

The production and exploitation of oil, natural gas, water, and other natural resources make up an important part of the UAE's economy. Companies engaged in the Natural Resource Business under concession agreements, are subject to income tax per the respective Emirate Tax Decree as listed below:

- Abu Dhabi Income Tax Decree of 1965 (as amended by Decree 4 of 1972)
- Dubai Income Tax Decree of 1969
- Sharjah Income Tax Decree of 1968
- Ras Al Khaimah Income Tax Decree of 1969
- Fujairah Income Tax Decree of 1966
- Ajman Income Tax Decree of 1968
- Umm Al Quwain Income Tax Decree of 1968

Each of the seven individual Emirates that constitute the UAE are responsible for the regulation of Natural Resources sector within their own territory. In most of Emirates, taxable income is subject to progressive rates of up to 55% under the relevant Income Tax Decree. However, Foreign concession holders who are engaged in the extraction of Oil and Gas are typically taxed at different tax rates and provisions agreed with the relevant authority under specific government agreements/fiscal letters in practice.

9. Present provisions for taxation of branches of foreign banks

UAE is a federation of seven Emirates comprised of Abu Dhabi, Ajman, Dubai, Fujairah, Ras Al Khaimah, Sharjah and Umm Al Quwain. No income tax is currently imposed at the federal level but most Emirates have issued income tax laws as follows:

- Income Tax Decrees providing for corporate income tax on business activities carried out in the respective Emirate;
- Special banking tax legislation subjecting foreign banks to corporate income tax.

Accordingly, branches of foreign/ international banks are subject to income tax in the Emirate where they are established and operate. The number of international banks subject to tax in the UAE as of today is around 30.

Mechanism of taxation under the banking tax regulations

Special banking tax regulations (“Regulations”) have been issued by certain Emirates including Dubai and Abu Dhabi. The Regulations are broadly similar and share the following key characteristics:

- The taxable income of foreign banks is typically subject to tax at 20%;
- The taxable profit is determined based on the audited branch accounts and subject to the adjustments as prescribed by the Regulations;
- The Regulations contain a number of provisions dealing with the allocation/attribution of revenue as well as expenses3 to the branch and expense deductibility rules4;
- The Regulations further contain specific guidance regarding accruals/provisions, depreciation of bankable assets and the carry forward of tax losses;
- The Regulations provide for procedural/administrative rules (e.g. filing deadline, late payment interest and penalties in case of non-compliance, payment of income tax and the appeal process).

All foreign banks operating in the UAE are required to prepare a tax computation in line with the Regulations.

10. Private or family trust holding

Family Foundations and trusts are typically established for philanthropic purposes and to protect and manage the assets of individuals or families for future generations. Business and business activities are not the primary focus of these entities, but they do the business and related activities if directly related to or are aimed at fulfilling the purpose for which the foundation and trust were established.

The family foundations and trusts perform various activities like receiving, holding, investing, disbursing, or otherwise managing funds and assets associated with savings or investments for the interest of the individual beneficiaries or to achieve a charitable purpose.

There is a difference between the family foundation and trust, but both aim to achieve the same non-profit objectives. In the family foundation, assets are transferred to the foundation and managed by the board, while in the trust, assets are transferred to the nominal owner (trustee), and the trustee ensures that the assets have been passed on to the beneficiaries according to the trust creator's wishes. Since both have the same purpose of establishment, so in corporate tax law (the law) issued by the government of the UAE, the foundation, trust and any other similar entity that meets the related criteria have been defined as a “family foundation.”

As defined in the law, the family foundation means “Any foundation, trust or similar entity that meets the conditions of Article 17 of this Decree-Law”.

Article 17 of the Decree Law requires that the foundation, trust and similar entity were established for the benefit of natural persons, or the benefit of a public benefit entity, or both. In addition, their principal activity is to receive, hold, invest, disburse, or otherwise manage assets or funds associated with savings or investment. Moreover, these entities are not conducting any business or business activity, and none of them was established to avoid corporate tax. Furthermore, they meet any other condition imposed by the Minister of Finance (MoF).

In light of the definition and requirements of Article 17 of the Decree Law, we can establish that any foundation, trust or similar entity that meets the given criteria should be named a “family foundation”, and such foundations, trusts, and similar entities (hereinafter referred as “family foundation”) will have the same corporate tax treatment under the name of the family foundation.

Generally, family foundations that are incorporated, established and registered in the UAE have a separate legal personality from their family member / trust creators and meet the definition of a juridical person as defined in the UAE CT law except for a few trusts (like trusts established in Dubai International Financial Centre (DIFC) or Abu Dhabi Global Market (ADGM) that have only contractual relationship between the persons and such trusts do not have legal personalities. Where the trusts have been created only through the contractual relationship, it will be treated as transparent for UAE CT purposes, and the income of such trusts will be taxable in the hands of the relevant parties.

By default, the family foundations incorporated in the UAE would have been subject to the CT being a juridical person established in the UAE, and their worldwide income would have been subject to CT, but keeping in view their non-profit nature of the activity, special provisions have been included in the law.

Under Article 17 of the Decree Law, as a special case, the family foundation has been given the option to be treated as an unincorporated partnership if the family foundation meets the criteria mentioned above and given in article 17 of the law. To avail of the option to be treated as an unincorporated partnership, the family foundation can apply to the Federal Tax Authority (FTA).

After the approval of the FTA, it will be treated as an unincorporated partnership from the commencement of the tax period in which the application is made, or from the commencement of a future tax period, or any other date determined by the FTA. Once the family foundation gets the status of an unincorporated partnership, all related provisions of the law that apply to the unincorporated partnership will also apply to the family foundation.

In the law, one point needs attention and it pertains to the family foundation. The criteria that have been applied to define the foundation, trust or similar entity as a family foundation; the same yardstick has been utilised for the family foundation to opt as an unincorporated partnership. It raises one question; is the family foundation itself an unincorporated partnership? We need more clarity on this. In the future, any clarification provided by FTA will be helpful to avoid this confusion and give us a thorough understanding of the concept.

In a nutshell, foundations, trusts and similar companies incorporated and established in the UAE for charitable purposes and to protect and manage assets of individuals and families, if not opted or opted for unincorporated partnerships but not approved by the FTA, should comply with the law.

Chapter 6

Residential Status and Its Relevance

This chapter covers the following:

- **Worldwide Taxation Vs Territorial Taxation**
- **UAE- Worldwide Taxation Approach on Taxation of Legal Persons**
- **New Tax Residency Rules under the Domestic Laws of UAE**
- **Meaning of UAE Sourced Income**
- **Article-4 Resident**

Introduction

Globalisation in the current environment has resulted into widening of business base outside the domestic territory. This has led to an increase in cross-border transactions wherein tax forms a considerable part of the overall cost of doing business today. A country's appetite for tax being insatiable, both the countries between which a cross-border transaction takes place want to levy tax on income from that transaction on nexus basis, leading to double taxation.

As already reiterated in the earlier chapters also, this creates a need for an international tax law that deals with such double taxation conflicts. Double taxation may arise;

- when the same income is taxed in two countries in the hands of a single taxpayer (jurisdictional double taxation) or
- taxation of the same income in the hands of two different taxpayers (economic double taxation).

The DTAA would, normally, decide on the distribution of the income between the two countries. Generally, in treaties focus is more on relieving juridical double taxation.

1. Worldwide Taxation Vs Territorial Taxation

1.1. Background

The League of Nations undertook the study on the issue of global double taxation. It concluded that, in practice, the maximum weightage should be given to "the origin of the wealth [i.e., source] and the residence or domicile of the owner who consumes the wealth [i.e., residence]". Henceforth, the League of Nations advocated that tax jurisdiction should generally be allocated between the state of source and the state of residence depending on the nature of the income in question. This was one of the earliest principles of international taxation and continues to be valid till date.

Residence is almost invariably a crucial concept in the international tax rules. Henceforth, the foremost step is the determination of residential status of an entity to resolve tax conflicts so as to promote fairness by imposing equal tax burdens on domestic and foreign tax payers with equal income and ability to pay, regardless of the source of income.

Taxation systems vary quite significantly across the globe with no real signs of harmonization. A comparison of tax systems around the world reveals some very interesting similarities and differences between countries and groups of countries. Today, countries use four different types of taxation

(i) Citizenship-based

(ii) Residential (Worldwide)

(iii) Territorial, and

(iv) Zero tax.

The concept of 'worldwide taxation' and 'Territorial Taxation' are two fundamental concepts in the domain of International Taxation which comes into play keeping in mind the Residency Factor. While conflict between these two concepts of taxation is a problem area in the international arena, it is interesting to see how these two terms delve upon. Countries generally use one of two methods to reduce or eliminate double international taxation of income earned abroad by multinational companies - the "worldwide" and the "territorial" method.

Territorial and worldwide systems would be the same if all countries had the same tax rates. Then, credits under a worldwide system would exactly offset otherwise-payable taxes on foreign-source income. But the systems are different if countries have different corporate tax rates. Territorial systems encourage a country's resident multinational corporations to shift real investment and reported profits to low-tax foreign countries.

1.2. Worldwide Taxation

Worldwide taxation is a system under which corporations deemed "resident" in a country are taxable by that country on their income from all over the world, regardless of where the income is derived.

The overarching purpose of the worldwide design is to "create equality among resident taxpayers," so as not to distort the investment decisions of domestically headquartered companies toward low-tax countries.

Under the worldwide method, income earned abroad by foreign subsidiaries is subject to tax by the home country with a credit for income taxes paid to foreign governments. This method taxes all domestic-source as well as the foreign-source income of resident corporations.

1.3. Foreign Tax Credit on Worldwide Income

To avoid double taxation of the same income base, worldwide systems provide credits for taxes paid to foreign governments.

- To prevent double taxation, countries with worldwide systems allow their resident corporations to claim tax credits to offset their foreign income taxes.
- The host countries can set their rates as high as the home country rate without raising the investor's final tax rate (ignoring the effects of deferral), but they can even set their rates higher than the home country rate to the extent that the higher foreign tax credits that those rates generate can be used to lower taxes on other foreign income. Therefore, host countries are likely to feel increased pressure to lower their CIT and withholding tax rates in order to attract foreign capital.
- The same can be illustrated by way of example as how excess Foreign Taxes can be claimed in the home country against Foreign Income from other than Host country income–

1.4. How does Credits work in Worldwide taxation

	A		**B**		**C**
Particulars	**Taxes under home country-UAE**		**Taxes in host country**		**Foreign income other than the host country**
	Option 1	**Option 2**	**Taxes @5%**	**Taxes @20%**	
Rate of taxes	9%		5%	20%	25%
Income in the Home country	200		100		50
Income in the Host Country	100		100		
Foreign Income other than income from Host Country	50		0		50
Total Income	350		100		50
Total Taxes(D)	31.5		5	0	12.5
Average rate of Tax (ART) (Total taxes/Total taxable Income)	9				
Taxes on Host countries on basis of ART (B*5%/10%)	5	20			

	A		B		C	
Taxes on Income other than the host countries on basis of ART (C*25%)	12.5	12.5				
Taxes on Total Foreign Income(FTC)(E)	**17.5**	**32.5**				
Balance Tax Payable (D)-(E)	14	-1				

1.5. Analysis of Options

Option 1 @5%	When the rate of taxes is 5% in Host country, we have to pay excess taxes in the Home Country
Option 2 @20%	When the rate of taxes is 20% in Host country the Set-off of taxes can be done to arrive at NIL taxes

Further arguments in favour of Option 2

a) Taxes already paid excess in the host country set off from foreign income of another country. Hence, taxes paid shall be NIL.

b) Taxes in such a case by host country are higher than the home country which needs to be reduced to attract foreign capital as reiterated above.

c) Without the shelter provided by a worldwide system with fungible foreign tax credits, high tax countries risk losing foreign investment if they do not cut their tax rates when major investor countries may go territorial.

- Most countries limit the credit for foreign income taxes to home country tax on foreign income, determined using a per-item, per-country, or overall approach.
- They also typically allow their resident companies to defer tax on active profits earned by foreign affiliates (controlled foreign corporations, or CFCs) until those profits are repatriated to the parent company. This feature of tax systems—known as deferral—substantially reduces effective tax rates on foreign-source income in countries with worldwide systems, making them not that different from territorial systems.
- Worldwide systems (with deferral) reduce this incentive because resident corporations pay the domestic tax rate when they repatriate profits earned in low-tax countries.

1.6. Disadvantages of Worldwide Taxation

- Worldwide systems place resident corporations at a disadvantage compared with companies based in countries with territorial systems that impose no domestic tax on the profits of their resident companies earn in low-tax foreign countries.

- To mitigate Worldwide taxes, residents tend to change/shift their residential status to other jurisdictions resulting in narrowing of a tax base of a country.

1.7. Territorial Taxation

It's a principle which flows in a country and is considered as taxable income arising within its jurisdiction regardless of the residence of the taxpayer, i.e. residents and non-residents are taxed on income derived from within the country.

Under the territorial method, also referred to as a "**participation exemption**" system, active business income earned abroad by foreign subsidiaries is wholly or partially exempt from home country tax with no credit for foreign taxes. The territorial tax system taxes only the portion of a corporation's income originating within the country's borders.

Countries with territorial tax systems impose corporate income tax on all profits arising from activities within their borders (domestic-source income), but do not tax profits arise from activities in other countries (foreign-source income). Thus, it imposes tax on active business income earned by corporations outside their countries of residence only in the source ("host") country.

It's a taxation system under which income (including income from interest and royalties) from sources outside a State is exempt from tax solely by reason of its source being outside that State (so-called "territorial" systems)[1].

1.8. Broad Principles of a Participation Exemption System

- Under the territorial method, also referred to as a "participation exemption" system, active business income earned abroad by foreign subsidiaries is wholly or partially exempt from home country tax with no credit for foreign taxes.
- This prevents double taxation of cross-border flows because resident corporations' foreign-source income is exempt from tax.
- The exemption refers to substantially all foreign source income earned by a resident company in a taxation system under which income (including income from interest and royalties) from sources outside a State is exempt from tax solely by reason of its source being outside that State (so-called "territorial" systems).

The reference does not include taxation systems under which only foreign source dividends or business profits from foreign permanent establishments/subsidiaries are exempt from tax by the residence State (so-called "**dividend exemption**" systems).

- The territorial design thus equalizes the tax costs between international competitors

[1] UN Model 2021

operating in the same jurisdiction, so that all entities may compete on a level playing field, and capital may flow to where it can achieve the best after-tax return on investment

- In such a world, a residence country may relinquishes its right, under the foundational premise, to assert taxation on residual income from economic activities that have no nexus to its jurisdiction other than stock ownership.

1.9. Differences between Territorial and Worldwide Taxation

	Territorial taxation	Worldwide taxation
Source vs Residence base	It is based on source based taxation	It is based on residence based taxation.
Impact of Corporate Investment Tax Rate (CIT)	Territoriality is likely to render corporations more sensitive to host country taxes and to divert investment from high-tax to low-tax jurisdictions.	Worldwide regimes effectively enable host countries to set higher CIT rates than territorial regimes.
Impact of non-Repatriation and Deferral Tax	So long as earnings are not technically repatriated, the investors face only host country taxation, so a worldwide system with deferral can fairly mimic a territorial regime.	The widespread exploitation of deferral under worldwide tax regimes would mute the income and distributional effects of a shift to territoriality.
Approach	Under the **territorial** approach, a country collects tax only on income earned within its borders.	Under the **worldwide** approach, all income of domestically headquartered companies is subject to tax, including income earned abroad.
Repatriation of Earnings	Under a territorial system, qualifying foreign subsidiary earnings can be repatriated with little or no tax;	Under a worldwide system, repatriated income generally is subject to additional tax if the foreign rate of tax is below the home country rate (as cited in the above Illustration)
Countries	All G-7 countries other than the United States have now adopted territorial taxation (or a partial version thereof)	Eight OECD nations have worldwide systems, including the U.S., Greece, Ireland, South Korea, and Mexico.

	Territorial taxation	Worldwide taxation
	for active business income. Among OECD nations, 26 have territorial systems including Australia, Canada, France, Germany, Japan, Spain, and the United Kingdom.	
Potential Effects	Government revenue in the host country will be limited to the source base taxation and the "competitiveness" of the home country in the globalized market will be better off .	Government Revenue, by and large maximises though Home country as the worldwide income is taxed, though it may not be a investor free market.

1.10.Impact of Pure territorial taxation

- It creates tax avoidance through the moving of income offshore.
- Territorial taxation most frequently impacts non-citizens who work or invest in territorial tax countries. If one owns an apartment in Malaysia and rent it, for example, one would need to pay tax on that income, and if salary income is earned there, tax would have to be paid on that as well.
- Once the incomes are limited on the basis of pure territorial principle then problems of characterization of income may arise along with incentives to convert income from one form to another.
- The beauty of territorial tax countries is that one can live in the country for substantial periods of time and not pay any tax – provided one don't work much during their visit, this makes such countries an attractive option for Nomad Capitalists looking for a second residence to avoid triggering residency requirements in other countries

2. UAE-Worldwide Taxation approach on Taxation of Legal persons-

2.1.[2]Background-

The Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses

[2] https://tax.gov.ae/en/taxes/corporate.tax/corporate.tax.topics/what.is.corporate.tax.aspx

(hereinafter referred to as the "Corporate Tax Law") was issued by the United Arab Emirates ("UAE"), on 09 December 2022.

The Corporate Tax Law provides the legislative basis for the introduction and implementation of a Federal Corporate Tax ("Corporate Tax") in the UAE and is effective for financial years starting on or after 1 June 2023.

The introduction of Corporate Tax is intended to help the UAE achieve its strategic objectives and accelerate its development and transformation. The certainty of a competitive Corporate Tax regime that adheres to international standards, together with the UAE's extensive network of double tax treaties, will cement the UAE's position as a leading jurisdiction for business and investment.

Given the position of the UAE as an international business hub and global financial centre, the UAE Corporate Tax regime builds from best practices globally and incorporates principles that are internationally known and accepted. This ensures that the UAE Corporate Tax regime will be readily understood and is clear in its implications.

UAE follows worldwide taxation approach on the entities incorporated/registered under the laws of UAE.

2.2. Definitions at a glance under Article 1 of Federal Decree Law No. 47 (with Limited Reference to Residence)

a) **Business:** Any activity conducted regularly, on an ongoing and independent basis by any Person and in any location, such as industrial, commercial, agricultural, vocational, professional, service or excavation activities or any other activity related to the use of tangible or intangible properties.

b) **Corporate Tax -**The tax imposed by this Decree-Law on juridical persons and Business income

c) **Connected Person -**Any Person affiliated with a Taxable Person as determined in Clause 2 of Article 36 of this Decree-Law.

d) **Exempt Person** -A Person exempt from Corporate Tax under Article 4 of this Decree-Law

e) **Foreign Partnership -**A relationship established by contract between two Persons or more, such as a partnership or trust or any other similar association of Persons, in accordance with laws of a foreign jurisdiction.

f) **Family Foundation** -Any foundation, trust or similar entity that meets the conditions of Article 17 of this Decree-Law.

g) **Free Zone -**A designated and defined geographic area within the State that is specified in a decision issued by the Cabinet at the suggestion of the Minister.

h) **Free Zone Person** -A juridical person incorporated, established, or otherwise registered in a Free Zone, including a branch of a Non-Resident Person registered in a Free Zone.

i) **Government Entity** -The Federal Government, Local Governments, ministries, government departments, government agencies, authorities and public institutions of the Federal Government or Local Governments.

j) **Government Controlled Entity** -Any juridical person, directly or indirectly wholly owned and controlled by a Government Entity, as specified in a decision issued by the Cabinet at the suggestion of the Minister.

k) **Non-Resident Person -**The Taxable Person specified in Clause 4 of Article 11 of this Decree-Law.

l) **Person** -Any natural person or juridical person

m) **Qualifying Income** -Any income derived by a Qualifying Free Zone Person that is subject to Corporate Tax at the rate specified in paragraph (a) of Clause 2 of Article 3 of this Decree-Law.

n) **Qualifying Free Zone Person** -A Free Zone Person that meets the conditions of Article 18 of this Decree-Law and is subject to Corporate Tax under Clause 2 of Article 3 of this Decree-Law.

o) **Related Party -**Any Person associated with a Taxable Person as determined in Clause 1 of Article 35 of this Decree-Law.

p) **Resident Person** -The Taxable Person specified in Clause 3 of Article 11 of this Decree-Law

q) **Tax Group-** Two or more Taxable Persons treated as a single Taxable Person according to the conditions of Article 40 of this Decree-Law

r) **Taxable Person** -A Person subject to Corporate Tax in the State under this Decree-Law.

s) **State Sourced Income -**Income accruing in, or derived from, the State as specified in Article 13 of this Decree-Law.

t) **Unincorporated Partnership-**A relationship established by contract between two Persons or more, such as a partnership or trust or any other similar association of Persons, in accordance with the applicable legislation of the State.

u) **Withholding Tax** - Corporate Tax to be withheld from State Sourced Income in accordance with Article 45 of this Decree-Law.

v) **Withholding Tax Credit** – The Corporate Tax amount that can be deducted from the Corporate Tax due in accordance with the conditions of Clause 2 of Article 46 of this Decree-Law.

2.3. UAE taxability at a Glimpse under Article 11 of Decree-Law

Chapter Four – Taxable Person and Corporate Tax Base Article 11 – Taxable Person

Article 11 details the definition of a resident person and a non-resident person for the purpose of levy of corporate taxes. The article contains an exhaustive list of persons who would be considered as Resident Person. Also, any person who is not considered as a Resident Person under clause 3 of this Article and subject to fulfilment of certain conditions mentioned under this Article shall be considered as a Non-Resident Person.

It also confirms that a UAE branch of a UAE taxable person should be treated as "ONE" taxable person (i.e., once single tax registration and return).

Furthermore, it has been kept open for the Cabinet to specify the categories of Business or Business Activity conducted by a resident or a non-resident natural person that shall be subject to Corporate Tax.

Abstract of Article 11 of the Decree Law:

'Clause (3)

3. A Resident Person is any of the following Persons:

a. A juridical person that is incorporated or otherwise established or recognised under the applicable legislation of the State, including a Free Zone Person.

b. A juridical person that is incorporated or otherwise established or recognised under the applicable legislation of a foreign jurisdiction that is effectively managed and controlled in the State.

c. A natural person who conducts a Business or Business Activity in the State.

d. Any other Person as may be determined in a decision issued by the Cabinet at the suggestion of the Minister.

Clause (4)

4. A Non-Resident Person is a Person who is not considered a Resident Person under Clause 3 of this Article and that either:

a. Has a Permanent Establishment in the State as under Article 14 of this Decree-Law.

b. Derives State Sourced Income as under Article 13 of this Decree-Law.

c. Has a nexus in the State as specified in a decision issued by the Cabinet at the suggestion of the Minister.

Clause (5)

5. A branch in the State of a Person referred to in Clause 3 of this Article, shall be treated as one and the same Taxable Person.

Following table broadly define as how UAE will tax its persons-

Category of Persons	Sub-Category	Probable Sub-categories	Incorporated/ Unincorporated
Taxable Persons *	Sub-Category1- Resident – a. A juridical person that is incorporated or otherwise established or recognised under the applicable legislation of the State, including a Free Zone Person. b. A juridical person that is incorporated or otherwise established or recognised under the applicable legislation of a foreign jurisdiction that is effectively managed and controlled in the State. c. A natural person who conducts a Business or Business Activity in the State. d. Any other Person as may	Limited Liability Companies, Private Shareholding Companies, Public Joint Stock Companies, and other entities	Incorporated–Established under the laws of the UAE that have separate legal personality
		Limited liability partnerships, partnerships limited by shares and other types of partnerships where none of the partners have unlimited liability for the partnership's obligations or other partners' actions	Incorporated in UAE
		Natural Person includes- • An individual person • Sole establishments or proprietorships ➢ Individual partners in an unincorporated partnership that conducts business in the UAE ➢ Unincorporated partnerships and joint ventures/ associations of persons will be treated as 'transparent' and	Incorporated/Unincorporated

Category of Persons	Sub-Category	Probable Sub-categories	Incorporated/ Unincorporated
	be determined in a decision issued by the Cabinet at the suggestion of the Minister.	shall not be considered a Taxable Person in its own right. Persons conducting a Business as an Unincorporated Partnership shall be treated as individual Taxable Persons • A Family Foundation can make an application to the Authority to be treated as an Unincorporated Partnership for the purposes of this Decree-Law subject to certain conditions.	
		• Free Zone Person ➢ Qualifying Free Zone Person ➢ Person other than Qualifying Free Zone	
	Sub-Category-2 Non-Resident – a. Has a Permanent Establishment in	• Foreign legal entities that have a permanent establishment in the UAE or that earn UAE sourced income.	Incorporated – Established under the laws of the UAE

Category of Persons	Sub-Category	Probable Sub-categories	Incorporated/ Unincorporated
	the State as under Article 14 of this Decree-Law. b. Derives State Sourced Income as under Article 13 of this Decree-Law. c. Has a nexus in the State as specified in a decision issued by the Cabinet at the suggestion of the Minister	• Income derived from a Resident Person. • Where income is otherwise accrued in or derived from activities performed, assets located, capital invested, rights used, or services performed or benefitted from in the State.	
		Legal persons incorporated in a foreign jurisdiction that are effectively managed and controlled in the UAE will be treated as if they were UAE incorporated entities.	Incorporated in a foreign jurisdiction but POEM in UAE
		• Foreign Partnership shall be treated as an Unincorporated Partnership for the purposes of this Decree-Law subject to certain conditions.	Unincorporated
		• Foreign Branches and qualifying foreign shareholdings.	Incorporated under Foreign Corporations having offices in UAE
		• Non-Resident Person Operating	

Category of Persons	Sub-Category	Probable Sub-categories	Incorporated/ Unincorporated
		Aircraft or Ships in International Transportation	
		• Certain categories to be specified of Business or Business Activity conducted by a resident or non-resident natural person that are subject to Corporate Tax under this Decree-Law by the Cabinet Decision.	
#Exempt Persons as categorised under Chapter 3 (Article 4- FDL No. 47)		a) Government Entity. b) A Government Controlled Entity. c) Person engaged in an Extractive Business subject to conditions as prescribed under Article 7 of this Decree-Law. d) Person engaged in a Non-Extractive Natural Resource Business, subject to conditions as prescribed under Article 8 of this Decree-Law. e) Qualifying Public Benefit Entity under Article 9 of this	

Category of Persons	Sub-Category	Probable Sub-categories	Incorporated/ Unincorporated
		Decree-Law. f) Qualifying Investment Fund under Article 10 of this Decree-Law. g) Public pension or social security fund, or a private pension or social security fund subject to regulatory oversight. A juridical person incorporated in the State that is wholly owned and controlled by an Exempt Person specified in paragraphs (a), (b), (f) and (g) as above h) Any other Person as may be determined in a decision issued by the Cabinet at the suggestion of the Minister.	

*Taxation of Natural Persons and State Sourced Income under Article 13 have been further deliberated separately below.

#Exempt persons under Article 4 of UAE Decree Law have been taken together with Article 4-Residence of OECD model.

Availment of Foreign Tax Credit- Where income earned from abroad is not exempt, income taxes paid in the foreign jurisdiction can be taken as a credit against the CT payable in the UAE on the relevant income to prevent double taxation.

* Permanent Establishment referred to in Article 14 are discussed in detail in chapter 3 of the Study Material .

3. New Tax Residency Rules under the Domestic Laws of UAE[3]

3.1. Background

The UAE has had no domestic legal definition of tax residency for legal or natural persons under its domestic law. However, in order to adapt with the international taxation regime and the dynamic global economy, the UAE drafted the legislation to stay in pace with the ever- evolving tax landscape of the country. This is in line with the UAE Decree Law which has enacted the meaning of Residents under Clause 4 of the document. The concept of tax residency was linked to the existence of international agreements (i.e. DTAA) that the UAE has concluded with treaty partner jurisdictions.

3.2. Territorial Taxation of Juridical and Natural Person -

The UAE Federal Tax Authority provides a new domestic definition and criteria for when an individual or a legal entity (Natural or Juridical Person) shall be considered a Tax Resident of the UAE for the purposes of UAE Domestic tax law. The effective date of the new rules is 1st March 2023.

Juridical Person	A juridical person (entity or establishment) shall be considered a Tax Resident in the UAE, if any of the following conditions are satisfied: a) It was established, incorporated or recognized as per UAE laws. However, it does not include a branch registered in UAE by a foreign juridical person. b) It is considered a Tax Resident in accordance with the Tax Law in force in the UAE.
Natural Person	A natural person (individual) shall be considered a Tax Resident in the UAE if any of the following conditions are satisfied: a) His primary principal place of residence and the centre of financial and personal interests are in UAE, or he meets the conditions and criteria as specified by the minister. b) The place where the natural person habitually or normally resides is the jurisdiction where he spends most of his time when compared to any other jurisdiction as part of his settled routine in a way that is more than transient and that should be taken into account in the determination of whether a natural person's usual or primary place of residence is in the State

[3] UAE Cabinet Decision No. 85 of for 2022 dated 2nd September, 2022 & Ministerial Decision No. 27 of 2023 – Issued 22 Feb 2023 (Effective 1 March 2023)

	c) The place of the natural person's occupation, familial and social relations, cultural or other activities, place of business, place from which the property of the natural person is administered and any other relevant facts and circumstances should be taken into account in the determination of whether a natural person's centre of financial and personal interests is in the State. d) He has been physically present in the UAE for 183 days or more in the relevant 12 consecutive months period; or e) • He has been physically present in the UAE for 90 days or more within the relevant 12 consecutive months period, and • He is a UAE National and holds a valid Residence Permit or holds the nationality of any member state of the Gulf Cooperation Council and • meets any of the following criterion - i. He has a Permanent Place of Residence in the State; or ii. He carries on employment or business in the State. f) Exceptional Circumtances i. Any day that the natural person's presence in the State was due to exceptional circumstances may be disregarded by the Authority in determining whether the (183) one hundred and eighty-three day or (90) ninety-day period has been met during the relevant consecutive (12) twelve-month period. ii. An exceptional circumstance is an event or situation beyond the natural person's control, occurring while he is already in the State, which he could not reasonably have predicted or prevented and which prevents him from leaving the State as originally planned.

3.3. Tax Residency Certificate-

The Person who is considered a Tax Resident in the State in accordance with the provisions of Articles 3(Juridical Person) or Article 4 (Natural Person) of this legislation, may apply to the Federal Tax Authority for the purpose of issuing a Tax Residency Certificate to that Person in in accordance with the form and manner specified by the Authority.

If the person applying for TRC has met all the conditions in accordance with the provisions of this new statue and if the Authority is satisfied, it may approve the application and issue the Tax Residency Certificate as per its discretion.

3.4. Interplay with International Agreements and UAE Domestic Law -

1. The UAE has clarified that if any International Agreement (mainly DTAA) sets out certain conditions for determining the tax residency, the provisions of DTAA shall continue to apply for determining the tax residency and they shall prevail over this legislation.

2. The Minister shall specify the form and manner of issuing Tax Residency certificates for the determination of tax domicile under the International Agreement.

3.5. Key Takeaways

The new legislature is an important landmark in UAE Tax history. The main essence of this new statue being that it defines the terms "Natural Person" and "Legal Person" and also widening the scope of the same vis-à-vis DTAA. This Legislation is one step forward towards identification of tax residency for corporate entities and natural persons residing in the UAE. It clearly establishes the residential status, thereby assistance in determination of Tax Liability and eases the implementation of the provisions of DTAAs thereupon.

4. Meaning of UAE Sourced Income

4.1. Background of Residence Rule

[4]There are two main categories of case that international tax rules may have to deal with.

- First, there is taxation of persons from outside a country who work, enter into transactions, or have property or income in the country.
- Second, there is taxation of persons who belong to a country and work, enter into transactions, or have property or income abroad.

The usual term used in international taxation to denote the concept of a person's belonging to a country is "residence" ("resident" and "non-resident" being used to indicate whether a particular person belongs to a country or not);

Resident based taxation instructs that, the country can tax persons if they are residents or domiciled in the country, regardless of the source of income. In the case of companies, the place of *incorporation* or registration of the entity or the place where its place of effective management is located is its place of residence

Tax residence under the tax decrees of the various Emirates is based upon the French concept of territoriality. Basically, the French territoriality concept taxes profits based on territorial nexus and does not tax profits earn outside the country.

[4] https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch18.pdf

4.2. [5]Foreign-Source Income

As per OECD definition, it is the income realized from countries outside the country of residence of the taxpayer.

4.3. Source rule

The usual term for income arising in a particular place is “source” (“domestic” and “foreign” being used to indicate whether particular income is sourced inside or outside a country).

The source rule is also sometimes referred to as the “classification or assignment rule” as it classifies the income with reference to the source. The country where the income is generated gets the right to tax it. The logic behind this is that country which has, so to say, nurtured the income e.g., in case of royalties and patents, may have allowed tax breaks in the development of the patents and would now want a share in the revenue earned from those royalties or patents.

The Provision to tax certain source based income is either in the national law of a country or in a tax treaty which defines the concept of source for a particular type of income.

4.4. Guidelines under Decree-Law

a) Under Article 13 of UAE Decree Law, its clarified that Non-residents will be subject to UAE CT on:

- Taxable income from their Permanent Establishment in the UAE;
- Income derived from a Resident
- derived from activities performed, assets located, capital invested, rights used, or services performed or benefitted from in the State.

b) As per the guidelines of UAE Decree Law, Income which is sourced in the UAE includes-

- Income from the sale of goods in the State.
- Income from the provision of services that are rendered or utilised or benefitted from in the State.
- Income from a contract insofar as it has been wholly or partly performed or benefitted from in the State.
- Income from movable or immovable property in the State.
- Income from the disposal of shares or capital of a Resident Person.
- Income from the use or right to use in the State, or the grant of permission to use in the State, any intellectual or intangible property.
- Interest Income subject to certain conditions

[5] https://www.oecd.org/ctp/glossaryoftaxterms.htm#F

- Insurance or reinsurance premiums subject to certain conditions
  1) UAE sourced income earned by a foreign person that does not have a PE in the UAE will be subject to withholding tax at a rate of 0% (zero percent).
  2) The UAE decree law has placed specific rules and guidance to determine whether income has a source in the UAE However, income will generally be considered UAE sourced if the income is earned from a UAE resident person, if the payment is attributed to a PE in the UAE of a foreign company, or if the income is derived from activities or contracts performed in the UAE, assets located in the UAE, or rights used for economic purposes in the UAE subject to the provisions of Article 13 as reiterated above.

4.5. Qualifying Free Zone Person under Article 18 of Decree Law-

The same principles as reiterated above in Clause b) will be applied to determine if a Qualifying Free Zone Person earns income from a source in mainland UAE subject to the Provisions of Article 18 read with Article 34 & Article 35.The abstract of Clause 1 and Clause 2 are put forthwith here-

'Under Clause 1 of Article 18, a Qualifying Free Zone Person is a Free Zone Person that meets all of the following conditions:

a) Maintains adequate substance in the State.

b) Derives Qualifying Income as specified in a decision issued by the Cabinet at the suggestion of the Minister.

c) Has not elected to be subject to Corporate Tax under Article 19 of this Decree-Law.

d) Complies with Articles 34 and 55 of this Decree-Law.

e) Meets any other conditions as may be prescribed by the Minister.

A Qualifying Free Zone Person that fails to meet any of the conditions under Clause 1 of this Article at any particular 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 that has a branch in mainland UAE will be taxed at the regular CT rate on its mainland sourced income, whilst continuing to benefit from the 0% CT rate on its other income.

As per Public Consultation Document on UAE Corporate Tax

- A Qualifying Free Zone Person can benefit from a 0% CT
- rate on income earned from transactions with businesses located outside of the UAE, or from trading with businesses located in the same of any other Free Zone.
- The 0% CT rate may also apply to income from certain regulated financial services directed at foreign markets.

- Where a Free Zone Person transacts with mainland UAE but does not have a mainland branch, the Free Zone Person can continue to benefit from the 0% CT rate if its income from mainland UAE is limited to 'passive' income. This would include interest and royalties, and dividends and capital gains from owning shares in mainland UAE companies.
- The UAE wishes to maintain its status as the leading regional hub and headquarter location and, therefore, the 0% CT regime will also apply to transactions between Free Zone Persons and their group companies located in mainland UAE. However, to ensure the CT neutrality of such transactions, payments made to the Free Zone Person by a mainland group company will not be a deductible expense.
- A Free Zone Person located in a Designated Zone for Value Added Tax (VAT) purposes can benefit from the 0% CT rate on income from the sale of goods to UAE mainland businesses that are the importer of record of those goods
- Where a Free Zone Person benefits from the 0% CT regime in respect of mainland sourced income, such income will be within the scope of withholding tax (to be applied at 0%).

4.6. Our understanding (based on above)

The combined effect of the above UAE Decree Law read with Article 5[6] and Article 7[7] of DTAA is that the profits from any business activities or services performed in the territory of a UAE by a Non-Resident entity[8] are not taxable in UAE if they are not attributable to a permanent establishment situated therein Article 14 of UAE Decree Law can be considered as a base for the same. The same has been dealt in detail in a separate chapter.

[9]As explained in the OECD commentary under Article 5, the stand under which these profits are only taxable in the other state of Non-resident is supported by various policy and administrative considerations. It is consistent with the principle of Article 7 that until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State.

In purview of above, the domestic law of UAE shall provide NIL withholding Tax rate on UAE Sourced Income to a Non-Resident Person (Foreign Person other than individual) who does not have a PE in UAE, subject to the Provisions of Article 14 of UAE Decree Law.

Free zone businesses will be within the scope of UAE CT and required to register and file a CT return but can benefit from 0% CT if they comply with all regulatory requirements and do not conduct business with mainland UAE.

[6] Permanent Establishment
[7] Associated Enterprises
[8] Taxable Person as defined in UAE Decree Law
[9] Article 5 and Article 7 are deliberated in detail in a separate chapter in the Study Material.

The 0% CT rate applies to income earned from transactions with businesses located outside the UAE, in the same free zone, or any other free zone. Where a free zone entity earns any mainland sourced income other than passive income (i.e. interest, royalties, dividends, capital gains, etc), then all its income will be disqualified from the 0% CT regime.

It should be noted, however, that all member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services.

The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.

5. Article-4 Resident

5.1. Abstract of OECD commentary on Article 4- Resident

a. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

b. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

   i. he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

   ii. if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

   iii. if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

   iv. if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

c. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

5.2. Commentary on Article 4

I. Introduction –

Residency is a key determinant of whether business profits will be subject to CT in the UAE.

Tax residence is determined under the domestic tax laws of each jurisdiction. There might be situations where a person qualifies as a tax resident under the tax residence rules of more than one jurisdiction, and therefore becomes a tax resident in more than one jurisdiction.

It should be well understood that mere right to reside in a given jurisdiction (on permanent or temporary basis) or the fact of holding citizenship of a given jurisdiction does not automatically mean that a person shall be considered a tax resident in such a jurisdiction or that, merely by obtaining residency or citizenship of another jurisdiction will absolve the tax residency in the former jurisdiction of tax residence."

Tax Residency is generally first determined under the domestic tax laws of each jurisdiction but when a person becomes tax resident for one or more jurisdictions in respect to his income , treaty comes into play for determination of his tax residency to mitigate double taxation of the same income .

In the case of UAE Jurisdiction, our scope is limited to determine the residency of a person other than individual as UAE CT tax Regime scope covers only corporate taxation.

II. Preliminary remarks on Commentary

1. The concept of “resident of a Contracting State” has various roles to play -
    a) For ascertaining treaty application including both natural and legal persons
    b) in resolving cases where double taxation arises due to dual residence;
    c) in resolving cases where double taxation arises due to taxation in the State of residence as well as in the State of source or situs.
2. The Article is intended to define the meaning of the term “resident of a Contracting State” and to resolve issues arising out of dual residence.
3. The scope of the Article is limited to determination of share of taxes between residence and source or situs or where dual residence exists. This happens in the cases when their

respective domestic laws (Residence as well as Source state), either or both of the Contracting States claim that the person concerned is resident in their territory.

4. The treaties normally refrain themselves from setting up any parameters under which a person is to be treated fiscally "resident" and, thereupon becomes liable to tax in that State under the domestic laws of the Contracting States. The respective States lays down the provisions of domestic laws and take their own stand entirely on the same.

5. The aforesaid position manifests itself in both the conditions where there is no conflict at all between two states of residences (dual residency), but where the conflict exists only between residence and source or situs (residence vs source state).

6. The same position also applies to determination of residency when there is a conflict between two residences as no issue can be resolved without reference to the concept of residence adopted in the domestic laws of the States concerned. In such cases, the treaties must have special provisions to enable it to determine which of the two concepts of residency is to be given preference.

7. Example as given in OECD Commentary -. An individual has his permanent home in State A, where his wife and children live. He has had a stay of more than six months in State B and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being a resident of that State. Thus, both States claim that he is fully liable to tax. This conflict has to be solved by the Treaty.

8. In this particular case the Article (under paragraph 2) gives preference to the claim of State A. This is so because in case of such a conflict, option has to be necessarily explored for which the Article proposes special rules.

III. Commentary on the provisions of the Article 4

Our discussion will be limited only to taxable persons as broadly covered under various articles and mainly under Article 11 of UAE-Decree Law

Where, under paragraph 1 of Article 4, a person is considered to be a resident of both Contracting States based on the domestic laws of these States, paragraphs 2 and 3 of that Article make it generally possible to determine a single State of residence for the purposes of the Convention. Thus, paragraph 3 does not apply to an individual or legal person who is a resident of one of the Contracting States under the laws of that State but who, for the purposes of the Convention, is deemed to be a resident only of the other Contracting State.

<u>Paragraph 1-Commentary</u>

1. Paragraph 1 defines the expression "resident of a Contracting State" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws of the contracting states. It further states that the resident is liable to tax by way of domicile, residence, place of management or any other criterion of a similar nature.

Para 1 refers to persons who are "liable to tax" in a Contracting State under its laws by reason of various criteria as reiterated above.

In this respect, we should refer Article 4 -Exempt Person under UAE Decree Law which has categorically listed the exempt persons who are not subject to CT in UAE -

a. A Government Entity.

b. A Government Controlled Entity.

c. A Person engaged in an Extractive Business, that meets the conditions of Article 7 of this Decree-Law.

d. A Person engaged in a Non-Extractive Natural Resource Business, that meets the conditions of Article 8 of this Decree-Law.

e. A Qualifying Public Benefit Entity under Article 9 of this Decree-Law.

f. A Qualifying Investment Fund under Article 10 of this Decree-Law.

g. A public pension or social security fund, or a private pension or social security fund that is subject to regulatory oversight of the competent authority in the State and that meets any other conditions that may be prescribed by the Minister.

h. A juridical person incorporated in the State that is wholly owned and controlled by an Exempt Person specified in paragraphs (a), (b), (f) and (g) of Clause 1 of this Article and conducts any of the following:

   1) Undertakes part or whole of the activity of the Exempt Person.

   2) Is engaged exclusively in holding assets or investing funds for the benefit of the Exempt Person.

   3) Only carries out activities that are ancillary to those carried out by the Exempt Person.

i. Any other Person as may be determined in a decision issued by the Cabinet at the suggestion of the Minister.

The detailed discussions of these taxable persons is already done in Chapter 2 of the Background Material.

a) The second sentence of paragraph 1, does not consider any person a "resident of a Contracting State" if, even though not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources or to capital situated in that State. That situation exists in some States in relation to individuals, e.g., in the case of foreign diplomatic and consular staff serving in their territory but the same is outside the scope of our discussion.

b) According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. It also excludes companies and other persons who are not subject to comprehensive tax liability in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States.

c) The second sentence has to be interpreted in the spirit of its object and purpose, which excludes persons who are not liable to comprehensive tax in the contracting State. This reflects the true intent of law which is indeed not the adoption of territorial principle in their taxation which excludes all residents of countries from the scope of the convention.

d) Paragraph 1 of Article 4 provides that the Contracting States themselves, their political subdivisions and their local authorities are included in the definition of a "resident of a Contracting State" and are therefore entitled to the benefits of the treaty.

e) Paragraph 1 refers to persons who are "liable to tax" in a Contracting State under its domestic laws as per laid down standards. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax.

f) In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. UAE Decree Law document has granted Charities and other public benefit organisations status of exempt persons subject to certain conditions as mentioned therein.

g) Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, the partnership is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" the partners under the domestic law of that State, the partners are the persons who are liable to tax on the share of the partnership income and are thus are eligible to claim the treaty benefits of which they are residents. The same treatment will apply to income of other entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting State like JV, AOP, Unincorporated Entities.

2. <u>Partnership[10] –</u>

a) The UAE Decree Law has enacted following taxation principles for partnerships-

- An Unincorporated Partnership shall not be considered a Taxable Person in its own right, and Persons conducting a Business as an Unincorporated Partnership

[10] Taxation of Partnerships is been dealt in detail in a separate chapter

shall be treated as individual Taxable Persons for the purposes of this Decree-Law subject to the Provisions of Article 16 of UAE Decree Law.

- Transparent or Unincorporated Partnerships (as cited above) will not be taxpayers in their own right, but their income will instead 'flow through' and be taxed in the hands of the partners or members only. This flow-through treatment is widely recognised and accepted internationally, and also ensures tax neutrality for investors in collective investment funds that are often structured as limited partnerships
- Limited liability partnerships, partnerships limited by shares and other types of partnerships where none of the partners have unlimited liability for the partnership's obligations or other partners' actions will be subject to UAE CT in the same manner as a UAE company.

b) Taxability of partnerships in conjunction with UAE Decree Law

i. Where a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Treaty.

ii. Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Treaty.

iii. [11]The same principle is also reiterated in UAE Decree Law wherein its stated that a legal person that is incorporated in the UAE will automatically be considered a 'resident' person for UAE CT purposes and entitled to treaty benefits.

iv. Similarly, any natural person who is engaged in a business or commercial activity in the UAE, either in their own name or through an unincorporated partnership, will also be considered a resident person for purposes of the UAE CT regime.

   a. 'Limited and general partnerships and other unincorporated joint ventures and associations of persons will be treated as 'transparent' for UAE CT purposes. This means that they will not be taxpayers in their own right, but their income will instead 'flow through' and be taxed in the hands of the partners or members only. Subject to the Provisions of Article 16 of UAE Decree Law, under the given situations, if a Person who is a partner in an Unincorporated Partnership shall be treated as:

   b. Conducting the Business of the Unincorporated Partnership.

   c. Having a status, intention, and purpose of the Unincorporated Partnership.

[11] UAE CT CONSULTATION PAPER ISSUED ON 31ST JAN, 2022

d. Holding assets that the Unincorporated Partnership holds.

e. Being party to any arrangement to which the Unincorporated Partnership is a party.

v. This flow-through treatment is widely recognised and accepted internationally, and also ensures tax neutrality for investors in collective investment funds (CIT) that are often structured as limited partnerships.'

vi. Further, the paper also lays down criterion in case of a Foreign unincorporated Partnership. A Foreign Partnership shall be treated as an Unincorporated Partnership for the purposes of this Decree-Law where all of the following conditions are met:

a) The Foreign Partnership is not subject to tax under the laws of the foreign jurisdiction.

b) Each partner in the Foreign Partnership is individually subject to tax with regards to their distributive share of any income of the Foreign Partnership as and when the income is received by or accrued to the Foreign Partnership.

c) Any other conditions as may be prescribed by the Minister.

vii. The UAE Public Consultation paper has cited its reasons to do so-

a. Investing in and through unincorporated partnerships in a cross-border context can create difficulties and unintended tax consequences where one country treats the partnership as a transparent entity, and the other country taxes the partnership as if it were a company.

b. To align the tax treatment of partnerships in a cross-border context, the UAE CT treatment of foreign unincorporated partnerships would generally follow the tax treatment of the partnership in the respective foreign jurisdiction read with Clause 3(b) of Article 11-Taxable Person of UAE Decree Law.

Paragraph 2-Commentary

The role of determining the residential status of any person is to determine his taxability in a particular jurisdiction. In most of the treaties, a person is considered to be a resident of the country under the tax laws of which he is liable to pay taxes due to the reason of his stay, residence, or other similar criteria.

But sometimes, it may happen that one person simultaneously become a tax resident of more than one country according to the domestic tax laws of both the countries. The consequence will be that person, being an individual will be liable to pay tax on his global income in both the countries since most jurisdictions tax their residents on the global income.

In UAE context, residential status has to be determined for individuals having their own business so as to tax their business income.

And just to reiterate, UAE resident persons will be taxable in the UAE on their worldwide income, which for a natural person will be limited to the income earned from their business activity carried out in the UAE. However, certain income earned from overseas will be exempt from CT, including income from foreign branches and qualifying foreign shareholdings under the UAE Decree Law.

a. This paragraph determines the residential status of an individual when he is a resident of both Contracting States. As per the UAE Decree Law

b. , In order to level the playing field between incorporated businesses and unincorporated businesses owned by individuals, UAE CT will also apply to natural persons engaged in a business or commercial activity in the UAE. This will include sole establishments or proprietorships and individual partners in an unincorporated partnership that condu cts business in the UAE.

c. Hence, in order to determine the residential status of proprietorship concern, we will have to conduct the residency test of individuals for imposition of UAE CT on the proprietor concerns also.

   The subsequent tests/criterion as listed below are in decreasing order of relevance to be applied when an individual is a resident of both Contracting States and the preceding criteria do not provide a clear-cut determination of his residential status -

d. The Treaty gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion is generally sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only stays for a short period or duration in the other Contracting State.

e. Its further clarified in the OECD commentary that the concept of home may be of any form (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual shall have the dwelling available to him continuously, at all times and not occasionally for the purpose of a stay which, is of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).

f. If the individual has a permanent home in both Contracting States, paragraph 2(a) gives impetus to the Contracting State with which the personal and economic relations of the individual are closer, known as 'the centre of vital interests. In the cases where the residence cannot be determined by reference to this generic rule, sub-para (b) provides another criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, then CA will settle the question through MAP procedure as laid down in Article 25.

g. If the individual has a permanent home in both Contracting States, his personal and economic relations and interests are to be ascertained on the basis of facts. Thus, considerations like his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. has to be looked into. All the related circumstances must be thoroughly examined, but due considerations should be given to the personal acts of the individual. For example, If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

h. Subparagraph b) establishes a secondary criterion for two quite distinct and different situations:

   SITUATION 1 - the situation where the individual has a permanent home available to him in both Contracting States but unable to determine the place where his centre of vital interests lies;

   SITUATION 2 - the situation where the individual has a permanent home available to him in neither of the Contracting State.

   Preference is given to the Contracting State where the individual has an habitual abode based on the following-

   - In the first situation, where the individual has a permanent home available to him in both States, whether the individual has an habitual abode in one State rather than in the other state, and there is a doubt as to where the individual has his centre of vital interests lies would tilt more towards the State where he stays more frequently. For this purpose emphasis must be placed to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.
   - The second situation is the case of an individual who has no permanent home available to him in either of the Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without trying to ascertain the reasons for them.

i. Subparagraph b) does not quantify the length of time the comparison to be made while testing the habitual abode of the individual. The comparison must be of sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

j. In a situation n sub-paragraph b) where the individual has a habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them, sub-paragraph d) assigns the competent authorities to resolve by mutual agreement according to the procedure established in Article 25.

Illustration:

Ms Mary is a chef and leaves Ireland to come to the Dubai to look for work on 1 July 2022. She stays with friends. She does not find any work and returns to Ireland for two months over Christmas (she finds a Christmas job in a hotel in Dublin). She comes back to the Dubai in February 2023 and starts looking for work again.

Under UK rules, Mary is UK tax resident for 2022/23 as she spent more than 183 days here, so she is taxable in the UK on her worldwide income. Under Ireland's rules, Mary is tax resident there too. This leaves her Christmas job income potentially subject to both UK and Irish tax, due to her being treated as tax resident in both countries.

Mary can look at the double tax treaty to see if it can help avoid this double taxation situation. Where a dual-residence situation causes double taxation, most treaties contain a series of 'tie-breaker' tests to help determine which country's residence takes precedence. They generally say (under Article 4) that the 'winner' country (that is, the country where you are resident for the purposes of the treaty) is:

a) The country where the individual has a permanent home available to them

b) If the individual has a permanent home in both countries, the country (permanent home) where the individual's personal/economic ties are closer (this is known as 'centre of vital interests')

c) If it is not possible to determine at which permanent home the centre of vital interests lies, or if the individual does not have a permanent home, the country where the individual has a habitual abode

d) Where the habitual abode test is not decisive, the country where the individual is a national

e) If the individual is a national of both countries (or of neither), then the countries must settle the matter by mutual agreement.

The answer to the first test for Mary is 'Ireland' as this is where her family home is. As she meets the first test she does not need to look at the remaining tests. This means that Mary is treated as 'treaty resident' in Ireland and 'treaty non-resident' in the UK – these special treaty rules override the actual position.

In this case, the treaty says that the UK will give up its right to tax Mary on her Irish employment income as it will be taxed in Ireland only. Mary will therefore need to claim exemption under the treaty on her UK tax return in respect of this income.

By default, every person is a tax resident of his/her native country. But in the modern world, people can stay abroad longer than in their home country, and the tax status can be determined by different indicators.

In most countries, the main criterion for obtaining such status is staying on the territory of the country for more than 183 calendar days. This indicator is calculated as the total number of days, including vacation, or, for example, business trip.

Another factor determining the tax residence is the availability of real estate in the country - in ownership or lease. This rule works in a number of European countries – for example, in Austria, Germany, and the Netherlands.

The next criterion for obtaining residency is a personal interest in the country, for example, business, or residence in the country of the family. This rule is applied, for example, in Belgium, France, and Italy. And in case the family members (children, spouse) live in the country, the person is considered to be a resident, even if he/she comes to this country only for a couple of days a year.

It is not always possible to determine the place of interests of a particular person precisely, and in this case, the tax residence is determined by the place of residence (permanent residence). And if the person is not living in the territory of the country where he/she has a permanent residence, sufficient time, the tax residence is determined by citizenship.

The presence of US citizenship, for example, explicitly determines the tax residence in the country of citizenship, and no matter where and for how long this person is, that is, a person can live and work in another country, but still he/she will pay taxes to the US budget.

Paragraph 3-Commentary

i. This paragraph concerns companies and other bodies of persons, irrespective of whether they are legal persons or not. There may be instances where a company may be subject to tax as a resident in more than one State, for example, if one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc., also, special rules as to the preference must be established.

ii. It would not be appropriate to give importance to a purely formal criterion like registration. Therefore paragraph 3 gives importance to the place where the company, etc. is actually managed.

iii. The idea of the preference criterion in respect of non-natural persons was considered in reference with the taxation of income from shipping, inland waterways transport and air transport. Most of the DTAA give the taxing power to the State in which the "place of management" of the enterprise is situated on such income; some DTAA may give priority to its "place of effective management", and few may opt "fiscal domicile of the operator".

a) Place of Effective Management (POEM)as per OECD

As a result of these considerations, the "place of effective management (POEM)" has been adopted as the preferred option for persons other than individuals. The place of effective management is the place where key management and commercial/operational decisions of the entity's business as a whole are in substance made. All relevant facts and circumstances must be reviewed to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

This concept is widely acceptable and most of the treaties based on OECD MTC considers that in case of person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

The term 'POEM' has not been defined in the UN or OECD Model Convention. However, the OECD Model Commentary on Article 4 states that POEM refers to a place where the key management and commercial decisions that are necessary for conduct of entity's business as whole are in substance made. It further provides that an entity may have more than one 'place of management' but it can have only one POEM at any one time.

As per OECD, determination of a POEM is a tedious activity and there is no thumb rule that can be applied straightforward for ascertainment of the same.

The OECD has provided some directive principles which are not binding on taxpayers and neither on the tax authorities. However, they play an important role and can assist in determining the POEM of the Company in following manner-

i. One must consider and recognise the place where decisions are made,

ii. Where the actions are determined,

iii. Where is the decision-making function performed,

iv. Where is the place of incorporation,

v. Where are corporate documents kept / stored / maintained,

vi. Place where CEO, office staff, senior executives reside to carry out activities.

Under the UN Model Commentary on Article 4 refers to following situations to be considered for establishing POEM:

i. Place where company is actually managed and controlled;

ii. Place where decision making at the highest level on important policies essential for management of the company takes place;

iii. Place that plays a leading part in the management of a company from an economic and functional point of view;

iv. Place where most important accounting books are kept.

[12]Foreign entities with POEM in UAE

Under UAE Context and as per UAE Decree Law, a place of management where management and commercial decisions that are necessary for the conduct of the Business are, in substance, subject to the provisions of Article 16.

The POEM is directly not referred to as anywhere in the UAE Decree Law but in pursuance of the above and read with Clause 3(b) of Article 11, a foreign company may be treated as a resident person if it is effectively managed and controlled in the UAE. Determining whether an entity is effectively managed and controlled in the UAE is a question of fact but would typically look at where the directors or other decision makers of the company makes the key management and commercial decisions.

For the application of UAE CT, legal persons incorporated in a foreign jurisdiction that are effectively managed and controlled in the UAE will be treated as if they were UAE incorporated entities.

A foreign company may be treated as a resident person if it is effectively managed and controlled in the UAE. Determining whether an entity is effectively managed and controlled in the UAE is a question of fact, but would typically look at where the directors or other decision makers of the company make the key management and commercial decisions.

Key international rulings on concept of POEM-

Case 1) De Beers Consolidated Mines Ltd v. Howe [1906] A.C. 455 (H.L.) (Eng.)

In this British case, South African company was held resident of UK as London office controlled key management decisions.

In the given case, The House of Lords held that company should be held to be resident for the purpose of income-tax where the real business is carried on. "Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad." Thus, House of Lords accepted Revenue's contention that trade and business of the taxpayer was carried out and exercised in United Kingdom at its London office. Further, the head and seat and directing power of the affairs of the company were at the office in London, from whence the chief operations of the company, both in the United Kingdom and elsewhere, were, in fact controlled, managed, and directed.

Thus, it was held that the company was resident of United Kingdom even though it was registered in South Africa.

[12] The same is discussed in detail in a separate chapter .

Case 2) The Oceanic Trust Co. Ltd N.O v Commissioner of South African Revenue services (Western Cape High Court of South Africa) Case number 2011/22556/09

In this case, South-African High Court lays down principles for determination of POEM

The taxpayer was a company registered in Mauritius with its principal place of business at Port Louis Mauritius. It was the sole trustee of a trust, Specialized Insurance Solution (Mauritius)(SSIM) which was also established and registered in Mauritius as a category I Global Business License.

It was also registered as trust under South African Trust Property Control Act and conducted business as captive reinsurer to mCubed Life Limited (a South African registered company).

The tax authorities of South Africa alleged that SISM was resident of South Africa because it had place of effective management in South Africa. The tax authorities claimed that all the investments of SSIM were in South Africa and it generated entire income from business activities actually conducted in South Africa.

Noting the facts stated above, the Court held that taxpayer has not made out a case for declaratory relief it prayed for i.e. declaring that SSIM is resident of Mauritius. Further, the Court observed that at least some key managerial or commercial decisions were taken in South Africa. Noting that all the material facts required to determine POEM are not sufficiently clear for the Court to make decision on POEM, the Court held that it is unable to decide this issue. The Court observed that it does not have the power to make the required finding of facts and legislature has given such powers to the Tax Court.

Case 3) Bywater Investments Ltd. & Ors. Vs. Commissioner of Taxation (Australian Federal Court) [2016] HCA 45

In this case, Australian Federal Court holds POEM as place where the board of directors makes its decisions.

In case of appellant companies - Chemical Trustee, Derrin, Bywater, and HWB (out of which first 2 were incorporated in United Kingdom and remaining 2 were incorporated in Bahamas and Samoa respectively), the issue of determining their residential status for the period 2001-2007 had come up before the Federal Court of Australia. The Court noted that though the shares of these companies were held by JA Investments & MH Investments (a Cayman Island based groups) and Mr. Borgas and family were directors and shareholders on record, but ultimately the affairs of appellant companies were controlled by Mr. Gould from Sydney. HC observed that Mr. Borgas and family (only recorded directors and shareholder) just mechanically carried out Mr. Gould's decisions, thus place of central management and control was Sydney from where Mr. Gould made substantive decisions.

Referring to the POEM definition in relevant DTAAs, Court noted that the place of effective management may "ordinarily" be the place where the board of directors makes its decisions, "all relevant facts and circumstances must be examined to determine [where] the place of effective management" of a company is located. Court concluded that as the key management and commercial decisions were made by Mr Gould in Australia, it was the "place of effective management".

Case 4) R.A. Hewitt & Sons Ltd. v. The Queen (Canadian Tax Court) 2000 DTC 2441 (TCC)

Canadian Tax Court rules that POEM of taxpayer's Bahamian subsidiary lies in Canada where real business runs.

The taxpayer/appellant, R.A. Hewitt & Sons Ltd., is a corporation incorporated under the laws of the Ontario (a province in Canada). At all material times its directors were Robert A. Hewitt and Yvonne M. Hewitt, with Robert A. Hewitt (a Canadian resident) as its controlling shareholder. Further, A. Hewitt and Sons (Bahamas) Limited ('the subsidiary') was incorporated in the Commonwealth of the Bahamas having three directors, Robert A. Hewitt, his wife, Yvonne J.M. Hewitt and their son David R. Hewitt (all residents of Canada.).

The subsidiary had 5,000 issued shares of which (A) 3,000 were registered in the name of Abaco Grower Limited ("Abaco") which is a corporation incorporated under the laws of the Commonwealth of the Bahamas and (B) 2,000 were registered in the name of the Appellant.

Because 60% of its issued shares were registered in the name of Abaco, the subsidiary took the position when dealing with the Bahamian government that it was beneficially owned as to a minimum of 60% by persons of Bahamian nationality. However, the Tax Court of Canada ruled that the subsidiary was a resident corporation of Canada during the years in question i.e. 1994,1995 and 1996, because –

(1) Its directors were always Canadian residents. Almost all directors meetings occurred in Woodstock. The corporate seal and the minute book of the subsidiary were in Woodstock, Ontario. There is no evidence of a share registry outside of the minute book.

(2) Subsidiary's corporate decisions were done by Robert and Yvonne Hewitt at their residence in Woodstock, Ontario. Further, the corporate returns and filings were made from Woodstock by Robert Hewitt. It also had a bank account in the Bahamas.

(3) Subsidiary operated an unsuccessful farm in the Bahamas which Robert Hewitt and Yvonne Hewitt managed respecting all major decisions including kinds of crops, changes of crops, exporting, capital purchases and government dealings in the Bahamas.

Thus, Court concluded that subsidiary's real business was carried on at Woodstock and its central management and control abided at Woodstock, Ontario.

b. Mutual Agreement Procedure (MAP) –

By virtue of the provisions of paragraph 1, the competent authorities of the Contracting States shall take recourse to mutual agreement (MAP) when a person other than an individual is a resident of both Contracting States. The same shall be decided thereupon as to which Contracting State such person shall be deemed to be a resident for the purposes of the DTAA with respect to place of effective management (POEM), the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of POEM clause in the DTAA, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting State.

Competent authorities on the basis of supporting documents and circumstantial evidence may determine the residence of a legal person for purposes of the DTAA.

Abbreviations

1.	**ART**	Average Rate of Tax
2.	**UAE CT**	UAE Corporate Tax
3.	**CIT**	Corporate Investment Tax Rate
4.	**DTAA**	Double Taxation Avoidance Agreement
5.	**FTC**	Foreign Tax Credit
6.	**FTA**	The Federal Tax Authority of UAE
7.	**UAE FDL No. 47**	UAE Federal Decree -Law Number 47 of 2022/UAE Decree Law
8.	**MNE**	Multinational Enterprises
9.	**MAP**	Mutual Agreement Procedure
10.	**OECD**	Organisation of Economic Co-operation and Development
11.	**POEM**	Place of Effective Management
12.	**TRC**	Tax Residency Certificate
13.	**UAE**	United Arab Emirates

Chapter 7

Free Zone Person under UAE Corporate Tax Law

This chapter covers the following:

- **Relevant Definitions**
- **Qualifying Free Zone Person (Article 18)**
- **What is Qualifying Income?**
- **Corporate Tax Rate on Qualifying Free Zone Person (Article 3)**
- **Corporate Tax Rate in Mainland UAE (Article 3)**
- **Difference between Corporate Tax Rate on Person in Mainland UAE and Qualifying Free Zone Person**
- **Taxability of Qualifying Free Zone Person with group companies**
- **Election to be Subject to Corporate Tax (Article 19)**

1. Introduction

Free Zones referred to as Free Trade Zones, are created to facilitate single-window administration for the convenience of foreign investments while promoting global trade in UAE. Free Zones in the UAE are either associated with ports or are industry specific. In the United Arab Emirates, namely in Dubai and Abu Dhabi, there are several Free Zones. Numerous multinational corporations as well as small and medium-sized businesses have registered wholly foreign-owned subsidiaries without a domestic shareholder in the majority of free zones. The majority of Free Zone Companies in the UAE are regarded as crucial to international commerce. Free Zones enjoy umpteen exemptions such as 100% foreign ownership, 100% customs and VAT exemptions, 100% returns on capital & profits, etc. The UAE has long been a hub for international business, and with the new Corporate Tax Law, as the nation's economy has grown, so has its connection to the UAE community's culture of entrepreneurship.

This chapter of the UAE Corporate Tax Law deals with the taxability of Free Zone Persons (FZP). A free Zone Person is a Qualifying Free Zone Person who is eligible to pay Corporate Tax at the rate of 0% on their "Qualifying Income" and 9% on non qualifying income.

2. Relevant Definitions

a) **Free Zone**: A designated and defined geographic area within the State that is specified in a decision issued by the Cabinet at the suggestion of the Minister.

b) **Free Zone Person**: A juridical person incorporated, established or otherwise registered in a Free Zone, including a branch of a Non-Resident Person registered in a Free Zone.

c) **Qualifying Free Zone Person**: A Free Zone Person that meets the conditions of Article 18 of this Decree-Law and is subject to Corporate Tax under Clause 2 of Article 3 of this Decree-Law.

d) **Qualifying Income**: Any income derived by a Qualifying Free Zone Person that is subject to Corporate Tax at the rate specified in paragraph (a) of Clause 2 of Article 3 of this Decree-Law.

e) **Corporate Tax**: The tax imposed by this Decree-Law on juridical persons and Business income.

3. Qualifying Free Zone Person (Article 18)

What is Qualifying Free Zone Person?

A Qualifying Free Zone Person is defined under Article 1 as, A Free Zone Person that meets the conditions of Article 18 (Conditions for Free Zone Person) and is subject to Corporate Tax under Clause 2 of Article 3.

Conditions for Qualifying Free Zone Person

Article 18 of UAE Corporate Tax Law provides the conditions that must be met for the person to qualify as Qualifying Free Zone Person. The conditions for Qualifying Free Zone Person are provided below:

I. A Qualifying Free Zone Person is a Free Zone Person that meets all of the following conditions:

   a) Maintains adequate substance in the State.

   b) Derives Qualifying Income as specified in a decision issued by the Cabinet at the suggestion of the Minister.

   c) Has not elected to be subject to Corporate Tax under Article 19 of this Decree-Law.

   d) Complies with Article 34 (Arm's Length Principle) and Article 55 (Transfer Pricing Documentation) of this Decree-Law.

   e) Meets any other conditions as may be prescribed by the Minister.

II. A Qualifying Free Zone Person that fails to meet any of the conditions mentioned above at any particular time during a Tax Period shall cease to be a Qualifying Free Zone Person from the beginning of that Tax Period.

III. Notwithstanding Clause 2 of this Article, the Minister may prescribe the conditions or circumstances under which a person may continue to be a Qualifying Free Zone Person, or cease to be a Qualifying Free Zone Person from a different date.

IV. The application of paragraph (a) of Clause 2 of Article 3 of this Decree-Law to a Qualifying Free Zone Person shall apply for the remainder of the tax incentive period stipulated in the applicable legislation of the Free Zone in which the Qualifying Free Zone Person is registered, which period may be extended per any conditions as may be determined in a decision issued by the Cabinet at the suggestion of the Minister, but any one period shall not exceed (50) fifty years.

Points to Remember

1. A Free Zone Person that is a Qualifying Free Zone Person can benefit from a preferential Corporate Tax rate of 0% on their "Qualifying Income" only.
2. In order to be considered a Qualifying Free Zone Person, the Free Zone Person must:
   - maintain adequate substance in the UAE
   - derive 'Qualifying Income
   - not have made an election to be subject to Corporate Tax at the standard rates, and
   - comply with the transfer pricing requirements under the Corporate Tax Law.
3. The Minister may prescribe additional conditions that a Qualifying Free Zone Person must meet.
4. If a Qualifying Free Zone Person fails to meet any of the conditions, or makes an election to be subject to the regular Corporate Tax regime, they will be subject to the standard rates of Corporate Tax from the beginning of the Tax Period where they failed to meet the conditions.

4. What is Qualifying Income?

As per Article 1 of UAE Corporate Tax Law, Qualifying Income shall be defined as, "Any income derived by a Qualifying Free Zone Person that is subject to Corporate Tax at the rate specified in paragraph (a) of Clause 2 of Article 3 of this Decree-Law."

As per Public Consultation Document on UAE Corporate Tax, the following can be considered as Qualifying Income:

a. **Income from outside of UAE**: A Free Zone Person can benefit from a 0% CT rate on income earned from transactions with businesses located outside of the UAE, or from trading with businesses located in the same of any other Free Zone can be considered as Qualifying Income.

b. **Income from Regulated Financial Services**: The 0% CT rate may also apply to income from certain regulated financial services directed at foreign markets.

c. **Income from trading with mainland UAE with a branch**: A Free Zone Person that has a branch in mainland UAE will be taxed at the regular CT rate on its mainland sourced income, whilst continuing to benefit from the 0% CT rate on its other income.

d. **Income from trading with mainland UAE without a branch**: Where a Free Zone Person transacts with mainland UAE but does not have a mainland branch, the Free Zone Person can continue to benefit from the 0% CT rate if its income from mainland UAE is limited to 'passive' income. This would include interest, royalties, dividends, and capital gains from owning shares in mainland UAE companies.

e. **Income from the Sale of Goods to mainland to a Free Zone Person located in a Designated Zone**: A Free Zone Person located in a Designated Zone for Value Added Tax (VAT) purposes can benefit from the 0% CT rate on income from the sale of goods to UAE mainland businesses that are the importer of record of those goods.

Illustration

- CDE is a company situated in a Free Zone in UAE. It has a branch in mainland UAE. The total income of CDE is AED 546,000 in tax year 2024 out of which the income from branch is AED 146,000. What is the taxable amount and tax payable by CDE?

  Solution: A Free Zone Person that has a branch in mainland UAE will be taxed at the regular CT rate on its mainland sourced income, whilst continuing to benefit from the 0% CT rate on its other income.

  As per above statement, qualifying income of AED 400,000 (546,000-146,000) is not taxable whereas income from branch AED 146,000 is taxable.

  And, the tax payable by CDE is AED 13,140 (146,000*9%).

- GIF is a company located in Free Zone in UAE with no other branch elsewhere. The total income of GIF is AED 850,000. Out of which AED 560,000 is related to business income in Free Zone; AED 150,000 is related to principal business in mainland UAE; AED 40,000 from interests in mainland; AED 80,000 from Royalties in mainland; AED 20,000 from capital gains in mainland. What is the taxable amount and tax payable by GIF?

  Solution: Where a Free Zone Person transacts with mainland UAE but does not have a mainland branch, the Free Zone Person can continue to benefit from the 0% CT rate if its income from mainland UAE is limited to 'passive' income. This would include interest and royalties, and dividends and capital gains from owning shares in mainland UAE companies.

  Consequently, the taxable income is AED 150,000 (WN1) and tax payable is AED 13,500 (WN1)

Working Note 1

Particulars	Amount AED	Final Amount AED
Total Income		8,50,000
Less:		
Income in Free Zone	5,60,000	
Royalties	80,000	
Capital Gain	20,000	
Interest	40,000	7,00,000
Taxable Amount		1,50,000
Tax Payable @9%		13500

5. Corporate Tax Rate on Qualifying Free Zone Person (Article 3)

Corporate Tax will affect the businesses in the free zones of the UAE. Free Zone Persons are required to register themselves and file corporate returns.

As per Article 3(2) of UAE Corporate Tax Law shall be imposed on a Qualifying Free Zone Person at the following rates:

a) **0%** (zero per cent) on Qualifying Income.

b) **9%** (nine per cent) on Taxable Income that is not Qualifying Income under Article 18 of this Decree-Law and any decision issued by the Cabinet at the suggestion of the Minister in respect thereof.

Illustration: DEF is a company situated in Free Zone in UAE. It has a total income of AED 900,000. Out of total income of AED 900,000; the qualifying income of DEF is AED 633,000. What is the amount of tax payable by DEF?

Solution: As per Article 3(2) of UAE Corporate Tax Law shall be imposed on a Qualifying Free Zone Person at the following rates:

a) **0%** (zero percent) on Qualifying Income.

b) **9%** (nine percent) on Taxable Income that is not Qualifying Income under Article 18 of this Decree-Law and any decision issued by the Cabinet at the suggestion of the Minister in respect thereof.

In the given case, total income of DEF is AED 900,000. Out of which AED 633,000 is a qualifying income on which no tax is payable. Consequently, AED 267,000 is a Non-qualifying income.

Therefore, tax payable by DEF is AED 24,030 (AED 267,000*9%).

6. Corporate Tax Rate in Mainland UAE (Article 3)

As per Article 3(1) of UAE Corporate Tax Law, Corporate Tax will be levied at a headline rate of **9%** on Taxable Income exceeding **AED 375,000**. Taxable Income below this threshold will be subject to a 0% rate of Corporate Tax.

7. Difference between Corporate Tax Rate on Person in Mainland UAE and Qualifying Free Zone Person

Corporate Tax Rate

All companies other than Qualifying Free Zone Person:

- Nil for taxable Income upto AED 375,000.
- 9% on Taxable Income exceeding AED 375,000.

For Qualifying Free Zone Entities:

- Nil on Qualifying Income
- 9% on Non-Qualifying Income

8. Taxability of Qualifying Free Zone Person with group companies

As per Public Consultation Document on UAE Corporate Tax, the **0%** Corporate Tax regime will also apply to transactions between Free Zone Persons and their group companies located in mainland UAE. To ensure the Corporate Tax neutrality of such transactions, **mainland group companies will not be able to deduct payments made to Free Zone Persons**.

Illustration: ABC is a company located in Free Zone and it is a part of a group PQR Group which is situated in mainland UAE. ABC transfers goods worth AED 400,000 to the XYZ, a subsidiary of PQR Group, the cost of which is AED 350,000.

What is the taxable amount and tax payable by ABC? Will the payment of AED 400,000 made by XYZ to the ABC be deductible?

Solution: As per Public Consultation Document on UAE Corporate Tax, the 0% Corporate Tax regime will also apply to transactions between Free Zone Persons and their group companies located in mainland UAE. However, to ensure the Corporate Tax neutrality of such transactions, payments made to the Free Zone Person by a mainland group company will not be a deductible expense. Pursuant to above, it can be concluded that since ABC is a Free Zone Person, the profit of AED 50,000 (400,000-350,000) will not be taxable and it will enjoy 0% Corporate Tax.

Also, payment or expense of AED 400,000 in the hands of XYZ due to such transfers shall be non-deductible.

9. Election to be Subject to Corporate Tax (Article 19)

1. A Qualifying Free Zone Person can make an election to be subject to Corporate Tax at the rates specified under Clause 1 of Article 3 of this Decree-Law, i.e., it may elect to have its Qualifying Income be treated as Taxable Income and consequently be taxed at the normal rates.

2. The election under Clause 1 of this Article shall be effective from either of:

a) The **commencement** of the **Tax Period** in which the election is made.

b) The **commencement** of the Tax Period **following the Tax Period** in which the election was made.

Points to Remember

1. A Qualifying Free Zone may at its option elect to pay tax at normal tax rates on its Qualifying Income.
2. The election shall be effective from:
   a. Beginning of tax period in which such election is made, or
   b. Beginning of subsequent tax period.

Regulated financial services directed at foreign markets

As per Public Consultation Document, Income earned from the following transactions is likely to benefit from 0per cent *(zero percent)* CT:

Transactions with businesses located outside UAE.

Trading with businesses located in the same or any other free zone.

*Certain regulated financial services directed at foreign market sale of goods (from VAT Designated Zones) to customers in mainland if the customers are the importer-on-record.

Profit from Mainland branch (allocation of income and expenses)

If a freeZone company has a branch in Mainland, then 9% tax will be applicable for all the income earned on its mainland scourced income at the branch. It will continue to benefit from the 0% CT rate on its other income.

Transaction between FZP and its group company in Mainland UAE – Trade off

The UAE wishes to maintain its status as the leading regional hub and headquarter location and, therefore, the 0% CT regime will also apply to transactions between Free Zone Persons and their group companies located in mainland UAE. However, to ensure the CT neutrality of such transactions, payments made to the Free Zone Person by a mainland group company will not be a deductible expense.

Disqualification from 0% CT rate vs. Opting out of 0% CT rate

To prevent Free Zone businesses from gaining an unfair competitive advantage compared to businesses established in mainland UAE, any other mainland sourced income will disqualify a Free Zone Person from the 0% CT regime in respect of all their income.

A Free Zone Person will at any point in time be able to make an irrevocable election to be subject to the regular CT rate.

Chapter 8
Computation of Taxable Income

This chapter covers the following:

- **Accounting Profit**
- **Accounting standards and calculation of Accounting Profits and Losses**
- **Adjustment for exemptions, disallowances**
- **Unrealized gains / loss – Capital vs. Revenue items**
- **Thin-capitalization: Interest expense capping**
- **Relief for small business / start-ups – Simplified financial and tax reporting**

Introduction

We have discussed the scope of UAE Corporate Tax in the earlier chapter, where it was established that every taxable person is liable to pay tax on their taxable income.

1. Accounting Profit

Accounting profit, also referred to as financial profit or bookkeeping profit, is a company's net income, or total revenue minus costs. Accounting profit is used to assess a company's performance and compare its financial position to competitors.

Basically, accounting profit is achieved as a result of operating and non-operating activities of the company. Reflecting an entity's profitability and performance in the future, accounting profit is essentially the actual financial gain that is received after subtracting total expenses from total revenue of the business. It also ascertains how meticulously the resources of a company are allocated. It's accounting profit that tells the company's liquidity and solvency to the users of the financial statement.

The UAE Federal Law provides the definition under Article 1 of Accounting Income which states that

The accounting net profit or loss for the relevant Tax Period as per the financial statements prepared in accordance with the provisions of Article 20 of this Decree-Law.

2. Accounting standards and calculation of Accounting Profits and Losses

As per the Corporate Tax Law of the UAE Article 20(1), the taxable persons will be liable to prepare the financial statements as per applicable accounting standards in the UAE. We know that International Financial Reporting Standards (IFRS) are effective in the UAE, so the taxable persons will be liable to prepare the financial statements as per IFRS. In the law, there is no compulsion to get the financial statements audited. However, article 54(2) of the UAE law still empowers the minister of Finance to issue a decision requiring categories of taxable persons to prepare and maintain audited or certified financial statements.

The IFRS requires that the financial statements be prepared by applying the accrual basis of accounting. However, article 20(5)(a) empowers the minister to prescribe circumstances and conditions under which a person may prepare financial statements using the cash basis of accounting. Once the cash basis of the accounting has been applied, a taxable person can apply to the Federal Tax Authority (FTA) to change its method of accounting from a cash basis to an accrual basis. Once approved by the FTA, changes will be effective from the commencement of the tax period in which the application is made or from the commencement of a future tax period.

While applying the IFRS and UAE CT Law, if there is any conflict between these two, the UAE CT law's provisions should always be precedence over IFRS.

Moreover, article 20(2) of the UAE CT Law has bound the taxable persons to apply the indirect method to calculate the taxable income, so the taxable persons will be liable to prepare the financial statements as per IFRS and adjust the accounting profits to arrive at the taxable income.

3. Adjustment for exemptions, disallowances

As per Article 20 of the UAE CT Law, the Taxable Income for the tax period is the net profit or loss reported in the financial statements, after making adjustments as necessary, for the following items:

Unrealized gains or losses: Businesses that prepare their financial statements on an accrual basis will have an option as to how they account for unrealized accounting gains or losses. Under option 1, the business can elect to recognize gains and losses for all assets and liabilities only when they are realized. Under option 2, the business can elect for the realization basis to apply only to assets and liabilities held on capital account. Gains and losses on other assets and liabilities would be included in taxable income on a current basis.

Exempt income (Article 22)**:** This includes dividends and other income distributions from a resident juridical person, dividends that qualify for participation relief, certain income from foreign permanent establishments and certain income from non-residents in connection with operating ships and aircraft. This is further explained in Chapter 10 of this module.

Income that meets the conditions for Qualifying Group relief and Restructuring relief.

Allowable deductions: Generally, this will be the business expenses attributable to taxable activities. However, interest is subject to deduction limitation rules. These rules provide restrictions to discourage tax avoidance through excessive debt financing on intra-group transactions. As per Article 30, general rule states that businesses with net interest expenditure above a threshold to be set by the Minister will be allowed to deduct interest expenditure up to 30% of earnings before interest, tax, depreciation and amortization (EBITDA). This will not apply to banks, certain other financial institutions, insurance businesses and individuals. As per Article 31, specific Interest rule for Related Party loans used to finance certain Corporate Tax-exempt income. Here, the taxpayer will have to demonstrate that the main purpose was not to gain a Corporate Tax advantage. There are also special rules for entertainment expenses, which generally limit the deduction to 50% of cost (Article 32). These expenses include expenditure incurred for the purposes of receiving and entertaining the Taxable Person's customers, shareholders, suppliers or other business partners, including, but not limited to, expenditure in connection with any of the following:

a. Meals.

b. Accommodation.

c. Transportation.

d. Admission fees.

e. Facilities and equipment used in connection with such entertainment, amusement or recreation.

f. Such other expenditure as specified by the Minister.

Deductions that are not allowable for tax purposes. (Article 33) This includes:

- Donations, grants and gifts to non-qualifying entities;
- Fines, penalties and other amounts awarded as compensation for damages or breach of contract;
- Bribes or other illicit payments;
- Dividends, share of profits or benefits of similar nature paid to the owner of the Taxable Person;
- Payments to a natural person who is a Taxable Person or a partner in an unincorporated partnership;
- Corporate Tax payable.
- Recoverable Value Added Tax.

- Tax levied outside the UAE.
- Any other expenditure as specified in Cabinet Decisions.

Transactions with Related Parties and Connected Persons

Loss relief: This includes carried forward losses and the transfer of losses within the group.

Incentives or special tax reliefs

Foreign tax credit. This arises from foreign tax that is paid on income that is also liable to UAE Corporate Tax. It can be used as a deduction to reduce taxable income.

Any other adjustments specified by the Minister.

4. Unrealized gains / loss – Capital vs. Revenue items

An unrealised gain or loss happens when there is a change in the value of an asset or liability held by a business but no transaction takes place to generate a gain or loss. The gain would be unrealised when the value of a business property increases but the property is unsold. An unrealised loss results from holding an asset that has decreased in price, but not yet selling it and realizing the loss.

Under Article 20(3) of the UAE CT Law, an option has been given to the taxable person to take into account the gains and losses on a realisation basis related to all assets and liabilities that are subject to fair value or impairment accounting under the applicable accounting standards; or all assets and liabilities held on capital account at the end of a tax period. However, the gain or loss on all assets and liabilities held in the revenue account will be considered on an unrealized basis as given in article 20(3)(b) of the UAE CT Law. This means the taxable person can elect for the gain to be taxed or the loss to be allowed on a realisation basis only for the assets and liabilities subject to fair value or impairment accounting or held on capital account. Whatever the treatment, it will apply to all assets and liabilities of the respective category.

The assets and liabilities subject to fair value generally include financial assets, financial liabilities, investment property, biological assets measured at fair value less cost to sell, and Intangible assets acquired in a business combination. The assets subject to impairment accounting include property, plant, and equipment (PPE), goodwill, intangible assets not acquired in a business combination, investments in equity instruments that are not held for trading etc.

The "assets held on capital account" include assets that the person does not trade, assets that are eligible for depreciation, or assets treated under applicable accounting standards as property, plant and equipment, investment property, intangible assets, or other non-current assets. The "liabilities held on capital account" refers to the incurring of which does not give rise to allowable tax expenditure or non-current liabilities.

The "assets and liabilities held on revenue account" refers to assets and liabilities other than those held on a capital account. These assets and liabilities are items held for generating revenue rather than for use in the ordinary course of business operations. These assets and liabilities are typically short-term and expected to be converted into cash or consumed within one year same as inventory items.

The taxable person can realise gain and loss on the assets and liabilities subject to fair value or impairment testing or held on account on a realisation basis. When the taxable person sells such assets or settles liabilities, the gain will be taxable, and the loss will be allowable. Still, for the assets and liabilities held on the revenue account, the taxable person will have to assess the unrealised gain or loss by the end of the tax period and adjust the accounting profits accordingly.

For example, if P Ltd (taxable person) buys a stock (inventory item) for \$500, which is part of the inventory items by the end of the year, and its market value increases to \$550, P Ltd will be liable to pay tax on this unrealised gain of \$50. On the contrary, if the value of the closing inventory has been reduced to \$ 400, then \$100 will be allowed as a tax-deductible expense. In both scenarios, accounting profits will be adjusted accordingly.

In the second situation, suppose P Ltd has bought machinery (asset held on the capital account) of \$1 million, which will be used for business purposes and booked as a non-current asset. The tax written down value (WDV) of the machinery is \$0.8 million after two years, but the market value of the same machinery is \$0.9 million simultaneously. In this scenario, P Ltd is not required to pay any tax on the unrealised gain if P Ltd has already elected to tax the gain on a realisation basis. If P Ltd has yet to elect to tax the gain on realisation basis, then P Ltd will be liable to pay tax on \$ 0.1 million. In the same way, tax loss if any, will be allowed on a realisation basis if elected. If not elected, then unrealized tax loss will be allowed by the end of the tax period. In both cases, P Ltd will adjust the accounting profits accordingly.

5. Thin-capitalization: Interest expense capping

Article 30 of the UAE CT Law, provides for Limitation Rules on General Interest Deduction. A Taxable Person may claim General Interest Deduction by deducting upto 30% before the deduction of interest, tax, depreciation and amortisation (EBITDA) for the relevant Tax Period, excluding any Exempt Income under Article 22 of this Decree-Law.

A Taxable Person's Net Interest Expenditure for a Tax Period is the amount by which the Interest expenditure incurred during the Tax Period, including the amount of any Net Interest Expenditure carried forward, exceeds the taxable Interest income derived during that same period. The calculation of Net Interest Expenditure shall exclude Interest expenditure that has not been allowed by any other provision of the UAE Corporate Tax Law. The amount of Net Interest Expenditure that is disallowed during deduction may be carried forward and deducted in the ensuing ten (10) Tax Periods following the order in which the amount was incurred. Where a Taxable Person's Net Interest Expenditure for the applicable Tax Period does not exceed a certain threshold set by the Minister, the General Interest Deduction Limitation Rule will not be applicable.

The provisions for calculating Net Interest Expenditure and claiming deductions on the same to reduce Taxable Income is not applicable on the following Taxable Persons:

a) A Bank.

b) An Insurance Provider

c) A natural person carrying out a Business or Business activity within the State.

d) Any other Person determined by the Minister.

If a Taxable Person is associated with one or more Persons by means of ownership or control and is required to consolidate its financial statements by relevant accounting standards, the Minister may issue a decision specifying the applicability of provisions of Net Interest Expenditure deduction on such Taxable Person.

As per Article 31 of the UAE CT Law, no deduction will be provided as interest expenditure that is incurred by a Taxable Person, on any loan obtained by it from a related party connected directly or indirectly to such Taxable Person for any of the following transactions:

a) A payout of profits or dividends to a Related Party.

b) A transfer of shares to a Related Party for the purposes of redemption, repurchase, capital reduction, or return of share capital.

c) Capital Contribution to a Related Party.

d) Buying an ownership stake in a Person who is, or after such acquisition becomes a, a Related Party.

6. Relief for small business / start-ups – Simplified financial and tax reporting

Article 21 of the UAE CT Law provides tax relief for small businesses. A tax resident person may elect to be treated as not having derived any Taxable Income where the revenue for the relevant and previous Tax Periods do not exceed a threshold and meet certain conditions (to be confirmed by Cabinet Decision). If a tax resident person applies for "small business relief", certain provisions of the corporate tax law will not apply such as exempt income, reliefs, deductions, tax loss relief, transfer pricing compliance requirements, as specified in the relevant chapters of the corporate tax law. The Authority may request any relevant records or supporting information to verify the compliance within a timeline (to be confirmed by Cabinet Decision).

In case of startups/early-stage companies, incur hefty costs and have losses in the initial years can 'carry forward their losses indefinitely which they can subsequently set off with profits in the later years'.

Further, as per the above provision, which will allow small companies whose turnover is below a threshold (to be defined later) to be exempt from corporate tax. This is in addition to the general provision of 0 per cent rate of tax for taxable income up to AED 375,000.

Illustration:

XYZ LLC a mainland company earned a Profit of AED 1,000,000 in the year 2024. What would be the UAE corporate tax amount payable?

The CT liability will be calculated as follows:

- Taxable income of AED 375,000 (amount to be confirmed in a Cabinet Decision) subject to CT at 0%: AED 375,000 x 0% = AED 0
- Taxable income exceeding AED 375,000 (amount to be confirmed in a Cabinet Decision) subject to CT at 9%: (AED 1,000,000 – AED 375,000) = AED 625,000 x 9% = AED 56,250.

The UAE CT liability for the Tax Period will be AED 0 + AED 56,250 = AED 56,250

Chapter 9

Thin Capitalization Norm

This chapter covers the following:

- **What is Thin Capitalization Norm?**
- **OECD's approach towards Thin-cap norms**
- **Fixed ratio rule and Group ratio rule**
- **Intra-group borrowing and need for 'Valid commercial reasons'**
- **Safe-harbor protection**

1. What is Thin Capitalization Norm?

OECD's BEPS Action Plan 4 recommendations aim to limit base erosion through the use of interest expense to achieve excessive interest deductions or to finance the production of exempt or deferred income.

A company is typically financed (or capitalized) through a mixture of debt and equity. Interest on debt is allowed as deduction for calculation of taxable profits and for this reason, debt is often a more tax efficient method of finance than equity.

Thin capitalization refers to a situation where a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are also referred as highly leveraged or highly geared companies.

The manner in which a company is capitalized will often have a significant impact on the amount of profit it reports and offers for tax purposes in various tax jurisdictions. Normally, all the countries tax rules allow a deduction for interest paid or payable in arriving at the taxable profits. The higher the level of debt in a company, higher is the amount of interest it pays and thereby the lower will be its taxable profit.

Multinational Enterprises (MNEs) often structure their financing arrangements to maximize these benefits. MNEs establish a tax-efficient mixture of debt and equity in borrowing countries, influencing the tax treatment of the lender which receives the interest.

For example:

The arrangements between two companies A (lender) and B (borrower) belonging to the same MNE group may be structured in a way that allows the interest to be received in A's jurisdiction that either does not tax the interest income, or which subjects such interest to a low tax rate. Further B (operating in high tax jurisdiction) claims deduction on interest paid to A.

The exact effect on tax revenue of increased interest payments will, however, depend on any withholding taxes in B's tax jurisdiction and the provisions of any tax treaties in force between these jurisdictions. Countries typically tax interest on a source basis. This means that the recipient of the interest (in this case the non-resident lender, A) will be taxed in the country in which the interest arises (in this case the country of the borrower, B). i.e., A, the non-resident recipient of interest will be liable to tax in the country of the affiliate payer, B.

The interest recipient's tax liability is normally withheld by the paying affiliate, and then paid to the tax authority of the payer.

Bilateral tax treaties and conventions, which allocate taxing rights between the source (payer) and residence (recipient) countries, often eliminate or significantly lower withholding tax rates applied to interest paid to a non-resident recipient.

The manner in which a company is capitalized can have a significant effect on the amount of profit it reports, and thus the amount of tax it pays. For this reason, country tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country's tax base.

Chapter 9 of Federal Decree-Law No. 47 of 2022 ("UAE CT Law" or "Law") dealing with deductions has similarly, in line with OECD's BEPS Action Plan has incorporated Article 30 - General Interest Deduction Limitation Rule.

Before we understand the concept in the context of UAE CT Law, let us understand certain key aspects pertaining to the same.

2. OECD's approach towards Thin-cap norms

2.1 Introduction

As mentioned above, Action 4 recommendations aim to limit base erosion through the use of interest expense to achieve excessive interest deductions or to finance the production of exempt or deferred income. The work by the Inclusive Framework member jurisdictions on Action 4 resulted in the 2015 OECD report Limiting Base Erosion Involving Interest Deductions and Other Financial Payments.

2.2. Issue identified by OECD:

Multinational groups may achieve favourable tax results by adjusting the amount of debt in a group entity. BEPS risks in this area may arise in three basic scenarios:

- Groups placing higher levels of third-party debt in high tax countries.
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third-party interest expense.

- Groups using third party or intragroup financing to fund the generation of tax-exempt income.

2.3 OECD conclusions on how this impacts and matters for BEPS

The use of third party and related party interest is perhaps one of the simplest of the profit-shifting techniques available in international tax planning. The fluidity and fungibility of money make it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity.

In particular, the deductibility of interest expense can give rise to double non-taxation in both inbound and outbound investment scenarios. The interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed at comparatively low tax rates or not at all at the level of the recipient. This is despite the fact that in some situations the multinational group may have little or no external debt.

2.4 OECD's approach and recommendations under BEPS Action Plan 4

The 2015 Action 4 report on Limiting Base Erosion involving Interest Deductions and Other Financial Payments focused on the use of all types of debt giving rise to excessive interest expense or used to finance the production of exempt or deferred income.

In particular, this report established rules that linked an entity's net interest deductions to its level of economic activity within the jurisdiction, measured using taxable earnings before interest income and expense, depreciation and amortisation (EBITDA).

This approach includes three elements:

a) Fixed ratio rule based on a benchmark net interest/EBITDA ratio;

b) Group ratio rule which may allow an entity to deduct more interest expense depending on the relative net interest/EBITDA ratio of the worldwide group

c) Targeted rules to address specific risks.

To regulate thin capitalization in the economy, tax administrators have introduced these rules in their respective jurisdictions. OECD has recommended these approaches to govern and tackle tax evasion through thin capitalisation.

It is duly seen that adopting anti-abuse provisions by linking interest deductions with EBITDA would be very unfavourable to the taxpayer as it differs from year-year irrespective of the interest paid being constant. Specially for start-ups, the EBITDA in their initial years could be fair and satisfactory and it may be higher as the entity grows. By adopting this approach and limiting the amount of interest deducted, may adversely affect the economies distorting the functioning of these subsidiaries. Fixed ratio-based approach might not oversee the resultant market conditions and its effect on specific industries which may cause inconsistent treatment of MNEs lacking in proper implementation of the provisions, Eg; the downfall due to Covid-19 has affected the profit ratio of several entities and their debts which required larger MNEs to lend support by providing funds.

3. Fixed ratio rule and Group ratio rule

3.1 Introduction

Ratio approaches determine the amount of deductible interest expense by reference to a specified ratio, such as the ratio of debt to equity.

Normally these rules include the following two types:

Fixed Ratio - For example, the rules might allow interest payments on debt of up to two times the total amount of equity invested in the group affiliate. Any additional interest would not be deductible.

Group Ratio – These rules compares the debt to equity ratio (or other financial indicators) of the entity under consideration to the worldwide group debt (or other financial indicator) to worldwide equity to determine (for the purposes of the thin capitalization rules) if the group affiliate's debt level is excessive.

3.2 Pros and Cons of Ratio approaches:

These approaches come along with their own Pros and Cons as follows:

Pros:

— Provides a great deal of certainty.

— Reduces compliance costs to companies and taxing authorities.

— Simple to implement.

— Reduces the resource costs of tax authorities.

Cons:

— Does not necessarily reflect economic reality.

— May distort behaviour by group affiliates.

— Does not take into account specific market situations or industries

— May result in inconsistent treatment of members of MNEs in comparisons to independent companies.

— There is no agreed international standard for the formulation of an appropriate ratio.

3.3 Debt and Equity needs to be defined

Ratio rules which employ the concepts of debt and equity necessarily need to define these terms.

Third party lenders define debt as anything that is substantively a loan. This includes finance leases, financial derivatives (synthetic loans), certain debt factoring arrangements, certain redeemable preference shares, and overdrafts.

For the purpose of thin capitalization legislation, debt should ideally be not limited to financial instruments classified as debt under accounting standards. The definition of debt avoids the difficulties in determining whether an instrument is effectively equity or debt by focusing on the deductibility of the interest or other finance charges for tax purposes, rather than the principles of accounting or financial standards.

Example: An instrument may be defined as debt if it gives rise to interest that is paid or payable that is otherwise deductible in the computation of taxable profit.

Some countries define debt for the purpose of their thin capitalization legislation as related-party debt only, whereas others apply total debt in the relevant ratios.

Example of the application of a ratio approach

Company X, a corporation resident in Country A, establishes group affiliate Company Y in Country B with an investment of 10 in equity capital and a loan of 90 from Company X at a 10% interest rate.

Company Y generates pretax and pre-interest income of 15 for year 20XX, and must pay interest to Company X at 10% i.e. a total interest payment of 9.

Under Country A's thin capitalization rules, deductions for payments of interest is limited by reference to a debt to equity ratio of 2:1. That is, interest on any debt that is in excess of 2x the level of equity will not be allowable for tax purposes.

On a simple application of the rules, then, interest on debt in excess of 2x the level of equity will be denied. That is, debt in excess of 20 (2x10). In such case, interest on debt of 70 (90-20) will be disallowed, i.e., 70x10% = 7. This leaves interest of 2 as allowable.

3.4 UAE's approach on Thin Capitalization Norm

UAE Tax Law follows the fixed ratio approach. However, the Thin Capitalization is not restricted to expenditure incurred by the Taxable Person for the related parties and includes any interest expenditure incurred perse as defined under Article 1 of the UAE Tax Law.

UAE Tax Law provides Article 29 which deals with interest expenditure. Such Article provides as follows:

Article 29 – Interest Expenditure

Notwithstanding paragraph (b) of Clause 2 of Article 28 of this Decree-Law, Interest expenditure shall be deductible in the Tax Period in which it is incurred, subject to the other provisions of Article 28 and Articles 30 and 31 of this Decree-Law.

Further, Article 30 incorporates the Thin Capitalization Norm as follows:

Article 30 – General Interest Deduction Limitation Rule

1. A Taxable Person's Net Interest Expenditure shall be deductible up to 30% (thirty percent) of the Taxable Person's accounting earnings before the deduction of interest, tax, depreciation and amortisation (EBITDA) for the relevant Tax Period, excluding any Exempt Income under Article 22 of this Decree-Law.
2. A Taxable Person's Net Interest Expenditure for a Tax Period is the amount by which the Interest expenditure incurred during the Tax Period, including the amount of any Net Interest Expenditure carried forward under Clause 4 of this Article, exceeds the taxable Interest income derived during that same period.
3. The limitation under Clause 1 of this Article shall not apply where the Net Interest Expenditure of the Taxable Person for the relevant Tax Period does not exceed an amount specified by the Minister.
4. The amount of Net Interest Expenditure disallowed under Clause 1 of this Article may be carried forward and deducted in the subsequent (10) ten Tax Periods in the order in which the amount was incurred, subject to Clauses 1 and 2 of this Article.
5. Interest expenditure disallowed under any other provision of this Decree-Law shall be excluded from the calculation of Net Interest Expenditure under Clause 2 of this Article.
6. Clauses 1 to 5 of this Article shall not apply to the following Persons:
    a) A Bank.
    b) An Insurance Provider.
    c) A natural person undertaking a Business or Business Activity in the State.
    d) Any other Person as may be determined by the Minister.
7. The Minister may issue a decision to specify the application of Clauses 1 and 2 of this Article to a Taxable Person that is related to one or more Persons through ownership or control and there is an obligation on them under applicable accounting standards for their financial statements to be consolidated.

Furthermore, Article 31 of the Decree Law provides as follows:

Article 31 - Specific Interest Deduction Limitation Rule

1. No deduction shall be allowed for Interest expenditure incurred on a loan obtained, directly or indirectly, from a Related Party in respect of any of the following transactions:

a) A dividend or profit distribution to a Related Party

b) ***A redemption, repurchase, reduction or return of share capital to a Related Party.***

c) ***A capital contribution to a Related Party.***

d) ***The acquisition of an ownership interest in a Person who is or becomes a Related Party following the acquisition***

2. ***Clause 1 of this Article shall not apply where the Taxable Person can demonstrate that the main purpose of obtaining the loan and carrying out the transaction referred to under Clause 1 of this Article is not to gain a Corporate Tax advantage.***

3. ***For the purposes of Clause 2 of this Article, no Corporate Tax advantage shall be deemed to arise where the Related Party is subject to Corporate Tax or a tax of a similar character under the applicable legislation of a foreign jurisdiction on the Interest at a rate not less than the rate specified in paragraph (b) of Clause 1 of Article 3 of this Decree-Law.***

UAE Tax Law also provides the definition of Interest and Net Interest Expenditure as follows under Article 1:

Interest: Any amount accrued or paid for the use of money or credit, including discounts, premiums and profit paid in respect of an Islamic financial instrument and other payments economically equivalent to interest, and any other amounts incurred in connection with the raising of finance, excluding payments of the principal amount.

Net Interest Expenditure: The Interest expenditure amount that is in excess of the Interest income amount as determined in accordance with the provisions of this Decree-Law.

3.5 Key points to be noted on the Thin Capitalization norms of UAE Tax Law

— General interest expenditure allowed is on net basis after reduction of interest income, if any and up to 30% of EBIDTA.

— EBIDTA calculation would exclude the exempt income as per Article 22 of the Decree Law .

— Exclusion is provided to interest expenditure if incurred by a bank, insurance providers, natural persons undertaking business activity and any other person as by be determined by the Minister of Finance.

— Carry forward is available for subsequent 10 years in event of any disallowance and such interest would be included for limit calculation in next tax period.

— Specific interest excluded for related parties as specified in Article 31

Example:

Tax Period 1

— Interest income – 30

— EBIDTA excluding interest income and including exempt income – 100

— Exempt income – 20

— General interest expenditure – 70

— Specific interest expenditure – 10

Tax Period 2

— Interest income – 40

— EBIDTA excluding interest income and including exempt income – 130

— Exempt income – 25

— General interest expenditure – 60

— Specific interest expenditure – 5

As per the UAE Tax Law, following shall be the interest expenditure available for Tax Period 1

EBIDTA for 30% limitation as per Article 30 = EBIDTA excluding interest income and including exempt income - Exempt income = 100-20 = 80

30% of EBIDTA as per Article 30 = 30% of 80 = 24

Net Interest expenditure = General interest expenditure – Interest income = 70-30 = 40

General interest disallowed = 40 – 24 = 16 (Carried forward for set-off during consequent 10 Tax periods as per Article 30(4))

Specific interest disallowed = 10 (No carried forward allowed)

As per the UAE Tax Law, following shall be the interest expenditure available for Tax Period 2

EBIDTA for 30% limitation as per Article 30 = EBIDTA excluding interest income and including exempt income - Exempt income = 130-25 = 105

30% of EBIDTA as per Article 30 = 30% of 105 = 31.5

Net Interest expenditure = General interest expenditure + carried forward amount as per Article 30(2) – Interest income = 60+16-40 = 36

General interest disallowed = 36–31.5 = 4.5 (Carried forward for set-off during consequent 10 Tax periods)

Specific interest disallowed = 5 (No carried forward allowed)

4. Intra-group borrowing and need for 'Valid commercial reasons'.

The UAE Tax Law specifically provides for certain interest which are not allowed and are not subject to the Thin Capitalization norms as well owing to the nature for which such loans may be arranged between the related parties.

The same is provided in Article 31 as provided above and the following reasons are hence may be termed as not valid commercial reasons for an Intra-group borrowing:

a) A dividend or profit distribution to a Related Party

b) A redemption, repurchase, reduction or return of share capital to a Related Party.

c) A capital contribution to a Related Party.

d) The acquisition of an ownership interest in a Person who is or becomes a Related Party following the acquisition

However, Article 31(2) also provides an exception to the above wherein an opportunity is given to the Taxable Person whereby they can demonstrate that the main purpose of obtaining the loan and carrying out the transaction referred to under Clause 1 of this Article is not to gain a Corporate Tax advantage. Furthermore, such demonstration may not be required where the Related Party is subject to Corporate Tax or a tax of a similar character under the applicable legislation of a foreign jurisdiction on the Interest at a rate not less than the rate specified in paragraph (b) of Clause 1 of Article 3 of UAE Tax Law.

The above discussions clearly enumerate the need for a valid commercial reasons for the Intra group borrowings. The OECD Transfer Pricing Guidance on Financial Transactions provides certain consideration for the intra group loans. Some of the key elements are as follows:

Determination of whether a purported loan should be regarded as a loan

— Commentary to Article 9 of the OECD Model Tax Convention notes at paragraph 3(b) that Article 9 is relevant "not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.

— In accurately delineating an advance of funds, the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances:

- the presence or absence of a fixed repayment date;
- the obligation to pay interest;
- the right to enforce payment of principal and interest;
- the status of the funder in comparison to regular corporate creditors;

- the existence of financial covenants and security;
- the source of interest payments;
- the ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- the extent to which the advance is used to acquire capital assets; and
- the failure of the purported debtor to repay on the due date or to seek a postponement.

— The process of accurate delineation of the actual transaction also requires an understanding of how the particular MNE group responds to those identified factors. In this regard, the MNE group's policies may inform the accurate delineation of the actual transaction through the consideration of, for instance,

- how the MNE group priorities the funding needs among different projects;
- the strategic significance of a particular MNE within the MNE group;
- whether the MNE group is targeting a specific credit rating or debt-equity ratio; or
- whether the MNE group is adopting a different funding strategy than the one observed in its industry sector.

The lender's and borrower's perspectives

— In considering the commercial and financial relations between the associated borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both the lender's and borrower's perspectives should be taken into account, acknowledging that these perspectives may not align in every case.

— The lender's perspective in the decision of whether to make a loan, how much to lend, and on what terms, will involve evaluation of various factors relating to the borrower, wider economic factors affecting both the borrower and the lender, and other options realistically available to the lender for the use of the funds.

— Borrowers seek to optimise their weighted average cost of capital and to have the right funding available to meet both short-term needs and long-term objectives.

Use of Credit ratings

— The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge.

— Credit ratings can be determined for the overall creditworthiness of an MNE or MNE group or for a specific issuance of debt.

Above are few guidance available from the OECD Transfer Pricing Guidance on Financial Transactions and would require analysis of several other factors as mentioned therein.

5. Safe-harbor protection

The Safe harbor /de minimis threshold was expected to be notified under the UAE CT - i.e., interest costs up to a threshold level would not attract any disallowances.

However, instead of any such threshold, Article 30(6) provides that that General Interest Deduction Limitation Rule would not apply to the following persons:

a) A Bank.

b) An Insurance Provider.

c) A natural person undertaking a Business or Business Activity in the State.

d) Any other Person as may be determined by the Minister.

This should help business entities wherein the direct expenditure (specifically banks and insurance providers) is the interest cost. Further, the natural persons are provided with ease of doing business whereby they can take loans/debt to increase the business activity even with negative or low EBITDA to claim a deduction for interest costs without any limitation.

It is also provided that Minister of Finance may on consideration of the case-to-case basis scenario exempt any taxable persons from the application of the Thin Capitalization Norm.

Chapter 10

Certain Incomes that are Exempt

This chapter covers the following:

- **Exemption to domestic profit distributions, including dividends (Article 22)**
- **Participation Exemption (Article 23)**
- **Foreign Permanent Establishment Exemption (Article 24)**
- **Income derived by a non-resident person operating aircraft or ships in International Transportation (Article 25)**

1. Introduction

The Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses ('UAE CT Law') provides the legislative framework for taxing corporations and businesses and also includes any income which is exempt from UAE Corporate Tax ('UAE CT'). However, the UAE CT Law should be read along with the Frequently Asked Questions (FAQs) published on the Ministry of Finance (MoF) website to gain a wholistic view on the intent and mechanics of the exempt income under Chapter 7.

Dividend and participation exemption regimes incorporated under the UAE CT Law draw genesis from the Latin maxim 'ne bis in idem' which means that a person cannot be prosecuted twice for the same offence. In tax terms, this means that a person should not be suffer taxation twice on the same income.

2. Exemption to domestic profit distributions, including dividends (Article 22)

Any dividend and other profit distributions received by a Taxable Person from UAE resident legal persons would be treated as exempt from UAE CT irrespective of the level of ownership including any dividend received from a Qualifying Free Zone Person (FZP). Further, there are other income also like dividend income and other income from participation interest, income from Foreign PE, income derived by Non-Resident from operating aircraft or ships in international transportation.

This exemption is in line with best tax practices prevalent in many other countries and leading international financial centers. The purpose of this exemption is to avoid double taxation of corporate profits i.e., first in the hands of the juridical person when profits are earned and second in the hands of shareholder when such profits are distributed. In the absence of this exemption, dividends and other profit distributions would be doubly taxed in the same jurisdiction.

Illustration

A LLC is a wholly owned subsidiary of B LLC, both companies are tax resident in UAE and are subject to UAE CT at regular rates. A earns taxable income of AED 1 million in 2024 and pays a tax of AED 56,250 on its taxable income and distributes the whole of after-tax profits of AED 943,750 as dividends to B LLC. Without the dividend exemption, AED 943,750 received by B LLC would be taxed again as taxable income of B LLC thereby leading to economic double taxation of the same income in the hands of different Persons in the same jurisdiction.

However, in the absence of adequate controls within the UAE CT framework, this exemption could lead to non-taxation of income, particularly, in case of dividends distributed by a Qualifying FZP enjoying the benefit of UAE CT at a rate of 0% or distributions made by other exempt persons not subjected to UAE CT.

3. Participation Exemption (Article 23)

A participation exemption regime is not a new concept and is prevalent across multiple tax jurisdictions across the world. Neutrality against double taxation can be achieved through either a Participation Credit system or a Participation exemption regime.

A Participation Credit system attributes credit to shareholders for taxes suffered by the participating interest on its income. However, this system is susceptible to abuse and difficult to administer.

Accordingly, in line with best practices, the UAE Government has adopted the Participation Exemption regime under UAE CT Law which exempts the following income derived from a Participating Interest:

a) Dividends and other profit distributions received from a foreign participation, effectively managed and controlled in the state.

b) Gains or losses derived on the transfer, sale or other disposition of a participating interest (or part thereof) after the qualifying period is mentioned in Clause 2 or clause 9 of Article 23.

c) Foreign exchange and impairment gains or losses in relation to a participating interest

Generally, Participating Interest means a 5% or greater ownership interest in the shares or capital of a juridical person (Participation) fulfilling the below conditions:

a) The Participating Interest is held or intended to be held for an uninterrupted period of 12 months or more - This condition seeks to mitigate the abuse of participation exemption by shareholders in a case where taxable persons hold the participating interest in a legal entity for a short period of time when the profits are distributed by the participation to avoid paying corporate tax on the dividends and after receipt of dividends, dispose the participating interest.

b) Participation is subject to a Corporate or any equivalent tax in its resident jurisdiction at a rate of 9% or more – Needs to be fulfilled where

— The principal objective and activity of the participation is acquisition and holding shares as per participation exemption criteria and the income of the participation during the relevant periods consists substantially of income from participating interests

— The participating interest is held in a Qualifying Free Zone Person or an exempt person under UAE CT Law

c) The ownership interest in the Participation enables the taxable person to receive 5% or more of the retained earnings and of the liquidation proceeds on cessation of the participation – This condition aims to establish that ownership interest in the participation is a beneficial interest of the taxable person and the taxable person is not merely holding the participating interest on behalf of some other person

d) Additionally, the direct and indirect assets of the participation do not consist of more than 50% ownership interests or entitlements that would have disqualified the taxable person from a participation exemption if directly held – This is an anti-abuse provision to mitigate tax motivated structuring to unduly benefit from participation exemption.

e) Any other conditions as may be prescribed by the Minister.

UAE CT Law provides that participation exemption shall be denied under following circumstances:

a) Where the Participation can claim a deduction for the dividend or other distributions under any domestic tax legislation;

b) In case a deductible impairment loss in respect of the Participation Interest is recognized by the taxable person before qualifying for the benefit as such;

c) Taxable person or its related party in UAE subject to UAE CT has recognized a deductible impairment loss in respect of a loan receivable from the Participation – However, in case the impairment loss is reversed in subsequent tax period, the associated income shall be exempt from UAE CT in such tax period up to the amount of income from the participating interest that was not exempted earlier.

In case of Participation Interest covering more than one tax year, any income treated as exempt in a prior year would be taxable in the year of default of the holding period criterion.

4. Foreign Permanent Establishment Exemption (Article 24)

UAE CT Law provides a resident taxable person with the option not to consider the income and associated expenditure of its Foreign Permanent Establishments (PE) while computing its taxable income. Provided that, such Foreign PE(s) are subject to a corporate or similar tax under applicable legislations at a rate of 9% or more.

Foreign PE(s) could take the form of a place of business or other similar presence outside UAE provided as per Article 14 of the UAE CT law or applicable domestic tax law in the PE jurisdiction.

As per the exemption, A Resident Person need not take into account the income, and associated expenditure, of its Foreign PE in determining Taxable Income subject to UAE CT including:

— Losses in any Foreign PE(s);

— Positive income and associated expenditure in any Foreign PE(s); and

— Eligible Foreign Tax Credit under Article 47 of UAE CT

In case of multiple Foreign PEs, this exemption would be available on an aggregated basis only.

For the purposes of this exemption, each Foreign PE should be regarded on an independent basis. Accordingly, for determining taxable income of a Foreign PE, any transfer of assets or liabilities between the taxpayer and Foreign PE would be deemed to be at Market Value at the date of such transfer.

5. Income derived by a non-resident person operating aircraft or ships in International Transportation (Article 25)

As per UAE CT Law, income derived by a Non-Resident from the operation of aircraft or ships for international transportation would not be subject to UAE CT if all the conditions below are met:

a) Such Non-Resident Person is in the Business of International transport of passengers, livestock, mail, parcels, merchandise or goods by air or by sea; or Leasing or chartering aircrafts or ships used in international transportation; or Leasing of equipment which are integral to the seaworthiness of ships or the airworthiness of aircrafts used in international transportation.

b) A UAE Resident that performs any of the activities mentioned above would be exempt, or not be subject to corporate or similar tax under applicable legislation of the country or territory in which the Non-Resident Person is resident.

This exemption seems to be in line with Article 8 of the OECD Model Tax Convention which provides the taxing rights for income from international transportation to the jurisdiction in which the taxpayer is resident. However, the UAE CT Law has imposed an additional requirement of reciprocity for exemption in foreign jurisdiction for UAE resident companies.

Chapter 11

Offset of Tax Losses

This chapter covers the following:

PART A

- Tax Loss Relief (Article 37)
- Transfer of Tax Loss (Article 38) 11.3
- Limitation on Tax Losses Carried Forward (Article 39)

PART-B-RELIEF FROM DOUBLE TAXATION

- Different methods of elimination of Juridical Double Taxation
- Methods of elimination of Juridical Double Taxation
- Foreign Permanent Establishment (PE) Exemption
- Foreign Tax Credit (FTC) under the Tax Treaties

PART C. GROUP TAXATION

- Introduction
- Tax Group (Article 40)
- Date of Formation and Cessation of a Tax Group (Article 41)
- Taxable Income of a Tax Group (Article 42)

PART D. CORPORATE REORGANIZATIONS

- Introduction
- Economic purpose & types of a corporate reorganisation
- Different classes of merger for tax purposes
- The Taxation of Corporate Reorganizations
- Grounds for preferential tax regimes in the framework of corporate mergers and
- reorganizations
- The Cross-Border Tax Effects of Mergers

Part A

1. Introduction

Offset of Tax Losses is enumerated under Chapter 11 which consists of Article 37, Article 38, and Article 39 of UAE Corporate Tax Law on Businesses and Corporations (hereinafter referred to as **Decree-Law**) which are provided below:

- **Article 37:** Tax Loss Relief
- **Article 38:** Transfer of Tax Loss
- **Article 39:** Limitation on Tax Losses Carried Forward

Tax Loss is defined under Article 1 of this Decree-Law as, "**any negative Taxable Income as calculated under this Decree-Law for a given Tax Period**".

2. Tax Loss Relief (Article 37)

A. A Tax Loss can be offset against the Taxable Income of subsequent Tax Periods to arrive at the Taxable Income for those subsequent Tax Periods.

B. The amount of Tax Loss used to reduce the Taxable Income for any subsequent Tax Period **cannot exceed 75%** (seventy-five percent) or any other percentage as specified in a decision issued by the Cabinet at the suggestion of the Minister of the Taxable Income for that Tax Period before any Tax Loss relief, except in circumstances that may be prescribed in a decision issued by the Cabinet at the suggestion of the Minister.

C. A Taxable Person cannot claim Tax Loss relief for:

a) Losses incurred before the date of commencement of Corporate Tax.

b) Losses incurred before a Person becomes a Taxable Person under this Decree-Law.

c) Losses incurred from an asset or activity the income of which is exempt, or otherwise not taken into account under this Decree-Law.

D. A Tax Loss carried forward to a subsequent Tax Period must be set off against the Taxable Income of that subsequent Tax Period, before any remainder can be carried forward to a further subsequent Tax Period, or any Tax Loss transferred under Article 38 of this Decree-Law can be utilised.

Points to Remember
1. Tax losses shall be used to offset the taxable income of subsequent tax periods.
2. Tax Loss to be utilised should not exceed 75% of the taxable income of that tax period before such offset.

3. Tax loss cannot be claimed for losses incurred before the commencement of this Act, losses incurred before a Person becomes taxable person or tax loss due to an activity the income of which is exempt or not taken into account under this Decree-Law.
4. Tax loss must be setoff first against the taxable income of subsequent period before it is carried forward to the next period or transfer under Article 38.

Illustrations

1. A company BAC has tax loss in the year 2025 of amount AED 650,000. In the subsequent year 2026, it incurs a profit of AED 400,000. What is the amount of tax loss offset and carry forward in the year 2026 and 2027 respectively?

   Solution: As per Article 37 clause (2), The amount of Tax Loss used to reduce the Taxable Income for any subsequent Tax \Period cannot exceed 75% (seventy-five percent) or any other percentage as specified in a decision issued by the Cabinet at the suggestion of the Minister of the Taxable Income for that Tax Period before any Tax Loss relief, except in circumstances that may be prescribed in a decision issued by the Cabinet at the suggestion of the Minister.

   So, BAC can offset the tax loss of amount AED 300,000 (400,000*75%) in the year 2026.

   Further, the tax income in 2026 is (400,000-375,000)-tax loss relief (25,000) equals NIL.

   BAC shall carry forward tax loss of AED 625,000 (650,000-25,000) in the year 2027.

2. All the facts remain the same except tax loss pertains to the activity the income of which is exempt as per Decree-Law. What is the amount of tax loss offset and carry forward in the year 2026 and 2027 respectively?

   Solution: As per Article 37clause (3) Para (c), A Taxable Person cannot claim Tax Loss relief for Losses incurred from an asset or activity the income of which is exempt, or otherwise not taken into account under this Decree-Law.

   So, as per above, BAC cannot claim the tax loss relief for tax loss of amount AED 650,000.

3. Transfer of Tax Loss (Article 38)

A. **Conditions of Transfer of Tax Loss**: A Tax Loss or a portion thereof may be offset against the Taxable Income of another Taxable Person where all of the following conditions are met:

   a) Both Taxable Persons are juridical persons.

b) Both Taxable Persons are Resident Persons.

c) Either Taxable Person has a direct or indirect ownership interest of **at least 75% (seventy-five percent) in the other, or a third Person has a direct or indirect ownership interest of at least 75% (seventy-five percent) in each of the Taxable Persons**.

d) The common ownership under paragraph (c) of Clause 1 of this Article must exist from the start of the Tax Period in which the Tax Loss is incurred to the end of the Tax Period in which the other Taxable Person offsets the Tax Loss transferred against its Taxable Income.

e) None of the Persons are an Exempt Person.

f) None of the Persons are a Qualifying Free Zone Person.

g) The Financial Year of each of the Taxable Persons ends on the same date.

h) Both Taxable Persons prepare their financial statements using the same accounting standards.

B. Where a Taxable Person transfers its Tax Loss to another Taxable Person under Clause 1 of this Article:

a) the Taxable Person which the Tax Loss is transferred to shall reduce its Taxable Income for the relevant Tax Period;

b) the total Tax Loss offset shall not exceed the amount allowed under Clause 2 of Article 37 of this Decree-Law; and

c) the Taxable Person shall reduce its available Tax Losses by the amount of the Tax Loss transferred to the other Taxable Person for the relevant Tax Period.

Points to Remember

a) Tax Loss or part thereof shall be transferred to the other taxable person when:

   a. Both taxable persons are juridical person

   b. Both taxable persons are resident person

   c. Either taxable person has direct or indirect ownership interest at least 75% in the other person.

   d. Third person has direct or indirect ownership interest at least 75% in each of the taxable person.

   e. The ownership interest of 75% must exist from the start of tax period of incur of tax loss till the end of tax period in which such tax loss is offset against the taxable income.

f. None are exempted or qualifying free zone persons.

g. Financial year of both persons must end at same date.

h. Both follow same accounting standards.

b) Tax loss transferred and to be utilised should not exceed 75% of the taxable income before such offset.

The details regarding transfer of tax loss to another person under Clause 1 of this Article:

a) the Taxable Person which the Tax Loss is transferred to shall reduce its Taxable Income for the relevant Tax Period;

b) the total Tax Loss offset shall not exceed the amount allowed under Clause 2 of Article 37 of this Decree-Law; and

c) the Taxable Person shall reduce its available Tax Losses by the amount of the Tax Loss transferred to the other Taxable Person for the relevant Tax Period.

Illustrations

1. Below is the data of two companies. Both companies follow different accounting standards for maintaining books of accounts.

   a. Company PQR has a taxable loss of AED 150,000 in Tax period 2024.

   b. Company BAC has a taxable income of AED 600,000 and holds 90% interest in PQR in Tax Period 2024.

   Can PQR transfer its taxable loss to BAC for FY 2024? If yes, then what will be the amount of tax loss transfer?

   Solution: As per Article 38 clause (1) para (h), the Tax Loss or a portion thereof may be offset against the Taxable Income of another Taxable Person where all the following conditions are met:

   Both Taxable Persons prepare their financial statements using the same accounting standards.

   Here, both companies don't follow the same accounting standards. So, PQR can't transfer tax loss of AED 250,000 to BAC.

2. All the facts above remain the same except both companies follow the same accounting standards. Can PQR transfer its taxable loss to BAC for FY 2024? If yes, then what will be the amount of tax loss transfer and utilisation?

   Solution: As per Article 38 clause (2), Where a Taxable Person transfers its Tax Loss to another Taxable Person under Clause 1 of this Article:

a) the Taxable Person to which the Tax Loss is transferred shall reduce its Taxable Income for the relevant Tax Period;

b) the total Tax Loss offset shall not exceed 75% of taxable income; and

c) the Taxable Person shall reduce its available Tax Losses by the amount of the Tax Loss transferred to the other Taxable Person for the relevant Tax Period.

As per Article 38(1), if all the conditions are met and as per Article 38(2), PQR can transfer tax loss of (600,000 *75%) i.e. 450,000 however, the loss available is AED 150,000.

The tax loss to be carried forward by PQR to the subsequent year is NIL (150,000-150,000).

The taxable income of BAC is AED 450,000 (600,000-150,000). Thus, tax payable is 9% of 75,000 (450,000-375,000) i.e. 6,750.

4. Limitation on Tax Losses Carried Forward (Article 39)

A. Tax Losses can only be carried forward and utilised in accordance with the provision of Clause 2 of Article 37 of this Decree-Law provided that:

a) From the beginning of the Tax Period in which the Tax Loss is incurred to the end of the Tax Period in which the Tax Loss or part thereof is offset against Taxable Income of that period, the same Person or Persons continuously **owned at least a 50% (fifty per cent) ownership interest** in the Taxable Person.

b) The Taxable Person continued to **conduct the same or a similar Business or Business Activity** following a **change in ownership of more than 50%** (fifty per cent).

B. For the purposes of paragraph (b) of Clause 1 of this Article, relevant factors for determining whether a Taxable Person has continued to conduct the same or a similar Business or Business Activity following a change in the direct or indirect ownership include:

a) the Taxable Person **uses some or all of the same assets** as before the ownership change;

b) the Taxable Person **has not made significant changes to the core identity or operations** of its Business since the ownership change; and

c) where there have been **any changes, these result from the development or exploitation of assets, services, processes, products or methods** that existed before the ownership change.

C. Clause 1 of this Article shall **not apply** to a Taxable Person whose **shares are listed on a Recognised Stock Exchange**.

Points to Remember

1. Same person must have at least 50% of ownership interest from beginning of tax period in which loss is incurred till the end of the tax period in which such loss is offset against the taxable income.
2. If there is a change in the ownership interest of more than 50%, the taxable person must conduct the same or similar Business or Business Activity.
3. The limitation of 50% shall not apply if the taxable person is listed on recognised stock exchange.

Part-B. Relief from double taxation

1. Introduction

Individuals and firms who operate in different countries frequently face double taxation. It occurs when two or more nations tax the same income, resulting in a larger total tax burden for the taxpayer. Countries have evolved several methods to grant relief from double taxation to address this issue.

Following the "Residence rule and/or Source rule of taxation" is a classic illustration of the source of double taxation.

Double taxation may be classified into two types:

Juridical double taxation occurs when an income is taxed twice in the hands of taxpayers, once in the nation of residence and once in the country of source. Most nations experience double taxation because of income being taxed in more than one country.

Reasons for juridical double taxation:

- Taxation of worldwide income of residents
- Taxation of worldwide income of citizens
- Deemed Dual residency
- Triangular cases

Taxation of worldwide income of residents

Many governments tax their residents' worldwide income. As a result, a taxpayer's income is taxed twice: once in his home country and again in the country where he earned it.

For example, a UK subsidiary firm pays an annual royalty to its Indian parent company. The Indian Company is taxed in India on its global income (including royalties) under the residence rule, but the royalty is taxed in the UK under the source rule.

Taxation of worldwide income of citizens

Some governments tax their citizens' worldwide income even if they live in another country. This results in double taxation, first in the country of citizenship and again in the country of residence.

For example, a US citizen who is a tax resident of India would be taxed on his worldwide income in India under the residence rule and in the US under the citizenship rule.

Deemed Dual residency

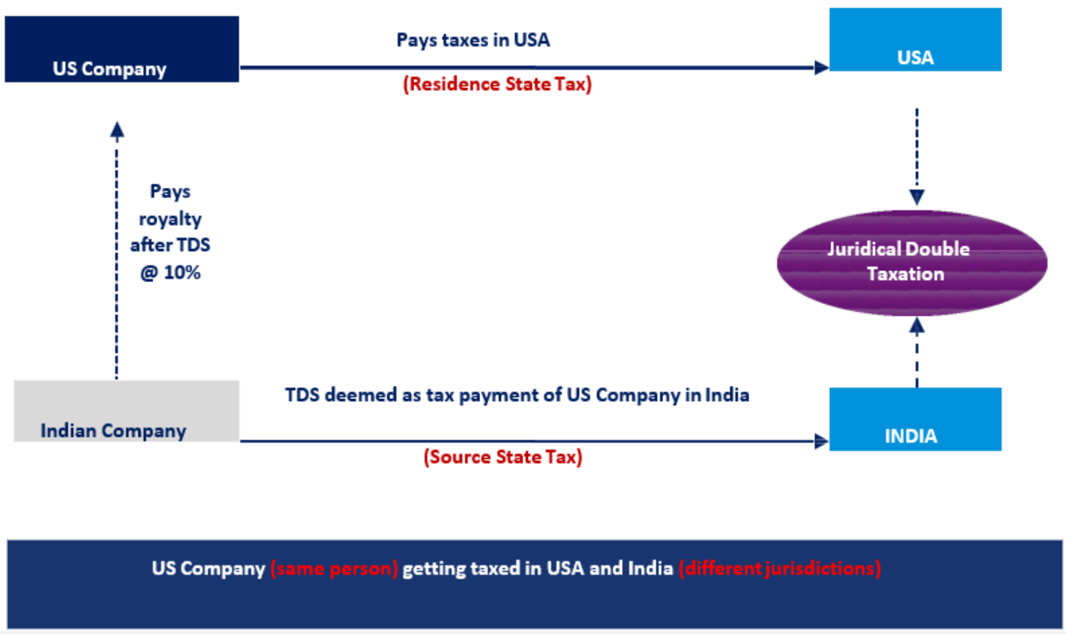
A person may be deemed to be a resident of more than one country, in which case both governments may tax the individual's worldwide income.

For example, if a person residing in Canada relocates to India and dwells in India for 182 days or more during that year, he may be considered a resident of two nations, resulting in taxation of his income in both countries.

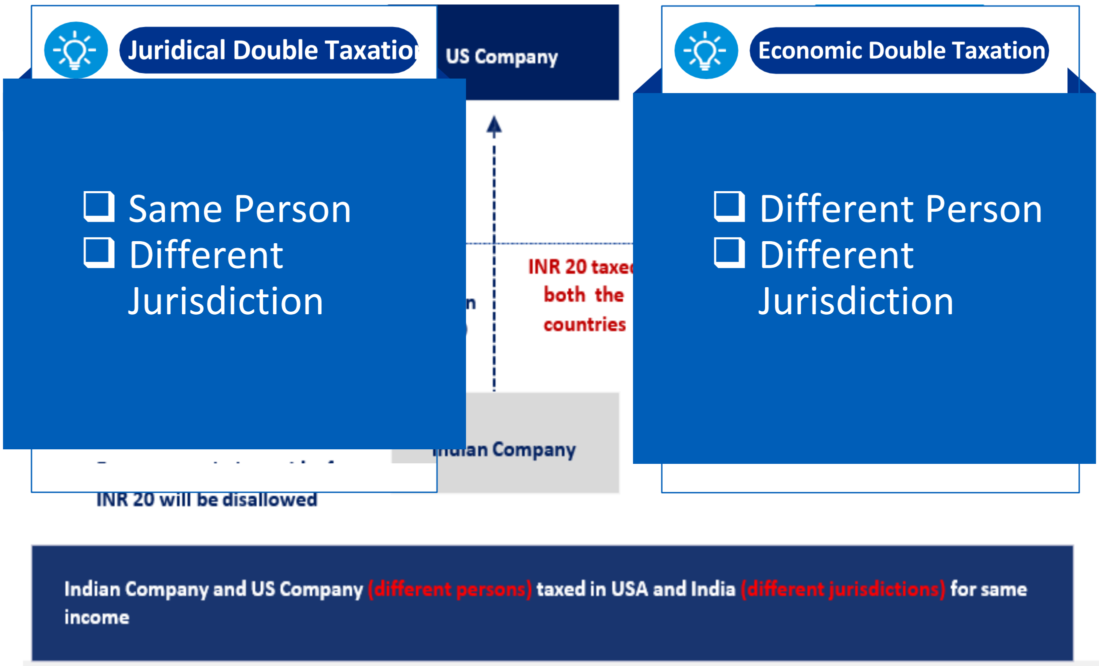
Triangular cases

Double taxation occurs when two nations tax the same individual who is not a resident of both countries on income earned in one of them.

e.g.: A Company based in India is having a Permanent establishment (PE) in Singapore. If the Singapore PE derives income from Canada, the income of the PE would be taxable in Singapore as well in Canada.



Economic double taxation occurs when the same income is taxable in the hands of two taxpayers, for example. Dividends are taxed both in the hands of the corporate and in the hands of the shareholder. This type of double taxation is referred to as 'economic double taxation.'



2. Different methods of elimination of Juridical Double Taxation:

2.1 Exemption method

The exemption method is the most basic method of avoiding double taxation and refers to a scenario in which the country of residence relinquishes its right to tax certain profits in favour of the source country.

It is most frequently employed when developing countries import capital and technology from wealthy countries. Developing counties offer fiscal incentives (exemptions/tax holidays/lowered tax rates, etc.) to encourage capital inflows. However, if the exporter's income is taxed in the country of residence, the benefit provided by the developing country to the capital/technology exporter from the developed country may be offset. In such a case, the exemption method assures that the advantage intended for the capital/technology exporter is preserved by the exporter and is not offset by taxation in the country of residence.

The exemption method majorly focuses on income. The two variants followed under this category are:

- Full exemption method and
- Exemption with progression method

Full exemption method

Under the complete exemption method, income is totally exempted in the country of residence in respect of income earned and taxed in the source country. In other words, the country of residence does not have the right to consider income generated in the source country when computing income earned in the country of residence.

For easy understanding, an illustration for computation of relief under the 'full exemption' method for the Year 2023 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Country of residence	1,000,000
2	Income earned in the source Country	300,000
3	Total income earned by the individual [1+2] in case there is ***no exemption***	1,300,000
4	Tax liability on (3) above based on income tax slab (including surcharge and education cess *(if any)*)	83,250
5	Total income to be considered under ***full exemption method*** [only (1) above can be included]	1,000,000
6	Tax liability on (5) above based on income tax slab (including surcharge and education cess *(if any)*)	**56,250**

Exemption with progression method

Income generated in the source country, however exempt, is included in total income in the country of residence exclusively to establish the effective tax rate under the exemption with progression method. To put it simply, the country of residence does not tax such foreign income but incorporates it in calculating the tax rate applicable to the remaining income.

For easy understanding, an illustration of the computation of relief under the 'exemption with progression' method for the Year 2023 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Country of residence	1,000,000
2	Income earned in the source Country	300,000

Sl. No.	Particulars	Amount (in Rs.)
3	Total income earned by the individual [1+2]	1,300,000
4	Tax liability on (3) above based on income tax slab (including surcharge and education cess *(if any)*)	83,250
5	Effective tax rate [i.e. (4)/ (3) * 100]	6.40%
6	Total income to be considered under ***exemption with progression method*** [only (1) above can be included]	1,000,000
7	Tax liability on (6) above is based on the effective rate as computed in (5)	64,000

2.2 Credit method

Under the principle of credit, the Country of residence would determine the resident's worldwide income (including the foreign-sourced income) and compute the tax liability thereon. The country of residence would offer a deduction for foreign tax paid on the foreign-sourced income based on the calculated tax due.

If the tax payable in the Country of residence is more than the taxes paid in the source Country, then the resident would be liable to pay the differential tax in the Country of residence. If the foreign tax exceeds the resident Country's tax on the same income, the excess tax credit may be carried forward or forfeited. As per the provisions of domestic law, such excess FTC is forfeited.

The main feature of the credit method is that the Country of residence retains the right to tax the foreign income but it allows credit for the taxes paid in the source Country.

Most of the DTAAs relieve double taxation only through the credit method. For a Country of residence, the loss of revenue is lower in the credit method. Hence, generally, most countries prefer the credit method.

This method of relief focuses on tax liability rather than the income taxable. The variants of the credit method are:

- Full credit method
- Ordinary credit method
- Tax-sparing credit method and
- Underlying Tax credit method

Full credit method

Under this method, the Country of residence allows full credit for tax paid in the source

Country in respect of income taxed in the Country of residence. In other words, tax paid in the source Country will be allowed as a credit in the Country of residence in respect of income doubly taxed.

For easy understanding, an illustration of the computation of relief under the ‘full credit' method for the Year 2023 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Country of residence	1,000,000
2	Income earned in the source Country	300,000
3	Total income earned by the individual [1+2]	1,300,000
4	Tax paid in Source Country on (2) say at 5% - this shall be provided as a ***full credit*** in the Country of residence	15,000
5	Tax liability in Country of residence on (3) above based on income tax @9%	82,250
6	Net tax liability in the Country of residence after providing relief of ***full credit*** of taxes paid in the source Country [i.e. (5)-(4)]	68,250

Ordinary credit method

Under the ordinary credit method, the Country of residence allows a deduction of the total taxes paid in the source country, However, the maximum deduction is restricted to the extent of the taxes that would have been paid on such income in its own Country.

Therefore, the taxpayer shall be liable to pay the deficit tax if the domestic Country equivalent tax exceeds the foreign tax paid on the same income. However, in case excess foreign tax is paid by the assessee (i.e. in excess to the tax payable in the domestic Country on the same income), the foreign tax which exceeds the home tax, such excess is not refunded.

For easy understanding, an illustration of the computation of relief under the ‘ordinary credit' method for the Year 2023 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Resident Country	1,000,000
2	Income earned in Source Country	300,000
3	Total income earned by the individual [1+2]	1,300,000
4	Tax paid in Source Country on (2) say at 20%	60,000
5	Tax liability in Resident Country on (3) above based on income tax @9%	83,250

Sl. No.	Particulars	Amount (in Rs.)
6	The effective tax rate for taxes paid in Resident Country [i.e. (5) / (3) * 100]	6.40%
7	The relief provided under the ***ordinary credit method*** [i.e. (2) * (6)] – as the effective rate of tax in the Resident Country is lesser, credit is restricted to the rate applicable in Source Country	19,200
8	Net tax liability in Resident Country after providing relief under ***ordinary credit method*** of taxes paid in Source Country [i.e. (5)-(7)]	64,050

In the said method of relief, it may be noted that extra tax paid in the source Country (as seen in the above illustration) is an additional liability to the taxpayer.

Article 47 of the Federal Decree-Law No. 47 of 2022 covers the foreign tax credit rules of the UAE corporate tax. As per Article 47, the corporate tax due under the Decree-Law can be reduced by the amount of Foreign Tax Credit for the relevant Tax Period. The Foreign Tax Credit under this Decree-Law cannot exceed the amount of Corporate Tax due on the relevant income. Further, the unutilised Foreign Tax Credit cannot be carried forward or carried back. Also, the Taxable Person shall maintain all necessary records to claim a Foreign Tax Credit.

Tax Sparing Credit method

If income earned in the Source Country is exempted under the domestic laws (say, section 10 of the Indian Income Tax Act, 1961), the actual tax payment in the Source Country may be Nil. However, under the 'Tax Sparing credit method', the taxpayer would get a credit of an amount of tax which would have been paid in Source Country had there been no such exemption on the said income under the domestic tax laws.

The rationale for providing tax sparing credit is like that of the 'exemption method'. Tax sparing credit can be applied only if there is a specific provision to that effect in the tax treaty which enables tax credit for taxes that are spared by the source Country.

Tax sparing can be illustrated by a simple example:

- India-UAE DTAA provides for a tax rate of up to 5/12.5 per cent on interest.
- India exempts tax on interest payable by the Government on sums of money borrowed by it to sources outside India under section 10(15)(iv) of the Income Tax Act, 1961.
- India-UAE DTAA provides that where a UAE resident receives interest from a resident of India, UAE shall grant a foreign tax credit equal to the amount of tax payable in India by the UAE resident.
- The treaty provides that the term 'tax payable in India' shall be deemed to include the amount of Indian tax which **would have been paid if the Indian Income had not been**

exempted or reduced per the special incentive measures under the provisions of the Income-Tax Act, 1961, which are designed to promote economic development in India, effective on the date of signature of this Agreement, or which may be introduced in the future in modification of, or in addition to, the existing provisions for promoting economic development in India, and such other incentive measures which may be agreed upon from time to time by the Contracting States.

- Suppose, Co. A, a UAE resident corporation lends money to the Government of India and receives an interest payment of INR 400,000. Tax Credit available to a UAE Resident is computed as under:

Sl. No.	Particulars	Amount (in Rs.)
1	Interest income earned by UAE resident	4,00,000
2	Tax payable in UAE @ 20% (Assume)	80,000
3	Foreign tax credit under tax sparing credit method– taxes payable in India as per India-UAE DTAA @ 12.5% if the interest income is not treated as exempt (i.e. 12.5% of interest income)	50,000
4	Tax payable in UAE after Foreign Tax Credit (i.e. 2 – 3)	30,000

Underlying Tax Credit method

The underlying Tax Credit ('UTC') method is a method of providing credit wherein credit on account of foreign taxes paid may be given, in the Country of residence, for the tax paid on the underlying profits out of which the dividend is paid by a company in the source Country.

The credit as described under the UTC method can be availed only if there is a specific provision to that effect in the tax treaty. DTAAs generally prescribe minimum shareholding required to be eligible for claiming credit under the UTC method.

Most of the treaties allowing credit under the UTC method provide that where a Company resident in India declares a dividend, and the foreign company receiving such dividend declared by the Indian Company either directly or indirectly holds 10/25 per cent of the voting power or issued capital of the Indian Company, then in such situation, the foreign company receiving dividend gets credit for corporate taxes paid on such profits out of which dividend is declared.

Few DTAAs with India contain UTC provisions, viz, DTAAs executed with China, Australia, Ireland, Japan, Malaysia, Mauritius, Singapore, Spain, the UK, United Mexican States, USA.

Under India-Singapore DTAA, India provides UTC to a company resident in India deriving a dividend from Singapore Company for the taxes paid by Singapore Company in respect of the profits out of which such dividend is paid. Article 25 of the said DTAA reads as under:

> *"2. Where a resident of India derives income which, per the provisions of this Agreement, may be taxed in Singapore, India shall allow as a deduction from the tax on the income of that resident an amount equal to the Singapore tax paid, whether directly or by deduction. Where the income is a dividend paid by a company which is a resident of Singapore to a company which is a resident of India and which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, the deduction shall take into account the Singapore tax paid in respect of the profits out of which the dividend is paid. The such deduction, in either case, shall not, however, exceed that part of the tax (as computed before the deduction is given) which is attributable to the income which may be taxed in Singapore."*[1]

However, for Indian residents, UTC is available only under the DTAAs with Singapore and Mauritius. Under other DTAAs, UTC is available only to taxpayers in other countries and not to Indian residents.

Further, since there are no provisions in domestic laws which allow credit for underlying taxes paid by overseas subsidiaries, it could be reasonably inferred that no credit for underlying taxes would be available otherwise.

UTC is illustrated as under:

- Company X Ltd. has an income of Rs. 100,000 in the source Country
- Company Y Ltd. is a holder of 50% of the share capital of company X Ltd
- The tax rate applicable in the source Country is 30% and the withholding tax rate applicable is 5%
- The tax rate applicable in the Country of residence is 40% (the Country in which Y Ltd. is situated)

In the source Country:

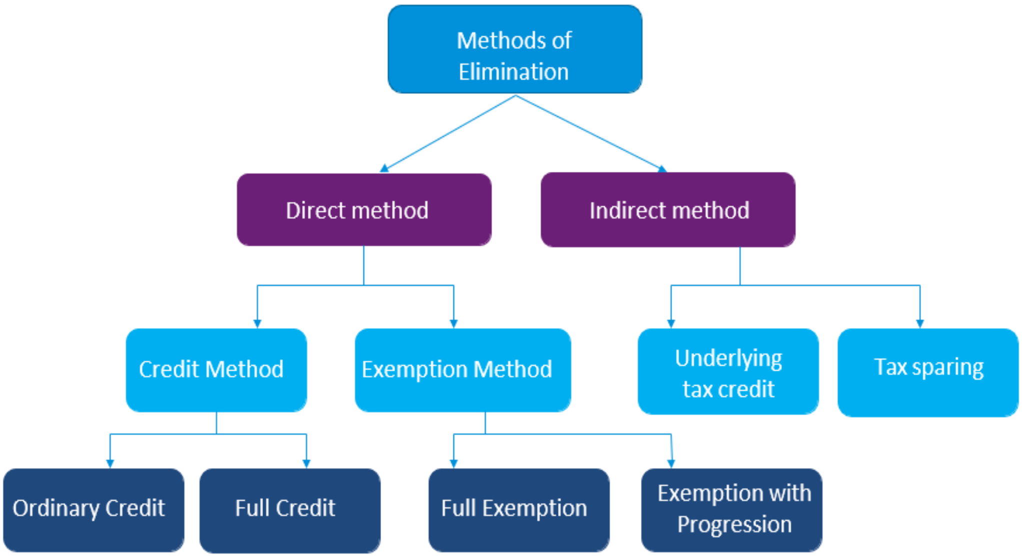
Sl. No.	Particulars	Amount (in Rs.)
1	Income earned by X Ltd. in the source Country	100,000
2	Tax paid in the source Country @ 30% on (1)	30,000
3	Income after tax (i.e. 1 – 2)	70,000
4	Dividend distributed by X Ltd. in the source Country	70,000
5	Taxes withheld by X Ltd. in the source Country @ 5% on (4)	3,500

[1] *AVOIDANCE OF DOUBLE TAXATION*,https://incometaxindia.gov.in/DTAA%20Articles/Singapore/108020000000006398.htm.

6	Share held by Y Ltd. in X Ltd.	50%
7	Underlying Tax Credit available for Y Ltd. in the Country of residence [i.e. (2) * 50%]	15,000
8	Foreign Tax Credit available for Y Ltd. in the Country of residence [i.e. (5) * 50%]	1,750

In the Country of Residence:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned by Y Ltd. in Country of residence (including dividend received)	135,000
2	Tax payable in the Country of residence @ 40% on (1)	54,000
3	Foreign Tax Credit available [as per point (8) of earlier table]	1750
4	Underlying Tax Credit available [as per point (7) of earlier table]	15,000
5	Balance tax payable by Y Ltd. in the Country of residence (i.e. 2 – 3 -4)	37,250



3. Methods of elimination of Economic Double Taxation:

3.1 Domestic Context

A company's profits are taxed without distinction between disbursed and undistributed profits under a classical or separate system of taxation. When gains are issued as dividends, they are taxed again in the hands of the shareholders (corporate or individual). As a result, the identical gains are taxed twice: once at the corporate level and once at the shareholder level.

This economic double taxation may induce investors to favour debt over equity and to utilise branch or hybrid structures. Furthermore, it may generate an incentive to keep earnings and avoid dividend payments.

Many states partially or completely eliminate economic double taxation on domestic dividends by employing various methods, either at the company or shareholder level or both.

The following methods of providing relief at the business level can be classified:

- Dividend deduction or credit method, which treats dividend payments as a tax-deductible cost for the paying corporation. Alternatively, the tax withheld on dividend distributions may be deducted from the corporation tax owed
- The split-rate method states that dispersed income is taxed at a lower rate than retained income. The corporation is subject to a greater corporate tax, and it obtains credit for the tax difference when dividends are paid (e.g. in Germany before 2001).
- Dividend exemption scheme, in which the corporation pays a greater tax on dispersed profits than on retained income because of an extra corporate tax payable when dividends are issued. There is no withholding tax, and the income in the hands of the shareholders is tax-free (e.g. in India before 2020).

Methods that give relief at the shareholder level (i.e. where the firm is subject to corporate tax but relief is granted at the shareholder level) include the following:

- Imputation or tax credit systems (dividend credit), in which shareholders either receive a complete imputation credit based on the underlying tax paid by the distributing company or a partial imputation as a dividend tax credit, independent of corporate tax paid.
- Shareholder relief under the classical system (dividend relief), where dividends received is either entirely tax-exempt (dividend exemption) or subject to partial tax-exemption relief (partial exclusion). The relief may also be provided in the form of a dividend received deduction.

Dividend relief is available in several states for domestic intercompany dividends. While some states exempt all intercompany dividends (for example, Ireland, Sweden, and the United Kingdom), many only exempt direct investment (for example, considerable shareholdings) under their domestic participation exemption laws (e.g. Germany and Italy).

The company is taxed on its profits under the imputation system, while the shareholders receive a partial or full dividend credit for the corporate tax paid by the company. The shareholders claim the imputed credits (also known as franking credits) and either balances them against their individual tax bill or receive a refund if their marginal tax rate is lower than the corporate tax rate. This credit is subject to the dividend being paid from fully taxed income. If it is paid from untaxed or partially taxed income, the distributing corporation must pay an equalisation tax. The extra tax guarantees that dividends paid to shareholders are properly franked by corporate tax payments.

Unlike the classical system, the imputation method considers corporate tax to be an advance payment of the income tax that would otherwise be due from shareholders when corporate income is allocated to them. These systems vary widely and lead to several tax issues. For example, they create timing issues and encourage tax arbitrage, and the corporate tax preferences given to encourage investors have often washed out in computing the imputation credits (as the effect of the imputation system for shareholders is that the dividends are taxed at the shareholders' actual marginal tax rate). Moreover, their administration and tax compliance can be complex.

Because corporate earnings are not subject to economic double taxation when dispersed to shareholders, states that use an imputation system tend to charge higher effective corporation tax rates. However, because the imputed tax credit is often only available to local shareholders, it functions as a traditional system for international shareholders.

Imputation systems have fallen out of favour within the European Union. The Court of Justice of the European Union has decided that the provisions of imputation systems violate the principle of free movement of capital within the European Union.

As a result, EU Member States transitioned from an imputation system to offering shareholder relief under a modified classical system, particularly the exemption system, which provides neutrality regarding the taxpayer's residence.

However, a few states outside the European Union continue to use the imputation system. Australia, Mexico, and New Zealand employ a full credit system, whereas Canada and Chile use a partial credit system.

3.2 International (Cross-Border) Context

Generally, relief from international economic double taxation is offered unilaterally rather than through a tax treaty. Such relief is frequently provided in the form of an exemption or an indirect credit.

Participation exemption

Many countries broaden the definition of "participation exemption" to cover any method of avoiding economic double taxation on intercorporate dividends. As a result, it incorporates both dividend income relief under the specific rules of participation exemption (also known as affiliation privilege) and dividend-received deduction. Dividend income is exempt and not liable to corporation tax in the hands of the receiving firm under domestic participation exemption rules, providing the shareholders fulfil certain qualifying participation conditions. The dividend-received deduction rules allow the shareholder firm to deduct dividend income.

Several states have expanded their domestic participation exemption provisions to include dividends from overseas qualified subsidiaries received by resident corporations. Some jurisdictions grant the same tax exemption to dividends received by qualifying permanent establishments of non-resident corporations if the distributing company's shares are part of the permanent establishment's assets (e.g. Belgium and Luxembourg). Similar benefits are offered to eligible direct investments in EU Member States under the Parent-Subsidiary Directive (2011/96).

Certain states have extended the participation exemption provisions to capital gains from the sale of eligible shares. Furthermore, some states enable participation expenditures to be deducted from other taxable income, even if the corresponding dividends are tax-free.

The participation exemption is generally granted on dividends from direct (non-portfolio) investment and is conditional on a certain percentage or quantity of share ownership or voting rights. It may also require that the qualifying shareholding be kept for a set amount of time. Some states demand that the dividend-paying state have a comparable tax structure or that it not be a tax-favoured jurisdiction. Others set additional criteria, such as anti-abuse provisions that limit the exemption for dividends from passive income.

In the UAE, Article 23 of the Federal Decree-Law No. 47 of 2022 deals with the concept of the participation exemption. Article 23 exempts the income from a Participating Interest on fulfilment of certain conditions. Further, Participating Interest has been defined as at least 5% ownership in the shares or capital of a juridical person subject to the following conditions:

- The Taxable Person has held or has the intention to hold, the Participating Interest for an uninterrupted period of at least (12) twelve months.
- The Participation is subject to Corporate Tax or any other tax imposed under the applicable legislation of the country in which the juridical person is a resident which is similar to Corporate Tax at a rate not less than 9%.
- The ownership interest in the Participation entitles the Taxable Person to receive at least 5% of profit distributions and liquidation proceeds on cessation of the participation.
- Not more than 50% (fifty per cent) of the direct and indirect assets of the Participation consist of ownership interests or entitlements that would not have qualified for an exemption from Corporate Tax under this Article if held directly by the Taxable Person subject to any conditions that may be prescribed by the Minister
- Any other conditions as may be prescribed by the Minister.

Additionally, for a free-zone person, the condition of at least 9% corporate tax will be satisfied subject to any conditions that may be prescribed by the Minister.

Where the conditions of participation mentioned above continue to be met, the following income shall not be taken into account in determining Taxable Income:

- Dividends and other profit distributions received from a foreign Participation that is not a Resident Person under paragraph (b) of Clause 3 of Article 11 of the Decree-Law.
- Gains or losses on the transfer, sale, or other disposition of a Participating Interest (or part thereof) derived after the expiry of the time period specified in paragraph (a) of Clause 2 or Clause 9 of this Article.
- Foreign exchange gains or losses concerning a Participating Interest.
- Impairment gains or losses concerning a Participating Interest.

A Participation shall be treated as having met the condition under paragraph (b) of Clause 2 of this Article where all of the following conditions are met:

- The principal objective and activity of the Participation is the acquisition and holding of shares or equitable interests that meet the conditions of Clause 2 of this Article.
- The income of the Participation derived during the relevant Tax Period or Tax Periods substantially consists of income from Participating Interests.

The exemption under Article 23 shall not apply to income derived by the Taxable Person from a Participating Interest:

- The Participation can claim a deduction for the dividend or other distributions made to the Taxable Person under the applicable tax legislation;
- The Taxable Person has recognised a deductible impairment loss in respect of the Participating Interest prior to the Participating Interest meeting the conditions of Clause 2 of this Article 23;
- The Taxable Person or its Related Party who is subject to Corporate Tax under this Decree-Law has recognised a deductible impairment loss in respect of a loan receivable from the Participation.

Where the impairment loss referred to in paragraph (c) of Clause 6 of this Article is reversed in a subsequent Tax Period, the associated income of the Taxable Person shall be exempt from Corporate Tax in that Tax Period up to the amount of income from the Participating Interest that was not exempted under paragraph (c) of Clause 6 of this Article.

The exemption under this Article does not apply to a loss realised on the liquidation of a Participation.

The exemption under this Article shall not apply for a period of (2) two years where a Participation was acquired in exchange for the transfer of an ownership interest that did not meet the conditions of Clause 2 of this Article or a transfer that was exempted under Article 26 or 27 of this Decree-Law.

Also, where a Taxable Person fails to hold a 5% (five per cent) or greater ownership interest in the Participation for an uninterrupted period of at least (12) twelve months, any income previously not taken into account under this Article shall be included in the calculation of the Taxable Income in the Tax Period in which the ownership interest in the Participation falls below 5% (five per cent).

Indirect credit

In addition to direct credit, an indirect credit for the pro rata part of corporation tax paid by the foreign distributing business (underlying tax) on foreign dividends may be granted.

In general, the indirect credit is computed using the following formula:

$$\frac{\text{gross dividend distributed before withholding tax}}{\text{after-tax profits of distributing company}} \times \text{corporate tax paid by distributing company}$$

The dividend is grossed up by the direct and indirect credits to compute the foreign income subject to tax in the residence state, and the ordinary credit limitation is applied to the grossed-up dividend.

Example:

Assume a taxpayer has a wholly-owned foreign subsidiary that makes a dividend distribution of 100. The state of the subsidiary levies a 20% tax on income derived from its resident companies. In addition, a 10% withholding tax is levied on dividends distributed to non-resident shareholders. The state of residence of the taxpayer levies tax on the worldwide income earned by its residents, applying a flat rate of 40%.

Gross Income	125
Corporate Income tax	25
Dividends distributed	100
Withholding tax in source state	10
Total tax payable in source state	35
Dividends received	100
Taxable dividends (grossed-up amount)	125
Tax in residence state	50

Indirect credit	(25)
Direct ordinary credit	(10)
Tax payable in residence State	**15**

Because dividends can be paid from both current and historical profits, domestic legislation or practice may include ordering rules. The creditable tax is decided by the effective tax rate imposed on those earnings, and the dividends are linked to the appropriate post-tax profits from which the distribution is made. The computation is further influenced by the exchange rate used to convert the creditable foreign tax, which may be the rate in effect at the time the foreign tax was paid (historical rate) or the rate at the time the dividend was distributed (current rate).

In general, indirect credit is only awarded for considerable participation, i.e. when the shareholder owns a certain percentage of the foreign company's stock or has voting rights in it. Furthermore, when the subsidiary's undistributed income is credited to it under controlled foreign corporation regulations, many countries grant the parent business tax credit for the foreign tax paid by the subsidiary.

4. Foreign Permanent Establishment (PE) Exemption

As per Article 24 of the Corporate Tax Law of the UAE, a Resident Person can make an election to not take into account the income, and associated expenditure, of its Foreign Permanent Establishments in determining its Taxable Income. Further, in determining the income and associated expenditure of a Foreign PE, a Resident Person and each of its Foreign PE shall be treated as separate and independent Persons. Also, a transfer of assets or liabilities between a Resident Person and its Foreign PE shall be treated as having taken place at Market Value at the date of the transfer to determine the Taxable Income of that Resident Person.

This exemption applies to all the eligible Foreign PE of the Resident Person i.e. an all or none approach. Furthermore, an eligible foreign PE is one that is subject to Corporate Tax or a tax of a similar character under the applicable legislation of the relevant foreign jurisdiction at a rate not less than 9%.

Although, the taxable person who opts for foreign PE exemption shall not take into account the following in determining its Taxable Income or Corporate Tax Payable:

- Losses in any of its Foreign Permanent Establishments, calculated as if the relevant Foreign Permanent Establishments were a Resident Person under this Decree-Law;
- Positive income and associated expenditure in any of its Foreign Permanent Establishments, calculated as if the relevant Foreign Permanent Establishments were a Resident Person under this Decree-Law; and

- Any Foreign Tax Credit that would have been available under Article 47 of the Decree-Law had the election under Clause 1 of this Article not been made.

5. Foreign Tax Credit (FTC) under the Tax Treaties[2]

Although many countries have retained unilateral relief schemes, a parallel system of reciprocal relief has arisen. Sir Young said in the Commons while presenting income tax relief for the Dominions:

“There is a great deal to be said for the provisions of this Clause which aim, at any rate, at putting individuals on an equal footing of taxation, whether their investments are within the United Kingdom or partly or wholly in other parts of the Empire. The idea, I believe, will be accomplished if the Dominions’ Governments pass reciprocal legislation, as is suggested by the Royal Commission.”[3]

Although Prussia and Saxony signed the first treaty to eliminate double taxation in 1869, governments also sought reciprocity for double taxation relief by agreeing to exempt foreign ships from income taxes if other countries granted comparable treatment. The Netherlands was the first to adopt this principle in 1819, while the United States and the United Kingdom followed suit in 1921 and 1923, respectively. These were then expanded to include air transport, increasing the number of agreements to eliminate double taxation.

While the two systems evolved concurrently, the question of which will take precedence, or which should be reviewed first, arises when a tax treaty is available and relevant.

Indeed, to appropriately implement the provisions of each framework, the link between domestic tax legislation and tax treaties must be fully understood. "The two contracting states commit themselves to relinquish or restricting their taxing rights" under the framework of a tax treaty.

The provisions of the tax treaty govern when income or capital is taxed in just one of the contracting states or when both states have a right to tax.

This indicates that the method article, which is normally included in articles 23A and 23B of a tax treaty, is not the sole way to prevent double taxation. Certainly, "the application of the method article is not always necessary" and "in some cases, double taxation is avoided by the allocation rules themselves, namely when the allocation rules assign exclusive taxing rights to one state". It is so beneficial to comprehend the situations in which the method article becomes appropriate.

[2] Exemption Method and Credit Method-The Application of Article 23 of the OECD Model, Vol. 24 WU - Tax Law and Policy Series

[3] Hansard 1803-2005, Finance Bill Deb 7 July 1920, vol 131, col. 1566, available at https://api.parliament.uk/historic-hansard//commons/1920/jul/07/clause-26-relief-in-respect-of-dominion

Avoidance of residual double taxation

As previously noted, a variety of tax treaty provisions aim to eliminate double taxation, and the method article will only be used where the distributive rule does not provide one country with an exclusive taxing power. As a result, "a more precise heading [for articles 23A and 23B] would be 'Methods for eliminating residual double taxation'," it has been proposed.

Residual double taxation occurs when the distributive rule allows both contracting states to tax income or capital, including when the tax burden is reduced. When the distributive rule is unable to offer an absolute entitlement to one jurisdiction, the method article will deal with the remaining double taxation.

Because articles 23A and 23B are written in a general manner, taxpayers will look to the guidance in the relevant domestic law to determine the computation methods, the classification of income or capital, and the characterization of the foreign entity after becoming acquainted with the content of the provisions and consulting the Commentary. The Commentary on the OECD Model attempts to address the functioning and implications of the methods through the use of figures. These examples merely identify and compare the amount of tax relinquished by the residence jurisdiction without determining the exact implementation procedures.

Articles 23A and 23B of the OECD MTC

Articles 23A and 23B of the OECD Model address juridical double taxation, which occurs when both contracting states tax the same person on their global income or capital, or when both the residence and source jurisdiction imposes a tax on income or capital emerging in the source state.

It applies to the resident jurisdiction and gives nations the choice of using the exemption method or the credit method; nevertheless, it is not envisaged that countries will use only one of the methods; they should be complemented by features from both.

Articles 23A and 23B of the UN Model address legal double taxation in the same conditions as those specified by the OECD Model. Countries may choose to employ the exemption or credit method, or they may apply various methods to different situations. However, developing countries have expressed concerns about how the foreign tax credit, as well as the potential benefits of low taxes or special concessions offered by them, may "in large part benefit the treasury of the capital-exporting country rather than the foreign investor for whom the benefits were designed," as stated in the Commentary on Articles 23A and 23B of the UN Model. As a result, revenue would move from the developing country to the capital-exporting country.

This particular challenge is addressed by the tax-sparing provision in article 23B (which is briefly explained below). Article 23A(1) of both OECD and UN Models, provides for the exemption method and requires that the resident state exempt income or capital subject to tax in the source state. However, this is only possible to the extent that the source state is permitted to tax based on the provisions of the tax treaty because the income or capital is derived by or owned by a resident of the other state.

Article 23A (2) allows for credit in the resident jurisdiction for taxes on dividends and interest paid in the source jurisdiction. This deduction, however, should not exceed the appropriate domestic rate, and it will not apply if the source state also exempts or allows a deduction for dividends and interest. This treatment is extended by the UN Model to royalties and fees for technical services. Article 23A(3) allows for the application of the exemption with development.

Finally, article 23A(4) establishes the switchover rule and states that article 23A(1) does not apply if the source state uses tax treaty provisions to exempt the income or capital, or if it applies the lower rate applicable to articles 10(2) and 11(2) on dividends and interest. "The purpose of this paragraph is to avoid double non-taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or the interpretation of the provisions of the Convention," according to the OECD Model Commentary on Articles 10(2) and 11(2) of the OECD Model. Article 23A(4) applies when the source state interprets the facts of a case or the provisions of a tax treaty in a way that eliminates or limits the source state's right to tax the income or capital, and the residence state adopts a different interpretation that establishes that the income or capital may be taxed in the source state. In certain cases, the residence jurisdiction has the authority to deny the exemption. The UN Model broadens the scope of this norm to include royalties (article 12) and fees for technical services (Article 12A).

Article 23B relates to the credit method and requires the resident state to grant a deduction from income or capital tax equal to the taxes paid in the source state; however, as with article 23A(1), this is only applicable to a limited degree (as mentioned above). The deduction should not be more than the taxes imposed in the resident jurisdiction. If the income is exempt, it can be used to calculate the amount of tax to be paid, allowing progressive rates to be used.

The two articles do not provide further detail regarding their application: “The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is computed, this being left to the domestic laws and practice applicable.” As a result, significant reference will need to be made to domestic law to determine the following: (i) the computation methods; (ii) the credit limitation overall – per country or on the item of income; (iii) the treatment of losses; and (iv) timing issues, among other factors.

Domestic law, particularly in common law jurisdictions, advises on whether income or capital is regarded to have a foreign or domestic source, in addition to the characteristics described above. This is significant for both contractual states because, "if they employ the credit method but defer to their domestic rules on the foreign tax credit, granting such credit only if the relevant income has its source in the other contracting state". However, this may lead to ambiguities in interpretation, resulting in unresolved double taxation. To address this issue, certain tax treaties incorporate deemed source rules, which establish that if income may be taxed in the other contracting state, it has its source there.

The interpretation of specified elements of a tax treaty may result in additional conflicts of interpretation or qualification. According to the Commentary on Articles 23A and 23B of the OECD Model, interpretation of the phrase, “may be taxed in the other contracting state per the provisions of this convention”, contained in both articles, is especially important when the residence and source jurisdiction classify the same item of income or capital differently. This gives rise to conflicts of qualification. There are also specific challenges of interpretation that arise due to the “different interpretation of facts or different interpretation of the provisions of the Convention”.

Since the implementation of the methods will rely on domestic law, there are instances when the residence state and the source state interpret the provisions of the tax treaty or the facts of the case under consideration differently, which results in an interpretation conflict giving rise to double taxation. When this is the case, such conflicts will need to be resolved by way of a mutual agreement procedure, under Article 25 of the OECD and UN Models.

Conclusion

The method article is only utilised when the distributive provisions of a tax treaty do not grant one contracting state exclusive taxation powers. When this occurs, taxpayers will have the option of using either the exemption or the credit method generally provided for in articles 23A and 23B. Domestic laws are utilised as supplemental advice to establish the applicability of the method article, notably the credit method. On its own, the method article highlights some of the alternatives commonly used by nations - at the domestic level - to alleviate double taxation, while governments may have additional options when acting unilaterally. However, depending on the taxpayer's facts and circumstances, as well as the income or capital at stake, either the unilateral action or the method article may be advantageous.

Part C : Group Taxation

1. Introduction

Group taxation is enumerated under Chapter 12 which consists of Article 40, Article 41, and Article 42 of UAE Corporate Tax Law on Businesses and Corporations (hereinafter referred to as **Decree-Law**) which are provided below:

- **Article 40**: Tax Group
- **Article 41**: Date of Formation and Cessation of a Tax Group
- **Article 42**: Taxable Income of a Tax Group

Tax Group is defined under Article 1 of this Decree-Law, which is, "**Two or more Taxable Persons treated as a single Taxable Person according to the conditions of Article 40 of this Decree-Law**."

2. Tax Group (Article 40)

A. **Conditions for Tax Group**: A Resident Person, which for the purposes of this Decree-Law shall be referred to as a "Parent Company", can make an application to the Authority to form a Tax Group with one or more other Resident Persons, each referred to as a "Subsidiary" for the purposes of this Chapter, where all of the following conditions are met:

a) The Resident Persons are juridical persons.

b) The Parent Company owns at least 95% (ninety-five percent) of the share capital of the Subsidiary, either directly or indirectly through one or more Subsidiaries.

c) The Parent Company holds at least 95% (ninety-five percent) of the voting rights in the Subsidiary, either directly or indirectly through one or more Subsidiaries.

d) The Parent Company is entitled to at least 95% (ninety-five percent) of the Subsidiary's profits and net assets, either directly or indirectly through one or more Subsidiaries.

e) Neither the Parent Company nor the Subsidiary is an Exempt Person.

f) Neither the Parent Company nor the Subsidiary is a Qualifying Free Zone Person.

g) The Parent Company and the Subsidiary have the same Financial Year.

h) Both the Parent Company and the Subsidiary prepare their financial statements using the same accounting standards.

B. Notwithstanding paragraph (e) of Clause 1 of this Article, one or more Subsidiaries in which a Government Entity directly or indirectly owns **at least a 95% (ninety-five percent) ownership interest** as specified in paragraphs (b), (c) and (d) of Clause 1 of this Article can form a Tax Group, subject to the conditions to be prescribed by the Authority.

C. An application made under Clause 1 of this Article shall be made to the Authority by the Parent Company and each Subsidiary seeking to become member of the Tax Group.

D. A Tax Group formed under Clause 1 of this Article is treated as a single Taxable Person for the purposes of this Decree-Law, represented by the Parent Company.

E. The Parent Company shall comply with all obligations set out in Chapters Fourteen (Payment and Refund of Corporate Tax), Sixteen (Tax Registration and Deregistration) and Seventeen (Tax Returns and Clarifications) of this Decree-Law on behalf of the Tax Group.

F. The Parent Company and each Subsidiary shall be jointly and severally liable for Corporate Tax Payable by the Tax Group for those Tax Periods when they are members of the Tax Group.

G. The joint and several liability under Clause 6 of this Article for a Tax Period can be limited to one or more members of the Tax Group following approval by the Authority.

H. The Parent Company and each Subsidiary shall remain responsible for complying with the provisions under Article 45 of this Decree-Law.

I. A Subsidiary can join an existing Tax Group following submission of an application to the Authority by the Parent Company and the relevant Subsidiary.

J. **Subsidiary leaving Tax Group**: A Subsidiary shall leave the Tax Group in the following circumstances:

   a) Following approval by the Authority of an application by the Parent Company and the relevant Subsidiary.

   b) Where the relevant Subsidiary no longer meets the conditions to be a member of the Tax Group as specified in Clause 1 of this Article.

K. **Cessation of Tax Group**: A Tax Group shall cease to exist in any of the following circumstances:

   a) Following approval by the Authority of an application by the Parent Company.

   b) Where the Parent Company no longer meets the conditions to form a Tax Group as specified in Clause 1 of this Article, subject to the provisions of Clause 12 of this Article.

L. **Change in Parent Company**: The Parent Company of a Tax Group can make an application to the Authority to be replaced by another Parent Company without discontinuation of the Tax Group, in any of the following circumstances.

   a) The new Parent Company meets the conditions under Clause 1 of this Article relating to the former Parent Company.

   b) The former Parent Company ceases to exist and the new Parent Company or a Subsidiary is its universal legal successor.

M. Notwithstanding Clauses 11 and 12 of this Article, the Authority may, at its discretion, dissolve a Tax Group or change the Parent Company of a Tax Group based on information available to the Authority, and notify the Parent Company of such action taken.

Points to Remember

1. A Parent company can form a tax group with the other Residents if:
   a. The **Resident Persons** are **juridical persons**.
   b. The Parent Company owns **at least 95%** (ninety-five percent) of the **share capital** of the Subsidiary, **either directly or indirectly** through **one or more** Subsidiaries.
   c. The Parent Company holds **at least 95%** (ninety-five percent) of the **voting rights** in the Subsidiary, **either directly or indirectly** through **one or more** Subsidiaries.
   d. The Parent Company is entitled to **at least 95%** (ninety-five percent) of the Subsidiary's **profits and net assets, either directly or indirectly** through **one or more** Subsidiaries.
   e. **Neither** the Parent Company nor the Subsidiary is an **Exempt Person**.
   f. **Neither** the Parent Company nor the Subsidiary is a **Qualifying Free Zone Person**.
   g. The Parent Company and the Subsidiary have the **same Financial Year**.
   h. **Both** the Parent Company and the Subsidiary **prepare** their **financial statements** using the s**ame accounting standards**.
2. Even the Government Company which owns at least 95% of the ownership interest, directly or indirectly can form a Tax Group.
3. Tax Group shall be dealt with as a single taxable person.
4. All the members of the tax group shall be jointly and severally responsible for the Corporate Tax payable.
5. A subsidiary can join or leave the Tax Group after the parent company and such subsidiary make an application for the same.
6. If the Parent company fails to meet the condition to form a Tax Group, the Tax Group shall cease to exist.
7. A parent company can be replaced by another parent company in the Tax Group after making an Application to the Authority.

Illustrations

1. A company ABC is a qualifying free zone person who has a fully owned subsidiary XYZ and has an ownership interest of 75% of company PQR in UAE mainland. Will company ABC, XYZ or PQR form a Tax Group?

Solution: No.

As per Article 40(1)(b) The Parent Company owns at least 95% (ninety-five per cent) of the share capital of the Subsidiary, either directly or indirectly through one or more Subsidiaries. And, as per Article 40(1)(f), Neither the Parent Company nor the Subsidiary is a Qualifying Free Zone Person.

Since both conditions are not met. So, company ABC, XYZ or PQR cannot form a Tax Group.

2. Facts in above remains the same except ABC is a government company in mainland. Will company ABC, XYZ or PQR form a Tax Group?

Solution: Partly Yes.

As per Article 40(1)(b) The Parent Company owns at least 95% (ninety-five percent) of the share capital of the Subsidiary, either directly or indirectly through one or more Subsidiaries.

And, as per Article 40(2), Notwithstanding paragraph (e) of Clause 1 of this Article, one or more Subsidiaries in which a Government Entity directly or indirectly owns at least a 95% (ninety-five percent) ownership interest as specified in paragraphs (b), (c) and (d) of Clause 1 of this Article can form a Tax Group, subject to the conditions to be prescribed by the Authority.

So, as per above, ABC can form Tax Group with XYZ but ABC cannot form Tax Group with company PQR.

3. Date of Formation and Cessation of a Tax Group (Article 41)

A. Formation of Tax Group or joining of New Subsidiary: For the purposes of Article 40 of this Decree-Law, a Tax Group shall be formed, or a new Subsidiary shall join an existing Tax Group from the beginning of the Tax Period specified in the application submitted to the Authority, or from the beginning of any other Tax Period determined by the Authority.

B. Cessation of Tax Group or Leaving of Subsidiary (1): For the purposes of paragraph (a) of Clause 10 of Article 40 and paragraph (a) of Clause 11 of Article 40 of this Decree-Law, the relevant member of a Tax Group shall be treated as leaving that Tax Group from the beginning of the Tax Period specified in the application submitted to the Authority, or from the beginning of any other Tax Period determined by the Authority.

C. Cessation of Tax Group or Leaving of Subsidiary (2): For the purposes of paragraph (b) of Clause 10 of Article 40 and paragraph (b) of Clause 11 of Article 40 of this Decree-Law, the relevant member of a Tax Group shall be treated as leaving that Tax Group from the beginning of the Tax Period in which the conditions under Clause 1 of Article 40 of this Decree-Law are no longer met.

Points to Remember

Tax Group shall be formed or new Subsidiary shall be joined from the date as specified in the application or any other Tax Period as specified by the Authority.

1. Tax Group shall cease or Subsidiary shall leave the Tax Group from the date as specified in the application or any other Tax Period as specified by the Authority.
2. Tax Group shall cease or Subsidiary shall leave the Tax Group from the beginning of the Tax Period in which the conditions under Clause 1 of Article 40 of this Decree-Law are no longer met.

Illustration

1. A company XYZ makes an application to the Authority to join the Tax Group wherein company ABC is a parent company. The application specifies the 1st January 2024 to join the Tax Group. But Authority provides the date of 1st January 2025 in the approval certificate. What will be the date of joining the Tax Group.

   Solution: As per Article 41(1), For the purposes of Article 40 of this Decree-Law, a Tax Group shall be formed, or a new Subsidiary shall join an existing Tax Group from the beginning of the Tax Period specified in the application submitted to the Authority, or from the beginning of any other Tax Period determined by the Authority.

   So, the joining date will be 1st January 2025.

4. Taxable Income of a Tax Group (Article 42)

A. **Computation of Taxable Income**: For the purposes of determining the Taxable Income of a Tax Group, the Parent Company shall consolidate the financial results, assets and liabilities of each Subsidiary for the relevant Tax Period, eliminating transactions between the Parent Company and each Subsidiary that is a member of the Tax Group.

B. The relevant provisions of this Decree-Law shall apply as the context requires to the Tax Group.

C. Unutilised Tax Losses of a Subsidiary that joins a Tax Group (referred to in this Article as "pre-Grouping Tax Losses") shall become carried forward Tax Losses of the Tax Group and can be used to offset the Taxable Income of the Tax Group insofar this income is attributable to the relevant Subsidiary.

D. Where a new Subsidiary joins an existing Tax Group, unutilised Tax Losses of the existing Tax Group cannot be used to offset the Taxable Income of the Tax Group insofar as this income is attributable to the new Subsidiary.

E. The application of Clauses 3 and 4 of this Article is subject to the conditions of Articles 37 and 39 of this Decree-Law.

F. Where a Subsidiary leaves a Tax Group, Tax Losses of the Tax Group shall remain with the Tax Group, with the exception of any unutilised pre-Grouping Tax Losses of the relevant Subsidiary.

G. **Cessation of Tax Group**: On cessation of a Tax Group, unutilised Tax Losses of the Tax Group shall be allocated as follows:

a) Where the Parent Company continues to be a Taxable Person, all Tax Losses shall remain with the Parent Company.

b) Where the Parent Company ceases to be a Taxable Person, Tax Losses of the Tax Group shall not be available for offset against future Taxable Income of individual Subsidiaries, with the exception of any unutilised pre-Grouping Tax Losses of such Subsidiaries.

H. Paragraph (b) of Clause 7 of this Article shall not apply where there is a continuation of the Tax Group under Clause 12 of Article 40 of this Decree-Law.

I. Clause 1 of this Article shall not apply where an asset or liability has been transferred between members of the Tax Group and either the transferor or transferee leaves the Tax Group within (2) two years from the date of the transfer, unless the associated income would have been exempt from Corporate Tax or not taken into account under any other provisions of this Decree-Law.

J. Any income that was not taken into account with regards to a transfer described in Clause 9 of this Article shall be taken into account on the date the transferor or transferee leaves the Tax Group and shall result in a corresponding adjustment of the cost base for Corporate Tax purposes of the relevant asset or liability.

K. The Tax Group must prepare consolidated financial statements per the State's accounting standards.

Points to Remember

1. For computing Taxable Income, the Parent company shall consolidate the financial results, assets and liabilities of each Subsidiary for the relevant Tax Period, eliminating transactions between the Parent Company and each Subsidiary that is a member of the Tax Group.

2. Pre-Grouping Tax Losses of Subsidiary shall be carried forward as Tax Losses of Tax Group insofar as the income is attributable to the relevant Subsidiary.

3. Unutilised losses of the Tax Group shall not be utilised to offset Taxable Income of the Tax Group insofar as this income is attributable to the new Subsidiary if the new Subsidiary joins the tax group.
4. If a Subsidiary leaves a tax group, it can take only unutilised Pre-grouping losses.
5. When the tax group cease to exist, tax losses shall be allocated to the Parent company which is still a Taxable Person.
6. Tax losses of ceased tax group shall not be allocated to the Subsidiary to offset the taxable income with the exception of unutilised Pre-grouping losses.
7. If any member of the tax group leaves the group within 2 years of the transfer of assets or liabilities, the parent company shall not eliminate the intra-group transfers with the exception of exempted income or any other income not taxable under this Decree-Law.
8. The eliminated taxable income between the transfer and transferee in the tax group shall be taken into account on the date of leaving the group and the cost basis shall be determined accordingly.
9. Tax Group shall prepare the consolidated financial statements as per the prescribed accounting standards.

Illustration

1. A company XYZ joins the Tax Group wherein company ABC is a parent company bringing unutilised tax losses of AED 500,000. The income of the tax group is AED 1,500,000. The income attributable to XYZ is 300,000. Will unutilised tax losses of XYZ be carried forward in the group and what will be the amount of tax loss setoff and amount of carry forward to the subsequent year?

   Solution: As per Article 42(3), Unutilised Tax Losses of a Subsidiary that joins a Tax Group (referred to in this Article as "pre-Grouping Tax Losses") shall become carried forward Tax Losses of the Tax Group and can be used to offset the Taxable Income of the Tax Group insofar this income is attributable to the relevant Subsidiary.

   As per Article 37(2), The amount of Tax Loss used to reduce the Taxable Income for any subsequent Tax Period cannot exceed 75% (seventy-five per cent) or any other percentage as specified in a decision issued by the Cabinet of the Taxable Income for that Tax Period before any Tax Loss relief.

   So, an unutilised tax loss of AED 500,000 can be carried forward in the tax group.

   The amount to be utilised to offset tax loss is AED 225,000 (Income of AED 300,000*75%).

   The unutilised amount to be carried forward to the next year is AED 275,000 (Tax Loss of AED 500,000 – Utilised amount of AED 225,000).

Part D. Corporate reorganizations

1. Introduction

The variety of transactions that a Company might use to restructure its operations prohibits the concept of corporate reorganisation from being defined in anything other than a broad business. However, corporate reorganisations include, among other things, mergers, demergers, partial demergers, share exchanges, liquidations, changes in legal form, and transfers of the corporate seat. Most states have preferential regimes on the taxation of corporate reorganisations in their domestic law, under which such transactions benefit from a tax deferral, i.e. no tax is payable on the earned capital gains at the time the reorganisation occurs. Even though the transaction may involve the transfer of property, the accompanying capital gain is not considered to have been realised because the shareholders continue to invest after the corporate reorganisation. The tax conducted cumulated capital gains is postponed until the gain is realised, for example, by selling shares in the new corporation established as a result of a merger that benefited from a tax deferral at the time it was carried out.

In general, such advantages are limited to domestic reorganisations to ensure that the earned gains remain within the jurisdiction of that state in the event of a subsequent disposal. As a result, cross-border reorganisations are often taxed under general rules.

In a tax treaty context, in the absence of a specific provision, capital gains arising as a consequence of corporate reorganizations are taxable either exclusively in the residence state of the shareholder (unless a provision drafted along the lines of Article 13(4) of the OECD Model or Article 13(5) of the UN Model applies) or both in the source state and the residence state of the “alienator” when other types of assets, such as immovable property, are alienated.

The lack of a common tax treatment for mergers and acquisitions at the international level creates distortions and disparities that impede foreign investment and cross-border competition, necessitating the adoption of solutions to the unfavourable tax consequences of these transactions in the international context.

Let us understand this issue with help of the following example:

Example

Company A, a resident of state X, wishes to acquire Company B, a resident of state Y, which holds the significant intangible property. Company B ceases to exist as a consequence of the merger, and all of its assets and liabilities are now owned by Company A. If the absorbing Company had been a resident entity, the transaction would have benefited from a favourable regime in state Y, because any subsequent disposition of the intangible property that originally belonged to Company B would still be within state Y's taxable jurisdiction. However, because the merger was carried out across borders, Company B no longer exists, and the intangible property is now owned by Company A, the preferential regime is no longer applicable unless Company A maintains a permanent establishment in state Y and the intangible property is owned by such a permanent establishment. Assuming that the preferred regime applied in a situation where no permanent establishment was maintained in state Y, a later transfer of the intangible property would lead to any accumulated gains being taxable exclusively in the alienator's residence state, and therefore exclusively in state X. As a result, state Y would lose its authority to tax the gain on the intangible property, even if its development and increase in value occurred while it was owned by a resident Company (i.e. Company B, before the merger).

Even though neither the OECD nor the UN Models contain any specific provisions addressing corporate reorganisations, the Commentary on Article 13(4) of the OECD Model and the Commentary on Article 13(5) of the UN Model suggests that capital gains arising as a consequence of corporate reorganisations may be excluded from the scope of these provisions if contracting states so choose. In actuality, there are just a few tax treaties that directly cover capital gains resulting from corporate reorganisations.

Property transferred during a cross-border corporate reorganization may lead to an asymmetrical treatment, where the transfer is tax-deferred in one state, but taxable in the other. One example refers to transfers of immovable property occurring as a consequence of a merger. Using the above example, assume Company A and Company B are both residents of state X, with Company B owning immovable property in state Y. If Company A absorbs Company B as a consequence of a merger, the immovable property becomes the property of Company A. This would not represent a taxable event in state X. However, from the point of view of state Y, where the immovable property is situated, alienation of the immovable property appears to have occurred, triggering a taxable gain. Under Article 13(1) of the OECD Model, state Y is entitled to tax the gain arising as a consequence of this transaction.

2. Economic purpose & types of a corporate reorganisation[4]

As discussed in the preceding section, the definition of corporate reorganisation is ambiguous, and the first step in determining the conditions for considering a transaction to be potentially included within the "category" of reorganisations is to determine the goal of the companies entering into these transactions.

In general, the primary goal of a Company undertaking a reorganisation is to achieve a better structure from a legal or economic standpoint to improve the enterprise's organisation to enhance its competitive position in the relevant market, allowing it to take advantage of market opportunities and gain competitive advantages through synergies, risk reallocation, or an extension of the Company's offer or market.

[4] Reorganization Clauses in Tax Treaties Author-Domingo J. Jiménez-Valladolid de L'Hotellerie-Fallois

The aim of improving a Company's legal or economic structure can take several forms depending on the individual demands of each organisation. Furthermore, there are other feasible justifications for these transactions that may cloud or even exclude the primary aim of reforming a Company. However, for this section, it will be considered that the primary motive for undertaking a reorganisation is to improve the Company's structure.

Even though there are virtually unlimited transactions that could serve the general objective of improving a Company's structure, because the transactions must be tailored to the needs of a specific Company, there are some categories within which most reorganisation transactions can be included in a broad sense. In this respect, a helpful classification of transactions that can generally be utilised for reorganisation purposes will first make a distinction based on the number of companies participating in the transaction. In this regard, a distinction is made between internal and external reorganisations.

2.1 Internal reorganizations

Internal reorganisations, also known as internal restructuring, are transactions in which only the Company reorganising its structure participates, i.e. they occur inside the same Company. These transactions seek to achieve a more efficient financial, legal, or functional structure to decrease costs and risks, improve financial capacity, or gain a competitive aim. The most typical reorganisations in this case are those that affect either the Company's legal structure or its financial structure.

Re-incorporations, changes in the real seat of the Company, and transformations are examples of transactions that change the legal structure of the Company. In these cases, the Company's statutes are amended to be adapted to a new legal configuration, either resulting from the transformation of the Company's legal form, e.g. from a limited liability Company to a partnership or another corporate structure, provided they do not require the transforming Company to liquidate; or if the Company is subject to a new jurisdiction as a result of the transaction.

Other internal reorganisations affect the Company's financial structure by increasing the sources of external or internal finance or changing the ratio between these sources. These transactions include recapitalizations, debt restructuring or workouts, and changes in the Company's share capital.

Finally, alternative types of restructuring that do not involve any financial or legal changes but affect the way the enterprise is structured might occur to reallocate functions and risks across the Company's parts.

2.2 External reorganizations

External reorganisations, on the other hand, affect more than one Company. In this context, there is a distinction to be made between transactions that combine the business enterprises of two or more companies and transactions that aim to divide a Company's enterprise structure into two or more companies. The overarching goal of these transactions is to allow the participating companies to reorganise their size in reorganisation to compete in the relevant market and gain a competitive edge over other rivals. These aims may include achieving economies of scale, avoiding duplication of costs, entering new markets, or dispersing risk more efficiently.

A Company buys either the control or the assets of another Company to merge their activities as a result of reorganisations that involve the combining of businesses or acquisitive reorganisations. To analyse these transactions, first, distinguish between transactions in which the acquired Company ceases to exist after the transaction or completion of the reorganisation plan and transactions in which the target Company retains its legal existence.

Mergers, in a wide sense, encompass not only legal mergers but also other de facto mergers, to the extent that they involve the integration of two companies and that at least one of them ceases to exist once the reorganisation is completed.

Acquisition-driven reorganizations

Acquisitive reorganisations that do not result in the target Company ceasing to exist can be distinguished by whether or not compensation is paid to the acquired Company's shareholders and the sort of compensation paid. In this respect, combinatory reorganisations that do not necessarily involve any compensation for the target firm's shareholders include, for example, dual-listed Company schemes and other contractual mergers or enterprise alliances. These transactions, in theory, do not involve any changes to the economic or legal structures of the participating companies, with the effects manifesting themselves at the level of corporate governance.

The acquisition of control of a Company, on the other hand, can be structured by issuing shares of the acquirer to the shareholders of the target Company through an exchange of shares or share merger, or by exchanging cash or other assets for the target's shares.

Divisive reorganizations

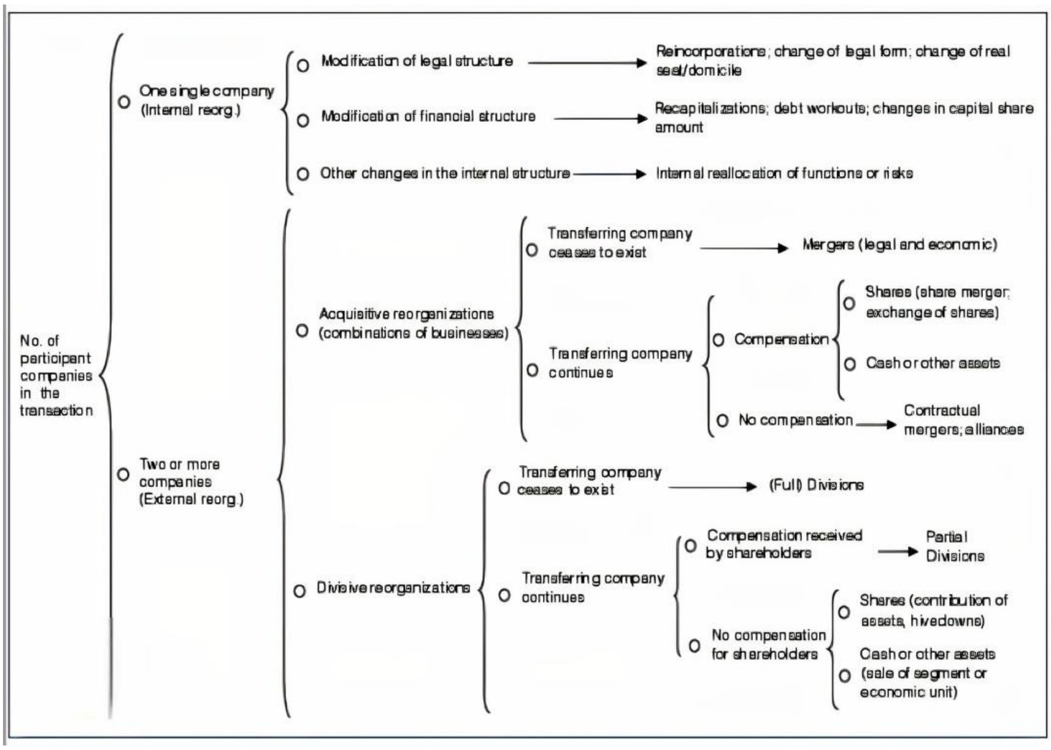
In contrast, contentious reorganisations divide a Company's activities or divisions among one or more companies. The first distinction, as in the case of acquisitive reorganisations, is based on whether or not the transferring Company dissolves as a result of the transaction. The first set of cases comprises demergers or total divisions of companies, which result in the transferring Company dissolving as a result of the transaction or reorganisation plan, and the corporate segments or divisions of the Company being transferred to two or more separate organisations.

The second set of cases, on the other hand, contains various transactions based on the person who gets compensation for the transfer of the transferring Company's corporate section and its qualification. If the compensation is received in the form of shares in the capital of the beneficiary or beneficiaries' companies by the shareholders of the transferring Company, the transaction qualifies as a partial split of the transferring Company.

On the other hand, if the compensation in shares of the beneficiary Company is received by the transferring Company without being transferred to its shareholders, the transaction would imply the gift of assets or a business unit to another Company in exchange for its shares.

Finally, the sale of a business unit of the transferring Company would have an impact on the Company's structure. The distinctions are depicted as a pictorial representation below, essentially differentiating possible types of corporate reorganisations that can occur in the broad sense; however, other distinctions can be drawn based on whether the reorganisation is between affiliated companies or independent parties, for example.

However, the classification in the summary below is useful since it differentiates the various reorganisations based on the fundamental aspects of each class, addressing the parties' primary motive for undertaking the transaction.



3. Different classes of merger for tax purposes

Mergers are private law procedures that allow the integration of two or more companies inside one single Company without the transferring Company being liquidated. This legal concept of a merger is common, but not exclusive, in Continental jurisdictions where the transaction is carried out through the universal succession of the beneficiary Company in the positions of the transferring Company, i.e. all of the transferring Company's assets and liabilities are automatically transferred to the beneficiary Company.

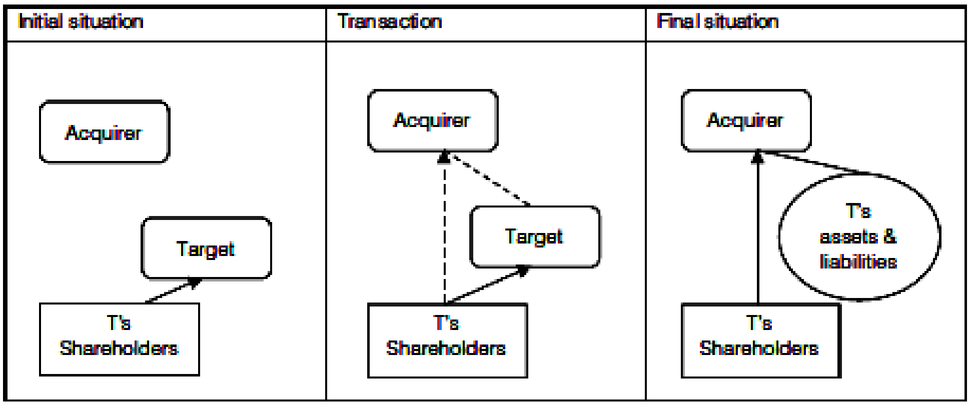
Most common law jurisdictions, on the other hand, lack a comparable legal concept, although they normally permit the integration of companies with the same significant effects as Continental law mergers through the liquidation of the transferring Company or the dissolution without liquidation under judicial sanction.

Nonetheless, the effects of the transaction are similar in both cases because they involve the integration of companies and their shareholders into a single entity that will assume the position of the transferring companies in their external relations, either through the operation of the law or through judicial or liquidation actions.

These transactions can take place in a variety of ways, depending on the positions of the participating companies and the composition of their capital. The following classes of legal mergers can be distinguished based on the degree of flexibility provided by domestic business regulation when undertaking these transactions:

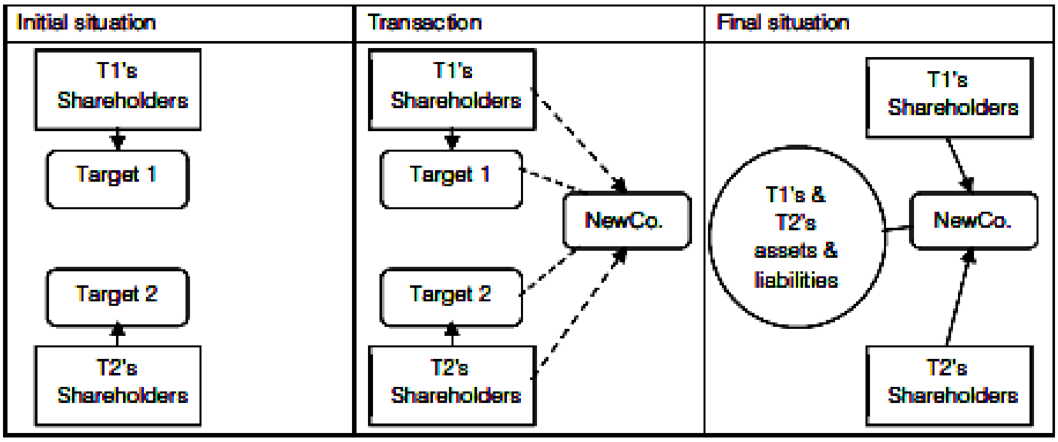
3.1 Merger by absorption or amalgamation

This transaction entails one or more companies transferring their assets and liabilities to another existing Company during their dissolution without liquidation, with the shareholders of the transferring companies receiving shares in the capital of the absorbing Company in proportion to their participation in the capital of the transferring Company.



3.2 Merger by creation of a new Company or consolidation

In this case, two or more companies transfer their assets and liabilities to a newly formed Company after their dissolution without liquidation. The shareholders of the transferring companies will get participation in the capital of the beneficiary Company in proportion to their participation in the capital of the transferring companies.

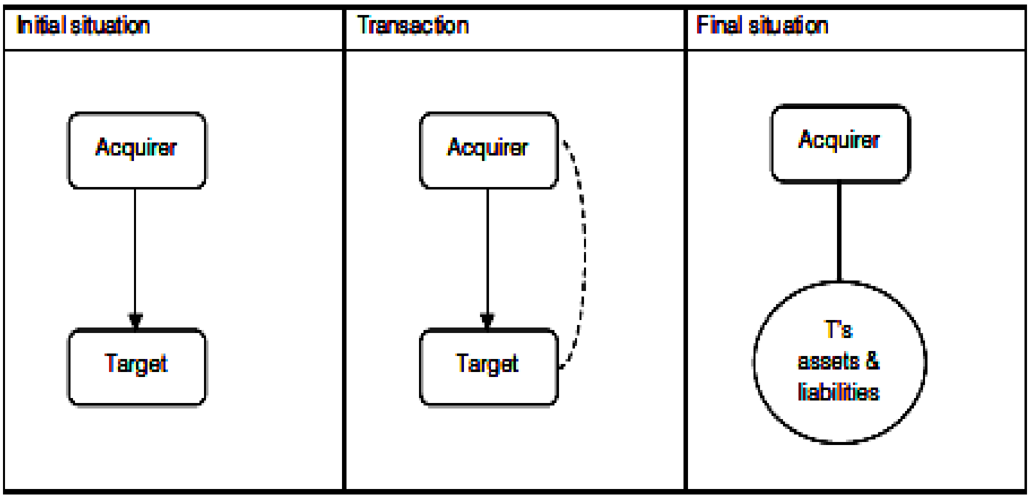


3.3 Merger of a wholly controlled subsidiary into its parent Company

Except for the fact that the absorbing Company owns the whole share capital of the transferring Company, this transaction is identical to a merger through absorption. In this case, no new shares of the beneficiary Company will be issued since the transferring firm's, the subsidiary's, and economic ownership of the assets are preserved because no new shareholders are added following the transaction.

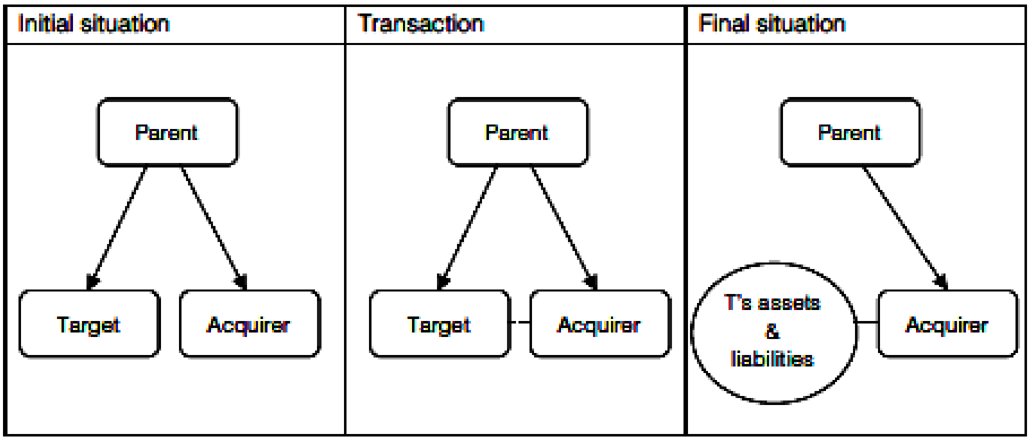
Furthermore, some jurisdictions permit the transaction to take place when the parent Company controls the majority of the capital of the subsidiary, requiring a prior buyout of the minority shareholders' participation, or the issuance of shares up to the limit of the exchange of shares to the minority shareholders, and the merger of a second or greater level subsidiary into its(great)parent Company. Similarly, this transaction can be structured as a reverse merger, in which the parent Company is merged into the subsidiary without the need to issue additional shares.

The reason for not issuing new shares in these cases is because the economic ownership of the assets and liabilities transferred as a result of these transactions does not issue due to the link between the companies involved in the merger.



3.4 Merger of subsidiaries

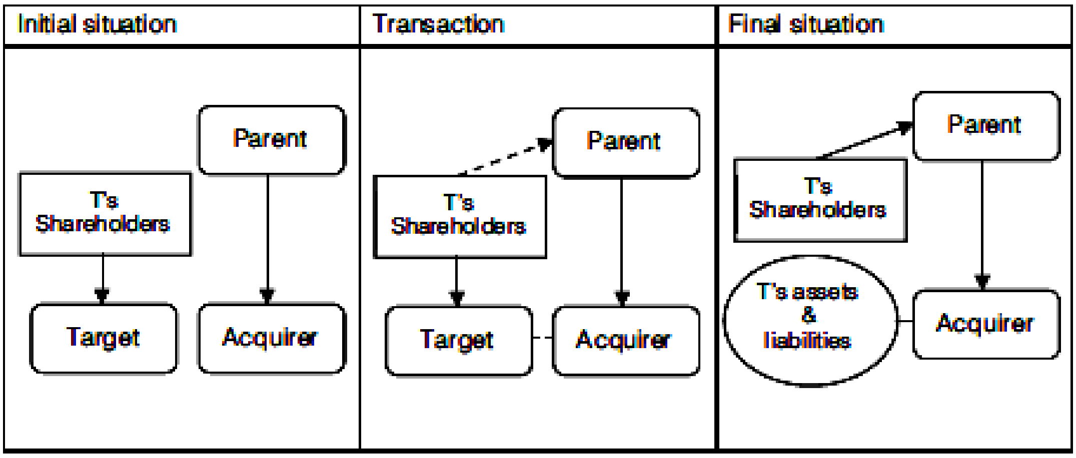
Similarly, to the case of a wholly owned subsidiary merging into its parent Company, some jurisdictions permit the merger of wholly owned subsidiaries, i.e. sister companies, without the need to issue new shares because the absorbing Company's capital structure does not change as a result of the transaction.



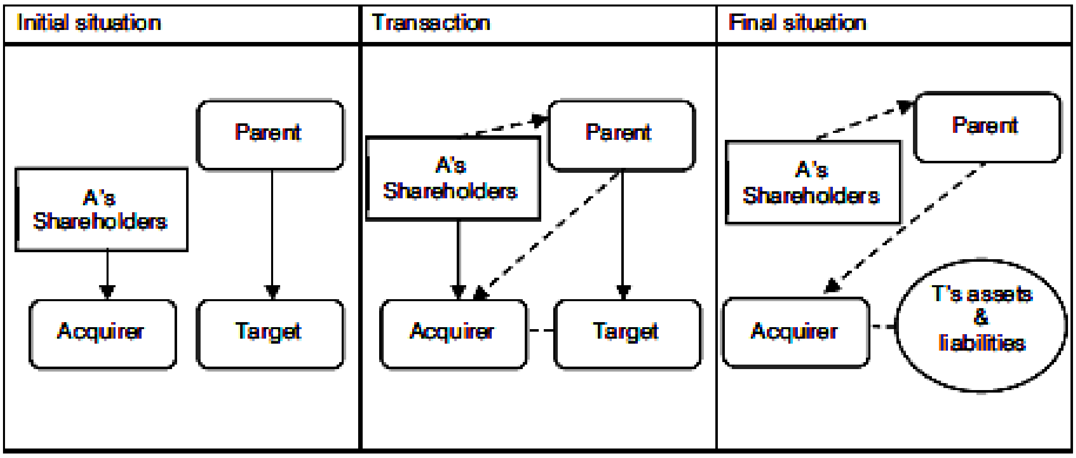
3.5 Triangular mergers

Some jurisdictions permit a merger to occur under specific conditions without integrating the shareholders of the transferring Company into the capital of the beneficiary Company. Instead, the shareholders of the transferring Company acquire shares of another Company in these cases. In most cases, the shareholders of the transferring Company get shares of the parent Company of the beneficiary Company. These transactions can take the place of a forward triangle merger, in which the subsidiary absorbs the target Company, or a reverse triangular merger, in which the target Company acquires the subsidiary but its shareholders exchange their shares for shares in the parent Company.

Forward Triangular Merger



Reverse Triangular Merger



4. The Taxation of Corporate Reorganizations

4.1 Introduction

When it comes to how corporate reorganisations should be taxed, the major issue is that these transactions should not be discouraged to encourage efficiency in business organisation and restructuring.

To the extent that the tax systems of developed and most developing countries are based on the ability-to-pay premise, income taxation is considered the foundation upon which the tax system is built.

As a result, the definition of the taxable base for income taxes, as well as the definition of the concept itself, play a significant role in dividing the costs of public spending among taxpayers based on their ability to pay.

Corporate reorganisations can be considered realisation events under a jurisdiction's tax rules and hence be the source of capital gains taxation when the reorganisation occurs. This would imply that the appreciation of assets and participations transferred during a reorganisation might be considered capital gains and taxed accordingly when the transaction occurs. As a place, when the transaction occurs, all parties will face immediate tax obligation due to the transaction's consideration as a realisation event.

However, in most developed and emerging jurisdictions, this otherwise inevitable consequence of the transaction is generally prevented by various methods aimed at preventing the immediate taxation of otherwise taxable capital gains from impeding the implementation of corporate reorganisations.

In this regard, the justifications of these preferential tax regimes should be analysed in light of the legal and economic principles of taxation as they involve a severe deviation from the normal tax consequences that would otherwise arise.

4.2 The tax consequences of mergers

It is a widespread practice, in the taxation of the variations in the value of capital that these increases or decreases are not taxed on an annual or periodic basis; instead, the taxation of the appreciation of the taxpayer's wealth is often postponed until certain events take place. These events are normally referred to as realization events and generally represent the moment when the taxpayer sells, exchanges or disposes of the asset(s)giving rise to capital gains.

The realisation principle is not commonly defined; instead, some events are regarded as realisation events that, when they occur, generally trigger the taxation of capital gains. Sales, exchanges of property, gifts or transfers after death, transfers to companies in exchange for shares, or transfers from companies in the event of their liquidation are some examples. In most cases, the realisation requirement may thus be shifted to the existence of alienation.

In any case, capital gains - or losses - calculated in this manner are taxed separately or within the framework of income taxation. When the personal income tax is progressive, long-term capital gains are commonly subject to special preferential rates to avoid the progressivity being applied to gains generated in more than one tax period, and to avoid, to some extent, savings being subject to double taxation, especially when savings are invested in companies.

Legal mergers are a method in which a Company transfers all of its assets and liabilities to another Company, either pre-existing or newly formed, in the process of ceasing to exist. As a result of the transaction, the transferring business's shareholders are integrated into the capital of the beneficiary Company through an exchange ratio that symbolises their participation in the transferring Company in proportion to the value of the beneficiary Company. In most civil law countries, Company law also adds extra requirements for the transaction to qualify as a legal merger, such as universal succession or the transferring Company not being liquidated but rather dissolved when the transaction occurs.

Other laws, on the other hand, let similar transactions take place during the firm's liquidation or even enable the transferring Company to live to some extent. Although these issues are central to the commercial law characterization of the transaction, they have no bearing on the fundamental premises on which most tax systems build their specific tax regimes for these transactions, namely the continuation of business and the continuation of shareholders' interest.

As can be easily evidenced, the transfers that occur during these transactions can be deemed to be alienations for tax purposes. In such an event, the transaction could give rise to capital gains at both shareholder and corporate levels. If these transfers are considered to be alienations, and therefore realization events, the tax system can adopt three basic approaches.

- To begin, these gains can be taxed and incorporated in the taxable base under general rules on realization.
- Second, the gains so deemed to arise can be tax-free, creating an incentive for the completion of these transactions.
- Finally, even if the transaction is deemed to constitute a realization event for the purposes of capital gains taxation, the tax system can provide for the non-recognition of realized gains, postponing their actual taxation, under certain conditions.

Because income attributable to commercial companies and their shareholders is taxed separately, a merger would result in a change in ownership of the assets held by the transferring Company as well as a change in the assets held by the shareholder, i.e. shares of the absorbing Company in exchange for shares in the transferor. Although the existence of alienation, in this case, is debatable under private law, for tax purposes, both the transferring Company and its shareholders are deemed to have alienated their assets and shares, respectively.

As a place, capital gains are deemed to arise at both the shareholder and corporate levels when the transaction occurs. In this regard, the transferring Company is deemed to have transferred all its assets at market value and is taxed on the difference between the book value of the assets and their market value when the transaction occurs, using an arm's length approach.

The book value is collected from the accounting records and contains the acquisition or production cost of the assets less the deductible depreciation as the basis for calculating capital gains. That basis is also adjusted to reflect inflation in the case of immovable property and other fixed assets.

Example

Company A owns the following assets, which are recorded for accounting purposes under the following valuation rules – including depreciation allowances:

- Immovable property (owned since 2000): 1,000
- Participations: 1,000
- Inventory assets: 1,000

The market value of each asset is 2,000; 1,500 and 1,100, respectively. Inflated Value of immovable property is 1969.

For tax purposes, the amount of gains would be the following:

- Immovable property: 2,000 – 1969 = 803
- Participations: 1,500 – 1,000 = 500
- Inventory assets: 1,100 – 1,000 = 100

Hence, the tax base on the capital gains deemed to be realized at the moment when the transaction takes place would be 1,403

Provided that the amount of income has arisen to the Company since the beginning of the tax period is 500 and there are non-exhausted losses and tax credits amounting to 700, the final tax return of the Company due to its existence ceasing because of the merger would amount to 1,203. If the transaction were not regarded as a realization event, the final tax return would have been negative on 200.

When determining the exchange rate to issue new shares to the shareholders of the transferring Company in the case of a merger of completely independent companies, the valuation of goodwill will be taken into account. In the case of a completely owned Company merger, the goodwill will be represented by the difference between the acquisition price paid for the transferring business's shares and the market value of its identified assets.

Although goodwill is not a physical asset, most tax laws acknowledge, to some extent and subject to certain conditions, the potential of deducting its depreciation in the case of taxable mergers if acquired in an arm's length transaction.

As previously stated, the purchasing Company will record the assets received at their market value, utilising this latter value to calculate future gains or depreciation allowances. Other tax characteristics of the transferring Company, such as non-exhausted fiscal losses, tax credits, or exempt reserves, are not transferred to the beneficiary Company since the taxpayer who is entitled to them disappears as a result of the transaction.

Furthermore, the assets will be considered to have been transferred per the holding periods to qualify for the application of various reliefs. However, for tax purposes, the beneficiary Company will be considered the successor of the transferring Company.

In this regard, any collection operation launched against the transferring Company would be maintained against the beneficiary Company, which will eventually be accountable for the payment of outstanding taxes assessed on the transferring Company as well as any punishment imposed on the transferring Company. At the shareholder level, the outcomes will be similar since the new shares will be valued based on the market value of the shares swapped during the merger, including, if applicable, any cash payment. Furthermore, tax characteristics applicable to the old shares, such as the duration of the shares while owned by the shareholder to meet holding periods, will not be carried over to the new shares since they will be regarded as having been received through a fresh transaction.

4.3 Exemption of gains derived from mergers

In most developed countries, full exemption of gains generated from a merger is now unusual. Although the phrase "exempt mergers" is frequently used to refer to favourable tax regimes for reorganisations, it is somewhat misleading because this expression is generally used in the context of non-recognition regimes.

However, from the 1970s through the 1980s, the full exemption of merger gains was exploited in Spain as a tax benefit for the formation of corporate groupings.

This tax system supplemented the regular tax regime under which mergers were treated as taxable events, resulting in the instant taxation of capital gains. The preferential tax scheme, on the other hand, was solely voluntary and required taxpayers to meet several conditions.

Gains resulting from the transfer of assets by the transferring Company may be virtually entirely exempt at the transferring Company level under this approach, with the assets being recorded at the beneficiary Company level at their market value. This mechanism resulted in a step-up in the tax assessment of the assets with essentially no taxation on the gains obtained. However, the regime was removed with the incorporation of the EU Merger Directive into Spanish law in 1991.

4.4 Non-recognition/deferment of gains derived from mergers

Most developed and emerging nations' tax systems envision favourable tax regimes for mergers and other reorganisations based on avoiding immediate taxation of gains earned during the transaction at both the corporate and shareholder levels. At the comparative level, there are two basic different approaches:

- The rollover relief of gains; and
- The pure tax deferment of the gains.

Both strategies address issues about the immediate taxation of capital gains obtained during the transaction. However, the effects of applying both procedures differ significantly in terms of long-term taxation of the gains obtained during the transaction.

Tax systems that rely on pure tax deferment to provide tax relief for mergers and reorganisations first calculate capital gains derived during the transaction at the transferring Company level to provide a full exemption of these gains, which are later taxed at the beneficiary Company level. In this regard, the amount of gains on which tax will be paid is established in such a way that their taxation is postponed until a taxable event happens, or the gains are partially recognised in successive instalments. In the case of mergers of unrelated companies, the French statute provides an example of the latter approach.

Countries that use rollover relief to structure their preferential tax regimes for mergers and reorganisations, on the other hand, provide for the full exemption of gains at the transferring Company level, with the condition that the beneficiary Company records the assets received for tax purposes at the book value of these assets recorded by the transferring Company.

In this regard, when these assets are later alienated, these countries will tax the built-in gains that were not taxed when the transaction occurred in the hands of the beneficiary Company, as well as any subsequent appreciations - or depreciations - in the value of the assets. In this respect, the amount of unrecognised gains is not calculated at the time of the transaction. Most tax regimes, including Spain, India, and the United States, employ this mechanism to provide advantageous tax treatment for mergers and reorganisations.

The essential distinction between the two strategies is that in the case of rollover relief, capital gains originating from the transaction are not recognised at the time of the transaction, and tax values are retained to calculate any subsequent capital gains. As a result, in the event of a subsequent alienation, capital gains will be computed using the "old" book values.

Capital gains, on the other hand, will be calculated but not collected until a later date in the case of technical tax deferral. As a result, further capital gains are calculated based on their stepped-up values in certain cases. In reality, however, the same expression, such as tax deferment, is frequently used in both cases.

Furthermore, some tax systems that provide favourable tax regimes based on the application of rollover relief allow the taxpayer to recognise gains to some extent within the context of these regimes. As a result, certain hybrid features of non-recognition and taxable mergers can be found in these cases, where the taxpayer, i.e. the transferring Company, is entitled to recognise gains for tax purposes only in the framework of a single transaction. Although there are disparities in the extent to which the taxpayer can demand the recognition of gains, the beneficiary Company will be entitled to a step-up on the assets whose gains are recognised. Although the goals of each differ, some examples of this approach may be found in Austrian and German.

4.5 Specific anti-abuse provisions in case of a merger

Most of the tax systems of developed countries rely on the bona fide commercial or business purposes test as a specific anti-abuse rule to be applied in the case of mergers and other reorganizations or similar substance-over-form doctrines. Together with that rule, some other provisions are included in certain circumstances to define the requirements for the transactions to qualify for the application of tax benefits.

The business purpose test originated in common law jurisdictions and was first applied in the United States in the landmark judgement of Gregory v. Helvering. In his decision on appeal, Second Circuit Judge Learned Hand placed the substance of a transaction over its legal structure to reject its character as a reorganisation, a position supported by the Supreme Court. In the case at the line, the taxpayer engaged in a series of transactions that were consistent with the meaning of the statutes to be classified as a reorganisation. However, these transactions were only structured in this way to allow the taxpayer to take advantage of the non-recognition restrictions and other tax benefits after the transaction was completed.

To summarise, when a transaction's "clear purpose [is] the avoidance of income tax and does not at the same time involve some economic substance, it can be set aside by the courts as having no effect for tax purposes and replaced by another characterization of the underlying factual situation," it can be set aside by the courts as having no effect for tax purposes and replaced by another characterization of the underlying factual situation.

4.6 Business restructuring relief available in the UAE

Article 27 of the Federal Decree-Law No. 47 of 2022 (UAE Corporate Tax Law) deals with Business restructuring relief. Article 27 is discussing the circumstances under which a gain or loss does not need to be taken into account when determining Taxable Income. It states that this is the case when a Taxable Person transfers their entire business or an independent part of it to another person in exchange for shares or other ownership interests and that certain conditions must be met, such as the transfer being done under state legislation, the Taxable Persons being Resident or Non-Resident with a Permanent Establishment in the state, and the transfer is done for valid commercial or non-fiscal reasons.

It also states that when a Taxable Person applies this rule, certain requirements must be observed such as treating the assets and liabilities as transferred at their net book value and making sure the value of the shares or ownership interests received does not exceed the net book value of the assets transferred and liabilities assumed. Also, the unused tax losses incurred by the transferor before the transfer is completed can be carried forward as tax losses for the transferee, subject to conditions set by the Minister. However, in the case of a demerger, carrying forward only those unutilised Tax Losses that can be reasonably attributed to the independent part of the Business being transferred is allowed.

Further, this preferential regime is only applicable when the following conditions are fulfilled:

- The transfer is undertaken in accordance with and meets all the conditions imposed by, the applicable legislation of the State.
- The Taxable Persons are Resident Persons or Non-Resident Persons that have a Permanent Establishment in the State.
- None of the Persons is an Exempt Person.
- None of the Persons is a Qualifying Free Zone Person.
- The Financial Year of each of the Taxable Persons ends on the same date.
- The Taxable Persons prepare their financial statements using the same accounting standards.
- The transfer is undertaken for valid commercial or other non-fiscal reasons which reflect economic reality.

The provisions of this Article shall apply, as the context requires, where, in the case of a transfer under Clause 1 of this Article:

a. shares or ownership interests are received by a Person other than the Taxable Person that is the transferor;

b. shares or ownership interests are issued or granted by a Person other than the Taxable Person that is the transferee; or

c. no shares or ownership interests are received by the Taxable Person who is a partner in an Unincorporated Partnership that is treated as a Taxable Person under Clause 9 of Article 16 of this Decree-Law.

Where a Taxable Person transfers an independent part of its Business, paragraph (d) of Clause 3 of this Article shall apply only to those unutilised Tax Losses that can be reasonably attributed to the independent part of the Business being transferred.

Where Clause 6 of this Article applies, the transfer of the Business or the independent part of the Business shall be treated as having taken place at Market Value at the date of the transfer

The preferential tax regime under Article 27 shall not apply if within 2 years of the transfer, the shares or ownership interests in the transferor or transferee are sold, transferred, or disposed of to a non-qualifying group member within two years of the transfer, or if there is a subsequent transfer or disposal of the transferred business or its independent part.

5. Grounds for preferential tax regimes in the framework of corporate mergers and reorganizations

The usual grounds for these regimes may be divided into three basic categories. The first is related to the character of these transactions as realisation events and is firmly tied to the distinct concept of income for tax purposes. The second line of reasoning to justify these deviations from feasible tax laws stems from many questions regarding the feasibility of immediate taxation of gains obtained during the transaction. Finally, the final group of justifications is based on the desirability of protected transactions and the neutrality from a competence perspective to justify this special taxation.

5.1 Lack of consideration of these transactions as realization events

The primary reason for avoiding gains arising from mergers and reorganisations recognise that they are not recognised as realisation events. This justification might be based on some arguments that all lead to the same result.

The initial argument for this justification was developed in the United States and is based on the legislative and historical context in which the non-recognition provisions for reorganisations were implemented. In this regard, it is argued that the non-recognition regulations in this area are the result of a compromise between the accretion and consumption methods of income taxation.

The second set of arguments in this area is similar to the first. In this regard, it is sometimes argued that capital gains obtained through mergers and reorganisations are only paper gains rather than true gains. This is true, as the economic position of the taxpayer, i.e. the shareholder, regarding the underlying assets owned by the transferring Company does not alter once the merger has taken place, being thus regarded as "mere rearrangements". In this respect, taxing gains obtained from these transactions is analogous to taxing fictional income.

In this area, the ultimate argument is based on commercial law laws that govern mergers in various countries. Under most Continental or civil law nations' domestic commercial or Company law, legal mergers involve the ope legis transfer of the transferring firm's assets and liabilities, with the beneficiary Company deemed to be the legal successor of the previous Company. In this regard, universal succession is considered a basis for the tax ramifications of these transactions.

5.2 Issues of Applicability

The second set of reasons for preferred regimes in the context of reorganisations is related to the first set of reasons for non-recognition norms. These grounds are based on the transaction's lack of liquidity and the inevitable difficulties that tax authorities would face in determining the market value of the assets and shares transferred in the transaction. It should be noted that these grounds accept that gains are realised in the context rather than focusing on the lack of realisation character of reorganisations; however, for practical reasons, it is more "convenient" not to tax the gains deemed to arise in the context of these transactions as they are realised.

Furthermore, liquidity is present or present just to a limited extent in certain transactions. As a result, if the shareholders - and the companies participating in the transaction - were taxed at the place of the transaction, they would be obliged to sell some of the assets received to face their tax liabilities, making the transactions unworkable. This argument is then linked to the broader issues raised by the adoption of the realisation criterion for capital gains taxation.

The fundamental argument is that the taxpayer receives no compensation in cash or other easily determined assets, determining it difficult for the tax administration to determine the market worth of the assets transferred for purposes of capital gains calculation. It is also claimed that the application of general tax regulations has increased the number of conflicts between taxpayers and the administration. Because of the afore-mentioned problems, it is best not to tax these transactions under general principles.

5.3 Neutrality and efficiency concerns

In this regard, two points of view can be distinguished. The first perspective examines the efficiency argument from a corporate standpoint, whereas the second examines efficiency from a market standpoint.

However, from a market perspective, it is the market's efficiency that is being addressed, not the transactions. The major aim of favourable tax regimes for reorganisations in this regard is to avoid taxation from influencing business choices. With this regard, tax neutrality concerning the market is viewed as a tax policy objective to facilitate the most effective allocation of resources while not interfering with market competitive forces. Taxation is regarded as an externality that affects the behaviour of market agents in this context.

In this regard, it is frequently argued that the use of favourable tax regimes based on rollover provisions neither encourages nor discourages taxpayers from reorganising because taxation is not exempted but rather postponed. However, if the existence of favourable tax regimes affects business decisions, this concept of neutrality is problematic.

The only reasonable consideration in this regard is addressing the neutral tax treatment as a recourse to encourage the integration of enterprise structure to change market conditions to promote enterprise productivity and competitive capacity about an increasingly interconnected global economy.

Furthermore, in the context of the EU Merger Directive, for example, this argument would require a more permissive approach to the transactions eligible for the relief given. In this respect, the non-recognition of merger gains can be viewed as an effective approach for improving firms' responsiveness to market conditions without generating a predisposition for integration, which would result in market failures. When favourable tax regimes for reorganisations coexist with conventional tax regimes, the situation might be different. In any case, it should be noted that most tax systems incorporate other components that affect the aforementioned neutrality concerning the choice to enter into a business combination. In this regard, the availability of carry-over of tax losses and other tax benefits can be argued as a tax factor that distorts economic behaviour by creating a significant preference for non-taxable reorganisations.

6. The Cross-Border Tax Effects of Mergers

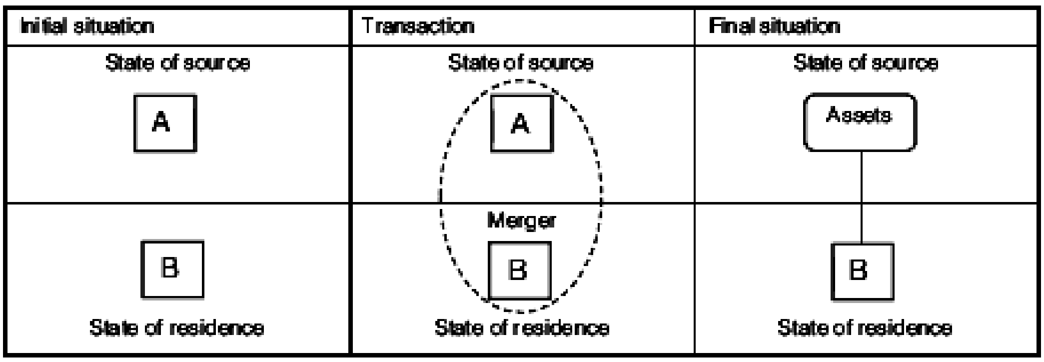
Reorganizations generally benefit from preferential tax treatment based on avoiding the immediate taxation of gains and income deemed to arise as a place of present transfers and exchanges that occur at both the corporate and shareholder levels. However, as a general rule, this preferential tax treatment is not directly applicable to reorganisations involving cross-border elements. In this regard, two major issues may impede the application of preferential tax regimes in a cross-border context:

- A state's difficulties in having its tax claims secured after having deferred taxation on the gains or income deemed to have arisen in the course of the transaction, i.e. the taxes deferred by a state do not escape this jurisdiction; and
- The difficulties in assimilating transactions undertaken according to foreign legislation to those undertaken according to domestic laws.

Even if these obstacles are overcome, the interaction between the tax rules of the many states involved in the transaction may imperil the goal of obtaining worldwide neutrality.

6.1 Basic structure to be analysed

Cross-border transactions include cases of direct cross-border transactions conducted by companies based in separate states. In this case, the Company based in the source state transfers all of its assets and liabilities to another Company based in a different state. The situation is depicted below:



In this case, the state of residence of the transferor Company will be entitled to tax the alienator's gains or income received during the transactions due to the transferor's personal connection with that state. As a result of the transaction, the alienator's state of residence may or may not maintain a genuine nexus with the transferred assets and liabilities, entitling the state to levy its taxation rights on the eventual gains or income earned from those assets and liabilities. As will be seen later, the fact that both states have a tax treaty in place has no impact on this structure.

6.2 The function of tax treaties

Activities that cross borders are exposed to international double taxation due to the overlap between two or more tax jurisdictions. When this overlap results in the same income being taxed under an identical or analogous tax by two or more states in the hands of the same person, the situation is referred to as juridical double taxation.

The repercussions of this situation are universally regarded as detrimental to the development of cross-border transactions and international trade flows. As a result of the negative economic consequences, states tend to prevent these situations from occurring through unilateral/domestic or international mechanisms to encourage cross-border investment and, eventually, their contradiction with the ability-to-pay principle, when applicable under the constitutional order.

Tax treaties are the more significant mechanisms for avoiding international double taxation. Tax treaties are often bilateral treaties between states, i.e. international treaties or agreements, intending to reduce double taxation that may arise as a result of cross-border activities between the contracting states.

As a result, depending on each country's constitutional organisation, they will either become part of domestic laws in a privileged position or be placed on the same level as domestic law. This disparity is critical for the application of tax treaties and their position in any country's legal order and treaties were considered to have precedence over domestic law.

In the context of reorganisations, the existence of a tax treaty may facilitate the application of preferential tax treatment for reorganisations in which the state of source is unable to tax the gains or income obtained during the transaction. On the contrary, the lack of a tax treaty may create further obstacles for these transactions since the state of source will be able to tax any income or gains that are deemed to be originated within the scope of the state's tax authorities. In any case, even if a tax treaty exists, the application of non-recognition regimes may be threatened if the state of origin is entitled under the relevant tax treaty to tax the income or gains received from the transaction. In this regard, the analysis will first include the characterization of the income derived during the transaction under the general allocation rules of the OECD Model to analyse the implications of non-recognition rules in this context, and then the outcome of source taxation, if applicable, in this context to eliminate double taxation and, eventually, in light of the objective of global tax neutrality.

6.3 Effects at the corporate level

A cross-border merger at the corporate level means that a resident Company joins with another foreign Company. As a result, a resident Company will cease to exist. The first approach will be to levy an exit tax on gains generated from the alienation of that Company's assets. However, in many cases, the cessation of the transferring Company will lead to the assets of that Company remaining attached to a PE on which the transferring Company's state of residence will have primary taxing rights. In these cases, the use of rollover relief or tax deferment is permissible as long as the state of the transferring Company has its taxable rights.

There will be no immediate consequences for the beneficiary Company's state. In the long run, it should be noted that this state will "gain" taxing rights on gains and income that were previously beyond its jurisdiction. The primary perspective for third states will be whether their taxation rights will be maintained after the transaction due to the application of new allocation criteria under the applicable treaty with the beneficiary state. This issue may result in a loss of tax income for third-party states, discouraging them from using their preferential tax regimes.

6.4 Effects at the shareholder level

At the shareholder level, three distinct possibilities may be distinguished. The transaction will involve a strictly domestic situation becoming a cross-border situation from the perspective of the shareholder resident in the state of the transferring Company. Although that state will retain taxing rights on gains derived from the alienation of shares in the beneficiary Company by this shareholder, it should be noted that the relevant treaty provision may make these rights residual due to the interaction of immovable property Company clauses or substantial participation clauses. Furthermore, if dividends are delivered to the shareholder, the state of residence is obliged to refund foreign taxes that would not have arisen in a purely domestic situation.

The exchange of shares of the transferring Company into shares of the beneficiary Company results in a wholly domestic situation for the shareholder who is a resident of the beneficiary Company's state. As a result, the state of residence will no longer be required to remove international double taxation. If the state of the transferring Company was entitled to tax the gains derived by non-resident shareholders under the applicable treaty rules, the transaction will imply that this state is no longer entitled to tax these gains, implying that the application of a preferential tax regime will result in a risk of tax revenue loss.

Finally, because the treaty laws with the states of residence of the participating companies differ, the cross-border merger will have repercussions for shareholders who are residents in a third state. If a particular significant participation provision is envisioned in the tax treaty between both states, gains that were previously taxable exclusively in the state of residence may now be principally taxed by the state of residence of the beneficiary Company. However, if the transferring Company's state of residence was entitled to tax gains obtained by non-resident shareholders, the transaction's outcome will destroy these taxing rights, making the application of a preferential tax regime impossible due to the loss of taxation rights.

Chapter 12

Administrative aspects of the Corporate Tax Regime

In this Chapter, the administrative aspects relating to the Corporate Tax regime to be implemented in the UAE from Financial Year ('FY') beginning on or after 1 June, 2023 have been covered. The contents have been prepared based on the perusal of the Public Consultation Document ('PCD') issued by the Ministry of Finance, UAE, on 28th April 2022 and also Federal Decree-Law No. 47 of 2022 published on 9th December 2022 which deal with the following matters:

- **Registration and deregistration;**
- **Filing of income-tax return, payment and refund of income-tax;**
- **Assessment and clarifications from the Federal Tax Authority ('FTA');**
- **Documentation Requirements;**
- **Transitional Rules (Article 61)**

1. Registration and deregistration

(a) Registration (Article 51)

- Legal and natural persons that are subject to the Corporate Tax regime(Taxable Person) shall suo-moto be required to register themselves with the FTA and obtain a Tax Registration Number ('TRN') within the prescribed time , except in circumstances prescribed by the Minister.
- If the Taxable Person do not voluntarily register then the FTA have the ability to register a Person for Corporate Tax effective from the date the Person became a Taxable Person
for corporate tax purposes. effective from the date the Person became a Taxable Person.
- For the purposes of an exemption from Corporate Tax under this Decree-Law or for purposes of Clause 6 of Article 53 of this Decree-Law, the Authority may require the relevant Person under paragraphs (e), (f), (g), (h) and (i) of Clause 1 of Article 4 of this Decree-Law, or the Unincorporated Partnership, as applicable, toregister for Corporate Tax and obtain a Tax Registration Number.
- On 23rd January 2023, the Federal Tax Authority ('FTA') has kickstarted with the

Corporate Tax ('CT') registrations and published the Corporate Tax Registration Manual.

(b) Deregistration (Article 52)

- If a company ceases to be subject to the Corporate Tax regime due to cessation or liquidation of its business or business activity, then it must apply to the FTA for deregistration in the form and manner and within the timeline prescribed by the Authority. (within **three** months of the date of cessation was earlier mentioned in the Public Consultation Document)
- However, the FTA will deregister a company only if it is satisfied that the company has filed its corporate tax returns and settled all the tax liabilities and penalties (if any) due for all periods up to and including the date of cessation.
- If the Tax Deregistration application is approved, the Authority shall deregister the Person for Corporate Tax purposes with effect from the date of cessation or from such other date as may be determined by the Authority.
- If a person does not apply for deregistration within the time limits or comply with the payment and filing obligations, then the FTA may deregister the person based on the available information with effect from later of either.
  a) the last day of the Tax Period in which it became apparent to the Authority that the conditions under Clause 2 of this Article have been met; or
  b) the date the Taxable Person ceases to exist.

2. Filing, Payment and Refund

Tax Returns (Article 53)

- There is no requirement to make an advance payment of tax or file a provisional corporate tax return.
- For ease of compliance, single tax payment based on self-assessment and only **one** corporate tax return along with other related supporting schedules will be required to be filed with the FTA within **nine** months from the end of the relevant tax period.
- The Tax Return shall include at least the following information, as applicable:
  a. The Tax Period to which the Tax Return relates.
  b. The name, address and Tax Registration Number of the Taxable Person.
  c. The date of submission of the Tax Return.
  d. The accounting basis used in the financial statements.
  e. The Taxable Income for the Tax Period.

f. The amount of Tax Loss relief claimed under Clause 1 of Article 37 of this Decree Law.

g. The amount of Tax Loss transferred under Article 38 of this Decree-Law.

h. The available tax credits claimed under Articles 46 and 47 of this Decree-Law.

i. The Corporate Tax Payable for the Tax Period

- A Taxable Person shall provide the Authority with any such information, documents or records as shall be reasonably required by the Authority for the purposes of implementing the provisions of this Decree-Law.
- As an exception to the provisions of this Article and any other relevant provision of this Decree-Law, the Minister may prescribe the form and manner in which a Tax Return and other information is to be filed with the Authority by a Taxable Person where the disclosure of information may impede national security or may be contrary to the public interest. The Authority may request a Qualifying Public Benefit Entity, Qualifying Investment Fund, A public pension or social security fund, or a private pension or social security Fund, A juridical person incorporated in the State that is wholly owned and controlled by an Exempt Person or any other person as may be determined in a decision issued by the Cabinet at the suggestion of the Minister to submit a declaration.
- The Authority may, by notice or through a decision issued by the Authority, request the authorised partner in an Unincorporated Partnership that has not had an application approved under Clause 8 of Article 16 of this Decree-Law to be reated as a Taxable Person to file a declaration on behalf of all the partners in the Unincorporated Partnership.
- The Parent Company must file a Tax Return to the Authority on behalf of the Tax Group.
- For better understanding, we have illustrated below the due date for the payment of corporate tax and filing of the corporate tax return for the first tax year which would depend upon the FY followed by the legal or natural person:

FY followed for accounting purpose	First tax year	Due date for payment of corporate tax and filing of the corporate tax return
January to December	1 January 2024 to 31 December 2024	On or before 30 September 2025
April to March	1 April 2024 to 31 March 2025	On or before 31 December 2025

Currency (Article 43)

- All amounts must be quantified in the United Arab Emirates dirham. Any amount quantified in another currency must be converted at the applicable exchange rate set by the Central Bank of the United Arab Emirates, subject to any conditions that may be prescribed in a decision issued by the Authority.

Calculation and Settlement of Corporate Tax (Article 44)

The Corporate Tax due under this Decree-Law is settled in the following order:

- First, by using the Taxable Person's available Withholding Tax Credit, as determined under Article 46 of this Decree-Law.
- To the extent there is a residual amount after Clause 1 of this Article, by using the Taxable Person's available Foreign Tax Credit as determined under Article 47 of this Decree-Law.
- To the extent there is a residual amount after Clause 2 of this Article, by using any credits or other forms of relief as specified in a decision issued by the Cabinet at the suggestion of the Minister.
- To the extent there is a residual amount after Clause 3 of this Article, this amount of Corporate Tax Payable must be settled in accordance with Article 48 of this Decree-Law.

In simpler words, the Corporate Tax due under this Decree-Law is settled in the following order:

1. Withholding Tax Credit;
2. Foreign Tax Credit;
3. Any relief at the suggestion of the Minister; and
4. Corporate Tax Payment

Withholding Tax (Article 45)

- The following income shall be subject to Withholding Tax at the rate of 0% (zero percent) or any other rate as specified in a decision issued by the Cabinet at the suggestion of the Minister:

a) The categories of State Sourced Income derived by a Non-Resident Person as prescribed in the decision issued by the Cabinet pursuant to this Article, insofar such income is not attributable to a Permanent Establishment of the Non Resident Person in the State.

b) Any other income as specified in a decision issued by the Cabinet at the suggestion of the Minister.

- The Withholding Tax payable under Clause 1 of this Article shall be deducted from the gross amount of the payment and remitted to the Authority in the form and manner and within the timeline prescribed by the Authority.

In simple words, the following income shall be subject to Withholding Tax at the rate of 0% (zero percent) or any other rate as specified in a decision issued by the Cabinet at the suggestion of the Minister:

- State Sourced Income derived by a Non-Resident Person;
- Any other income as specified in a decision issued by the Cabinet at the suggestion of the Minister.

Withholding Tax Credit (WTC) (Article 46)

- If a Person becomes a Taxable Person in a Tax Period, the Person's Corporate Tax due under Article 3 of this Decree-Law can be reduced by the amount of Withholding Tax Credit for that Tax Period.
- The maximum Withholding Tax Credit under this Decree-Law is the lower of:
    a. The amount of Withholding Tax deducted under Clause 2 of Article 45 of this Decree-Law.
    b. The Corporate Tax due under this Decree-Law.
- Any excess Withholding Tax Credit for a Tax Period as a result of Clause 2 of this Article shall be refunded to the Taxable Person in accordance with Article 49 of this Decree-Law.

In simple words, if a Person becomes a Taxable Person in a Tax Period, the Person's Corporate Tax due can be reduced by the amount of WTC for that Tax Period.

The maximum WTC under this Decree-Law is the lower of:

- The amount of Withholding Tax deducted.
- The Corporate Tax due under this Decree-Law.

Any excess WTC for a Tax Period shall be refunded to the Taxable Person.

Foreign Tax Credit (FTC) (Article 47)

- Corporate Tax due under Article 3 of this Decree-Law can be reduced by the amount of Foreign Tax Credit for the relevant Tax Period.
- The Foreign Tax Credit under this Decree-Law cannot exceed the amount of Corporate Tax due on the relevant income.
- Any unutilised Foreign Tax Credit as a result of Clause 2 of this Article cannot be carried forward or carried back.

- A Taxable Person shall maintain all necessary records for the purposes of claiming a Foreign Tax Credit.

In simple words, Corporate Tax due can be reduced by the amount of FTC for that Tax Period to the extent, the corporate tax due on such relevant Income. Any unutilized FTC cannot be carried forward or carried back and a Taxable Person shall maintain all necessary records for the purpose of claiming a FTC.

Corporate Tax Payment (Article 48)

A Taxable Person must settle the Corporate Tax Payable under this Decree-Law within (9) nine months from the end of the relevant Tax Period, or by such other date as determined by the Authority.

Corporate Tax Refund (Article 49)

- A Taxable Person may make an application to the Authority for a Corporate Tax refund in accordance with the provisions of the Tax Procedures Law in the following circumstances:
  a) The Withholding Tax Credit available to a Taxable Person exceeds the Taxable Person's Corporate Tax Payable.
  b) Where the Authority is otherwise satisfied that the Taxable Person has paid Corporate Tax in excess of the Taxable Person's Corporate Tax Payable.
- The Authority shall issue the Taxable Person a notice of the Authority's decision on an application under Clause 1 of this Article in accordance with the Tax Procedures Law

In simple words, a Taxable Person may make an application to the Authority for a Corporate Tax refund in the following circumstances:

- The WTC available exceeds Corporate Tax payable
- Where the Taxable Person has paid Corporate Tax in excess of the amount Payable.

3. Assessment and clarifications from FTA

Assessment of corporate tax and penalties (Article 60)

- The Corporate Tax regime is based on self- assessment principle. Thus, the tax payers will be responsible for ensuring that the corporate tax return and any supporting schedules submitted to the FTA are correct, complete and comply with the Corporate Tax regime.
- FTA will have the powers to review / assess the corporate tax return filed by the taxpayers within the timeframe to be prescribed in the Tax Procedure Law.
- If there is any adjustment to the corporate tax return based on the assessment by the

FTA, then the same can be challenged by the taxpayer using the procedures and processes to be outlined in the Tax Procedures Law

- The Tax Procedures Law referred to in the preamble and the decisions issued in the implementation of its provisions shall determine the relevant penalties and fines relevant to the implementation of this Decree-Law.

As per Article 59, taxpayers can also obtain clarifications in advance from the FTA on a proposed or already entered arrangement or transaction to determine taxability under the Corporate Tax regime. The clarification sought from the FTA would be binding on the FTA provided there is no change in the facts and circumstances outlined in the clarification.

4. Documentation Requirements

- As per Article 54, The Authority may, by notice or through a decision issued by the Authority, request a Taxable Person to submit the financial statements used to determine the Taxable Income for a Tax Period in the form and manner and within the timeline prescribed by the Authority.
- Certain exempted persons will also be required to maintain records to allow FTA to ascertain the person's exempt status. As per the PCD, the following are exempt from the provisions of the UAE corporate tax:
    1. Federal and Emirate Governments and their departments doing non-commercial activity;
    2. Wholly owned government companies engaged in sovereign or mandated activity;
    3. Entities engaged in extraction and exploitation of natural resources;
    4. Charities and public benefit organizations;
    5. Public and regulated private social security and retirement pension funds; and
    6. Investment funds.
- The Minister may issue a decision requiring categories of Taxable Persons to prepare and maintain audited or certified financial statements. For the purposes of Clause 1 of Article 54, the Authority may request a partner in an Unincorporated Partnership to provide financial statements showing all of the following:
    a. The total assets, liabilities, income and expenditure of the Unincorporated Partnership.
    b. The partner's distributive share in the Unincorporated Partnership's assets, liabilities, income and expenditure.

- For other legal persons subject to corporate tax, the requirement to get their books of accounts audited will be determined by the applicable company laws and regulations.
- As per Article 55 (Transfer Pricing Documentation) the Authority may, by notice or through a decision issued by the Authority, require a Taxable Person to file together with their Tax Return a disclosure containing information regarding the Taxable Person's transactions and arrangements with its Related Parties and Connected Persons in the form prescribed by the Authority.
- If a Taxable Person's transactions with its Related Parties and Connected Persons for a Tax Period meet the conditions prescribed by the Minister, the Taxable Person must maintain both a master file and a local file in the form prescribed by the Authority.
- The documentation under Clause 2 of this Article must be submitted to the Authority within (30) thirty days following a request by the Authority, or by any such other later date as directed by the Authority.
- Upon request by the Authority, a Taxable Person shall provide the Authority with any information to support the arm's length nature of the Taxable Person's transactions or arrangements with its Related Parties and Connected Persons, within (30) thirty days following the request by the Authority, or by any such other later date as directed by the Authority.
- As per Article 56, a Taxable Person shall maintain all records and documents for a period of (7) seven years following the end of the Tax Period.
- An Exempt Person shall maintain all records that enable the Exempt Person's status to be readily ascertained by the Authority for a period of (7) seven years following the end of the Tax Period to which they relate.
- As per Article 57, the Financial Year of a Taxable Person shall be the Gregorian calendar year, or the (12) twelve-month period for which the Taxable Person prepares financial statements.
- As per Article 58, a Taxable Person can make an application to the Authority to change the start and end date of its Tax Period, or use a different Tax Period, subject to conditions to be set by the Authority.

5. Transitional Rules (Article 61)

- A Taxable Person's opening balance sheet for Corporate Tax purposes shall be the closing balance sheet prepared for financial reporting purposes under accounting standards applied in the State on the last day of the Financial Year that ends immediately before their first Tax Period commences, subject to any conditions or adjustments that may be prescribed by the Minister.

- The opening balance sheet referred to in Clause 1 of this Article shall be prepared taking into consideration the arm's length principle
- For the purposes of Clauses 1 and 2 of this Article, and as an exception to the provisions of Article 70 of this Decree-Law, the provisions of Article 50 of this Decree-Law shall apply to transactions or arrangements entered into on or after the date this Decree-Law is published in the Official Gazette.
- The Cabinet may, at the suggestion of the Minister, issue a decision prescribing other transitional measures related to the implementation of this Decree-Law and the application of its provisions.

Chapter 13

Overview of Articles of OECD MC

This chapter covers the following:

- **Article 12 – Royalties and Fees for Technical Services**
- **Article 10 – Dividend**
- **Article 11 – Interest**
- **Article 6 – Income from Immovable Property**
- **Article 13 – Capital Gains**

1. Article 12 – Royalties and Fees for Technical Services

The OECD article 12 deals with Royalties and Fees for Technical Services which states that

"1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."

For the purposes of this Article, the term "royalties" means:

a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work, including cinematograph films or work on films, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; and

b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than income derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic.

For the purposes of this Article, the term "fees for technical services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including the provisions of services of technical or other personnel) which:

a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment is received; or

b) are ancillary and subsidiary to the enjoyment of the property for which a payment is received; or

c) make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design.

The definitions of fees for technical services shall not include amounts paid:

a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property, other than property;

b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships, or aircraft in international traffic;

c) for teaching in or by educational institutions;

d) for services for the private use of the individual or individuals making the payment; or

e) to an employee of the person making the payments or to any individual or partnership for professional services as defined Article 15 (Independent personal services) of the OECD Convention.

The provisions of paragraphs (1) of this Article shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 (Business profits) or Article 15 (Independent personal services) of this Convention, as the case may be, shall apply.

Royalties and fees for technical services shall be deemed to arise in a Contracting State where the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties or fees for technical services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to make payments was incurred and the payments are borne by that permanent establishment or fixed base, then the royalties or fees for technical services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

Where, owing to a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties or fees for technical services paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

2. Article 10 – Dividend

“The OECD article 10 deals with dividend which states that

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

    a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

    b) 15 per cent of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

    This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

Article 10(1) deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State but dividend paid are attributable to a permanent establishment which an enterprise has in the other Contracting State.

The important phrases used in this article are "Dividend paid" and "Company". As per Para 1 of the OECD Commentary, "the term 'paid' has a very wide meaning, since the concept of payment means the fulfillment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or custom."

Article 10(2) of OECD Model is similar to Article 10(2) of UN Model. However, OECD Model specifies the percentage for clause (a) & (b) at 5 % & 15 % respectively. Further, it also provides direct holdings of entity @ 25 % as against 10 % in clause (a) of UN Model.

This Article enables the Source Country a limited right to tax dividend at concessional rate. The benefit of concessional tax rate is given subject to fulfillment of certain conditions.

Accordingly, the recipient of dividend should be:

(a) a resident of other Country;

(b) a Company;

(c) a beneficial owner of Dividend; and

(d) holds at least prescribed percent of the capital of the Company paying dividend.

The reasons for lower tax rate are for the prevention of double economic taxation and encouragement of investment. A lower tax rate generally has been subjected to the condition of holding a prescribed percentage of capital because it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation.

Dividend in common parlance means a sum paid to or received by a shareholder proportionate to his shareholding in a Company out of the total sum distributed or distribution of profits to the shareholders by Companies limited by shares. Thus this definition incorporates the meaning in three parts, one as income from shares or other rights not being debt claims, two as participation in profits and the third part being other corporate rights as per the domestic laws of the state where company paying the dividend is resident.

The term "Jouissance Shares" as used in Article 10(3) means written documents that carry right to participate in company profits and proceeds of liquidation. For easy understanding "Jouissance Shares" are corporate forms of sleeping partners. "Jouissance Rights" are the rights in the property of the company which shareholders would be entitled to but do not carry voting power or other controls. Further, it may be noted that the article draws reference to the domestic tax laws to know the characteristics of dividend being a source state meaning of the dividend.

The commentary on OECD Model Convention states that the definition of "Dividend" provided in the model convention merely mentions examples which are found in majority of member countries' laws and that it is open to the Contracting States through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of "dividends" other payments by companies falling under the Article.

Article 10(4) of the OECD Model deals with shares/rights etc. which generate dividend and are effectively connected to the PE. In such a case, the normal taxing provision of article 10(1) and 10(2) would not be applicable but provisions of article 10(4) come into play. Accordingly, the Country where PE is situated would be entitled to tax such income as business income. This will give a Country where PE exists a right to tax entire income attributable to PE so that the question of treating dividend as distinct item does not arise.

Where share/securities are held as stock in trade, the dividend income may well form part of the business profits. Similar should be the situation for holding which is effectively connected with PE. This article, which enables treatment of dividend as part of business, ensures that non-resident shareholder does not get greater advantage than resident. It is recognized in the Commentaries (i.e. OECD) that application of this provision may present difficulties.

It is worth noting that since Force of attraction rule is not applicable, dividend is not deemed to arise to the PE of the company in source country always. This Article only permits dividends to be taxed as business profits "if they are paid in respect of holdings forming part of the assets of the PE or otherwise effectively connected with that PE." What is effectively connected has not been defined in the UN Model Convention. However, a particular location will constitute a PE only if business operations are carried on therein. Mere recording of shareholding in books of accounts of the PE without any business operation does not mean "effectively connected".

According to Klaus Vogel, the term 'Effectively Connected' means the right giving rise to dividends

- Must form part of the assets of the PE;
- Must enhance the economic strength of the PE;
- Claim must be connected in form and substance; and
- Something really connected rather than legally connected.

The OECD Commentary states that the "economic" ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the dividends attributable to the ownership of the holding and potential exposure to gains or losses from the appreciation or depreciation of the holding).

For e.g. Citibank USA has a branch in India which advances a loan to Indian Co. against security of shares. Therefore, shares are held by Citibank India and it receives dividend. i.e. the PE has economic ownership to exploit the asset. Such dividend shall be "effectively connected" with the PE in India and hence, taxed as Business Income.

As per Article 10(5), Source Country should not tax the dividend distributed by non-resident company to shareholders merely because such non-resident company derives its corporate profit that originated in Source Country.

To say, this article prohibits the right of Country A to tax the dividend paid by a Company in Country B to its shareholders even though such dividend is paid out of profit arising/ accruing in Country A except;

(a) Dividend is distributed to shareholders of Country A;

(b) Dividend is effectively connected with PE of the company in Country A.

In this way, article 10(5) prohibits such 'extraterritoriality' with respect to taxation of dividend. Further, this article also prohibits Country of source from taxing of undistributed profits of a company resident of other Country even if the profits were wholly, mainly or partly derived from sources within Country of source.

3. Article 11 – Interest

The OECD article 11 deals with Interest which states that

"Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State

— However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

— The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

— The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

— Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

— Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."

Therefore, the Resident state can always tax the income unless DTAA prohibits it. Even without this clause, the Resident Country could tax interest. However, this Article does not apply to interest arising in a third State or to interest rising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State.

The 2 important phrases used in this article are "Paid" and "may be taxed". The term “Paid” should not be restricted to physical payment in cash as it might include performance in kind or set off amounts. The term "May be taxed" gives right to the Resident state to tax the interest income.

Article 11(2) of OECD Model specifies the percentage at 10%. Thus, it may be seen that interest is taxed in both the States, the Source State as well as the Resident State. This Article provides to the Source Country a limited right to tax dividend as per its domestic laws at concessional rate. The benefit of concessional tax rate is given subject to fulfillment of certain conditions. Accordingly, the recipient of interest should be:

a) a beneficial owner of Interest; and

b) a resident of other Country.

The OECD Model provide for a division or sharing of taxing rights in respect of interest income between the Source Country and the Residence Country. Thus, it does not provide for an exclusive right of taxation in favour of the residence country. The Source Country has the primary right of taxing cross border interest on gross basis under Article 11(2) but it will tax the interest in accordance with its own domestic tax laws. The Country of residence has a right to tax cross border interest in terms of provisions of Article 11(1). The taxation by the Country of residence will also depend upon its domestic laws along with the provisions of Article 23 (method of dealing with double taxation), and on the basis of which it may either exempt the interest altogether or include it in the lenders income and give credit for the taxes paid / deducted in the Source Country.

The definition of interest and covers all kinds of income which may be regarded as interest in various domestic tax laws. Further, it may be noted that no reference has been drawn to the domestic tax laws while defining the term interest (as opposed to the article on dividends) so as to avoid any possible dispute and uncertainty about the import of ‘interest’ which may arise with the change in domestic law.

The definition of interest in all the three models viz. OECD, UN and US Model is similar in that it essentially means income from debt claims of every kind. The OECD commentary states that “the definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of non -traditional financial instruments where there is no underlying debt (for example, interest rate swaps).

However, the definition will apply to the extent that a loan is considered to exist under a “substance over form” rule, an “abuse of rights” principle, or any similar doctrine. The second sentence of Paragraph 3, excludes from the definition of interest the penalty charges for late payment but Contracting States are free to omit this sentence and treat penalty charges as interest in their bilateral convention…."

Interest charged by banks or financial institutions or payable on money borrowed for purchase of either machinery or goods or raw materials abroad, are not taxable in many developing countries. Exemptions are provided to encourage industrial development.

As per the OECD Commentary (Para 18 of Article 11), the term "Debt claim of every kind" is very wide and it includes cash deposits, security in form of money, Govt. securities, bonds & debentures. It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital (revenus de capitaux mobiliers), even though certain countries assimilate it to income from immovable property. Debt claims having right to participate in debtor's profits are regarded as loans if the contract by its general character clearly evidences a loan at interest. The debt claim further includes premiums and prizes attached to above.

The Article 11(6) states that where a special relationship prevails between the payer of interest and beneficial owner of the interest and the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. Here, Special Relationship means i) participation in management, control and capital (direct or indirect) and ii) relatives (relationship by blood or marriage). Therefore, benefits of article 11 for lower tax rates applies only to the arms' length interest.

The OECD Commentary states that with regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary as a minimum to remove the limiting phrase "having regard to the debt claim for which it is paid". If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds".

Thus, such excess payment needs to be classified under the type of income to which its 'nature' relates, in cases of disputes it will be necessary to resort to the mutual agreement procedure provided by the Convention.

For e.g. A subsidiary company in India pays interest @ 15% to the Holding Company in USA but interest @ 10% to another unrelated company in USA, the excess of 5% would be required to be scrutinised. The exact nature of excess amount has to be determined in order to categorize such income as dividend or other income under the domestic laws. Only the rate of interest can be adjusted and not the interest amount. Possibly Article 7, 10, 21 of the relevant tax treaty may apply.

4. Article 6 – Income from Immovable Property

The OECD article 6 deals with Income from Immovable Property which states that

"1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise."

The primary right to tax the income from immovable property is with the Contracting State where the immovable property is situated. The situs i.e. place of the immovable property has vital role in determining the taxation rights of the contracting states on the income from such immovable property. This is because of the fact that there is always a very close economic connection between source of this income and the state where property is situated, as compared to the state where the recipient of such income resides.

The meaning of immovable property as envisaged in the Model Conventions can be divided into following parts:

1. Meaning as per the domestic law of the contracting state where the immovable property is situated;
2. Specific inclusions – certain items to be always regarded as immovable property;
3. Specific exclusions - this refers to certain items not to be regarded as immovable property;

There are some specific inclusions in the definition of immovable property, which shall always be considered as 'immovable property' even if not considered as 'immovable property' under normal parlance or under the domestic laws of the contracting state where the property is situated. These specific inclusions are:

- Property accessory to immovable property - Property accessory or appurtenant property generally should include buildings, machines on the land or furniture in a house or such similar assets which may or may not be attached to land, but contribute in generating income in a composite form along with primary/principal immovable property. For the purpose of determining whether an accessory property is attached to an immovable property, should be treated as an immovable property, object and purpose of attachment of such accessory property is important. The degree and nature of attachment no doubt should be a consideration, but the more important consideration should be the object of attachment which is a question of fact to be determined by the circumstances of each case. If a thing is embedded in the earth or attached to something which is already embedded for the permanent beneficial enjoyment of such property to which it is attached, then it is a part of immovable property.

- Livestock and equipment used in agriculture and forestry – Since income from agriculture or forestry is to be considered as income from immovable property, Livestock and equipment which are used in the activities of agriculture and forestry shall also be included within the meaning of immovable property.
- Rights to which the provisions of general law respecting landed property apply – This involves right to develop (construct) the property, right to acquire land or buildings. Aforesaid rights, shall be considered to be situated where such immovable property is situated and the income from such rights shall be taxed accordingly in the state where the immovable property is situated.
- Usufruct of immovable property - This involves rights such as right in a co-operative society which entitles a member to a flat or an apartment or easements or similar rights arising from immovable property.
- Rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources - Rights attached to extraction of natural resources is regarded as immovable property. Such rights attached to extraction may be variable or fixed payments.

The specific exclusion are Ships, boats, aircrafts are not regarded as immovable property. Profits derived from the operations of ships, boats or aircrafts are governed by Article 8.

Income from immovable property includes income earned by the use or lease of immovable property. Further, capital gains or taxation of immovable property (akin to wealth tax), is dealt separately by Article 13 and Article 22.

All forms of income earned from the exploitation of immovable property, be it direct or indirect is covered under Article 6. Every kind of income sourced from immovable property falls within the domain of Article 6 and may be taxed in the state of location of such immovable property. Paragraph three specifically prescribes direct use and letting. The term ‘letting’ has not been defined in the convention /treaty, therefore it will be defined according to the laws of the state where the immovable property is situated. Also, the term includes income from sub -letting. However, income in the form of interest earned by securing debt through immovable property is governed by Article 11 relating to interest. Further compensation received for waiving rights under long-term leases of immovable property falls within the ambit of Article 6.

With regard to income from agriculture and forestry, Indian tax treaties have shown a varied trend, i.e. few of the treaties do refer to income from agriculture and forestry as a part of income from immovable property whereas other treaties do not refer to the same as being part of income from immovable property. The treaty with Armenia, Austria, France, Indonesia, etc. include whereas, treaties with Australia, UK, Belgium, Brazil, China, Denmark, Japan, etc. do not include income from agriculture and forestry under Article 6.

However, one must observe that in the treaties where such income is not included in Article 6, definition of immovable property under Paragraph 2 includes livestock and equipment used for the purpose of agricultural and forestry activity. In cases where income from agriculture and forestry is not covered in Paragraph 1, such income is likely to be governed by Article 7 – business profits article. However, in majority of the cases the concerned person is likely to have a permanent establishment in India and the corresponding income is likely to be taxable under Article 7.

Paragraph 4 of the article makes it clear that the provisions of paragraphs 1 and 3 of the article apply to income from immovable property of industrial, commercial and other enterprises. Also, if a permanent establishment is engaged in the business of trading or managing immovable property, such business income also falls under paragraph 4 of Article 6 and not under Article 7.

The commentary on Model Convention has made it clear that Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in a third state. In a situation where a resident of one of the Contracting State earns income from immovable property located in a third state, it falls outside the ambit of Article 6 and comes within the article of 'Other Income' and taxed accordingly.

5. Article 13 – Capital Gains

The OECD article 13 deals with Capital Gains which states that

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation

of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident."

Article 13(1) applies on satisfaction of the following conditions:

- Capital gains are derived by a "resident" of a Contracting State (say Country A)
- Such gains are derived from alienation of an immovable property
- The "immovable property" is such as is referred to in Article 6
- The immovable property is situated in the other Contracting State (say Country B)

One may appreciate that on account of use of the word 'may', both the countries i.e. the country from which the aforesaid income is sourced and the country of which the taxpayer is a resident thereof, have the right to tax the aforesaid income. That is to say, gains from alienation of immovable property situated in Country B, earned by a resident of Country A shall be chargeable to tax in accordance with the domestic tax laws of Country B. However, Country A, based on the residence of the taxpayer, shall also have the right to levy taxes on the aforesaid income

The credit of the taxes paid in the source country may be available in the country of residence. Accordingly, where a resident of Country A earns income from sale of shares in country B, the said person shall be liable to pay taxes in such country (i.e. Country B). However, credit to the extent of taxes paid in country B could be available to the said person in country A.

The definition of the term "immovable property" shall be as per the meaning assigned to it under the domestic laws of the country in which the property is situated. However, the following are specifically included under the ambit of the term "immovable property":

- property accessory to immovable property;
- livestock and equipment used in agriculture and forestry;
- rights to which the provisions of general law respecting landed property apply;
- usufruct of immovable property;
- rights to variable or fixed payments as consideration for the working of, or the right to
- work, mineral deposits, sources and other natural resources.

Ships, boats and aircrafts are specifically excluded from the ambit of term "immovable property"

Article 13(2) applies on alienation of movable property:

a) "forming part of" the business property of a PE which an "enterprise of a Contracting State" (say Country A) has in another state (say Country B); or

b) pertaining to a fixed base available to a "resident of a Contracting State" in Country B for the purposes of performing Independent Personal Services

Where the above conditions are satisfied, gains will be taxable in the country in which PE is situated or in the country in which there is a fixed base for performing independent personal services.

Example: Say X Limited, tax resident of Country A, has a PE in Country B. The said PE holds properties in Country C. In a scenario where the movable property of the said PE, situated in Country C is alienated by the PE, gains arising therefrom shall be chargeable to tax in Country B, in which the PE is located.

This clause does not apply in case of immovable property, despite being business property of the PE. Gains on alienation of such immovable property shall be governed by the provisions of Article 13(1). Accordingly, in the above example, where the aforesaid property, situated in Country C, is immovable property (as defined under Article 6), the gains on alienation of such immovable property shall be taxable in Country C.

It may be interesting to analyse a scenario where an enterprise (say tax resident of Country A), which has a PE in (say) Country B, is alienated. In this connection, attention is invited to the following extracts from the OECD Model commentary:

> "25. The paragraph makes clear that its rules apply when movable property of a permanent establishment is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment."

In the aforesaid scenario, as a consequence of the alienation of the enterprise, the PE situated in Country B shall also stand alienated. Accordingly, Article 13(2) shall be applicable.

However, the provisions of Article 13(2) will be applicable only to the extent of gains attributable and arising on account of transfer of business property of such PE and the same shall not extend to gains arising on alienation of the enterprise as a whole. It may also be noted that the gains arising on transfer of movable business properties of a PE can be taxed as per Article 13(2) even in a situation where PE has ceased to exist at the time of alienation of such movable business properties. However, gains arising on account of alienation of stock-in-trade, shall not be governed by the above article despite it being movable business property of the PE, since the same has been specifically covered under the ambit of Article 7 dealing with Business Profits.

Article 13(3) applies to gains arising from alienation of the following properties:

- Ships or aircrafts operated in international traffic;
- Boats engaged in inland waterways transport;
- Movable property "pertaining" (or connected/ relating/ relatable) to the operation of such ships, aircraft or boats

Under this clause, taxation of gains arising from alienation of aforesaid properties shall be chargeable to tax in the country in which the Place of Effective Management ('POEM') of the entity is located. This clause gives exclusive taxation rights to the country where POEM is located.

POEM, in summary, means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole, are in substance made.

Commentaries on Article 4 of the OECD Model (2014), POEM has been explained as under:

"The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time."

Example: X LLP owns and operates an aircraft plying from Country A to Country B on regular basis. All the key managerial personnel are based out of Country A and hence all the commercial decisions that are necessary for the conduct of the business of X LLP is concluded in Country A. X LLP now proposes to sell the aforesaid aircraft to Y LLP, tax resident of Country B, while it is parked at the airport in Country B. As per the local tax laws of Country B, since the said property (aircraft) is transferred in Country B, the said income is said to be 'sourced' and therefore taxable in Country B. In such a situation, assuming that the aforesaid clause [Article (13(3)] exists in the DTAA between Country A and Country B, the country with taxing rights shall be the place where the POEM of X LLP is situated. Accordingly, the aforesaid capital gains shall be chargeable to tax in the hands of X L LP by Country A and not by Country B.

This article is applicable for gains arising on alienation of shares of a company other than alienation of shares referred to in Article 13(4) [i.e. shares which derive its value directly or indirectly from immovable property]. This article provides that gains arising on alienation of shares of a company by a resident of one country, holding more than the prescribed percentage of shares of a company in another country for a particular time period, will also be taxable in the country in which the company, whose shares are alienated, is resident. This article provides non-exclusive taxation right to the country in which the company, whose shares are to be transferred, is a resident. Where the percentage of shares held or the time period is less than what is prescribed in the DTAA the country in which the company, whose shares are to be alienated, will not have the right to tax.

Article 13(6) is a residuary clause and accordingly seeks to cover within its ambit gains arising on alienation of all the properties which are otherwise not covered in the aforesaid clauses.

The residuary clause may cover the following:

- Sale of shares in a company [unless covered in Article 13(4)/ (5) above];
- Securities such as bonds, debentures, units, intangibles such as trademark copyright;
- Movable property [unless covered in Article 13(2)], etc.

This clause allows the country of residence of the alienator to tax the income in the nature of capital gains sourced from other countries. Thus, all the movable properties other than those specifically set out in aforesaid clauses, shall be subject to taxes only in the state of residence of the alienator.

Chapter 14

Overview of BEPS

This chapter covers the following:

- **Introduction of BEPS and its Action Plans**
- **Tax Treaty Abuse and Treaty shopping**
- **DTAAs with the MLI**
- **BEPS 2.0 - Pillar 1 and Pillar 2**
- **Global minimum effective tax rate**

1. Introduction

Base Erosion Profit Shifting ('BEPS')

BEPS refers to tax planning strategies used by multinational enterprises (MNEs) that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level.

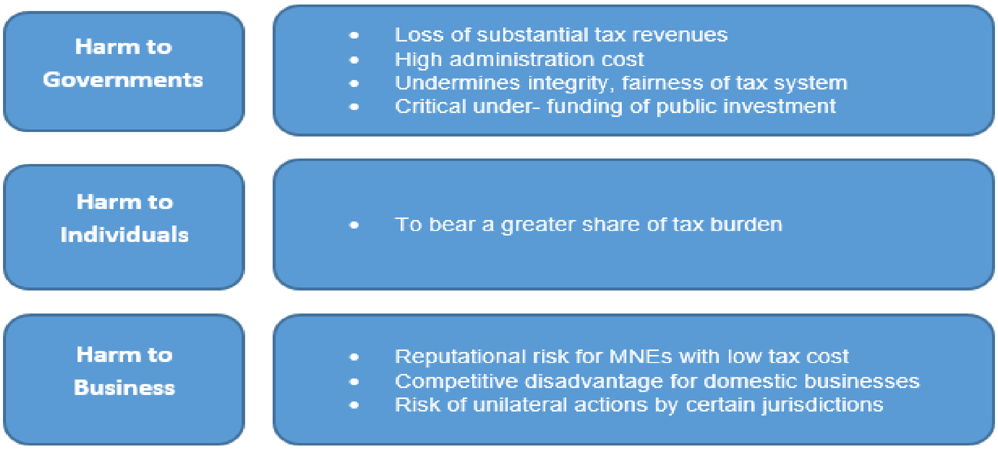
BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. BEPS practices cost countries USD 100-240 billion in lost revenue annually. Working together within OECD/G20 Inclusive Framework on BEPS, over 135 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs and can effectively participate in the process of standard-setting on international tax.

OECD and G20 countries along with developing countries that are participating in the implementation of the BEPS Package and the ongoing development of anti-BEPS international standards are establishing a modern international tax framework to ensure profits are taxed where economic activity and value creation occur. Work is being carried out to support all countries interested in implementing and applying the rules in a consistent and coherent manner, particularly those for which capacity building is an important issue.

BEPS- Concern

As the economy became more globally integrated, so did corporations. MNEs now represent a large proportion of global GDP. According to the OECD, around 60% of the world trade takes place within MNE. Further, intra-firm trade comprises of a growing proportion of overall trade. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. These developments have been exacerbated by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus providing MNEs with more confidence in taking aggressive tax positions.

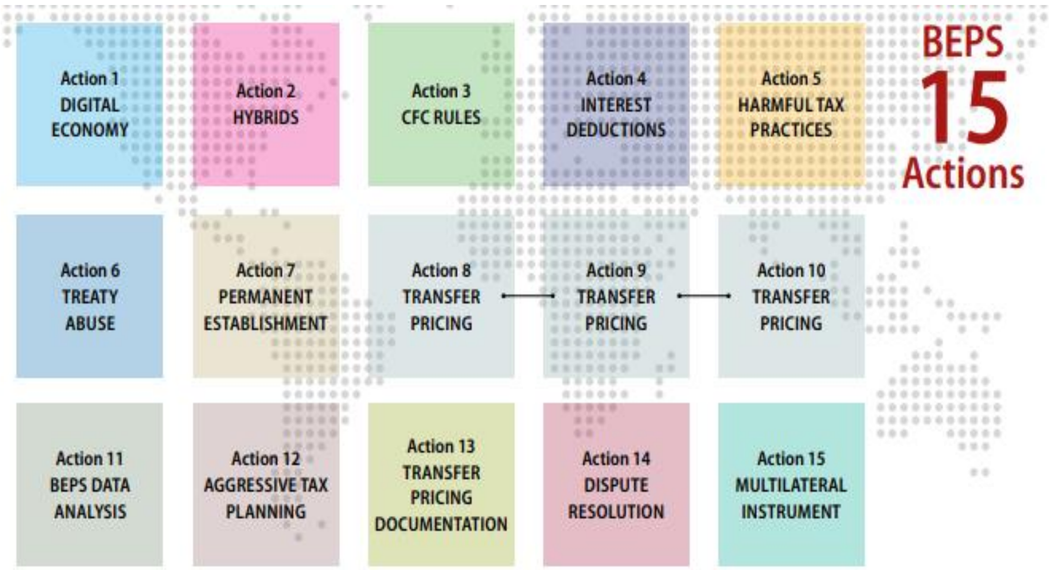
These developments have opened up opportunities for MNEs to greatly minimise their tax burden. It has become a critical issue and concern for all parties:



BEPS and its Action Plans

In the background of the above repercussions and the global financial crisis in 2009, the G-20 countries shifted their focus to strengthen the international financial system. The G-20 mandated the OECD to address the issue of tax avoidance, in light of which during February 2013, the OECD published a report on "Addressing Base Erosion and Profit Shifting" iterating the need for analyzing the issue of tax base erosion and profit shifting by global corporations. The OECD followed it up with publishing draft Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013 which came to final fruition in October 2015.

The BEPS package provides 15 Action Plans that equip governments with the domestic and international instruments needed to tackle tax avoidance. Countries now have the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. These tools also give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements.

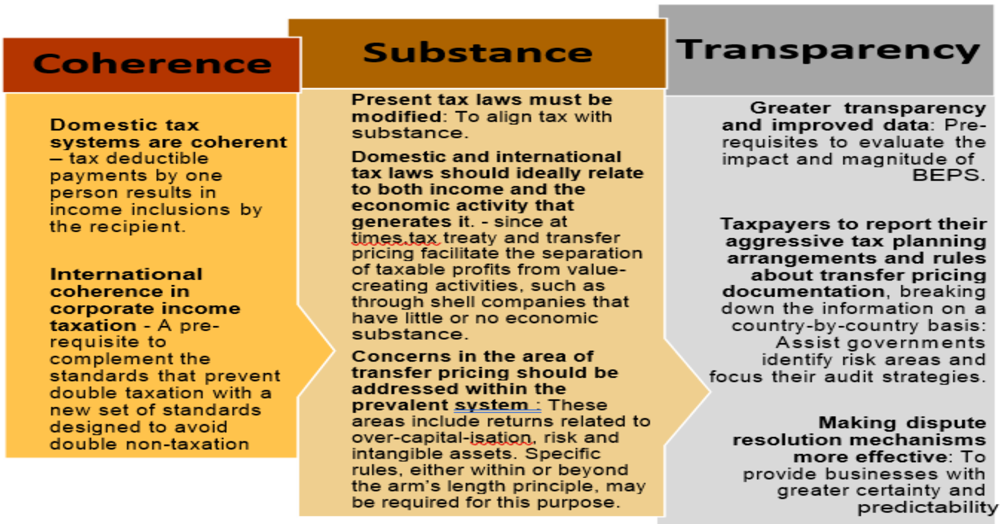


The Action Plans were structured around three fundamental pillars viz.:

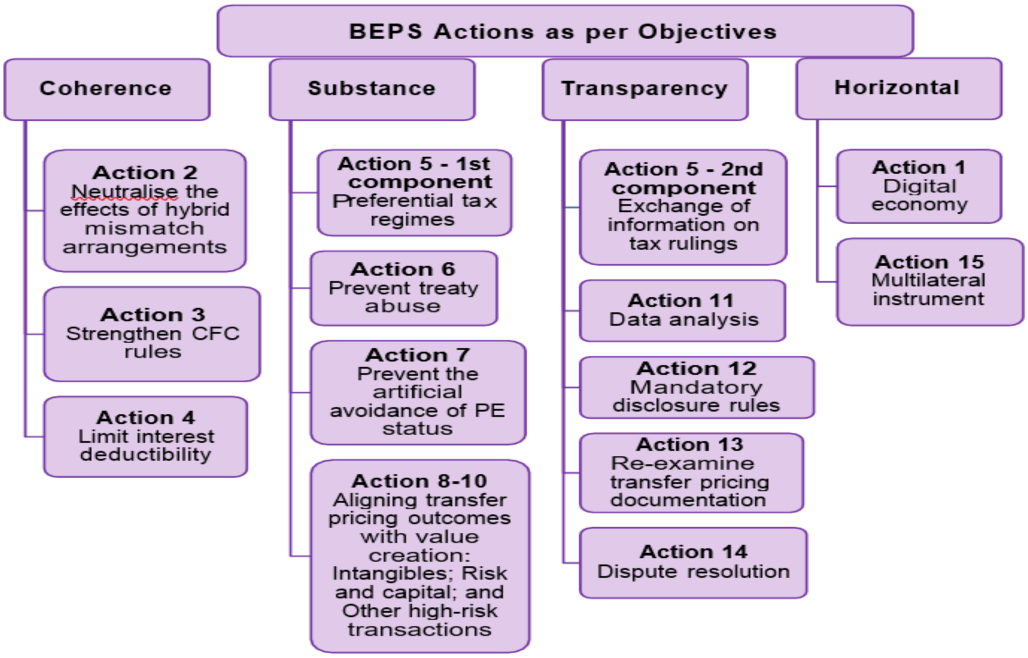
(i) Introducing **coherence** in the domestic rules that affect cross-border activities.

(ii) Reinforcing of **'substance'** requirements in existing international standards; Alignment of taxation with location of value creation and economic activity; and

(iii) Improving **transparency** and **tax certainty**.



A brief classification of the Action Plans based on the fundamental pillars is as under:



An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G-20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards. The Inclusive Framework on BEPS works to ensure that the international tax framework for MNEs remains relevant for today and the future, thereby promoting economic efficiency and global welfare. It will also ensure that governments continue to efficiently raise revenues not only from traditional but also from digital businesses, both for direct tax and indirect tax purposes.

The summary explanatory statement indicates the level of political commitment by OECD, G20 and other States involved in the 2015 work to the various reports. The OECD has iterated the following terms to indicate the commitment by various participant countries:

New minimum standard - New minimum standard implies application of a new rule to be implemented by all states, since non-implementation may result in negative spill overs (including adverse impact of competitiveness) on other countries. Each of the four BEPS minimum standards [namely, Actions 5, 6, 13 and 14] is subject to peer review in order to ensure timely and accurate implementation and thus safeguard the level playing field. All members of the Inclusive Framework on BEPS commit to implementing the minimum standards, and commit to participating in the peer review.

Revision of a standard which already exists – Existing standards have been updated and will be implemented but with the caveat that all BEPS participants have not endorsed the underlying standards on tax treaties or transfer pricing; and

Best practice – A best practice is not a standard but optional recommendation for states to follow. Guidance based on best practices will support those countries proposing to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation.

Action Plan 1- Address the tax challenges of the digital economy

BEPS Action Plan 1 includes the following description of the work to be undertaken in relation to the digital economy:

The main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.

At their meeting in St. Petersburg on 5-6 September 2013, the G20 Leaders fully endorsed the BEPS Action Plan, and issued a declaration that included the following paragraph related to BEPS:

In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. The growth of the digital economy also poses challenges for international taxation. We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created […] (G20, 2013).

BEPS is a concern in the context of the digital economy. The actions will help address these concerns. However, there are specificities that need to be taken into consideration. This will require a thorough analysis of the different business models, the ever-changing business landscape and a better understanding of the generation of value in this sector. Moreover, indirect tax aspects should also be considered. Drawing on the other actions included in this plan, a dedicated task force on the digital economy will be established.

The digital economy, new business models and key features

The digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardized, improving business processes and bolstering innovation across all sectors of the economy. Sectors as diverse as retail, logistics, financial services, manufacturing & agriculture, education, healthcare and broadcasting & media have changed and keep changing due to the spread of ICT. Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present, however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multisided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations. *An example* of such a challenge is a company that has a significant digital presence in the economy of another country than from which the company is run. Like selling digital products, or advertising to the local market. Current tax rules are not very clear on how to tax the profits of such a company.

Emergence of new business models

The digital economy has given rise to a number of new business models. The business models discussed below are by no means exhaustive. Indeed, just as innovation in the digital economy allows the rapid development of new business models, it can also quickly cause existing businesses to become obsolete. The types of business include E-commerce, payment services (payment service provider act as an intermediary typically using, software as-a-service model, e-wallets etc.), App stores, **Online advertising**, cloud computing (e.g., cloud computing service models: Infrastructure-as-a-service, Platform-as-a-service etc.), High frequency trading and participative networked platforms.

Key features of digital economy

There are number of features that are increasingly prominent in the digital economy and which are potentially relevant from a tax perspective. They include:

- Mobility, with respect to (i) the intangibles on which the digital economy relies heavily, (ii) users, and (iii) business functions as a consequence of the decreased need for local personnel to perform certain functions as well as the flexibility in many cases to choose the location of servers and other resources.
- Reliance on data, including in particular the use of so-called “big data”.
- Network effects, understood with reference to user participation, integration and synergies.

- Use of multi-sided business models in which the two sides of the market may be in different jurisdictions.
- Tendency toward monopoly or oligopoly in certain business models relying heavily on network effects.
- Volatility due to low barriers to entry and rapidly evolving technology

Tackling BEPS in the digital economy

Many of the key features of the digital economy, particularly those related to mobility, generate BEPS concerns in relation to both direct and indirect taxes. For example, the importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes. The mobility of users creates substantial challenges and risks in the context of the imposition of value added tax (VAT).

The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures have been implemented in a co-ordinated manner, taxation is more aligned with the location in which economic activities take place. This will address BEPS issues at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks. These BEPS risks were identified and the work on the relevant actions of the BEPS Project was informed by these findings and took these issues into account to ensure that the proposed solutions fully address BEPS in the digital economy.

Evaluation of the broader direct and indirect tax challenges raised by the digital economy and of the options to address them

The digital economy triggers systemic questions about the ability of the current domestic and international tax systems to deal with the changes brought about by advances in information and communication technology (ICT). These tax policy issues have implications for the overall design of tax systems. These challenges may therefore have broader implications than BEPS and the countermeasures developed in the course of the Project. These include issues related to the allocation of taxing rights among countries as well as to the tax policy considerations that should be taken into account when weighing the relative costs and benefits of the various tax solutions.

In the area of **direct taxation**, the main policy challenges raised by the digital economy fall into three broad categories:

- **Nexus:** The continual increase in the potential of digital technologies and **the reduced need in many cases for extensive physical presence** in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.

The digital business, thus, challenges physical presence-based permanent establishment rules. If permanent establishment (PE) principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e., place of business, location, and permanency must be reconciled with the new digital reality.

- **Data:** The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information across borders to an unprecedented degree. This raises the issues of how to **attribute value** created from the generation of data through digital products and services, and of how to characterise for tax purposes a person or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way.
- **Characterization:** The development of **new digital products or means of delivering services** creates uncertainties in relation to the proper characterization of payments made in the context of new business models, particularly in relation to cloud computing.

In the area of **indirect tax challenges of the digital economy:**

- **Collection of VAT** on cross-border transactions concluded through digital media was identified by the Task Force on the Digital Economy (TFDE) as a key issue that must be addressed urgently to level the playing field between foreign and domestic suppliers and to protect countries' VAT revenues. Cross-border trade in both goods and services create challenges for VAT systems, particularly where such goods and services are required by private customers from suppliers abroad.

Developing options to address the broader direct tax challenges of the digital economy

Due to the tax challenges arising from digitalization, G20-OECD BEPS Action Plan Committee as part of its 2015 the Action Plan 1 Report identified a number of broader tax challenges raised by digitalization, notably in relation to nexus, data and characterization.

The Action Report 1 analysed the following three options, namely-

i) a new nexus rule in the form of a **significant economic presence**

ii) **a withholding tax** which could be applied to certain types of digital transactions, and

iii) **an equalization levy**, intended to address a disparity in tax treatment between foreign and domestic businesses where the foreign business had a sufficient economic presence in the jurisdiction.

The **OECD has recommended** several options to tackle the direct tax challenges under Action Plan 1 of the BEPS project which includes:

1. **Modifying the existing definition of PE rule** to provide for whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it is maintained a significant digital presence in another country's economy.

2. Introducing the concept of **a virtual fixed place of business in the concept of PE** ie., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.

3. **Imposition of a final withholding tax** on gross basis in case of certain payments made for digital goods or services provided by a foreign e-commerce provider or imposition of a equalization levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

It was concluded that countries could introduce any of these options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. The above options can be resorted to as an interim measure until a clear solution emerges on taxing digital economy.

Taxing into consideration that potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in the terms of such digital transactions. In order to arrive at a long term solution, the OECD along with the BEPS Inclusive Framework is working on arriving at a consensus based solution to tackle the tax challenges arising out of the digital economy as part of a ' Unfit Approach' under Pillar One.

Equalisation Levy

For instance, consequent to the BEPS Action Report 1, in India, committee was constituted by the Central Board therein, to evaluate the alternative suggested for addressing the challenges arising on taxing the digital economy and on the recommendations of the Committee **"Equalisation Levy"** was introduced @ 6% of the amount of consideration for specified services (describe under the section of the Finance Act, 2016) received or receivable by a non-resident not having PE in India, from a resident in India who carries out business or profession, or from non- resident having in PE in India.

Action Plan 2- Neutralise the effects of hybrid mismatch arrangements

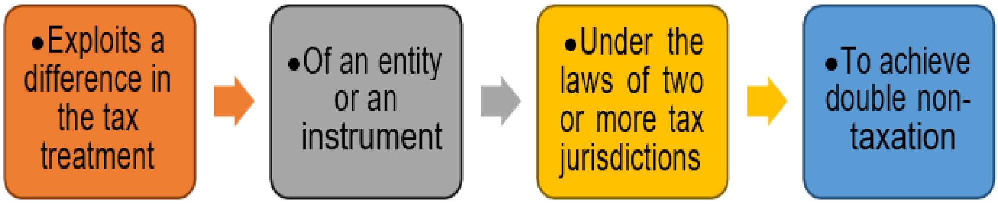
Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention *should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping*

One area in which the OECD has not done significant work in the past is CFC rules. *One of the sources of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate. CFC and other antideferral rules have been introduced in many countries to address this issue. However, the CFC rules of many countries do not always counter BEPS in a comprehensive manner. While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.*

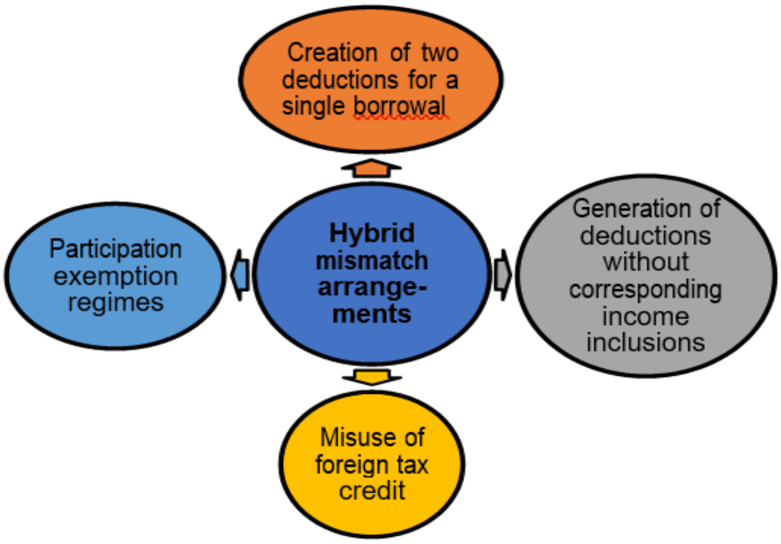
Before understanding what Action Plan 2 recommends, we must understand what a hybrid mismatch is.

Hybrid Mismatch Arrangement: Meaning

A hybrid mismatch is an arrangement that:



Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways –



Hybrid mismatch arrangements involve the use of hybrid entities or hybrid instruments to provide multiple deductions for a single expense, deductions in one country without taxation in another, and multiple foreign tax credits for a single amount of foreign tax paid. Hybrid entities generally involve cases in which the entity is not seen as a separate entity from one country's perspective but is from another country's perspective. Hybrid instruments are financial arrangements that are treated as debt in one jurisdiction and equity in another.

These types of hybrd mismatch arrangements were widespread and resulted in a substantial erosion of the taxable bases of the jurisdictions concerned. These risks were highlighted in the context of international banking in the 2010 OECD report Addressing Tax Risks Involving Bank Losses and a subsequent review by various OECD member countries identified examples of tax planning using hybrid mismatch arrangements which led to the 2012 OECD report Hybrid Mismatch Arrangements: Tax Policy and Compliance issues. The 2012 report identified that hybrid mismatch arrangements, in addition to their impact on tax revenues, also have an overall negative impact on competition, efficiency, transparency and fairness.

BEPS Action Plan 2 recommendations target mismatches resulting from differences in the tax treatment of financial instruments or entities. The work on hybrid mismatches was subsequently expanded to deal with similar opportunities that arise through the use of branch structures, resulting in a 2017 OECD report Neutralising the Effects of Branch Mismatch Arrangements.

As part of the common approach to addressing hybrid mismatches, work continues amongst OECD/G20 Inclusive Framework members to share practical examples of these structures to ensure consistent, comprehensive and coherent outcomes from the application of the new rules.

OECD Recommendation and amendments thereon are as follows:

<u>Recommendation</u>

- Change in the domestic law & make rules to neutralize the effect of Hybrid Mismatch Arrangements
- Chane in tax treaty to deal with dual resident companies, transparent entity, Hybrid entity etc.

<u>Recommended general amendments</u>

- A rule denying transparency to entities where the non-resident investors' resident country treats the entity as opaque (non-transparent);

Example: Let us say, X Co., a parent company in country X indirectly holds Y Co., an operating company in country Y. Between X Co. and Y Co. is a hybrid entity that is treated as transparent or disregarded for country X tax purposes and as non-transparent for country Y tax purposes. X Co. holds all or almost all equity interest in the hybrid entity which in turn holds all or almost all equity interests in Y Co. The hybrid entity borrows money from a third party and the loan is used to invest equity into Y Co (or to buy the shares in Y Co from either another company of the same group or from an unrelated third party). The hybrid entity pays interest on the loan. Except for the interest, the hybrid entity does not claim any other significant deduction and does not have any significant income.

With respect to Country Y, for tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country Y group companies' income under the country Y group tax relief regime. On the other hand, country X treats the hybrid entity as transparent or disregarded, with the result that its interest expenses are allocated to X Co, which deducts the interest expense to offset unrelated income. The net effect is that there are two deductions for the same contractual obligation in two different countries.

Therefore, by virtue of rule denying transparency to an entity which is treated as opaque in the subsidiary company's country, the double deduction can be avoided.

- A rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer;

Example: N Co, a company resident in country N is funded by M Co., a company resident in country M with an instrument that qualifies as equity in country M but as debt in country N. A payment made under the instrument would be deductible as interest expense for N Co under country N tax law. The corresponding receipts are treated as exempt dividends under the tax laws of country M. Consequently, deduction is available under the tax laws of country N without a corresponding income inclusion in country M.

Therefore, by virtue of rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer, exemption of such income in country M would not be possible.

- A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity; and
- Amendments to CFC and similar regimes attributing local shareholders the income of foreign entities that are treated as transparent under their local law.

Treaty Changes: Action Plan 2 recommends a new provision in the case of income earned by a transparent entity. As per the new provision, treaty benefits will only be afforded to so much of the income of the entity as the income of a resident of that State. A specific or general saving rule is proposed so that a State can tax a resident entity generally unrestricted by treaty.

Anti-hybrid rules: The report further issued a series of dedicated domestic anti-hybrid rules which would work in two stages. The primary rules would deny deductions to payers in situations where either:

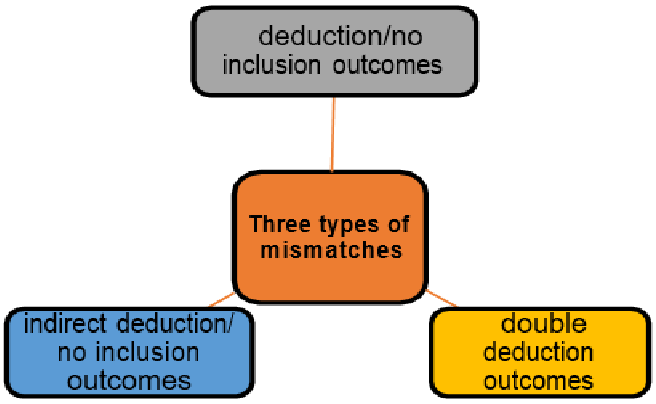
(i) Those payments will not be included in the recipient's ordinary income, or

(ii) The same amount is being simultaneously deducted by another entity.

- **Branch Mismatches**: Branch mismatches occur where two jurisdictions take a different view as to the existence of, or the allocation of income or expenditure between, the branch in head office of the same taxpayer.

  Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch.

  The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches:



The 2017 report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

Action Plan 3- Strengthen Controlled Foreign Company (CFC) Rules

Develop recommendations regarding the design of controlled foreign company rules. This work will be coordinated with other as necessary

Shifting investment income and passive income to subsidiaries in low tax or no tax jurisdictions: Deferral of home country taxation

Under the tax laws of several countries, a shareholder of a corporation is not taxed on the corporation's income until the income is distributed as a dividend. Therefore, it was common for publicly traded companies to form foreign subsidiaries in tax havens and shift "portable" income to those subsidiaries. Generally, income shifted were mainly investment income (interest and dividends) and passive income (rents and royalties), as well as sales and services income involving related parties. Tax in parent country on this income was avoided until the tax haven country paid a dividend to the shareholding company. This dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many countries (where global multi-nationals are based) have high tax rates as compared to certain other countries, which used their low tax rates as a means of attracting inward investment. As a result, when dividends were repatriated from these lower tax countries, the recipient generally suffered additional tax on those profits. Therefore, many companies have a tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of deferring home country taxation.

Obviously, Governments were disturbed that multinationals based in their countries kept large amounts of profits offshore. In order to address this issue, governments in various countries have introduced legislation aimed at eliminating the benefits of deferral, by currently taxing income in the parent country even when the income has not been repatriated or remitted to that country. These rules are generally referred to as Controlled Foreign Corporation (CFC) rules.

CFC Rules: Addressing BEPS

CFC rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

CFC are corporate entities incorporated in Tax Haven countries & controlled directly or indirectly by Resident of higher tax jurisdiction (Parent state).

Example: KLM Ltd. is an Indian Company setup a KLM LLC. subsidiary in Tax Haven Country. In this case KLM LLC. Is treated as CFC. Normally CFC earns passive income & accumulated such income in tax haven countries. Such income is taxable in parent state only if CFC distribute dividend but practically CFC never distribute dividend so such income is never taxable in parent state.

To curb these practices many countries come out with CFC regulation. As per CFC rules, Income earn by CFC is deemed to be income of parent entity and taxable in parent state. Normally CFC rules applicable in Interest, royalty, dividend, income from transactions with related parties etc.

The OECD Final Report does not propose a minimum standard for controlled foreign company (CFC) regimes. However, **OECD** regards CFC rules as being important in tackling BEPS and has made a series of best practice **recommendations** in relation to the ‘building blocks’ of an effective CFC regime. These building blocks would allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations and they include definition of CFC income, computation & attribution of CFC income, prevention and elimination of double taxes, CFC exemptions and threshold requirements.

The major reason why the OECD was unable to provide more than best practice was fundamental disagreement over the policy of CFC regimes, in particular whether states should use the regime to protect other states' tax bases from earnings stripping.

Action Plan 4- Limit base erosion via interest deductions and other financial payments

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.

Normally International Group taking loan or debt in High Tax jurisdiction because, interest is deductible expenses & they can reduce over all tax liability. Many time enterprise of MNE located in tax haven gives loan to entity located in high tax jurisdiction so their over all tax burden get reduced.

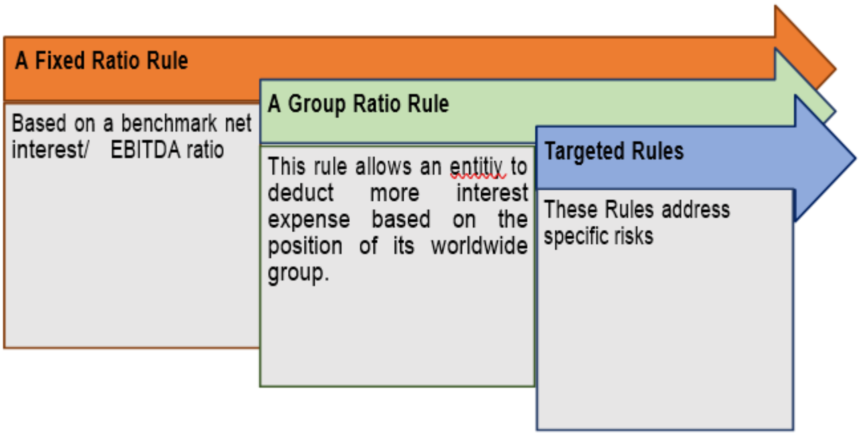
Example:

1. Locating third party debt in high tax countries;
2. Using intra-group loans to achieve interest deductions in excess of the group's actual third-party interest expense;
3. Using related party or third-party debt to finance the production of exempt or deferred income.

BEPS Action Plan 4 calls for the development of recommendations for the design of domestic rules to prevent tax base erosion through the use of interest expense and other financial payments that are economically equivalent to interest.

OECD Recommendation

The 2015 Report established a common approach which directly links an entity's net interest deductions to its level of economic activity, based on taxable earnings before interest income and expense, depreciation and amortisation (EBITDA). This approach includes three elements:



Action Plan 5- Counter harmful tax practices more effectively, taking into account transparency and substance

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

The Action 5 Report is one of the four BEPS minimum standards. The minimum standard of the Action 5 Report consists of two parts. One part relates to preferential tax regimes, where a peer review is undertaken to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions. The second part includes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.

In simpler terms, normally every country tax royalty on intellectual property at lower rate. MNEs normally develop intellectual property in high tax jurisdiction but registered that intellectual property in tax haven or low tax jurisdiction.

OECD recommended that low tax rate benefit should be available only if intellectual property is developed in that country.

Action Plan 6- Prevent Treaty Abuse

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.

Protection against treaty shopping: Treaty shopping means taking benefit of any treaty by any person which is not meant for that person.

OECD Recommendation

- Clear statement in preamble of treaty that such treaty is for avoidance of double taxation and not for creating opportunities for non-taxation through treaty shopping.
- Combined approach of Limitation of Benefits (LOB) Rules and Principle Purpose Test (PPT) Rules
- Alone PPT rules

The implementation of the Action Plan 6 minimum standard is subject to a peer review process. The first three peer reviews on the implementation of the Action 6 minimum standard were carried out in 2018, 2019 and 2020, following the process set out in the Peer Review Document (2017). The peer review for 2021 has been completed and is the first peer review process to be governed by the Revised Peer Review Document (2021). The peer review for 2022 is currently ongoing.

Action Plan 7- Prevent the artificial avoidance of PE status

Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.

This report includes changes to the definition of permanent establishment (PE) in the OECD Model Tax Convention that will address strategies used to avoid having a taxable presence in a country under tax treaties.

These changes will ensure that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes will also restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations; they will also address situations where the exception applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises.

Thus, the following steps have been advocated:

- **Reworking exceptions to PE definition** – An anti-fragmentation rule to be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. The above test can also be applied to understand whether the activities undertaken by an enterprise in a state are ‘preparatory or auxiliary’.

- **Analyzing arrangements entered through contractual agreements –** A Commissionnaire arrangement may be broadly defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Commissionnaire arrangements have been a major cause of concern for tax administrations in many countries.

Progress in implementation of BEPS Action Plan 7

The changes to the PE definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the MLI (Articles 12 to 15). The Multilateral Instrument (MLI) is a flexible instrument that allows jurisdictions to adopt BEPS treaty-related measures to counter BEPS and strengthen their treaty network. The MLI was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles that implement the permanent establishment changes [For detailed understanding of MLI, refer to discussion under Action 15].

Action Plan 8 to 10- Aligning Transfer Pricing Outcomes with Value Creation

These reports deal with TP rules and have focused on three key areas to ensure that the TP rules secure outcomes that see operational profits allocated to the economic activities which generate them. Work under Action 8 looked at TP issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to BEPS. Members of the MNE group are to be compensated based on the value they create through functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles. Work under Action 9 addressed the level of returns to funding provided by a capital rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company. Work under Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of TP methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation. The Report determines that risks contractually assumed by a Party that cannot in fact exercise meaningful and specifically defined control over the risks or does not have the financial capacity to assume the risks, will be allocated to the Party that does exercise such control and does have the financial capacity to assume the risks. For intangibles, the Guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions.

Action Plan 11- Measuring and monitoring BEPS

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, The Addressing Base Erosion and Profit Shifting report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, the fiscal effects of BEPS are significant. BEPS causes other adverse economic effects, including tilting the playing field in favour of tax aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure.

Indicators of BEPS activity

Six indicators of BEPS activity highlight BEPS behaviour using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

(i) The profit rates of MNE affiliates located in lower-tax countries are higher than their group's average worldwide profit rate. For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group's worldwide profit rate on average.

(ii) The effective tax rates paid by large MNE entities are estimated to be lower than similar enterprises with only domestic operations - This tilts the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.

(iii) Foreign direct investment (FDI) is increasingly concentrated - FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

(iv) The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly - For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries and has increased three-fold between 2009 and 2012.

(v) Royalties received by entities located in these low-tax countries accounted for 3% of total royalties - This provides evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

(vi) Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

Action Plan 12- Require taxpayers to disclose their aggressive tax planning arrangements

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.

A significant challenge faced by tax authorities worldwide is the lack of timely, comprehensive and relevant information on aggressive tax planning strategies. Timely access to such information would facilitate quick response to tax risks through informed risk assessment, audits, or changes to legislation or regulations. BEPS Action Plan 12 recognises the advantages of tools designed to facilitate the information flow on tax risks to tax administrations and tax policy makers. The Report provides a modular framework for guidance drawn from best practices for use by countries without mandatory disclosure rules to design a regime that suits their requirement to get early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries can decide whether or not to introduce mandatory disclosure regimes. Where a country opts for mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and more timely information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.

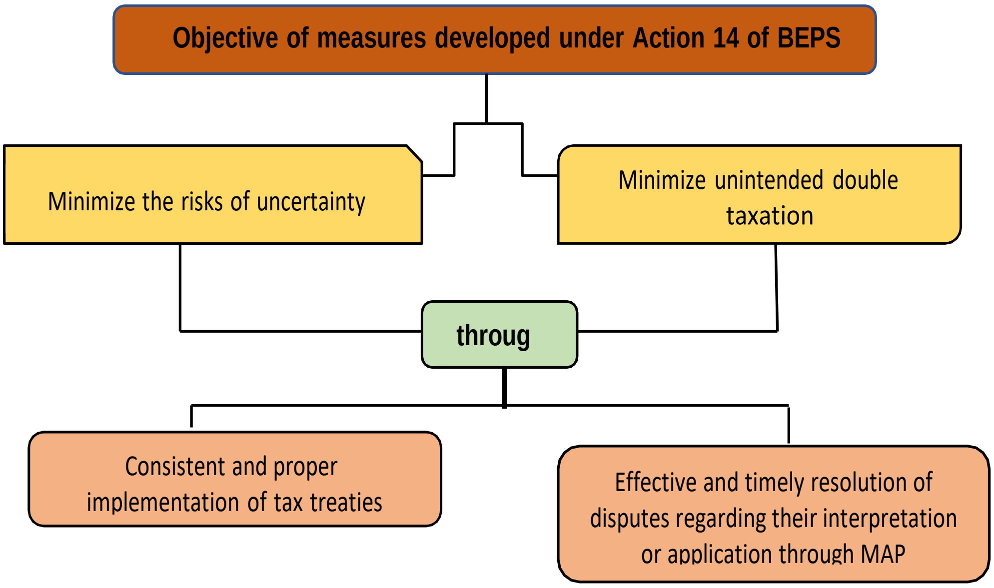
Action Plan 13- Re-examine transfer pricing documentation

This action contains revised standards for TP documentation, a three-tiered system is suggested:

1) First is the master file, it requires the MNE to provide high-level information regarding the global business operation and TP policy.
2) Second is the local file, it requires the transactional details specific to each country, identifying material RPT, the amounts involved in those transactions.
3) Third is Country by Country Reporting (CbCr), it is required for large MNEs that provides annually and for each tax jurisdiction in which they do business the amount of revenue, profit before tax and tax paid. It also requires MNE to report no. of employees, capital, retained earnings and tangible assets.

Action Plan 14- Make dispute resolution mechanisms more effective

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.



Due to implementation of BEPS action plan, there may be risk of uncertainty or unintended double taxation. The above issued should be resolved through proper implementation of tax treaties & resolution of dispute through Mutual Agreement Procedure (MAP).

Action Plan 15- Develop a Multilateral Instrument (MLI)

Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

The MLI is a flexible instrument which will modify tax treaties according to a jurisdiction's policy preferences with respect to the implementation of the tax treaty-related BEPS measures. The MLI provides for different types of flexibility:

(i) jurisdictions can choose amongst alternative provisions in certain MLI articles;

(ii) jurisdictions can choose to apply optional provisions (for instance, the provisions on mandatory binding arbitration);

(iii) jurisdictions may also choose to reserve the right not to apply MLI provisions (to opt out through a "reservation") with respect to all of their Covered Tax Agreements or with respect to a subset of their Covered Tax Agreements. Jurisdictions only have the possibility to opt out of provisions that do not reflect a BEPS minimum standard, with the possibility to withdraw their reservation (and opt in) later.

2. Treaty Abuse and Treaty Shopping

Over the last decades, bilateral tax treaties, concluded by nearly every jurisdiction in the world, have served to prevent harmful double taxation and remove obstacles to cross-border trade in goods and services, and movements of capital, technology and persons. This extensive network of tax treaties (3000 to 4000 treaties in force worldwide) has, however, also given rise to treaty abuse and so-called "treaty-shopping" arrangements. Abuse of tax treaties is an important source of BEPS.

Treaty abuse involves taking unintended benefits of the tax treaties through. various tax avoidance strategies

Treaty shopping means taking benefit of any treaty by any person which is not meant for that person. Treaty shopping typically involves the attempt by a person to indirectly access the benefits of a tax treaty between two jurisdictions without being a resident of one of those jurisdictions. There are a wide number of arrangements through which a person who is not a resident of a jurisdiction that is a party to a tax agreement may attempt to obtain benefits that a tax agreement grants to a resident of that jurisdiction.

Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving jurisdictions of tax revenues.

As we have discussed in above BEPS Action Plan 6 dealt with the preventing treaty abuse and sets out one of the four BEPS minimum standards, which is that members of the BEPS Inclusive Framework commit to include in their tax treaties provisions dealing with treaty shopping to ensure a minimum level of protection against treaty abuse. Action Plan 6 sets out other specific rules and recommendations to address other forms of treaty abuse.

3. DTAAs with the MLI

The MLI is a flexible instrument which will modify tax treaties according to a jurisdiction's policy preferences with respect to the implementation of the tax treaty-related BEPS measures. The MLI provides for different types of flexibility:

(i) jurisdictions can choose amongst alternative provisions in certain MLI articles;

(ii) jurisdictions can choose to apply optional provisions (for instance, the provisions on mandatory binding arbitration);

(iii) jurisdictions may also choose to reserve the right not to apply MLI provisions (to opt out through a "reservation") with respect to all of their Covered Tax Agreements or with respect to a subset of their Covered Tax Agreements. Jurisdictions only have the possibility to opt out of provisions that do not reflect a BEPS minimum standard, with the possibility to withdraw their reservation (and opt in) later.

The MLI helps the fight against BEPS by implementing the tax treaty-related measures developed through the BEPS project in existing bilateral tax treaties in a synchronized and efficient manner. These measures will prevent treaty abuse, improve dispute resolution, prevent the artificial avoidance of permanent establishment status and neutralize the effects of hybrid mismatch arrangements.

Before we embark into what is MLI, we must understand the need for an MLI under the international tax laws. The existing framework of international tax law is through tax treaties entered bilaterally between countries.

The MLI convention is synonymous to a treaty. Treaties are instruments which create international law, it is one of the most common and important sources of international law. They are agreements between sovereign states and are binding on every sovereign state signatory to such agreement. A treaty is defined by the Vienna Convention on the Law of Treaties (commonly referred to as 'VCLT') as 'an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation'. As much as treaties are instruments under international law, conventions, agreements, charters are all synonymously used along with treaty.

The tax treaty framework is through Countries which have entered into Double Tax Avoidance Agreements (generally referred to as 'DTAA') with several other countries on a bilateral basis i.e. agreement between two countries (e.g. Country A with Country B) to prevent double taxation of income. India has entered bilateral tax treaties with more than 90 countries. The bilateral tax treaties are, inter alia, entered with a view, majorly to prevent double taxation of income and give relief in respect of doubly taxed incomes.

The rapid growth of globalization led to the creation of Multinational Enterprises (MNEs) wherein the entities within a group were present all over the world and in many cases at jurisdictions which were set up with the main objective to obtain tax arbitrage using treaty shopping mechanism. Consequent to the 2008 global economic crisis, the international organizations and the fellow nations came up with the BEPS action plan to recognise and counter unfair tax planning strategies adopted by certain MNEs which had exploited the gaps in the global taxation system by artificially shifting profits to low or no-tax locations (where there is little or no economic activity which leads to little or no tax being paid). These tax planning strategies violated the 'Economic Allegiance' principle which means to compensate to a nation or a kingdom for the benefits that one derived from exploiting that nation or kingdom's resources. This resulted in the source taxation principle under the international tax principles.

As a result of the BEPS agenda, 15 Action Plans were brought out by the OECD under G20's mandate to tackle the unfair tax planning mechanisms adopted by MNEs. The action plan 15 can be considered as the machinery action, which is intended to put into play the anti-avoidance tax solutions proposed in the other BEPS action items. The need for such a machinery action item is because currently there are more than 3000 bilateral tax treaties that are active and to invoke the solutions proposed under the BEPS action plans, these bilateral tax treaties have to be amended. Amending the bilateral treaties and involves cumbersome legal process as each country have their own constitutional or other legal mechanisms to invoke international treaties into their domestic laws. Further, mere incorporation of these solutions in domestic law will not achieve the desired objective as the tax treaties will remain a tool for tax evaders. Therefore, to ensure the BEPS solutions are transposed into the tax treaty, action plan 15 objective was to bring all these amendments under one single umbrella and hence, the work on developing a multilateral agreement was undertaken.

Multilateral agreements are entered by three or more nations, thus, bringing many countries under one roof. Such agreements are considered effective and less time-consuming. The World Trade Organization (WTO) agreement, in which India is a party, is a classic example of multilateralism. Multilateral agreements, in the context of international taxation, is not new as there have been precedents from Scandinavian, Caribbean countries entering into such an agreement to avoid double taxation. India also has its experience through the SAARC Limited Multilateral Agreement for the avoidance of double taxation. But what distinguishes those agreements from the BEPS MLI is that the MLI is exclusively entered to ensure there are no double nontaxation and reduction of taxes, unlike the former whose objective was inter alia to avoid double taxation and to promote economic relations.

Therefore, the MLI modifies tax treaties not by directly amending the text of the tax treaty, but by being applied together with the relevant tax treaty. They do not make the existing DTAA otiose, they operate along with the existing DTAA and will modify the application of some clauses in the existing DTAA using the lex posterior (later in time) principle. Therefore, the BEPS MLI is an effective tool to implement the anti-avoidance measures in a synchronised manner without the need to bilaterally renegotiate each and every agreement. The BEPS MLI can act as a retaliatory tool for tax enforcers to use against the tax evaders, as it can disentitle a taxpayer from undertaking treaty shopping or availing unfair treaty benefits based on the anti-avoidance measures initiated under the BEPS action items.

4. BEPS 2.0- Pillar 1 and Pillar 2

The 2015 Action 1 report provided for options to safeguard against BEPS on account of digitalisation, however it did not provide for any recommendations and left it to the discretion of the countries to resort to these measures as part of their domestic law. The report also indicated that it was agreed between the members to continue to monitor developments in respect of the digital economy, with a further report to be delivered by October, 2021

In this regard, the Interim Report, 2018, on Tax Challenges arising from Digitalisation, considers an interim measure in the form of an excise tax on the supply of certain e-services within their jurisdiction that would apply to the gross consideration paid for the supply of such e-services by a registered e-services supplier.

After the delivery of the Interim Report in March 2018, the Inclusive Framework delivered a blueprint report in October 2020 including concrete proposals framed within two complementary pillars.

Pillar 1 - Re-allocation of profit and revised nexus rules: This pillar explores potential solutions for determining where tax should be paid for new business models and on what basis ("nexus"), as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located ("profit allocation").

Pillar 2 - Global anti-base erosion mechanism (Minimum Tax): This pillar explores the design of a system to ensure that multinational enterprises pay a minimum level of tax. This pillar is intended to address remaining issues identified by the OECD/G20 BEPS initiative by providing countries with new tools to protect their tax base from profit shifting to jurisdictions which tax these profits at below the minimum rate. The Inclusive Framework on BEPS, which groups 140 countries and jurisdictions on an equal footing for multilateral negotiation of international tax rules, decided to move ahead with a two-pillar negotiation to address the tax challenges of digitalisation.

The inclusive framework while releasing the blueprint report on both the pillars declared that: "A consensus-based solution comprising of two pillars (Pillar One focused on nexus and profit allocation whereas Pillar Two is focused on a global minimum tax intended to address remaining BEPS issues) can not only play an important role to ensure fairness and equity in our tax systems and fortify the international tax framework in the face of new and changing business models; it can also help put government finances back on a sustainable footing. The public pressure on governments to ensure that large, internationally operating, and profitable businesses pay their fair share and do so in the right place under new international tax rules has increased as a result of the current COVID-19 pandemic. At the same time, a consensus-based solution could provide businesses with much needed tax certainty in order to aid economic recovery

The OECD-BEPS Inclusive Framework is hoping to arrive at a consensus-based solution for tax challenges arising out of digitalization, before the end of 2021.

5. Global minimum effective tax rate[1]

Overview

The core principles of the international tax landscape are set to change from 2023. Almost all countries in the G20/OECD Inclusive Framework on BEPS ('the Inclusive Framework') have signed up to a joint political statement on the agreed components of their 'two-pillar' approach to global tax reform. Pillar Two sets out global minimum tax rules designed to ensure that large multinational businesses pay a minimum effective rate of tax of 15% on profits in all countries.

The Pillar Two Model Rules have been designed to make sure they accommodate a diverse range of tax systems, including different tax consolidation rules, income allocation, entity classification rules etc., as well rules for specific business structures such as joint ventures and minority interests. As such, many of the specific provisions of the Pillar Two Model Rules will not apply to all jurisdictions or each individual in scope MNE.

Taxpayers that either have no foreign presence or that have less than EUR 750 million (AED 3.15 Billion in UAE) in consolidated revenues are not in scope of the Model Rules. In addition, the Pillar Two Model Rules do not apply to government entities, international organisations and non-profit organisations (preserving domestic tax exemptions for sovereign, non-profit and charitable entities), nor do they apply to entities that meet the definition of a pension, investment or real estate fund (preserving the widely shared tax policy of not wishing to add an additional layer of taxation between the investment and the investor). These entities are excluded even if the MNE group they control remains subject to the rules.

The Pillar Two Model Rules also contemplate the possibility that jurisdictions introduce their own domestic minimum top-up tax based on the GloBE mechanics, which is then fully creditable against any liability under GloBE, thereby preserving a jurisdiction's primary right of taxation over its own income.

Key Operative Rules

GLOBE RULES

INCOME INCLUSION RULE (IIR)

- Top-up tax on UPE in respect of the low taxed income of its subsidiaries
- Operates as a minimum tax (GILTI)
- Protects tax base of UPE

UNDERTAXED PAYMENT RULE (UTPR)

- Functions as a back-up rule to IIR
- Denies deductions or equivalent adjustment for undertaxed payments
- Allocation based on where tangible assets and employees are located

NON-GLOBE RULES

SUBJECT TO TAX RULE (STTR)

- Denies treaty benefits in the absence of sufficient taxation below minimum rate
- Applies to certain related party payments
- Creditable as covered tax under GloBE
- Requires changes to domestic laws and tax treaties

QUALIFIED DOMESTIC MINIMUM TOP-UP TAX

- Prevents application of IIR and UTPR
- Collects domestic top-up tax from Pillar 2
- Creditable against any top-up tax due

Calculation of Effective Tax Rate

Firstly, a calculation of the income, and second a calculation of the tax on that income required.

Under Chapter 3, the income (or loss) is calculated based on financial accounts, which provides a base that is harmonised across all jurisdictions. Certain adjustments are needed to better align the financial accounts with tax purposes. These have been kept to a minimum and are made where necessary to reflect common permanent differences, such as to remove most dividends and equity gains so that the minimum tax does not apply to such income, or to remove expenses disallowed for tax purposes such as bribes and to correct prior year errors. There is also an exclusion for international shipping income.

The tax attributable to that income is calculated. It includes income taxes, defined in a way to provide consistent and flexible recognition across a wide range of tax systems, but does not include non-income based taxes such as indirect taxes, payroll and property taxes. Rules are also provided to allocate income taxes which are charged as a withholding tax or following the application of a CFC regime (which are allocated to the entity that earned the underlying income). The treatment of qualified refundable tax credits (i.e. tax credits that are refundable within four years) aligns with their current characterisation and treatment for accounting purposes.

Chapter 4 also sets out rules for addressing temporary differences, which arise when income or loss is recognised in a different year for financial accounting and tax. Rules are needed to address this given that the Pillar Two Model Rules rely on the financial accounts for calculating the income (or loss). Given that most businesses already use deferred tax accounting to reconcile differences between financial accounting and tax results, the Pillar Two Model Rules leverage these existing accounting principles to simplify compliance. Certain adjustments are made to the existing deferred tax accounts to protect the integrity of the Pillar Two Model Rules. For example, the credit for deferred tax liabilities is capped at the minimum rate in order to prevent any excess tax sheltering unrelated income. The rules also include a recapture mechanism that adjusts for certain deferred tax liabilities that have not reversed (i.e. the tax has not actually been paid) within five years. These rules should mean that minimum tax generally will not be owed by reason of a timing difference. In addition, because tax losses are tracked through deferred tax accounts, the deferred tax accounting rules enable the carry-forward of attributes resulting from tax losses. For businesses that do not wish to apply deferred tax accounting rules in a jurisdiction, an election is available instead to apply a simplified methodology whereby GloBE losses are effectively carried forward.

Calculation of the top-up tax

Once the effective tax rate is calculated (i.e. the tax divided by the income, and aggregated on a per jurisdiction basis), Chapter 5 then determines how much top-up tax is owed. The rate of tax owed is the difference between the 15% minimum rate and the ETR in the jurisdiction. That top-up tax percentage is then applied to the GloBE income in the jurisdiction, after deducting a substance based income exclusion. The substance based income exclusion reduces the exposure to the minimum tax and is calculated as a percentage mark-up on tangible assets and payroll costs. Finally, if a jurisdiction has a domestic minimum tax that is consistent with the Pillar Two Model Rules, such domestic tax is credited against any Pillar Two minimum tax liability.

Determination of the group entity liable for the top-up tax

A liability to top-up tax for a member of an in-scope MNE group arises under two types of provisions contained in Chapter 2. The primary rule is the Income Inclusion Rule (IIR). Under the IIR, the minimum tax is paid at the level of the parent entity, in proportion to its ownership interests in those entities that have low taxed income. Generally, the IIR is applied at the top, at the level of the ultimate parent entity, and works its way down the ownership chain. Rules are also provided to allow the IIR to be applied by a parent entity in which there is a significant minority interest, to minimise leakage of low taxed income.

A backstop is needed to ensure the minimum tax is paid where an entity with low taxed income is held through a chain of ownership that does not result in the low-taxed income being brought into charge under an IIR. This backstop is the UTPR. This rule works by requiring an adjustment (such as a denial of a deduction) that increases the tax at the level of the subsidiary. The adjustment is an amount sufficient to result in the group entities paying their share of the top-up tax remaining after the IIR. The share of the top-up tax is calculated based on a formula, in proportion to the relative share of assets and employees. This helps to ensure the rule is administrable, but also attaches the adjustment to entities that are most likely to have the capacity to pay the required amount of top-up tax.

The same calculations under Chapter 5 are applied whether the top-up tax is being charged under the IIR or the UTPR, to ensure co-ordinated outcomes. However, given that there will typically be subsidiaries in several different jurisdictions, the UTPR requires a higher level of administrative co-operation, which underlines the importance of the standardised information reporting requirements contained in Chapter 8. It is also one of the reasons the UTPR is a backstop rather than the primary rule.

Key Steps to determine its liability

Following five key steps, starting with whether the MNE is within scope of the rules; working through the mechanics of a jurisdictional ETR calculation in order to determine the amount of any top-up tax that may be due; and finally to determine the jurisdiction where such tax is payable an MNE might go through in order to determine tax liability under Pillar two model:

Step 1 – Constituent Entities within scope

- Identify Groups within Scope and the location of each Constituent Entity within the Group

Step 2 – GloBE Income

- Determine Income of each Constituent Entity

Step 3 – Covered taxes

- Determine taxes attributable to Income of a Constituent Entity

Step 4 – Effective Tax Rate and Top-up Tax

- Calculate the Effective Tax Rate of all Constituent Entities located in the same jurisdiction and determine resulting Top-up Tax

Step 5 – IIR and UTPR

- Impose Top-up Tax under IIR or UTPR in accordance with agreed rule order

Chapter 15

An Overview of UAE Transfer Pricing Laws

This chapter covers the following:

- **Introduction to Transfer Pricing**
- **Evolution of Transfer Pricing - A Historical Background**
- **Transfer Pricing Law in UAE**
- **Concept of Functional Analysis**

1. Introduction to Transfer Pricing

1.1 What is Transfer Pricing?

Tax evasion and tax avoidance are the basic problems faced by the revenue authorities of most of the countries of the world. This problem has become more acute due to globalisation and digitisation of the economy. Though transfer pricing is relevant for all transactions, but it is more relevant to transactions between close relative and associated concerns. It is general belief that commercial transactions between close relative and associates particularly between different parts of a multinational group may not be subject to the same market forces, shaping relations between two independent firms. Hence, specific provisions have been made by most of the countries of the world to value transactions between associated concerns based on arm's length principle/price (ALP). To ensure that the tax base of a multinational enterprise (MNE) is divided fairly, it is important that transfers within a group should approximate those which would be negotiated between independent firms.

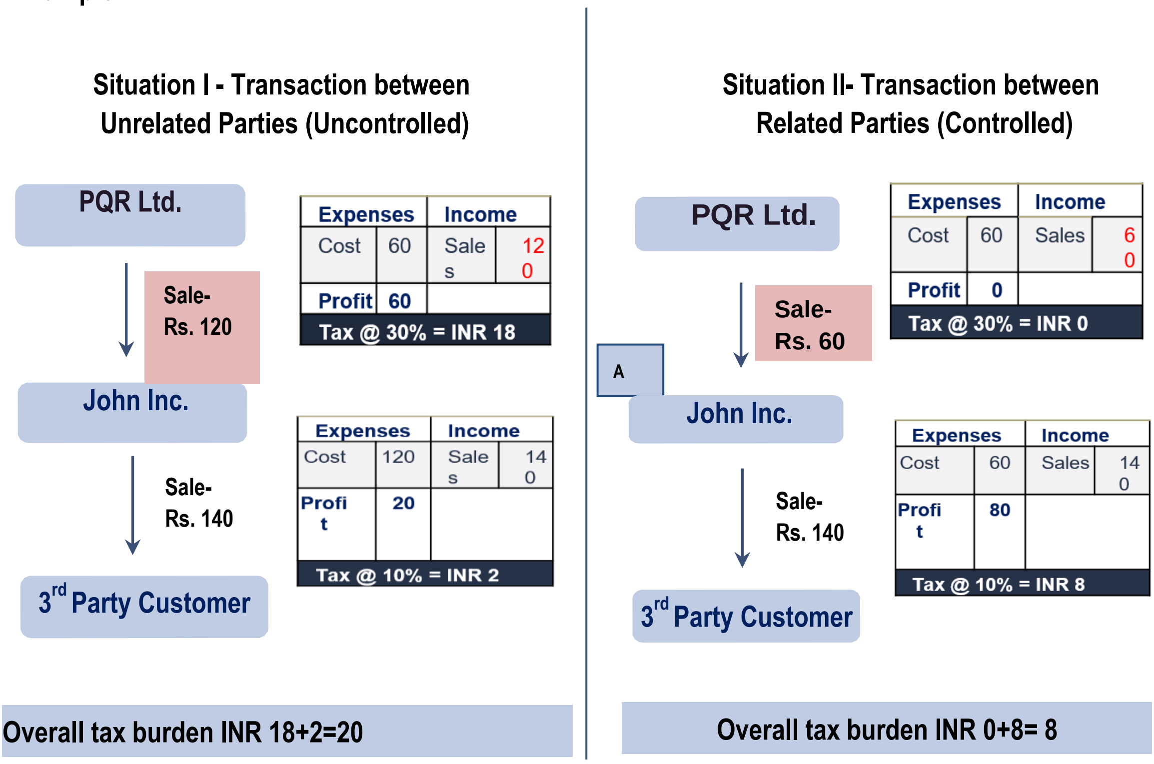
Now a days the major "Intra Group" transactions that are taking place between the MNE group consists of international transfers of goods and services, capital and intangibles (such as intellectual property). Under current scenario intra group transactions are growing at extensive rate which accounts for more than 60 per cent of all the international transactions. Moreover, the major proportions of MNE's commercial transactions consist of intangibles and multi-tiered services and it requires greater understanding and deep analysis to understand such Cross Border Transactions.

The price at which the transactions between the related parties of the MNE group take place are determined by the market and group driven forces which can differ from the open market transactions between independent entities. It is to be noted that majority of the international transactions are highly influenced by the interest of the group entities and are no longer governed entirely by the market forces. Therefore, it becomes really important to determine the accurate price i.e. "transfer prices" for the international transactions of supply of goods, services and intangibles between the related parties and the connected person and this gave rise to immense necessity for the same.

Thus, “Transfer pricing” is the general term for the pricing of transactions between related parties. Transfer pricing refers to the setting of prices for transactions between associated (i.e. members of the same MNE) involving the transfer of property or services. These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between persons that are not associated with each other and can be assumed to operate independently (“on an arm’s length basis”) in setting terms and conditions for such transactions.

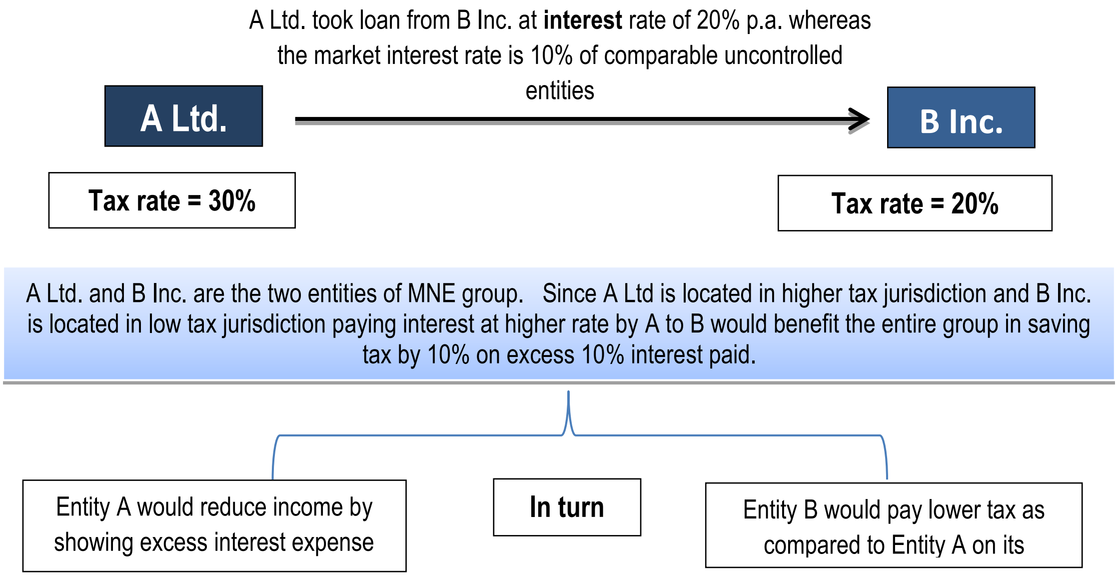
A few examples that will make it clear why Transfer Pricing is necessary:

Example 1



To Prevent Shifting of profits between related and connected parties by manipulating prices: **Detailed legislative provisions relating to** transfer pricing has been introduced.

Example 2



From the above example it is clear that transfer pricing provisions are very important for any country in order to protect their tax base, to eliminate double taxation and to enhance cross border trade and to streamline the system of transfer pricing between the group entities.

1.2 Basic issues underlying Transfer Pricing

Transfer price is the price at which related parties transact with each other and the income of the related parties involved in such Cross Border Transactions are to be determined on the basis of the transfer prices entered into between them. The transfer price therefore tends to shape the tax base of the countries involved in cross-border transaction.

There are three parties involved in the international tax scenario i.e., MNC (multinational group) taking as a whole and tax authorities of both the countries who would tend to determine whether the transaction that has been entered into are at arm's length principle or not. If the transaction is not at arm's length principle, then the tax authorities of one country taxes a unit of the MNE group and thereupon it has an effect on the tax base of the other country. In other words, cross-border tax situations involve issues related to **Jurisdiction, allocation and valuation.**

i. Jurisdictional issues

Jurisdictional issues are mostly related to **location of data and the specific laws that apply in that location.** These issues comprise **that which government has the authority to tax on the doubly taxed income of the MNE** in respect of International Transactions, and what if both the governments have the right to claim the tax? It is also possible that one income is taxable in more than one country, therefore one of the governments should give tax relief in order to avoid double taxation of MNE's income, and then the question arises which government should give the tax relief?

An extended dimension to the jurisdictional issues is the spirit of Transfer Pricing Manipulation as some of the MNEs are engaged in artificially setting prices in intra-company transactions to avoid taxes and reap maximum profits. Transfer Mispricing or fraudulent Transfer Pricing are all taken synonymously with Transfer Pricing Manipulation (TPM). TPM is about setting artificial pricing over the goods and services in a related party transaction. The aim behind this mispricing or fraudulent pricing is to avoid tax incidences and maximize profits for the MNC. Indulging into pricing manipulation by the multinationals is a serious menace faced by economies across boundaries. Imagine the scope of this mispricing practice, when 60% of the world's business happens within an intra-company environment.

So, in an intra-company set up, TPM is **fixing of pricing** on the **non-market basis** which eventually results in saving the total quantum of organization's tax by shifting accounting profit from high to low tax jurisdictions. This results in moving on one nation's tax revenue to another and eventually can lead to capital flights.

Thus, the main goal in such international transaction between related parties is to erode the base and shift the profit from high tax countries to low tax countries and the net result would be to maximise an international enterprise's after-tax profits.

For example, if an international enterprise has a tax rate in the residence country of TBD Inc (parent company) of 30% and it has a MNP Ltd (subsidiary entity) resident in another country with a tax rate of 20%, TBD Inc has an incentive to shift profits to its subsidiary i.e., MNP Ltd to reduce its tax rate on these amounts from 30% to 20%. If the parent company shifts $100 million of taxable profits to its subsidiary, it will make a tax saving of $10 million. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary.

ii. Allocation issues

The entities of the multinational enterprises share the common resources in order to provide services or produce goods and other intangibles. Therefore, optimum allocation of the resources becomes an important element for achieving maximum benefit and enhancing efficiency and effectiveness for the MNE group.

Allocation of income and cost also become important from taxation perspective. Therefore, sometimes it tends to be "tug-of- war" between governments in the allocation of costs and resources aimed towards maximising the tax base in their respective nation states.

If any trade or taxation barriers in the countries in which MNEs operate, which raises the groups transaction costs, then the group entities start allocating resources in order to take undue advantages. However, in the case of intangibles and service-related intra-group transactions, many of the common resources which are a source of competitive advantage for the MNEs cannot be disentangled from the global income of the MNEs for tax purposes.

iii. Valuation issues

Multinational companies face a myriad of transfer pricing and valuation challenges—particularly when the two aren't carefully coordinated to minimize potential risks. Those challenges include: **Lack of coordination** between purchase price allocations and transfer pricing valuations which can be very problematic. Sometimes it seems to be an underlying tension between the common goals of the MNEs and the overall economic and social goals of countries. **Unreliable profit forecasting** that doesn't take future transfer pricing policies into consideration can have serious tax consequences. Companies often fail to realize how much changing transfer pricing policies impact forecasts for the business, which can result in **unreliable financial projections and inaccurate valuations.** With the MNE being an integrated entity with the ability to exploit international differentials and utilise economies of integration not available to domestic firms, transfer prices within the group are unlikely to be the same prices unrelated parties would negotiate.

It is very clear from above that transfer pricing regulations are essential for countries in order to protect their tax base, to eliminate double taxation and to enhance cross border trade. For developing countries, to provide a climate of certainty and environment for increased cross-border trade while at the same time not losing out on critical tax revenue is of paramount importance and hence detailed transfer pricing regulations are a must.

2. Evolution of Transfer Pricing - A Historical Background

This section aims to trace the history and the reasons for the evolution of transfer pricing taxation regimes. In the dynamic environment, the marketplace is constantly changing and the new approaches and techniques are constantly being evolved to arrive at the right transfer price.

If we look at the historical background of transfer pricing legislation, it can be traced back to UK in 1915 and followed by USA in 1917. The intention was to curb the practice of over-stating or under-stating the price of cross border transactions with overseas associate enterprises.

The Organisation for Economic Co-operation and Development (OECD) was initially called the Organization for European Economic Cooperation (OEEC). It was started in 1948 after the end of World War II to run the Marshall Plan for the reconstruction of the European Economy. Once the Marshall Plan was complete Canada and the United States joined the OEEC nations, which created the OECD on December 14, 1960. It went into full force in 1961. OECD undertook an in-depth analysis of transfer pricing provisions and published a report on "Transfer Pricing and Multinational Enterprises" in 1979. It prescribed three standard methods of computing ALP namely Comparable Controlled Price, Resale Price and Cost Plus and mentioned the danger of using other bases for determining ALP. In 1984, OECD published its report which dealt with transfer pricing for intra group services and dealt with the treatment of intra-bank interest and other issues which could not be resolved under the tax treaties.

The United Nations (UN) published an important report on "International Income Taxation and Developing Countries" in 1988. The report discusses significant opportunities for transfer pricing manipulation by multinational enterprises (MNEs) that can harm the developing countries' tax bases. It recommends various mechanisms specially tailored to deal with the particular intra-group transactions by developing countries. The UN Conference on Trade and Development (UNCTAD) also issued a report on Transfer Pricing in 1999.

There were severe penalties, even in case of non-deliberate deviations from the arm's length principle. The US' aggressive transfer pricing regime and such severe penalties even on unintentional errors led to revisions in the transfer pricing methods by USA and other foreign groups. In order to avoid the risk of absorbing the effect of stronger enforcement of transfer pricing in developed countries, and, in effect paying at least some of the MNEs tax costs in those countries, many countries with less sophisticated tax systems and administrations have introduced new transfer pricing rules since that time.

The OECD publishes various reports in 1987, 1988 and 1994. These dealt with various problems relating to thin capitalization, the tax consequences of foreign exchange gains and losses and attribution of income to Permanent Establishment (PE).

The OECD Guidelines, published in 1995 represents a consensus among OECD Member countries, mostly developed countries, and have largely been followed in domestic transfer pricing regulations. Another transfer pricing framework of note which has evolved over time is the USA Transfer Pricing Regulations (26 USC 482).

The OECD Transfer Pricing Guidelines have been widely accepted in principle including in the UN Model Double Tax Convention but some countries, especially developing countries, find it very difficult to implement such guidelines in practice. There are five different prescribed transfer pricing methods (described in more detail in subsequent chapters) to arrive at an arm's length price, but though all these methods may be able to provide a computation of the arm's length price (i.e., a "proper" transfer price) within the MNE, in practice they may end up with figures of profits between two MNEs being either more than 100% or less than 100% due to adjustments carried out by the tax authorities without "corresponding adjustments" by the other country on transactions within the MNE group.

The UN is again taking a leadership role, through this Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidelines which can be used by countries all over the world in developing or calibrating their transfer pricing regulations. Such guidelines which are arrived at through detailed debate and discussion amongst all the UN member nations, including both developed and developing counties, aims to truly reflect an overall global consensus with respect to transfer pricing.

The below diagram shows a summary of evolution of transfer pricing over time:

1915-UK-adopted transfer pricing legislations

1917-USA-adopted transfer pricing legislations

1948-Organization for European Economic Cooperation (OECC) was established

1961-OECC changed OECD (Organisation for Economic Co-operation and Development)

1979 and 1984- Report on transfer pricing issued by OECD

1984- "The Controlled Foreign Corporation (CFC) rules" issued by United Kingdom

1988-United Nations issued report on 'International Income Taxation and Developing Countries'

1995- TP Guidelines issued by OECD

1999-Report on Transfer Pricing issued by UN Conference on Trade and Development (UNCTAD)

2011-guidelines on low-value-adding intra-group services issued by European Union Council

2016-Communication on a "Fair and Efficient Corporate Tax System in the European Union" by European Union

Following are the countries on which Transfer Pricing provisions have been introduced:[1]

These country profiles focus on countries' domestic legislation regarding key transfer pricing principles, including the arm's length principle, transfer pricing methods, comparability analysis, intangible property, intra-group services, cost contribution agreements, transfer pricing documentation, administrative approaches to avoiding and resolving disputes, safe harbours and other implementation measures. The following countries follow the rules indicated in OECD ***Transfer Pricing Guidelines and also have the regulations in their respective nations*****.**

1. Albania	2. Angola	3. Argentina	4. Australia
5. Austria	6. Belgium	7. Brazil	8. Bulgaria
9. Canada	10. Chile	11. China (People's Republic of)	12. Colombia
13. Costa Rica	14. Croatia	15. Czech Republic	16. Denmark
17. Dominican Republic	18. Egypt	19. Estonia	20. Finland
21. France	22. Georgia	23. Germany	24. Greece
25. Honduras	26. Hungary	27. Iceland	28. India
29. Indonesia	30. Ireland	31. Israel	32. Italy
33. Jamaica	34. Japan	35. Kenya	36. Korea
37. Latvia	38. Liberia	39. Liechtenstein	40. Lithuania
41. Luxembourg	42. Maldives	43. Malaysia	44. Malta
45. Mexico	46. Netherlands	47. New Zealand	48. Nigeria
49. Norway	50. Panama	51. Papua New Guinea	52. Peru
53. Poland	54. Portugal	55. Romania	56. Russian Federation
57. Saudi Arabia	58. Senegal	59. Seychelles	60. Singapore
61. Slovak Republic	62. Slovenia	63. South Africa	64. Spain
65. Sri Lanka	66. Sweden	67. Switzerland	68. Tunisia
69. Türkiye	70. Ukraine	71. United Kingdom	72. United States
73. Uruguay			

[1] https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm

2.1 Emergence of Transfer Pricing provisions in United Arab Emirates (UAE)

In 2017, European Union council announced a list of non-cooperative jurisdictions for tax purposes. UAE was added to the list along with other 17 jurisdictions. Thus, before 2018, there were neither Transfer pricing provisions in the UAE nor it was the part of any global organisation for the development of its economy resulted to evasion of tax by MNEs and Transfer pricing manipulations with related parties and connected persons which leads to loss of taxes and revenue for the government.

Later, the list was revised, and UAE was removed from the blacklist and moved to the grey list. Although added to the grey list, European Union confirmed that countries moved to grey list will be observed closely. In May 2018, the UAE joined the Organisation for Economic Co-operation and Development ("OECD") Inclusive Framework on Base Erosion Profit Shifting ("BEPS") and after several discussions with the dignitaries of the organisation, it decided to implement four BEPS minimum standard Actions:

ACTION PLANS IMPLEMENTED BY

Action	Action	Action	Action
Countering harmful tax practices	Countering tax treaty abuse	Country-by-country (CbC) reporting	Improving dispute resolution

After its commitment to align with the OECD objectives, the Ministry of Finance in the UAE took its first step by introducing the Economic Substance Regulations on 30 April 2019 through it Cabinet of Ministers Resolution No. 31 of 2019 as amended by Decision No. 57. The major objective behind its introduction was to ensure that entities of UAE report actual profits that are commensurate with the economic activity undertaken within the UAE.

For Action Plan 13, the UAE also introduced Country-by-Country Reporting ("CbCR") rules for multinational group of enterprises under the Cabinet Resolution No. 32 ("CR 32") in 2019 but the same was superseded by Cabinet Decision No. 44, published in 2020.

The CbCR rules of the UAE are in line with OECD Model Legislation. CbCR notification is to be submitted by the resident Ultimate Parent Entities of UAE by the last day of the financial year and the report is to be submitted within twelve months from the end of the financial year. But there is an relaxation in submission of CbCR notification for those constituent entities of UAE who are the member of a foreign headquartered MNE.

The purpose of CbCR is to eliminate any gap in information between the taxpayers and tax administrations with regards to information on where the economic value is generated within the MNE Group and whether it matches where profits are allocated and taxes are paid on a global level.

UAE also became one of the countries who are signatory to the Multilateral Competent Authority Agreement on the exchange of Country-by-Country Reports, on 24 June 2018.

On 28th April 2022, the Ministry of Finance issued a Public Consultation Document ('PCD') on the proposed introduction of Corporate Taxes in the UAE. The PCD also includes a chapter on the proposed treatment under the UAE Corporate Tax regime for transactions between related parties i.e. the introduction of Transfer Pricing.

The UAE Ministry of Finance (MoF) has enacted a new corporate tax regime in the UAE on 9th December 2022 and released **Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses.** The Law been supplemented with 158 Frequently Asked Questions, also released on the same date.

The new corporate tax laws will become effective for accounting period beginning on or after I June 2023. For MNE groups with a December year end, this provides for a 12- month period to prepare and assess the impact ahead of the effective date. However, general anti-avoidance and transitional rules do apply from the date the law is published in the Official Gazette.

3. Transfer Pricing Law in UAE [2]

To avoid any potential bias in the price of an international transaction due to the close relationship between the parties, the law lays out the rules for conducting international transactions. The UAE Transfer Pricing rules are applicable in respect of transactions between Related Parties; and Connected Person

So, this is very important to understand the meaning of "Related Party" and "Connected Person" that has been provided in ARTICLE 35 and ARTICLE 36 of UAE Corporate Tax Law respectively.

3.1 Article 35 – Related Parties and Control under the UAE Corporate Tax Law

Meaning of related person

1. For the purposes of this Decree-Law, "Related Parties" means any of the following:

   a. Two or more natural persons who are related within the fourth degree of kinship or affiliation, including by way of adoption or guardianship.

   b. A natural person and a juridical person where:

      1. **Ownership Interest:** The natural person or one or more Related Parties of the natural person are shareholders in the juridical person, and the natural person,

[2] Federal-Decree-Law-No.-47-of-2022-EN

alone or together with its Related Parties, directly or indirectly owns a 50% (fifty percent) or greater ownership interest in the juridical person; or

2. **Control:** The natural person, alone or together with its Related Parties, directly or indirectly Controls the juridical person.

c. Two or more juridical persons (legal entity) where:

1. **Ownership Interest:** The juridical person, alone or together with its Related Parties, directly or indirectly owns a 50% (fifty percent) or greater ownership interest in the other juridical person

2. **Control:** The juridical person, alone or together with its Related Parties, directly or indirectly Controls the other juridical person; or

3. **A person who has Ownership Interest or Control:** Any Person, alone or together with its Related Parties, directly or indirectly owns a 50% (fifty percent) or greater ownership interest in or controls such two or more juridical persons;

d. A Person and its Permanent Establishment or Foreign Permanent Establishment.

e. Two or more Persons that are partners in the same Unincorporated Partnership

f. A Person who is the trustee, founder, settlor or beneficiary of a trust or foundation, and its Related Parties

Meaning of Control under the UAE Corporate Tax Law

2. "Control" means the ability of a Person, whether in their own right or by agreement or otherwise to influence another Person, including:

a) The ability to exercise 50% (fifty percent) or more of the voting rights of another Person.

b) The ability to determine the composition of 50% (fifty percent) or more of the Board of directors of another Person.

c) The ability to receive 50% (fifty percent) or more of the profits of another Person.

d) The ability to determine, or exercise significant influence over, the conduct of the Business and affairs of another Person.

The abovementioned terms can be understood with the help of following example:

Example: Mr. A has business of manufacturing spare parts of cars. His son Mr. K has a business of assembling the spare part and sell the final product. Mr. K purchased spare part from Mr. A and assembled the same. Finally, sold car to unrelated party.

Related Parties- Mr. K and Mr. A are related party due to father and son relationship.

TP provision will be attracted on transaction of purchase of spare parts from Mr. A.

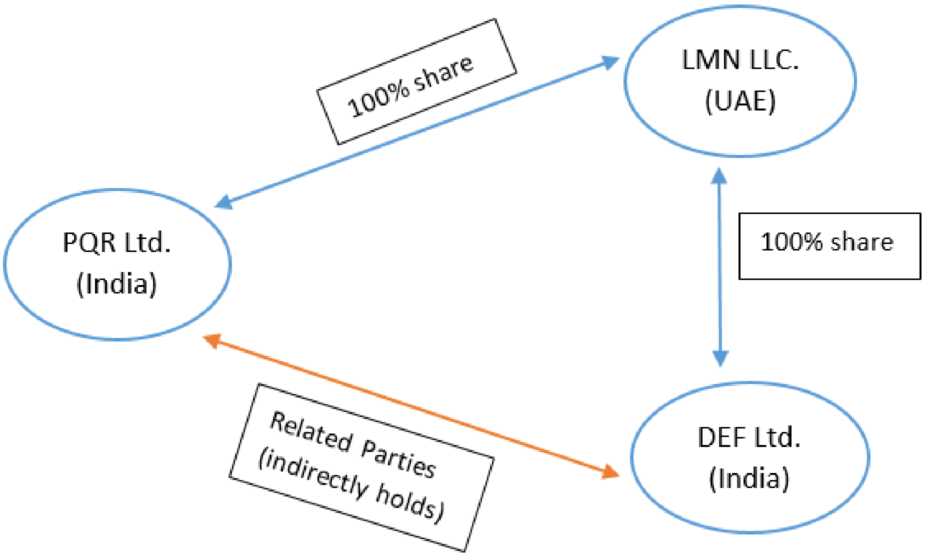
Example: Mr. Khalid holds 75% shares in KLM LLC (UAE).
Related Parties- Mr. Khalid and KLM LLC. are related parties since, Mr. Khalid (individual) a shareholder of the KLM LLC. (juridical person) and has 50% or more ownership interest in entity.

TP provision will be attracted on transaction takes place between both the parties.

Example: ABC Co. (UK) holding 90% of shares in DEF LLC. (UAE). ABC Co. sells goods to DEF LLC. (UAE).
Related Parties- ABC Co. and DEF LLC. are related parties since, ABC Co. (juridical person) holds 50% or more ownership interest, whether directly or indirectly in the DEF LLC. (other juridical person).

TP provision will be attracted on transaction takes place between both the parties.

Example: PQR Ltd. (India) holds 100% of LMN LLC. (UAE) and LMN LLC. holds 100% shares in DEF Ltd. (India).



Related Parties- PQR Ltd. and DEF Ltd are related parties since; PQR Ltd indirectly holds 50% or more ownership interest in the DEF Ltd *(though LMN LLC.)*.

Therefore, TP provision will also be attracted on transaction takes place between PQR Ltd. and DEF Ltd.

Example: ABC Co. (UK) holds 75% of voting rights in DEF LLC (UAE).

Control- ABC Co. has control over DEF LLC as it holds 50% or more of the voting rights.

Example: A Ltd. (USA) appoints 5 out of 8 directors of P LLC (UAE). P LLC provide software development services to A Ltd.

Control- A Ltd has the ability to determine the composition of 50% or more of the Board of directors of P LLC. TP provision will be attracted on the software development services provided by P LLC to A Ltd.

After understanding the meaning of Related Parties and Control let us know understand the meaning of Connected Person and Payment made to Connected Person.

3.2 Article 36 – Payments to Connected Persons under the UAE Corporate Tax Law

1. Without prejudice to the provisions of Article 28 of this Decree-Law, a payment or benefit provided by a Taxable Person to its Connected Person shall be deductible only if and to the extent the payment or benefit corresponds with the Market Value of the service, benefit or otherwise provided by the Connected Person and is incurred wholly and exclusively for the purposes of the Taxable Person's Business.

2. Meaning of Connected Person: For the purposes of this Decree-Law, a Person shall be considered a Connected Person of a Taxable Person if that Person is:

a. An owner of the Taxable Person.

b. A director or officer of the Taxable Person.

c. A Related Party of any of the Persons referred to in paragraphs (a) and (b) of Clause 2 of this Article.

3. Owner: For the purposes of paragraph (a) of Clause 2 of this Article, An 'owner' is a natural person having ownership interest in a Taxable Person or controls him, whether directly or indirectly.

4. In a situation where the Taxable Person is a partner in an Unincorporated Partnership, the Connected Person shall be someone who:

- Is a partner in the same Unincorporated Partnership and
- Is a Related Party to the partner

5. Payment made to Connected Person:

To determine that a payment or benefit provided by the Taxable Person corresponds with the Market Value of the service or otherwise provided by the Connected Person in exchange, the relevant provisions of Article 34 of this Decree-Law shall apply as the context requires.

The term Taxable Person means, "A Person subject to Corporate Tax in the State under the Decree-Law of United Arabs Emirates."

6. The provisions of this article shall not apply to any of the following:

a) A Taxable Person whose shares are traded on a Recognised Stock Exchange.

b) A Taxable Person that is subject to the regulatory oversight of a competent authority in the State.

c) Any other Person as may be determined in a decision issued by the Cabinet at the suggestion of the Minister.

Example: Mr. R director of JKL LLC. (UAE) provides management services @ AED 500 and the same service in the market takes place @AED 250. In this situation, only to the extent the payment made for the services corresponds to the Market Value i.e., AED 250 shall be deductible expense for JKL LLC. (i.e., Taxable Person's Business).

3.3 Article 34 – Arm's Length Principle under the UAE Corporate Tax Law

1. In determining Taxable Income, transactions and arrangements between Related Parties must meet the arm's length standard as specified in Clauses 2, 3, 4 and 5 of this Article and any conditions that may be prescribed in a decision issued by the Authority.

2. A transaction or arrangement between Related Parties meets the arm's length standard if the results of the transaction or arrangement are consistent with the results that would have been realised if Persons who were not Related Parties had engaged in a similar transaction or arrangement under similar circumstances.

3. Transfer Pricing Methods for determining the Arm's Length Price: The arm's length result of a transaction or arrangement between Related Parties must be determined by applying one or a combination of the following transfer pricing methods:

a) The comparable uncontrolled price method.

b) The resale price method.

c) The cost-plus method.

d) The transactional net margin method.

e) The transactional profit split method.

4. To apply any other method: If there is a situation that none of the methods can be applied reasonably for ascertaining arm's length result, then the Taxable Person can apply any method other than the ones mentioned. However, it has to show that none of the above methods can be reasonably applied to the arrangement or transaction, which is why it has had to resort to the application of another method.

5. Factors for Choosing and Applying Transfer Pricing Method: The choice and application of a transfer pricing method or combination of transfer pricing methods under Clause 3 or 4 of

this Article must be made having regard to the most reliable transfer pricing method and taking into account following factors:

a. The contractual terms of the transaction or arrangement.

b. The characteristics of the transaction or arrangement.

c. The economic circumstances in which the transaction or arrangement is conducted.

d. The functions performed, assets employed, and risks assumed by the Related Parties entering into the transaction or arrangement.

e. The business strategies employed by the Related Parties entering into the transaction or arrangement.

Application of the selected transfer pricing method or combination of transfer pricing methods may result in an arm's length range of financial results or indicators acceptable for establishing the arm's length result of a transaction or arrangement between Related Parties.

The transfer pricing method used by the Taxable Person shall be used by the Authorities to examine whether the income and expenditures resulting from the Taxable Person's relevant transactions or arrangements meet the arm's length standard in accordance with Clause 3 or 4 of this Article. While where the result of the transaction or arrangement between Related Parties does not fall within the arm's length range, the Authority shall adjust the Taxable Income to achieve the arm's length result that best reflects the facts and circumstances of the transaction or arrangement and where the Authority makes an adjustment to the Taxable Income, the Authority shall rely on information that can or will be made available to the Taxable Person.

Where the Authority or a Taxable Person adjusts the Taxable Income for a transaction or arrangement to meet the arm's length standard, the Authority shall make a corresponding adjustment to the Taxable Income of the Related Party that is party to the relevant transaction or arrangement.

However, where a foreign competent authority makes an adjustment to a transaction or arrangement involving a Taxable Person to meet the arm's length standard, such Taxable Person can make an application to the Authority to make a corresponding adjustment to its Taxable Income.

However, the arm's length price no doubt would help in bringing parity between domestic enterprises and MNEs and to make accurate assessment of economic conditions, to minimize double taxation, to reduce artificial pricing distortion and to determine real profits but along with this there would be practical difficulties such as -

i. **Agreement related issues:** The agreement between the related parties is entered at different time and the transaction at different point of time and the assessment at a different point of time and because of which usually the taxpayer do not have the relevant information at the time of entering the agreement with related parties. This leads to inadequate information with respect to market price of different products and services in different point of time and this time lag causes difficulties in applying the arm's length principle

ii. **Difficulty in finding adequate uncontrolled comparable:** Many a times due to complex nature of the transaction it becomes difficult to find the uncontrolled comparable transactions to benchmark the relevant transactions.

iii. **Time taking:** Due to non-timely availability of data and their reliability would pose a problem in applying TP Provisions.

iv. **Valuation of Intangibles:** When the cross-border transaction involves intangibles, valuation and pricing would be really a challenging task and may distort the pricing mechanism.

With a TP regime in line with the OECD TP guidelines, the UAE will be part of long list of countries that will adopt the arm's length principle.

The introduction of the new tax regime would be a "a game changer." UAE's infrastructure, political and economic stability and strategic location has always made UAE an attractive destination for investments and a strong candidate for a regional hub for MNCs. The implementation of a TP regime with a corporate tax rate set at 9%, (with a carve out for pillar two companies having minimum global rate of 15%) strengthens UAE's position as regional hub.

From a MNC's perspective, it is recommended that before the implementation of the new regime, they must perform an initial high-level impact assessment of the TP arrangements, which are at the core of any MNC's international tax policy. Once the new regime is implemented, they should undertake an optimization exercise to align their existing TP policies with the OECD principles and implement the same.

For every revolutionary change there might be some hurdles, problems and poses but the introduction of Transfer Pricing under Corporate Laws of UAE would definitely help in bringing the refined version of transfer pricing policies for the Cross Border transactions.

This chapter is just the overview of UAE Transfer pricing which is the part of corporate tax law. The detailed description and analysis with respect to Arm's Length Principle, Related Party, Connected Person, TP Documentation requirements, Disclosure Forms, Country-by-Country Reporting (CbCR), Advance pricing agreements (APAs), TP considerations for free zones, Consequences of noncompliance with TP requirements, General anti-abuse and transitional rules and its implication have been very well articulated in the separate chapters.

4. Concept of Functional Analysis

Functional analysis is the cornerstone of any transfer pricing exercise. Its purpose is to gain an understanding of the operations of an enterprise in connection with its transactions with related parties and connected person. Functional analysis typically involves identification of functions performed, assets employed and risks assumed (also called FAR analysis) with respect to the controlled transactions between members of an MNE.

FAR are also analyzed to determine the nature of functions performed, degree of risks undertaken and the nature of the assets employed by each party. This analysis helps to select the tested party/parties where needed (as explained in other chapter), the most appropriate transfer pricing method, the comparables, and ultimately to determine whether the profits (or losses) earned by the entities are appropriate to the functions performed, assets employed and risks assumed.

The OECD Guidelines[3] take a similar view when it states that, transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary.

4.1 Components of FAR Analysis

A detailed discussion of the three elements of the FAR analysis, namely, functions performed, assets employed and risk assumed is as under:

- **Functions Performed**

Functions performed are those activities that are carried out by each of the parties to the transaction. In performing the functional analysis, important and significant functions are considered. Such functions determined characterization of an entity, which in turn determine attributable return for the entity performing such functions. Thus, the focus should not only be on identifying the maximum number of functions but on identification of critical functions performed by the related parties.

Some of the important functions that are generally observed and examined in the transaction include the following:

- Research and development (R&D)
- Product design and engineering
- Manufacturing, production and process engineering
- Product fabrication, extraction and assembly
- Purchasing and materials management

[3] Para 1.51 of Chapter 1 of OECD Guidelines, 2022

- Marketing and distribution functions, including inventory management, warranty administration and advertising activities
- Transportation and warehousing
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services

Having identified the principal functions performed by the parties in controlled transaction, the next step is to compare the same with functions performed in the uncontrolled transactions to determine the extent of comparability for the purpose of carrying out the benchmarking process.

The functions performed in a controlled transaction require a detailed analysis and form a critical input in determining comparable uncontrolled transactions.

- **Assets Employed**

As regards assets employed, one needs to identify the assets (tangible as well as intangible) used in the course of the controlled transaction. One also needs to study the role of various departments in performing the desired functions and utilising of assets.

The study involves identification of the type and nature of capital assets used, such as the age, market value, location, rights etc. and quantify the same wherever possible.

It is also essential to know which entity developed the intangibles, which has the legal/ economic ownership of the intangibles and which receives the benefit of the intangibles.

- **Risk Assumed**

Risk study involves identification of various risks that are assumed by each of the parties to the transaction. It is commonly understood that risk and return go hand-in-hand. In the open market, more the risk assumed by an enterprise, higher the returns that it expects and vice-versa. Some of the significant risk present in transactions are tabulated below:

S.No.	Nature of risks	Particulars
1.	Market Risk	• Increased competition and relative pricing pressure, • Change in demand patterns and needs of customers
2.	Technology Risk	• Introduction of new products and change in technologies • Inefficiencies arising from obsolete infrastructure and tools as well as obsolescence of processes
3.	Product/ Service Liability Risk	• Risk associated with product/ service failures
4.	Credit Risk	• Risk arising from non-payment of dues by customers

5.	Foreign Exchange Risk	• Potential impact on profits that may arise because of changes in foreign exchange rates
6.	Manpower Risk	• Risk of losing its trained personnel
7.	Capacity Utilisation Risk	• Under-utilisation of manufacturing/ service facility/ personnel

Analysis of risks assumed is an important exercise as it facilitates adjustments based on differences in risks that are undertaken in a controlled transaction as compared to controlled transactions.

In practice, one cannot compare all the functions, risks and assets employed. Hence, it must be emphasized that only those functions, assets and risks that are economically significant and are likely to have an impact on cost/expenses, prices, profits arising in a transaction should be identified and compared.

Chapter 16

Comparability Analysis

This chapter covers the following:

- **Process**
- **Selection or rejection of comparables**
- **Comparability Adjustments**
- **Timing issues in comparability**
- **Arm's length range**
- **Location specific advantages (Including location savings and market premium)**

1. Introduction

The application of the arm's length principle for benchmarking any controlled transaction essentially comes down to establishing its 'comparability' with an uncontrolled transaction undertaken between uncontrolled enterprises under similar circumstances. Only when this comparability between the controlled and uncontrolled transactions or between the tested party and unrelated parties is established, can the process of comparison of the prices or the margins, as the case may be, initiated. Therefore, the United Nations Practical Manual on Transfer Pricing for Developing Countries 2017 (UN TP Manual 2017) has befittingly noted that "Transfer pricing theory meets practice in comparability analysis[1]".

The OECD defines comparability analysis[2] as a comparison of a controlled transaction under review with an uncontrolled transaction or transactions that are regarded as potentially comparable. Controlled and uncontrolled transactions are *comparable* if none of the differences between the transactions could materially affect the factor being examined in the methodology (price or margin) or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

The search for comparables is only part of the comparability analysis. It should be neither confused with nor separated from the comparability analysis. The search for information on potentially comparable uncontrolled transactions and the process of identifying comparables is dependent upon prior analysis of the taxpayer's controlled transaction and of the economically relevant characteristics or comparability factors. A methodical, consistent approach should

[1] Para B.2.5.1 of the UN TP Manual, 2017

[2] Page 24 of Glossary of OECD Guidelines, 2017

provide some continuity or linkage in the whole analytical process, thereby maintaining a constant relationship amongst the various steps: from the preliminary analysis of the conditions of the controlled transaction, to the selection of the transfer pricing method, through to the identification of potential comparables and ultimately a conclusion about whether the controlled transactions being examined are consistent with the arm's length principle as described in paragraph 1 of Article 9 of the OECD Model Tax Convention.

Thus, the determination of the arm’s length price (ALP) of a controlled transaction involves an analysis in two possible ways viz. either at transactional level by analysing controlled and uncontrolled transaction or at entity level by analysing tested party and uncontrolled transaction and in both these ways; comparability analysis is acritical pre-requisite.

The degree of comparability is typically determined on the basis of a number of attributes of the transactions or parties that could materially affect prices or profits and the adjustment that can be made to account for differences. These attributes, which are usually referred to as the five comparability factors, include:

- Characteristics of the property or service transferred;
- Functions performed by the parties taking into account assets employed and risks assumed, referred to as the “functional analysis”;
- Contractual terms;
- Economic circumstances; and
- Business strategies pursued. (*explained under Chapter 17)*

2. Process

Below is a description of a typical process that can be followed when performing a comparability analysis. This process is considered an accepted good practice but it is not a compulsory one, and any other search process leading to the identification of reliable comparables may be acceptable as reliability of the outcome is more important than process (i.e. going through the process does not provide any guarantee that the outcome will be arm’s length, and not going through the process does not imply that the outcome will not be arm’s length).

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer’s circumstances.

Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method, explained under Chapter 17), and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

Step 5: Determination of available sources of information on External comparables where such external comparables are needed taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).

Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors.

Step8: Determination of and making comparability adjustments where appropriate

Step 9: Interpretation and use of data collected, determination of the arm's length price and in accordance with computation made.

In practice, this process is not a linear one. Steps 5 to 7 in particular might need to be carried out repeatedly until a satisfactory conclusion is reached, i.e. the most appropriate method is selected, especially because the examination of available sources of information may in some instances influence the selection of the transfer pricing method. For instance, in cases where it is not possible to find information on comparable transactions (step 7) and/or to make reasonably accurate adjustments (step 8), taxpayers might have to select another transfer pricing method and repeat the process starting from step 4.

3. Selection or rejection of comparables

There are basically two ways in which the identification of potentially comparable third party transactions can be conducted.

The first one, which can be qualified as the "additive" approach, consists of the person making the search drawing up a list of third parties that are believed to carry out potentially comparable transactions. Information is then collected on transactions conducted by these third parties to confirm whether they are in effect acceptable comparables, based on the pre-determined comparability criteria. This approach arguably gives well-focused results – all the transactions retained in the analysis are carried out by well-known players in the taxpayer's market. As indicated above, in order to ensure a sufficient degree of objectivity it is important that the process followed be transparent, systematic and verifiable. The "additive" approach may be used as the sole approach where the person making the search has knowledge of a few third parties that are engaged in transactions that are comparable to the examined controlled transaction. It is worth noting that the "additive" approach presents similarities with the approach followed when identifying Internal comparables. In practice, an "additive" approach may encompass both internal and external comparables.

The second possibility, the "deductive" approach, starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions and do not present economic characteristics that are obviously different. The list is then refined using selection criteria and publicly available information (e.g. from databases, Internet sites, information on known competitors of the taxpayer). In practice, the "deductive" approach typically starts with a search on a database. It is therefore important to follow the guidance on internal comparables and on the sources of information on external comparables. In addition, the "deductive" approach is not appropriate to all cases and all transfer pricing methods.

It can be understood with the example i.e, Associated Advisors LLC. is a company incorporated in UAE providing investment advisory services to its related party, Associated Investors Inc. in USA. Whether this international transaction between Associated Advisors LLC. and Associated Investors Inc. is at arm's length will be determined by comparing the international transaction with either (a) a similar transaction or transactions conducted by one of these entities with an unrelated enterprise or (b) with a similar transaction or transactions entered into between two unrelated enterprises under similar conditions. If the terms of the said international transaction vis-à-vis the comparable transactions with/between the unrelated parties are found to be similar, then broadly the international transaction between Associated UAE entity. and Associated Inc. can be said to be conducted as if between unrelated parties in uncontrolled conditions i.e. at arm's length. However, to reach this conclusion, it is important to demonstrate that the prices or outcome of such transactions are based on data of comparable transactions or comparable entities entering into such transactions.

In practice, both quantitative and qualitative criteria are used to Include or reject potential comparables. Examples of qualitative criteria are found in product portfolios and business strategies. The most commonly observed quantitative criteria are:

- Size criteria in terms of Sales, Assets or Number of Employees. The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability.
- Intangible-related criteria such as ratio of Net Value of Intangibles/Total Net Assets Value, or ratio of Research and Development (R&D)/Sales where available: they may be used for instance to exclude companies with valuable intangibles or significant R&D activities when the tested party does not use valuable intangible assets nor participate in significant R&D activities.
- Criteria related to the importance of export sales (Foreign Sales/Total Sales), where relevant
- Criteria related to inventories in absolute or relative value, where relevant.
- Other criteria to exclude third parties that are in particular special situations such as start-up companies, bankrupted companies, etc. when such peculiar situations are obviously not appropriate comparisons.

- The choice and application of selection criteria depends on the facts and circumstances of each particular case and the above list is neither limitative nor prescriptive.
- The process followed to identify potential comparables is one of the most critical aspects of the comparability analysis and it should be transparent, systematic and verifiable. In particular, the choice of selection criteria has a significant influence on the outcome of the analysis and should reflect the most meaningful economic characteristics of the transactions compared. Complete elimination of subjective judgments from the selection of comparables would not be feasible, but much can be done to increase objectivity and ensure transparency in the application of subjective judgments. Ensuring transparency of the process may depend on the extent to which the Criteria used to select potential comparables are able to be disclosed and the reasons for excluding some of the potential comparables are able to be explained. Increasing objectivity and ensuring transparency of the process may also depend on the extent to which the person reviewing the process (whether taxpayer or tax administration) has access to information regarding the process followed and to the same sources of data.

3.1 Step by Step Guide on Selection and Rejection of Comparable

Step 1: A detailed functional analysis of the international transaction is carried out. On the basis of functions performed, assets employed and risks assumed (FAR analysis), the international transaction is characterized.

Step 2: From the various methods prescribed in Article 34 of the UAE CT Law, the most appropriate method (MAM) for computation of arm's length price (ALP) is chosen having regard to nature or class of transaction, or class of related parties/ connected persons, or functions performed and other relevant factors *(detail explanation under other relevant chapter).*

Step 3: A broad-based search by business segment etc. is conducted on corporate databases to identify a set of companies in the same sector or line of business as the tested party.

Step 4: Quantitative analysis of the broad set of companies selected after Step 3 is carried out by application of quantitative filters.

Step 5: Qualitative analysis of the companies shortlisted after Step 4 is carried to determine the comparability of these companies with the tested party in terms of functions, operations, products and services provided, market conditions etc. to arrive at a final set of appropriately comparable companies.

Step 6: The set of companies that remain after Step 5 represent the final set of comparable.

Step 7: ALP is then determined for the international transaction by the application of the most appropriate method. Adjustments to the ALP are made if there are differences between a comparable and the tested party that would materially affect the price, cost or profit margin in the open market.

Step 8: Where there is more than one final comparable and accordingly more than one ALP is determined by the application of most appropriate method, which is often the case, then the ALP for the international transaction shall be the arithmetical mean/ range of all the prices determined.

4. Comparability Adjustments

The need to adjust comparables and the requirement for accuracy and reliability are pointed out in these Guidelines on several occasions, both for the general application of the arm's length principle and more specifically in the context of each method. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Whether comparability adjustments should be performed (and if so, what adjustments should be performed) in a particular case is a matter of judgment that should be evaluated in light of the discussion of costs and compliance burden *(detailed discussion in another chapter)*.

4.1 Types of comparability adjustments:

- Capacity Utilization Adjustments,
- Working Capital Adjustments,
- Risk Adjustments, and
- Other Adjustments

The example of comparability adjustments includes such as adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions; segmentation of financial data to eliminate significant non-comparable transactions; adjustments for differences in capital, functions, assets, risks.

An example of a working capital adjustment designed to reflect differing levels of accounts receivable, accounts payable and inventory. The fact that such adjustments are found in practice does not mean that they should be performed on a routine or mandatory basis. Rather, the improvement to comparability should be shown when proposing these types of adjustments (as for any type of adjustment). Further, a significantly different level of relative working capital between the controlled and uncontrolled parties may result in further investigation of the comparability characteristics of the potential comparable.

4.2 Purpose of comparability adjustments:

- Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the difference for which an adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

- It bears emphasis that comparability adjustments are only appropriate for differences that will have a material effect on the comparison. Some differences will invariably exist between the taxpayer's controlled transactions and the third party comparables. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison. On the other hand, the need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable.
- It is not always the case that adjustments are warranted. For instance, an adjustment for differences in accounts receivable may not be particularly useful if major differences in accounting standards were also present that could not be resolved. Likewise, sophisticated adjustments are sometimes applied to create the false impression that the outcome of the comparables search is "scientific", reliable and accurate.
- Reliability of the adjustment performed: It is not appropriate to view some comparability adjustments, such as for differences in levels of working capital, as "routine" and uncontroversial, and to view certain other adjustments, such as for country risk, as more subjective and therefore subject to additional requirements of proof and reliability. The only adjustments that should be made are those that are expected to improve comparability.
- Documenting and testing comparability adjustments: Ensuring the needed level of transparency of comparability adjustments may depend upon the availability of an explanation of any adjustments performed, the reasons for the adjustments being considered appropriate, how they were calculated, how they changed the results for each comparable and how the adjustment improves comparability.

5. Timing issues in comparability

There are timing issues in comparability with respect to the time of origin, collection and production of information on comparability factors and comparable uncontrolled transactions that are used in a comparability analysis.

- **Timing of origin:** In principle, information relating to the conditions of comparable uncontrolled transactions undertaken or carried out during the same period of time as the controlled transaction ("contemporaneous uncontrolled transactions") is expected to be the most reliable information to use in a comparability analysis, because it reflects how independent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer's controlled transaction. Availability of information on contemporaneous uncontrolled transactions may however be limited in practice, depending on the timing of collection.

- **Timing of collection:** In some cases, taxpayers establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intra-group transactions were undertaken, i.e. on an ex ante basis (hereinafter "the arm's length price-setting" approach), based on information that was reasonably available to them at that point. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In effect, independent parties in comparable circumstances would not base their pricing decision on historical data alone.

  In other instances, taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle, i.e. on an ex post basis (hereinafter "the arm's length outcome-testing" approach). Such test typically takes place as part of the process for establishing the tax return at year-end.

  Both the arm's length price-setting and the arm's length outcome-testing approaches, as well as combinations of these two approaches, are found among OECD member countries. The issue of double taxation may arise where a controlled transaction takes place between two associated enterprises where different approaches have been applied and lead to different outcomes, for instance because of a discrepancy between market expectations taken into account in the arm's length price-setting approach and actual outcomes observed in the arm's length outcome-testing approach. Competent authorities are encouraged to use their best efforts to resolve any double taxation issues that may arise from different approaches adopted by jurisdictions to year-end adjustments and that may be submitted to them under a mutual agreement procedure

- **Valuation highly uncertain at the outset and unpredictable events:** The question arises whether and if so how to take account in the transfer pricing analysis of future events that were unpredictable at the time of the testing of a controlled transaction, in particular where valuation at that time was highly uncertain. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

  The arm's length pricing of transactions involving intangibles for which valuation is highly uncertain at the time of the transactions, applies by analogy to other types of transactions with valuation uncertainties. The main question is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation of the transaction. Where this is the case, the tax administration would be justified in determining the arm's length price for the transaction on the basis of the adjustment clause or re-negotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight. The mere existence of uncertainty should not require an ex post adjustment without a consideration of what independent enterprises would have done or agreed between them.

- **Data from years following the year of the transaction:** Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. The conduct of the parties in years following the transaction will also be relevant in accurately delineating the actual transaction.

- **Multiple year data:** In practice, examining multiple year data is often useful in a comparability analysis, but it is not a systematic requirement. Multiple year data should be used where they add value to the transfer pricing analysis. It would not be appropriate to set prescriptive guidance as to the number of years to be covered by multiple year analyses.

  In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle. Such an analysis may be particularly useful where a transactional profit method is applied. Multiple year data can also improve the understanding of long term arrangements.

  Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be use as a comparable.

Multiple year data can also improve the process of selecting third party comparables e.g. by identifying results that may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed, in some cases leading to the rejection of the comparable, or to detect anomalies in third party information.

The use of multiple year data does not necessarily imply the use of multiple year averages. Multiple year data and averages can however be used in some circumstances to improve reliability of the range.

6. Arm's length range

In General:

In some cases it will be possible to apply the arm's length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods Produces a range of figures all of which are relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction.

In some cases, not all comparable transactions examined will have a relatively equal degree of comparability. Where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated.

It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis.

A range of figures may also result when more than one method is applied to evaluate a controlled transaction. For example, two methods that attain similar degrees of comparability may be used to evaluate the arm's length character of a controlled transaction. Each method may produce an outcome or a range of outcomes that differs from the other because of differences in the nature of the methods and the data, relevant to the application of a particular method, used. Nevertheless, each separate range potentially could be used to define an acceptable range of arm's length figures. Data from these ranges could be useful for purposes of more accurately defining the arm's length range, for example when the ranges overlap, or for reconsidering the accuracy of the methods used when the ranges do not overlap. No general rule may be stated with respect to the use of ranges derived from the application of multiple methods because the conclusions to be drawn from their use will depend on the relative reliability of the methods employed to determine the ranges and the quality of the information used in applying the different methods.

Where the application of the most appropriate method (or, in relevant circumstances, of more than one method), produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

Selecting the most appropriate point in the range:

If the relevant condition of the controlled transaction (e.g. price or Margin) is within the arm's length range, no adjustment should be made.

If the relevant condition of the controlled transaction (e.g. price or Margin) falls outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present arguments that the conditions of the controlled transaction satisfy the arm's length principle, and that the result falls within the arm's length range (i.e. that the arm's length range is different from the one asserted by the tax administration). If the Taxpayer is unable to establish this fact, the tax administration must determine the point within the arm's length range to which it will adjust the condition of the controlled transaction.

In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. Where comparability defects remain, it may be appropriate to use measures of central tendency to determine this point (for instance the median, the mean or weighted averages, etc., depending on the specific characteristics of the data set), in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects.

Extreme results: comparability considerations

Extreme results might cons of losses or unusually high profits. Extreme results can affect the financial indicators that are looked at in the chosen method (e.g. the gross margin when applying a resale price, or a net profit indicator when applying a transactional net margin method). They can also affect other items, e.g. exceptional items which are below the line but nonetheless may reflect exceptional circumstances. Where one or more of the potential comparables have extreme results, further examination would be needed to understand the reasons for such extreme results. The reason might be a defect in comparability, or exceptional conditions met by an otherwise comparable third party. An extreme result may be excluded on the basis that a previously overlooked significant comparability defect has been brought to light, not on the sole basis that the results arising from the proposed "comparable" merely appear to be very different from the results observed in Other proposed "comparables".

An independent enterprise would not continue loss-generating activities unless it had reasonable expectations of future profits.

Simple or low risk functions in particular are not expected to generate losses for a long period of time. This does not mean however that loss-making transactions can never be comparable. In general, all relevant information should be used and there should not be any overriding rule on the inclusion or exclusion of loss-making comparables. Indeed, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.

Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Circumstances in which loss-making transactions/ enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions. Loss-making comparables that satisfy the comparability analysis should not however be rejected on the sole basis that they suffer losses.

A similar investigation should be undertaken for potential comparables returning abnormally large profits relative to other potential comparables.

7. Location specific advantages (Including location savings and market premium)

Location savings:

Location savings can be derived by an MNE group that relocates some of its activities to a place where costs (such as labour costs, real estate Costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation (such as termination costs for the existing operation, possibly higher infrastructure costs in the new location, possibly higher transportation costs if the new operation is more distant from the market, training costs of Local employees, etc.). Where a business strategy aimed at deriving location savings is put forward as a business reason for restructuring.

Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be shared among the parties.

In determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant Associated enterprises.

Other local market features:

Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location Savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified.

In assessing whether comparability adjustments for such local market features are required, the most reliable approach will be to refer to data regarding comparable uncontrolled transactions in that geographic market between independent enterprises performing similar functions, assuming similar risks, and using similar assets. Such transactions are carried out under the same market conditions as the controlled transaction, and, accordingly, where comparable transactions in the local market can be identified, specific adjustments for features of the local market should not be required.

In situations where reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should consider all of the relevant facts and circumstances. As with location savings, in each case where reliable local market comparables cannot be identified, it is necessary to consider (i) whether a market advantage or disadvantage exists, (ii) the amount of any increase or decrease in revenues, costs or profits, vis-à-vis those of identified comparables from other markets, that are attributable to the local market advantage or disadvantage, (iii) the degree to which benefits or burdens of local market features are passed on to independent customers or suppliers, and (iv) where benefits or burdens attributable to local market features exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such net benefits or burdens between them.

The need for comparability adjustments related to features of the local market in cases where reasonably reliable local market comparables cannot be identified may rise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm's length prices of goods transferred or services provided between associated enterprises,

In other circumstances, a business restructuring or the transfer of intangibles between associated enterprises may make it possible for one party to the transaction to gain the benefit of local market advantages or require that party to assume the burden of local market disadvantages in a manner that would not have been possible in the absence of the business restructuring or transfer of the intangibles. In such circumstances, the anticipated existence of local market advantages and disadvantages may affect the arm's length price paid in connection with the business restructuring or intangible transfer.

In conducting a transfer pricing analysis it is important to distinguish between features of the local market, which are not intangibles, and any contractual rights, government licences, or know-how necessary to exploit that market, which may be intangibles. Depending on the circumstances, these types of intangibles may have substantial value that should be taken into account in a transfer pricing analysis in the manner described in Chapter VI of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Special Considerations for Intangibles), including the guidance on rewarding entities for functions, assets and risks associated with the development of intangibles contained in Section B of Chapter VI. In some circumstances, contractual rights and government licences may limit access of competitors to a particular market and may therefore affect the manner in which the economic consequences of local market features are shared between parties to a particular transaction. In other circumstances, contractual rights or government licences to access a market may be available to many or all potential market entrants with little restriction.

For example, a country may require a regulatory licence to be Issued as a pre-condition for conducting an investment management business in the country and may restrict the number of foreign-owned firms to which such licences are granted. The comparability and functional analysis may indicate that qualifying for such a licence requires demonstrating to appropriate government authorities that the service provider has appropriate levels of experience and capital to conduct such a business in a reputable fashion. The market to which such a licence relates may also be one with unique features. It may, for example be a market where the structure of pension and insurance arrangements gives rise to large cash pools, a need to diversify investments internationally, and a resulting high demand for quality investment management services and knowledge of foreign financial markets that can make the provision of such services highly lucrative. The comparability analysis may further suggest that those features of the local market may affect the price that can be charged for certain types of investment management services and the profit margins that may be earned from providing such services. Under these circumstances, the intangible in question (i.e. the regulatory licence to provide investment management services) may allow the party or parties holding the licence to extract a greater share of the benefits of operating in the local market, including the benefits provided by unique features of that market, than would be the case in the absence of the licensing requirement. However, in assessing the impact of the regulatory licence, it may be important in a particular case to consider the contributions of both the local group member in the local market and other group members outside the local market in supplying the capabilities necessary to obtain the licence.

In a different circumstance, the comparability and functional analysis may suggest that a government issued business licence is necessary as a pre-condition for providing a particular service in a geographic market. However, it may be the case that such licences are readily available to any qualified applicant and do not have the effect of restricting the number of competitors in the market. Under such circumstances, the licence requirement may not present a material barrier to entry, and possession of such a licence may not have any discernible impact on the manner in which the benefits of operating in the local market are shared between independent enterprises.

Take the example of an enterprise that designs, manufactures and Sells brand name clothes. Assume that the manufacturing process is basic and that the brand name is famous and represents a highly valuable intangible. Assume that the enterprise is established in Country A where the labour costs are high and that it decides to close down its manufacturing activities in Country A and to relocate them in an affiliate company in Country B where labour costs are significantly lower. The enterprise in country A retains the rights on the brand name and continues designing the Clothes. Further to this restructuring, the clothes will be manufactured by the affiliate in Country B under a contract manufacturing arrangement. The arrangement does not involve the use of any significant intangible owned by or licensed to the affiliate or the assumption of any significant risks by the affiliate in Country B. Once manufactured by the affiliate in Country B, the clothes will be sold to the enterprise in Country A which will on-sell them to third party customers. Assume that this restructuring makes it possible for the group formed by the enterprise in Country A and its affiliate in Country B to derive significant location savings. The question arises whether the Location savings should be attributed to the enterprise in Country A, or its affiliate in Country B, or both (and if so in what proportions).

In such an example, given that the relocated activity is a highly competitive one, it is likely that the enterprise in Country A has the option realistically available to it to use either the affiliate in Country B or a third party manufacturer. As a consequence, it should be possible to find comparables data to determine the conditions in which a third party would be willing at arm's length to manufacture the clothes for the enterprise. In such a situation, a contract manufacturer at arm's length would generally be attributed very little, if any, part of the location savings. Doing otherwise would put the associated manufacturer in a situation different from the situation of an independent manufacturer, and would be contrary to the arm's length principle.

As another example, assume now that an enterprise in Country X Provides highly specialised and quality engineering services to independent clients. It charges a fee to its independent clients based on a fixed hourly rate that compares with the hourly rate charged by competitors for similar services in the same market. Suppose that the wages for qualified engineers in Country X are high. The enterprise subsequently subcontracts a large part of its engineering work to a new subsidiary in Country Y. The subsidiary in country Y hires equally qualified engineers to those in Country X for substantially lower wages, thus deriving significant location savings for the group formed by the enterprise and its subsidiary Clients continue to deal directly with the enterprise in Country X and are not necessarily aware of the sub-contracting arrangement. For some period of time, the well-known enterprise in Country X can continue to charge its services at the original hourly rate despite the significantly reduced engineer costs. After a certain period of time, however, it is forced due to competitive pressures to decrease its hourly rate (at an amount that would not allow the company in Country X to cover the wages for qualified engineers in Country X, but that would still yield a benefit if those services are provided by qualified engineers in country Y). Part of the location savings are passed on to its clients. In this case also, the question arises of which party(ies) within the MNE group should, at arm's length, be attributed the part of the location savings not passed on to the clients: the subsidiary in Country Y, the enterprise in Country X, or both (and if so in what proportions).

In determining which party(ies) should be attributed the location savings at arm's length, it will be important to consider the functions, risks and assets of the parties, as well as the options realistically available to each of them. In this example, assume that there is a high demand for the type of engineering services that the company in Country X sells. Assume also that the subsidiary in Country Y is the only company operating in a lower-cost location that is able to provide such services with the required quality standard, and Company Y is able to withstand competitive pricing pressures because the technical know-how it has established acts as a barrier to competition. Furthermore, the company in Country X does not have the option of engaging qualified engineers in Country X to provide these services, as the cost of their wages would be too high compared to the hourly rate charged to clients. Considering this, the enterprise in Country X does not have many other options available to it than to use this service provider. The remuneration payable by Company X to Company Y should take into account the location savings created by Company Y, in addition to the value of its services including any intangibles used in providing those services. In some instances, the nature of the contributions made by the enterprise in Country X and its subsidiary in Country Y may meet the criteria for the use of a transactional profit split method.

Chapter 17

Selection of Transfer Pricing Methods

This chapter covers the following:

- **What is an arm's length price?**
- **Selection of transfer pricing method**

1. What is an arm's length price?

The OECD Guidelines 2022 reiterates that arm's length principle is "*the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".*[1] The UN defines the arm's length principle as follows: "*The arm's length principle is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances."*[2]

Federal Decree-Law No. 47 of 2022 ("UAE CT Law" or "Law") defines the term arm's length price ("ALP") in Article 34 of the Law as *"A transaction or arrangement between Related Parties meets the arm's length standard if the results of the transaction or arrangement are consistent with the results that would have been realised if Persons who were not Related Parties had engaged in a similar transaction or arrangement under similar circumstances".* Accordingly, ALP means a price which is applied to a transaction between two unrelated persons undertaken in uncontrolled conditions. In effect, the ALP is also akin to 'market price'. Consequently, it provides a benchmark against which the controlled transactions can be compared. As ALP is the pivot on which the whole transfer pricing regulations revolve, identification of method for determining the ALP assumes great importance. ALP benchmarks the price existing between related parties under controlled conditions for determining appropriate transfer prices and in turn tax liability of a taxpayer. As neither controlled and uncontrolled transactions nor entities involved in the two sets of transactions are identical, the process for determining the ALP involves subjectivity and requires appropriate adjustments to reach the best solution.

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[1] Glossary, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022.

[2] Glossary, United Nations Practical Manual on Transfer Pricing for Developing Countries, 2021

2. Selection of transfer pricing method

2.1 Introduction

The selection of method goes hand-in-hand with comparability (which is a subject matter of another chapter) and is arguably the most critical step in the determination of the arm's-length price. The various available transfer pricing methods and the determination of the most appropriate method are discussed in greater detail in the paragraphs below. Article 34 of the Law provides the following methods for the computation of ALP:

- Comparable Uncontrolled Price ("CUP") Method
- Resale Price Method ("RPM")
- Cost Plus Method ("CPM")
- Transactional Profit Split Method ("PSM")
- Transactional Net Margin Method ("TNMM")
- such other transfer pricing method which satisfies the condition of Clause 2 of Article 34.

The said Article, further, provides that the ALP in relation to a transaction or arrangement between related parties should be determined by the most appropriate method out of the above-mentioned methods. Clause 5 of Article 34 identifies following factors which need to be kept in mind while determining the most appropriate method:

- the contractual terms of the transaction or arrangement;
- the characteristics of the transaction or arrangement;
- the economic circumstances in which the transaction or arrangement is conducted;
- the functions performed, assets employed, and risks assumed by the related parties entering into the transaction or arrangement; and
- the business strategies employed by the related parties entering into the transaction or arrangement.

The various methods identified by the UAE CT Law are classified by the OECD under two classes – traditional transaction methods and transactional profit methods.

Name of the method in Article 34 of the Law	Classified by OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations, 2022 (OECD Guidelines)
CUP Method	Traditional Transaction Methods
RPM	
CPM	

Name of the method in Article 34 of the Law	**Classified by OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations, 2022 (OECD Guidelines)**
PSM	Transactional Profit Methods
TNMM	

The UN Manual, 2021, also, recognises the methods mentioned above.

Further, the UAE CT Law also provides use of a sixth method referred to as *"other method".*

The above-mentioned methods are discussed in this chapter with specific examples.

Traditional Transaction Methods

2.2 CUP Method

An uncontrolled price is the price agreed between unrelated parties for the transaction of goods or services under similar circumstances. If this transaction is in all material respects comparable to the transaction between related parties, then that price is called a "comparable uncontrolled price". The CUP method is the most direct method for the determination of the ALP. The OECD puts CUP as one of the "traditional transaction methods" and defines it as *"transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances."*

2.2.1. International Regulations

According to the OECD Guidelines[3], the CUP method is the most direct way to compare the price in a related party transaction to the price charged in a comparable uncontrolled transaction. It observes as under:

"The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

An uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for the purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such

[3]OECD Guidelines, 2022 para 2.14 and 2.15

differences. Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods".

According to UN TP Manual CUP method is explained as under:

"4.2.1.1 "The Comparable Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The CUP Method may also sometimes be used to determine the arm's length royalty for the use of an intangible, or to determine an arm's length rate of interest on a loan. CUPs may be based on either "internal" comparable transactions or on "external" comparable transactions."

In the Australian Transfer Pricing Regulations, the CUP method is described as under:

"3.10. The CUP method compares 'the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances".

From the approaches mentioned above it can be appreciated that the CUP method requires a high degree of comparability of products, services and functions. Product/service similarity is the most important influencing factor in determining comparability under this method. The factors to be considered while evaluating the comparability between the controlled transaction and the uncontrolled transaction include functions, contractual terms, risks, economic conditions, geographic markets, property or services, etc.

Comparability can be improved by carrying out necessary adjustments, in respect of differences in product/service quality, contractual terms, geographic market, embedded intangibles, and foreign exchange fluctuation risks. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. However, the adjustment must not seek to change the product profile of transaction or entities involved in a significant manner.

Depending upon the entities being compared, there are two types of comparable uncontrolled transactions. The first, known as 'Internal Comparable', is a transaction between the tested party and an unrelated party. The second, called 'External Comparable', is a transaction between two unrelated parties (other than those involved in the international transaction). These can be appreciated from the examples below:

- the taxpayer sells similar goods in similar quantities and under similar terms to an independent enterprise in a similar market (an internal comparable);
- an independent enterprise sells the particular product in similar quantities and under similar terms to another independent enterprise in a similar market (an external comparable);
- the taxpayer buys similar goods in similar quantities and under similar terms from an independent enterprise in a similar market (an internal comparable); or

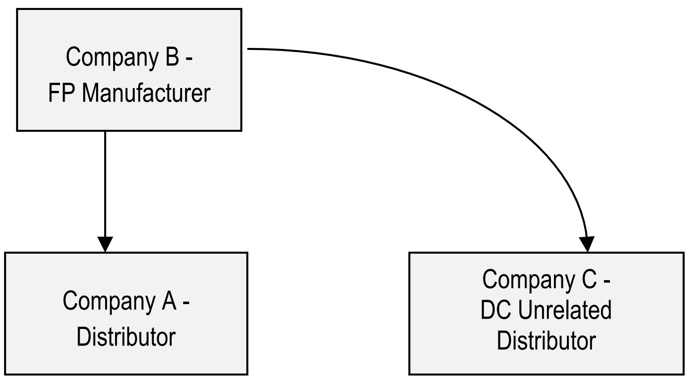
- an independent enterprise buys similar goods in similar quantities and under similar terms from another independent enterprise in a similar market (an external comparable).

Guidance on application of CUP can be taken from following:

- Case laws in other countries.;
- The OECD Guidelines;
- Canada Revenue provides its interpretation of the legislation in the information Circular IC 87-2R. This circular refers to OECD Guidelines;
- The Australian Transfer Pricing Regulations; and
- US Regulations' §1.482-3 provides methods to determine taxable income in connection with a transfer of tangible property; it also provides the detail guidelines with the examples on the application of CUP method.

The following diagram explains the CUP[4]:

Applicability of CUP



Example 1 - Preference for CUP

Company B sells toaster ovens to its subsidiary A and to unrelated distributor C. Toaster ovens sold to A and C are identical and there are no material differences between the B to A and B to C transactions. CUP is most reliable (best) method in such a situation.

As discussed, supra, under the CUP method, the price of the goods or services is directly compared with the price in uncontrolled transactions under similar conditions. Hence, it is the most direct method for determining the ALP. Its sensitivity on the properties of the product and the accompanying circumstances and conditions make its application difficult. Differences in the properties of the products, circumstances of trade (billing period, amount of trade, branding, trade terms etc.) may have a significant effect on the price. Product comparability is the most important factor, in particular, physical features such as size, weight, appearance along with

[4]**Source:** This, as well as other diagrams of the best method rule, referred to in this chapter, have been taken from IRC 482 of the US Regulation.

volume, reliability, storage requirements, regulatory requirements and the like. Other important factors include the market, delivery and payment terms, etc. Where an independent enterprise buys or sells the same product as is supplied in the controlled transaction and sufficient data on the uncontrolled transaction is readily available, the CUP method will always be the most suitable method. Examples of transactions in which the CUP method may be used include:

- the interest rate charged on a loan;
- royalty payment; and
- the price charged for the transfer of a homogeneous item, such as traded commodity.

CUP method is suitable for analysing transfer of goods and services where similar transactions are undertaken with/between unrelated parties in similar conditions.

2.2.2. Adjustments

Given the dynamic nature of business, it is often possible to have differences in two transactions and therefore the applicability of CUP method could be a challenge. It is possible to make adjustments to a potential comparable to take account of factors such as differences in volumes sold, markets traded, terms of trade, etc.

A comparable transaction with significant differences usually referred to as an 'inexact comparable'. Obviously, for such a transaction to be of any use it has to be possible to quantify with some accuracy the effect of any differences between the comparable transaction and the controlled transaction under review.

Hence, the CUP method requires a high degree of comparability along the following dimensions:

- Quality of the product or service
- Contractual terms (example- scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms)
- Level of the market (i.e. wholesale, retail, etc.)
- Geographic market in which the transaction takes place
- Date of the transaction
- Intangible property associated with the sale
- Foreign currency risks

Sometimes it is extremely difficult to meet these standards of comparability and adjustments are needed to make the controlled and uncontrolled transactions more comparable to each other. This can reduce the reliability of the conclusion regarding the ALP.

For every difference between the controlled and the uncontrolled transactions that affect the price, the taxpayer must make an adjustment to account for this difference. The taxpayer must provide sufficient proof by way of concrete documentation that the adjustments made were accurate and reliable.

Illustration on Application of CUP method

A FZE LLC a UAE Company is a subsidiary of B Inc. US. During previous year 2016-17, A FZE LLC has borrowed funds for working capital from B Inc. US amounting to USD 500,000 at the rate of LIBOR + 200 basis point. The tenor of loan is 3 years and it is unsecured loan. The credit rating of A FZE LLC is Baa3 (as per Moody's credit rating model). The details of third party loan agreement available in public domain are as follows:

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR
X Inc., US	Y Inc., US	Aa1	3 years	USD	Unsecure	50
X Plc, UK	Z Inc. US	Baa3	3 years	USD	Unsecure	150
M Ltd, India	N Inc. US	Baa3	10 years	USD	Secure	200
H Gmbh	I Plc, UK	Aa3	3 years	GBP	Unsecure	200
D Inc. US	F Plc, UK	Baa3	3 year	USD	Unsecure	250
P Pte	Q Inc. US	A2	3 year	USD	Unsecure	125

Determine arm's length rate of interest for loan borrowed by A FZE LLC from B Inc. US. Assume A FZE LLC has not taken any other loan.

Answer

During previous year 2016-17, A FZE LLC has borrowed funds for working capital from B Inc. US amounting to USD 500,000 at the rate of LIBOR + 200 basis point. The relevant details of inter-company loan arrangement is as follows:

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR
B Inc.	A FZE LLC	Baa3	3 years	USD	Unsecure	200

In the above questions, details of third-party loan arrangement between independent third parties are provided. Thus, such third-party loan arrangement is analysed to identify comparable uncontrolled transaction. Accordingly, CUP method as per Article 34 is used to determined ALP of interest rate on loan taken by A FZE LLC from B Inc. US.

Analysis of third party loan arrangement

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR	Whether comparable
X Inc., US	Y Inc., US	Aa1	3 years	USD	Unsecure	50	No, as credit rating is different
X Plc, UK	**Z Inc. US**	**Baa3**	**3 years**	**USD**	**Unsecure**	**150**	**Yes**
M Ltd, India	N Inc. US	Baa3	10 years	USD	Secure	200	No, as tenor is different and also it is secured
H Gmbh	I Plc, UK	Aa3	3 years	GBP	Unsecure	200	No, as credit rating and currency of loan is different
D Inc. US	**F Plc, UK**	**Baa3**	**3 year**	**USD**	**Unsecure**	**250**	**Yes**
P Pte	Q Inc. US	A2	3 year	USD	Unsecure	125	No, as credit rating is different

Thus, following two arrangements are comparable uncontrolled transactions:

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR
X Plc, UK	Z Inc. US	Baa3	3 years	USD	Unsecure	150
D Inc. US	F Plc, UK	Baa3	3 year	USD	Unsecure	250
Average						**200**

Application of CUP Method

Steps	Particulars	Amount in Euro
1	Average rate in comparable uncontrolled transaction	200
2	Adjustment: no adjustment is required	-
3	**Arm's Length Price**	**200**

Thus, ALP rate of interest is LIBOR + 200 basis point. Since the rate at which interest is paid by A FZE LLC to B Inc. is same i.e. LIBOR + 200%. The transaction is at ALP.

2.3 Resale price method ("RPM")

The RPM is a traditional transaction method which compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP. The RPM requires high level of functional comparability and is mainly applicable where the controlled party is a distributor.

The RPM evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the gross margin realised in comparable uncontrolled transactions.

2.3.1. International Regulations

The OECD Guidelines, 2022 describes the RPM as under:

"2.27 The resale price method begins with the price at which a product that has been *purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to trading operations."*

According to UN TP Manual, RPM:

4.3.1.1 "The Resale Price Method (RPM) is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The Resale Price Method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis.

4.3.1.2 The Resale Price Method analyses the price of a product that a related sales company (i.e. Associated Enterprise) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit *level is based on the functions it performs, the assets its uses and the risks it assumes. The remainder of the product's price is regarded as the arm's length price for the inter-company transactions between the sales company (i.e. Associated Enterprise) and a related company. As the method is based on arm's length gross profits rather than directly determining arm's length prices (as with the CUP Method) the Resale Price Method requires less direct transactional (product) comparability than the CUP Method".*

In the Australian Transfer Pricing Regulations, the RPM is described as under:

3.*20. The RP method is:*

'A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g., customs duties), as an arm's length price of the original transfer of property between the associated enterprises'.

3.21. The resale price margin is:

'A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit'.

From all the approaches mentioned above, it can be said that under RPM the yardstick of similarity of products/ services is more related than that in CUP method. The process can be summarised as under:

(a) Identify the price at which property or services are resold or provided to an unrelated party;

(b) Deduct the normal gross profit margin derived by the enterprise from the resale price of such property or services in comparable uncontrolled transactions. Also, the gross profit margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide;

(c) Also deduct expenses incurred in connection with the purchase of goods like customs duty from the price so arrived;

(d) Adjust the prices so computed for the differences between the uncontrolled transaction and the international transaction. These differences could be functional and other differences including differences in accounting practices. Further, these differences should be such as would materially affect the amount of gross profit margin in the open market;

(e) The adjusted price arrived at is the ALP for the property purchased or services obtained from related parties;

The resale normal gross profit margin is that margin which the enterprise would earn from purchase of the similar product from an unrelated party and the resale of the same to another unrelated party. This comparable gross margin is determined by reference to either:

- the resale price margin earned by a member of the group in comparable uncontrolled transactions (internal comparable); or
- the resale price margin earned by an arm's-length enterprise in comparable uncontrolled transactions (external comparable).

This resale margin should allow the seller to:

- recover its operating costs; and
- earn an arm's-length profit based on the functions performed, assets used, and the risks assumed.

2.3.2. Applicability of RPM

RPM is generally used to test transactions involving distribution function, i.e. when the tested party purchases products/ acquires services from related party and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value of the product/ services.

The salient features of RPM are as follows:

(a) The RPM begins with the price at which a product that has been purchased from related parties is resold to an independent enterprise. Therefore, the use of RPM is ideal for distribution activity, whereby the tested party purchases the products or obtains the service from its related parties and resells the products/services to independent enterprises;

(b) RPM measures the value of the functions performed;

(c) RPM is the most appropriate in a situation where the sellers add relatively little value to the goods and not alter the goods physically before the resale. Packaging, repacking, labelling or minor assembly does not ordinarily constitute physical alteration;

(d) RPM is used in cases where reseller does not apply intangible assets to add value. The greater the value-added to the goods by the functions performed by the seller, the more difficult it will be to determine an appropriate resale margin. This is especially true in a situation where the seller contributes to the creation or maintenance of an intangible property, such as a marketing intangible, in its activities;

2.3.3. Comparability in RPM

A reseller's gross profit provides compensation to the reseller for the performance of resale functions. Compensation includes an operating profit in return for the initial capital investment and the assumption of risks.

In making comparisons for purposes of the RPM, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed (taking into account assets used and risks assumed), product differences are less significant.

This method requires detailed comparisons of functions performed, risks borne, and contractual terms of controlled and uncontrolled transactions. As a result, a higher degree of comparability is more likely to exist between controlled and uncontrolled resale of property by the same reseller (i.e., internal RPM). In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate comparison may be derived from comparable uncontrolled transactions of other resellers (i.e., external RPM).

The resale margin will be influenced by the level of activities performed by the reseller. The level of activities can vary over a wide range from the case where the reseller performs only minimal services such as import and resale to the cases where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, warranty risk, inventory risk attached to products and other connected services. In these events the application of RPM needs to be carefully evaluated.

If the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party, the RPM could be considered as an appropriate method.

2.3.4. Adjustment to RPM

Where the transactions are not comparable in all ways and the differences have a material effect on price, one has to make adjustments to eliminate the effect of those differences. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. Specific examples of the factors that may be particularly relevant to this method include:

- Inventory (example inventory levels and turnover rate may have to be adjusted including any price protection programs offered by the manufacturer)
- Contractual terms (example scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms)
- Sales, marketing, advertising programs and services (including promotional programs, rebates, and co-op advertising)
- The level of the market (example wholesale, retail, etc.)
- Foreign currency risks

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables will materially affect the gross profit margin which in turn will affect the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit margin, the ability to make reliable adjustments for such differences can mislead the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between the cost of goods sold and operating expenses.

Example

There are two distributors selling the same product in the same market under the same brand name. Distributor A offers a warranty; Distributor B offers none. Distributor A is including the warranty as part of a pricing strategy and so sells its product at a higher price resulting in a higher gross profit margin (if the costs of servicing the warranty are not taken into account) than that of Distributor B, who sells at a lower price. The two margins are not comparable until an adjustment is made to account for that difference (i.e. impact of warranty).

Further, assume that a warranty is offered with respect to all products so that the downstream price is uniform. Distributor C performs the warranty function but is, in fact, compensated by the supplier through a lower price. Distributor D does not perform the warranty function which is performed by the supplier (products are sent back to the factory). However, Distributor D's supplier charges D a higher price than what is charged to Distributor C. If Distributor C accounts for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the differences is automatic. However, if the warranty expenses are accounted for as operating expenses, there is a distortion in the margins which must be corrected. The reasoning in this case would be that, if D performed the warranty itself, its supplier would reduce the transfer price, and therefore, D's gross profit margin would be greater.

Illustration on Application of RPM method

A taxpayer in UAE imports pure cotton shirts from a related party in USA. Further, the taxpayer also imports synthetic material shirt from unrelated party in USA for resale in India. For previous year 2016-17 the details of imports made by the taxpayer are as follows:

Import from related party		**Import from unrelated party**	
Number of units	**200**	**Number of units**	**100**
Price per unit (in AED)	**210**	**Price per unit (in AED)**	**180**
Total Price (200x210)	**42,000**	**Total Price (100x180)**	**18,000**

Sale price to third party customers in UAE is AED 250 per shirt for shirts purchased from related party and AED 225 per shirt for shirts purchased from unrelated party.

Analysis

If RPM is considered the most appropriate method, then arm's length price is determined as follows:

S. No,	Import from related party		Import from unrelated party	
Step 1	Resale Price per unit (a)	250	Resale Price per unit (a)	225
	Number of units sold (b)	200	Number of units sold (b)	100
	Resale Price (in AED) (a*b)	50,000	Resale price (in AED) (a*b)	22,500
Step 2	Less: Normal Gross Profit Margin	20%	Less: Purchase price (100*180)	18,000
	Gross Margin	10,000	Gross Margin	4,500
	Step1-Step2 (Arm's Length Price of imports)	40,000	Gross Profit Margin [(4,500/ 22,500)*100]	20%
Step 3	Less: Expense (if any) incurred in purchase	Nil		
Step 4	Adjustment for difference in controlled and uncontrolled transaction	Nil		
Arm's Length Price of imports from related party is AED 40,000 i.e. per unit price of AED200. The taxpayer has imported the shirts from related parties for AED 42,000 (i.e. 200* AED 210). Thus an adjustment of AED 2,000 will arise.				

Note: CUP method cannot be applied as shirts imported from related party are pure cotton shirts whereas those imported from non- related parties are synthetic shirts.

2.4 Cost plus method ("CPM")

The CPM determines an ALP by adding an appropriate gross profit margin to a related party and/ or connected person's costs of producing goods or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks assumed by the entity. The gross profit margin for a controlled transaction is calculated by reference to the gross profit margins made in comparative uncontrolled transactions.

2.4.1 International Regulations

The OECD Guidelines, 2022 describes CPM as under:

2.45 The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

2.46 The cost plus mark-up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions ("internal comparable"). In addition, the cost plus mark-up that would have been earned in comparable transactions by an independent enterprise may serve as a guide ("external comparable").

2.49 The cost plus method presents some difficulties in proper application, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where there is no discernible link between the level of costs incurred and a market price (e.g. where a valuable discovery has been made and the owner has incurred only small research costs in making it).

According to UN TP Manual, CPM is defined as under:

4.4.1.2 The Cost Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost-plus mark-up is then added to this cost, to calculate an appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.

4.4.1.3 The Cost Plus Method is most often used to analyse transfer pricing issues involving tangible property or services. It is typically applied to manufacturing or assembling activities and relatively simple service providers. The method evaluates the arm's-length nature of an intragroup charge by reference to the gross profit mark-up on costs earned by independent suppliers of tangible property or services in comparable uncontrolled transactions. That is, it compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies engaged in comparable transactions.

Ideally, the comparative transactions should be the same or similar to the controlled transactions. If an associated entity engages in both controlled and uncontrolled transactions for the supply of the same products or services, the uncontrolled transactions may provide a comparative gross profit margin. The following example explains how cost plus methodology will work:

- Company A has two units, one eligible and another non-eligible unit.
- Non-eligible unit (NEU) is engaged in the manufacture of auto ancillary goods of varied range. One of such goods is steering part which it sells to the eligible unit (EU).
- EU is engaged in the manufacture of suspension parts where it uses the steering parts purchased from the NEU as a raw material.
- NEU is not selling the steering parts to any of its other customers
- Few comparable companies are available which are engaged into selling similar products (steering parts).
- In the current scenario, CPM could be considered as the most appropriate method wherein, the NEU charges EU a price which is calculated by adding a reasonable mark up the cost of production of such goods.

The comparison under the CPM should reflect the functions performed, risks involved, and contractual terms. While the products, being compared under the CPM, need not be similar, there are limitations to the product differences. If there is a significant difference between the products being produced under controlled and uncontrolled conditions, the product differences may reflect different functions being performed by the suppliers and would make these transactions unreliable for comparison.

When applying the CPM, comparable accounting methods should be used. If there are differences between the accounting methods used for the controlled and uncontrolled transactions, the data will need to be adjusted to ensure that the same costs and the same methods of measuring the costs are being used.

The gross profit margins for controlled and uncontrolled transactions have to be measured consistently to ensure that the uncontrolled comparable(s) being used is a reliable indicator of ALPs.

This method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services. It is, also, useful where low end services are provided by related party.

As explained above, the cost plus method tends to evaluate the mark up charged on direct and indirect cost of production for the manufactured goods transferred between related parties.

Under Cost Plus Method, following category of costs generally to be considered for determining cost of production:

Direct costs- Cost of Raw Material, Freight Charges, Labour Expenses etc.

Indirect costs- Cost of repair and maintenance, rent, administration charges, Finance Charges etc

Application of cost plus method can be further explained with the help of following example:

X LLC has transferred goods to its wholly owned subsidiary Y LLC for AED 150,000. X LLC has incurred following cost of production for such goods:

- Cost of Raw Material: AED 75,000
- Labour Cost: AED 25,000
- Apportioned Indirect Cost: AED 20,000

Hence the total cost of production for X LLC comes to be at 120,000. This gives X LLC a profit of 30,000 i.e. a mark-up of 25% on its cost of production.

Now let's say independent comparable companies engage in similar business are available and a comparable study shows that mark up on direct and indirect cost of production charged by those companies is in similar range as charged by X LLC, the transaction between X LLC and its wholly owned subsidiary could be considered to be at arm's length.

UN Manual has explained the CPM with the help of following examples:

B .3 .2 .21.1. Example 1

LCO, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all the uncontrolled manufacturers and LCO. As the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences is definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established.

Example 2

The facts are the same as in Example 1 except that LCO accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit mark-ups of UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit mark-ups of UT1, UT2, and UT3 must be adjusted to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions the reliability of the results will decrease.

Example 3

The facts are the same as in Example 1 above, except that under its contract with FS, LCO uses materials consigned by FS. UT1, UT2, and UT3, on the other hand, purchase their own materials, and their gross profit mark-ups are determined by including the costs of the materials. The fact that LCO does not carry an inventory risk by purchasing its own materials, while the uncontrolled producers carry inventory, is a significant difference that may require an adjustment if the difference has a material effect on the gross profit mark-ups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit mark-ups will affect the reliability of the results of UT1, UT2, and UT3.

2.4.2. Issues in application of CPM

(a) Comparability

Whether results derived from the application of this method are the most reliable measure of the arm's-length result must be determined using the factors described under comparability analysis. The CPM may be the best method if the producer provides complete data. This method is ordinarily used for the manufacture, assembly or other production of goods that are sold to related parties. The procedure for CPM like the RPM requires comparability between the controlled party and uncontrolled party. The procedure necessitates an analysis of functional comparability and other comparability factors. The result so obtained can be adjusted to account for the difference between the controlled and the uncontrolled transactions.

(b) Trademark

In cases where there is a well-recognised trademark, the gross profit margins may be significantly higher because the gross profit margins will vary for each good produced. Also, in practice, it is usually difficult to find comparable product lines for principal manufacturers where significant trademarks exist, thereby preventing the CPM from being applied.

(c) Cost allocations

The CPM presents some difficulties in proper application, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where no discernible link exists between the level of costs incurred and a market price (example where a valuable discovery has been made and the owner has incurred only small research costs in making it).

(d) Comparable mark-up

In addition, when applying the CPM, one should pay attention to apply a comparable mark-up to a comparable cost basis. For instance, if the supplier to which reference is made is applying the CPM in carrying out its activities and employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. As with the RPM, the CPM relies upon a comparison of the gross profit margin on costs achieved by the controlled supplier of goods or services and the achieved by one or more uncontrolled entities on their costs with respect to comparable transactions. Therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the mark-up must be analysed to determine what adjustments should be made to the uncontrolled transactions' respective mark-up.

For this purpose, it is particularly important to consider differences in the level and types of expenses—operating expenses and non-operating expenses including financing expenditures—associated with functions performed and risks assumed by the parties or transactions being compared.

Consideration of these differences may indicate the following:

- If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus gross margin may be required.
- If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions need to be determined. Such functions may, for example, amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's-length arrangements may require separate adjustment.
- If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.

In any of the above circumstances, it may be appropriate to supplement the CPMs by considering the results obtained by applying other methods.

2.4.3. Functional comparability

The degree of comparability between controlled and uncontrolled transactions is determined by applying the general comparability factors as discussed above. A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's investment of capital and assumption of risks. Therefore, although all of the factors mentioned above must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit mark-up should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit mark-up may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

The factors for determining functional comparability include the following:

- Research and development (R&D)
- Product design and engineering
- Manufacturing, production and process engineering
- Product fabrication, extraction and assembly
- Purchasing and materials management
- Marketing and distribution functions, including inventory management, warranty administration and advertising activities
- Transportation and warehousing
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services

Comparability under the CPM is particularly dependent on the similarity of functions performed, risk borne and contractual terms as well as on the adjustments made to account for the effects of any such differences, effectively by relying more on functional comparability and somewhat less on physical similarity of products produced by the controlled and uncontrolled parties.

Other comparability factors

Comparability under this method is less dependent on close physical similarity between the products transferred than under the CUP method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected. Close consideration must be paid to those material differences that may potentially affect the gross profits. Examples of these differences include:

- Significant differences in value of the products. These could be due to value of a trademark or other proprietary information;
- Differences in cost structures, for example, the age of plant and equipment;
- Difference in business experience, such as the phase of development that an entity is in (example start-up, maturing or developing phase);

- Differences in management efficiency, exemplified by the expansion or contraction of sales trends in executive compensation over time.

2.4.4. Adjustments for CPM

If there are differences between the controlled and uncontrolled transactions that would affect the gross profit mark-up, adjustments should be made to the gross profit mark-up earned in the comparable uncontrolled transaction. For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, the effect on the gross profit of such differences, however, is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevance to this method include:

- the complexity of manufacturing or assembly
- manufacturing, production, and process engineering
- Procurement, purchasing, and inventory control activities
- testing functions
- Selling, general, and administrative expenses
- foreign currency risks
- Contractual terms (example scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms)

2.4.5. Consistency in accounting

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit mark-up affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit mark-up, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of costs between the cost of goods sold and operating expenses. The term “cost of producing” may include the cost of acquiring property that is held for resale and this could therefore distort the reliability of the gross margin being compared.

2.5 Transactional Profits Method

Profit split method (“PSM”)

The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship.[5]

[5] Page 206 UN Manual 2021

The PSM evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm's length with reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss.

The combined operating profit or loss must be derived from the most prominently identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity.

2.5.1. International Regulations

The OECD Guidelines, 2022 describes the PSM as under:

2.114 The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions. The method first identifies the profits to be split from the controlled transactions – the relevant profits – and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length. As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions and the compensation which would have been agreed in comparable transactions between independent enterprises for those contributions. The transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the relative shares of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.

Also, on 21 June, 2018, OECD released revised Guidance on application of PSM as part of OECD's Base Erosion and Profit Shifting ('BEPS') Action Plan 10.

According to UN TP Manual, PSM:

The profit split method is a useful, but often complex method of determining transfer prices based on an allocation of the relevant, combined profits made by the related parties in relation to the transaction(s).

The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

The Profit Split Method starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions. It then seeks to split those profits or losses between the associated enterprises based involved on an economically valid basis in order to achieve an arm's length outcome for each party. Typically, the split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed.

In the Australian Transfer Pricing Regulations, the PSM is described as under:

Profit split methods

Profit split methods are transfer pricing methods that identify the combined profit to be split for the associated enterprises from a controlled transaction or controlled transactions, and then split those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length between independent parties

The profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles.

The allocation of profit or loss under the PSM must be made in accordance with one of the following allocation methods:

- comparable profit split; or
- residual profit split.[6]

(a) Comparable profit split

A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(b) Residual profit split

Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set.

- ***Allocate income to routine contributions***

The first step is to allocate operating income to each party relevant the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and

[6] Referred to as contribution analysis and residual analysis under OECD guidelines

intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities.

- ***Allocate residual profit***

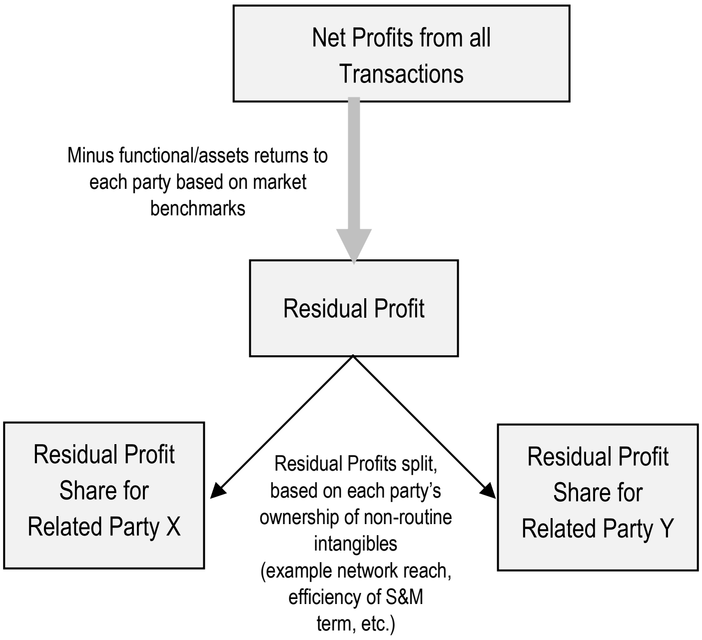
The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income, described above. Under this second step, the residual profit generally should be divided among the controlled taxpayer based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution. The relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of intangible contributions may be estimated by the capitalised cost of developing the intangibles and all related improvements and updates less an appropriate amount of amortisation based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of intangible contributions. If the intangible property contributed by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the intangibles must be made among all the business activities in which it is used.

OECD Guidelines, Para 3.9, refer that where transactions are very inter-related it might be possible that they cannot be evaluated on a separate basis.

Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The PSM first identifies the profit to be split for the related parties and/or connected person from the controlled transactions in which the related parties and/or connected persons are engaged. It then splits those profits between the related parties and/or connected persons on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles. The contribution of each parties is based upon a functional analysis, and valued to the extent possible by any available reliable external market data. The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions.

2.5.2. Applicability of PSM

The following chart explains the PSM[7]:



PSM generally does not rely directly on comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified. The allocation of profit is based on the division of functions between the related parties themselves. External data from independent enterprises is relevant in the profit split analysis primarily to assess the value of the contributions that each related party makes to the transactions, and not to directly determine the division of profit. As a consequence, the PSM offers flexibility by taking into account specific, possibly unique, facts and circumstances of the related parties that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the similar circumstances.

In PSM, it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analysing the contributions by the parties in respect of the

[7] This is an example of residual profit split method. Under comparable profit split method entire net profit will be allocated to X & Y.

intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies.

PSM generally applies to transactions related to intangible and is more relevant in the telecommunication industry, pharmaceuticals, courier or similar industry where intangible plays a vital role and are employed by both the transacting parties.

The following example helps in understanding the application of PSM:

(i) XYZ is a US entity that develops, manufactures and markets a line of products for police use in the US. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the US, Nulon has captured a substantial share of the US market for bulletproof material.

(ii) XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well-established entity that manufactures and markets XYZ products in Europe. XYZ-Europe has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it developed.

(iii) XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several European countries. Beginning with the 2006 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.

(iv) For the 2006 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 2006 taxable year, XYZ-Europe's Nulon sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are $200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's-length result. Based on an examination of a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of $20 million (10% × $200 million) for XYZ-Europe's Nulon business, and a residual profit of $180 million.

(v) Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Nulon ,i.e. the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the District Director compares the ratios of the capitalized value of expenditures as of 2006 on Nulon-related research and development and marketing over the 2006 sales related to such expenditures.

(vi) Because XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalises and amortises XYZ's protective product research and development expenses. This analysis indicates that the capitalised research and development expenditures have a value of $0.20 per dollar of global protective product sales in 2006.

(vii) XYZ-Europe's expenditures on Nulon research and development and marketing support only its sales in Europe. Using information on the average useful life of XYZ-Europe's investments in marketing and research and development, the district director capitalises and amortises XYZ-Europe's expenditures and determines that they have a value in 2006 of $0.40 per dollar of XYZ-Europe's Nulon sales.

(viii) Thus, XYZ and XYZ-Europe together contributed $0.60 in capitalised intangible development expenses for each dollar of XYZ-Europe's protective product sales for 2006, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the district director determines that an arm's-length royalty for the Nulon license for the 2006 taxable year is $60 million, i.e. one-third of XYZ-Europe's $180 million in residual Nulon profit.

In conclusion, PSM is generally applied in the following steps:

Step 1: Determination of combined net profits of the related parties arising out of the transactions in which they are engaged.

Step 2: Evaluation of relative contributions by each parties involved in the transaction, to earning of such combined net profit on the basis of functions performed, assets employed and risk assumed by each parties. This evolution is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated parties performing comparable functions in similar circumstances.

Step 3: Splitting of combined net profit amongst the parties in proportion to their relative contributions, as evaluated above.

Step 4: Profit thus apportioned to the party is taken into account at arm's length price in relation to the transaction.

Allocation of profit must be made in accordance with one of the following allocation methods:

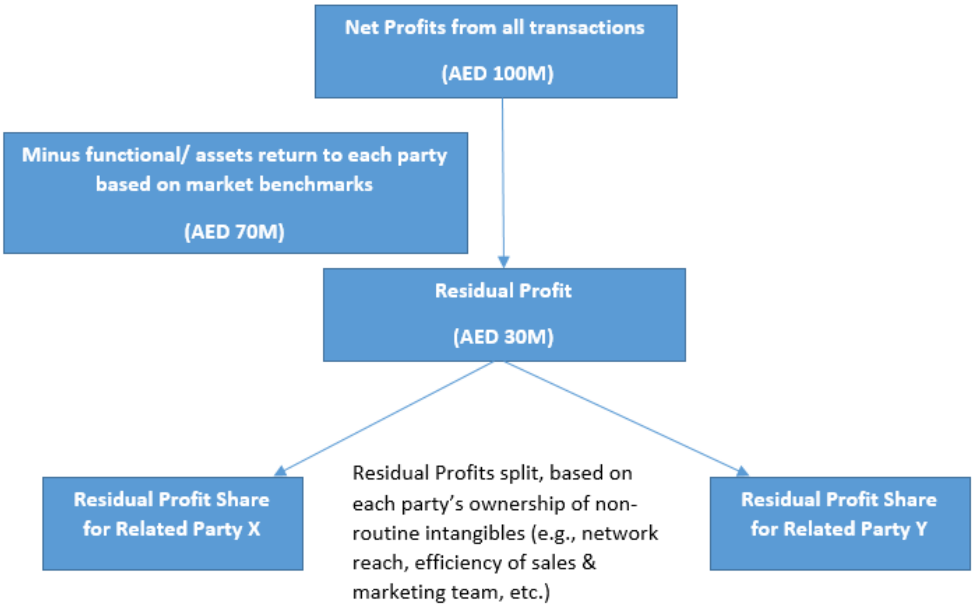
(a) Comparable profit split- Under this method, uncontrolled party's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(b) Residual profit split- Following two-steps process:

i. Allocate income to routine contributions

ii. Allocate residual profit

The following example explains the PSM:



Suppose in the above example, Net Profit margin from all the transactions were AED 100M. Depending on the contribution of each related party, the net profit of AED 70M will be distributed to all related parties (i.e., allocate income to routine contributions). Further, after the respective contribution is allocated specifically, the residual profit of AED 30M will be distributed among related parties based on various factors.

Total Profit for Related Party X:

1. Income from specific contribution (suppose 40% by X & 60% by Y) made by X: AED 28M (i.e. AED 70M* 40%)

2. Income as residual profit (i.e. 50:50) (allocated considering various factors): AED 15M (i.e. AED 30M* 50%)

Total arm's length profit of related party X: AED 43M (AED 28M + AED 15M).

2.5.3. Issues in application of PSM

(a) External data

The external market data considered in valuing the contribution each related party makes to the controlled transactions will be less closely connected to those transactions than is the case with the other available methods. The more tenuous the nature of the external market data used when applying the PSM, the more subjective will be the resulting allocation of profits.

(b) Internal data

On first review, the PSM may appear readily accessible to both taxpayers and tax authorities; however, related parties and tax authorities alike may have difficulty in accessing information from foreign affiliates. Moreover, independent enterprises do not ordinarily use the PSM to determine their transfer pricing (except perhaps in joint ventures). In addition, it may be difficult to measure combined revenue and costs for all the related parties participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the PSM is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the related parties other activities. Also, identifying and valuing the intangibles contributed by the transacting parties would pose a significant challenge involving inherent subjectivity.

The foregoing considerations should be taken into account in determining whether any particular application of the PSM is appropriate given the facts and circumstances. More importantly, because of the foregoing considerations, the application of the PSM is subject to the conclusions and limitations on transactional profit methods.

(c) Comparability

1. Comparable PSM

The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability standard. The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Comparability under this method is particularly dependent on the considerations described under the TNMM, referred in the following paragraphs, because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

- **Data and assumptions**

The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered:

(i) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced;

(ii) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

- **Other factors affecting reliability**

The comparable profit split relies exclusively on external market benchmarks. As the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded to the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

2. Residual PSM

The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions. The second step of the residual profit split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks.

- **Data and assumptions**

The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method.

In particular, the following factors must be considered:

(i) reliability of the allocation of costs, income and assets;

(ii) accounting consistency; and

(iii) reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants.

In particular, if capitalised costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Secondly, the calculation of the capitalised costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

- **Other factors affecting reliability**

The first step of the residual profit split relies exclusively on external market benchmarks. As the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

2.6 Transactional net margin method ("TNMM")

Under the TNMM, the ALP is determined by comparing the operating profit relative to an appropriate base (example costs, sales, assets) of the "tested" party with the operating profit of an uncontrolled party engaged in comparable transactions. The OECD Guidelines state that the TNMM may be particularly sensitive to differences in capacity utilisation, because differences in the levels of absorption of indirect fixed costs (example fixed manufacturing costs or fixed distribution costs) would affect the net profit indicator.

In comparing the profits or margins using the TNMM, typically some form of ratio analysis is used, measuring profits as a percentage of a given base. The ratios most commonly used express net profits as a percentage of costs (full cost or operating costs), a particular balance sheet category (example assets, capital employed, etc.) or sales/service receipts.

In other words, TNMM evaluates whether the amount charged in a controlled transaction is at arm's length, based on objective measures of profitability (PLIs) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

2.6.1. International Regulations

The OECD Guidelines, 2022 describes the TNMM as under:

2.64 The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, i.e. by reference to "internal comparables" (see paragraphs 3.27-3.28). Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise ("external comparables") may serve as a guide (see paragraphs 3.29-3.35). A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. Further, the other requirements for comparability, and in particular those of paragraphs 2.75 – 2.81, must be applied.

2.65 A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contributions, see paragraph 2.4. In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.119. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

2.66 There are also many cases where a party to a transaction makes contributions that are not unique – e.g. uses non-unique intangibles such as non-unique business processes or non-unique market knowledge. In such cases, it may be possible to meet the comparability requirements to apply a traditional transaction method or a transactional net margin method because the comparables would also be expected to use a comparable mix of non-unique contributions.

2.67 Finally, the lack of valuable and unique contributions involved in a particular transaction does not automatically imply that the transactional net margin method is the most appropriate method.

According to UN TP Manual, TNMM:

4.5.2.1 The TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to be aggregated). The profit margin indicators are discussed below. The TNMM looks at the profits of one of the related parties involved in a transaction, as do the Cost Plus Method and Resale Price Method. The party examined is referred to as the tested party.

4.5.2.2 The TNMM compares the net profit margin (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm's length prices the TNMM is a less direct method than the Cost Plus Method and Resale Price Method that compares gross margins. It is also an even more indirect method than the CUP Method that directly compares prices. Many factors may affect net profit margins but may have nothing to do with transfer pricing.

4.5.2.3 The TNMM is used to analyse transfer pricing issues involving tangible property, intangible property or services. It may be applied when one of the associated enterprises employs intangible assets, the appropriate return to which cannot be determined directly. In such a case the arm's length compensation of the associated enterprise(s) not employing the intangible asset is determined by determining the margin realized by enterprises engaged in a similar function with unrelated parties. The remaining return is consequently left to the associated enterprise controlling the intangible asset. The return to the intangible asset is, in practice, a "residual category" being the return left over after other functions have been appropriately compensated at arm's length. This implies that the TNMM is applied to the least complex of the related parties involved in the controlled transaction. This approach has the added benefit that generally more comparable data are available and fewer adjustments are required to account for differences in functions and risks between the controlled and uncontrolled transactions. In addition, the tested party typically does not own valuable intangible property.

Regarding application of TNMM the UN Manual 2021 states as follows:

"4.5.11.1. TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that arguably will be affected by factors unrelated to arm's length pricing. Consequently, one might expect the TNMM to be a relatively disfavoured method. Nevertheless, TNMM is typically applied when two related parties engage in a continuing series of transactions and one of the parties makes a less complex and more routine contribution to profits than does the other. In fact, it has become the

most commonly applied transfer pricing method in cross-border disputes, largely because of the unavailability of goods transactional comparables in many circumstances.

4.5.11.2. TNMM may also be appropriate for use in certain situations in which data limitations on uncontrolled transactions make it more reliable than traditional methods. TNMM may be more attractive if the data on gross margins are less reliable due to accounting differences (i.e. differences in the treatment of certain costs as cost of goods sold or operating expenses) between the tested party and the comparable companies for which no adjustments can be made as it is impossible to identify the specific costs for which adjustments are needed. In such a case, it may be more appropriate to use TNMM to analyze net margins, a more consistent measured profit level indicator than gross margins in case of accounting differences."

In the Australian Transfer Pricing Regulations, the TNMM is described as under:-

TNMM is a transfer pricing methodology based on comparisons at the net profit level between the taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealings. Comparisons at the net profit level can be made on a single transaction or in relation to some aggregation of dealings between associated enterprises. The concept of TNMM is identical to that of 'transactional net margin method' used by the OECD

A profit comparison usually begins with an examination of the net margin relative to an appropriate base (e.g., costs, sales, assets). Sometimes it may be necessary to make the appropriate comparison above the net profit line prior to interest or royalty payments, for example. In many respects, TNMM is an extension of the RPM and CPM.

Comparable operating profit is calculated by determining a PLI for an uncontrolled comparables, and applying the PLI to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity).

To the extent possible, PLIs should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the PLIs of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result. The TNMM works in similar line with the comparable profit method as provided in the US regulations.

Following are the steps to determine the TNMM:

Step 1: The net profit margin realised by the enterprise from a related party transaction is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base.

Step 2: The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base.

Step 3: The net profit margin referred to in Step 1 arising in comparable uncontrolled transactions is adjusted taking into account the differences, if any, between the related party transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market.

Step 4: The net profit margin realised by the enterprise and referred to in Step 1 is established to be the same as the net profit margin referred to in Step 3.

Step 5: The net profit margin thus established is then taken into account to arrive at an arm's-length price in relation to the related party transaction.

OECD Guidelines' Para 2.64 provides that the TNMM examines the net profit margin relative to an appropriate base (example costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate). Thus, a TNMM operates in a manner similar to the CPM and RPM. This similarity means that in order to be applied reliably, the TNMM must be applied in a manner consistent with the manner in which the RPM or CPM is applied. This means in particular that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise (external comparables) may serve as a guide. A functional analysis of the related party and, in the latter case, the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.

The net margins (example return on assets, operating income to sales, and possibly other measures of net profit) under TNMM are less affected by transactional differences than is the case with price, as used in the CUP method. The net margins also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits.

Further, it may not be necessary to determine the functions performed and responsibilities assumed by more than one of the related parties. Similarly, it is often not necessary to state the books and records of all participants in the business activity on a common basis or to allocate costs for all participants. This can be practically advantageous when one of the parties to the transaction is complex and has many inter-related activities or when it is difficult to obtain reliable information about one of the parties.

Para 2.65 of the OECD Guidelines provides that a TNMM is unlikely to be reliable if each party to a transaction makes valuable, unique contributions. In such a case, a transactional PSM will generally be the most appropriate method. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one.

2.6.2. Approaches under OECD and US regulations

The UAE Law does not provide any guidance on how to compute the operating profit margin either on cost, sales and assets. One can consider the standard parlance and related components for calculating the various ratios. However, OECD section B 3.3.and B 3.4 and US Regulations provide detailed guidance on these and one can take gainful reference.

As per OECD, only those items that (a) directly or indirectly relate to the controlled transaction at hand and (b) are of an operating nature should be taken into account in the determination of the net profit indicator for the application of the TNMM. Further Para 2.86 provides that non-operating items such as interest income and expenses and income taxes should be excluded from the determination of the net profit indicator. Exceptional and extraordinary items of a non-recurring nature should generally also be excluded. This, however, is not always the case as there may be situations where it would be appropriate to include them, depending on the circumstances of the case and on the functions being undertaken and risks being borne by the tested party.

(a) Sales revenue

Sales revenue means the amount of the total receipts from sale of goods and provision of services, less returns and allowances. Accounting principles and conventions that are generally accepted in the trade or industry of the controlled taxpayer under review must be used.

(b) Gross profit

Gross profit means sales revenue *less* cost of goods sold.

(c) Operating expenses

Operating expenses include all expenses not included in cost of goods sold except for interest expense, foreign income taxes, domestic income taxes, and any other expenses not related to the operation of the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, legal and professional, warehousing and distribution, administration and a reasonable allowance for depreciation and amortisation.

(d) Operating profit

Operating profit means gross profit *less* operating expenses. Operating profit includes all income derived from the business activity being evaluated by the comparable profits method, but does not include interest and dividends, income derived from activities not being tested by this method, or extraordinary gains and losses that do not relate to the continuing operations of the tested party.

(e) Operating assets

The term operating assets means the value of all assets used in the relevant business activity of the tested party, including fixed assets and current assets (such as cash, cash equivalents, accounts receivable, and inventories). The term does not include investments in subsidiaries, excess cash, and portfolio investments. Operating assets may be measured by their net book value or by their fair market value, provided that the same method is consistently applied to the tested party and the comparable parties, and consistently applied from year-to-year. In addition, it may be necessary to take into account recent acquisitions, leased assets, intangibles, currency fluctuations, and other items that may not be explicitly recorded in the financial statements of the tested party or uncontrolled comparable. Finally, operating assets must be measured by the average of the values for the beginning of the year and the end of the year, unless substantial fluctuations in the value of operating assets during the year make this an inaccurate measure of the average value over the year. In such a case, a more accurate measure of the average value of operating assets must be applied.

Illustration on Application of TNMM method

AE1 LLC., is a UAE company

AE1 LLC, manufactures compact disc (CD) writers and sells the same to AE2 located in mainland UAE, which is a related party of AE1 LLC.

As AE1 LLC, does not have similar transaction with a non- related party, no internal CUP is available. As AE1 LLC, does not have information and data to identify a comparable company, it has used the databases in public domain for carrying out the search. The result of the search may be summarised as follows:

Particulars	No. of companies
Search on the basis of following keywords:	
(a) Computer	800
(b) Computer hardware	250
(c) Computer peripherals	66
Sub total	1,116
Elimination process :	
Companies with different activities	800
Companies with duplication when multiple database are used	75
Companies with no financials	90
Companies having significant operations like sales or purchases with related party	100
Companies reporting no operations	50
Sub total	1,115
Company/companies selected – Z FZE LLC	1

Note: The search criteria and filters adopted above should be taken as illustrative only. The comparison between AE1 LLC, and Z FZE LLC, is carried out as follows:

Financials	**AE1 LLC AED (in million)**	**Z FZE LLC AED (in million)**
Sales	130	200
Other income	5	10
Total Income (A)	135	210
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Loss on sale of undertaking	5	0
Expenses relating to non-operating income	1	3
Total expenditure (B)	106	142
Net profits (A-B)	29	68

Operating margin	**AE1 LLC AED (in million)**	**Z FZE LLC AED (in million)**
Sales	130	200
Gross revenue	130	200
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Total operating cost	100	139
Operating profit	30	61
Operating margin (before interest and depreciation) [45 (130-85)/85]*100 / [80(200-120)/120]*100	52.94%	66.67%

2.6.3. Applicability of TNMM

The steps required to apply the TNMM include the following:

- Performing a functional analysis
- Identifying the tested party
- Identifying comparables
- Choosing a profit measure
- Determining the appropriate time period for analysis
- Testing the reasonableness of result

(a) Performing a functional analysis

The first step in applying TNMM is to analyse the functions performed, risk borne and assets utilised by the entity as well as related parties.

(b) Identifying the tested party

Next, in the TNMM process, one has to select the tested party. The tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

(c) Identifying comparables

The important step is to identify potentially comparable transactions or companies. The OECD Guidelines recommend using internal comparables, which are uncontrolled transactions in which the tested party or related parties and/or connected persons, if possible. Transactions in which the taxpayer is not involved should be used only if there are no internal comparable transactions. A function and risk assessment should be performed once the comparables have been identified, whether the comparables are internally generated or the company is relying on external comparables. This functions and risk analysis necessarily less thorough for external comparables than for analysis of the tested party. A great care must be taken to ensure that all differences that can affect profitability are identified and accounted for through adjustments to the comparables. The OECD Guidelines emphasise the need to carefully choose comparables that are as similar in function and product as is possible.

After deciding what comparables are to be used and whether to make adjustments for differences in functions and risk, it is necessary to choose a particular measure of profitability PLI in applying TNMM. Detailed guidance note is yet to be issued by the UAE FTA on identification of comparables to benchmark transactions under TP methods.

(d) Choosing a profit measure

PLIs are ratios that measure relationships between profits and costs incurred or resources employed. A variety of PLI's can be calculated in any given case. Whether use of a particular PLI is appropriate depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the PLI is likely to produce a reliable measure of the price that the tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all of the facts and circumstances. The PLIs should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years.

PLIs that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following:

Rate of return on capital employed

The rate of return on capital employed is the ratio of operating profit to operating assets. The reliability of this PLI increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this PLI depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable. Finally, difficulties in properly valuing operating assets will diminish the reliability of this PLI.

Financial ratios

Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's-length result. Financial ratios that may be appropriate include the following:

- ratio of operating profit to sales; and
- ratio of operating profit to operating expenses. Reliability under this PLI also depends on the extent to which the composition of the tested party's operating expenses is similar to that of the uncontrolled comparables.

(e) Determining the appropriate time period for analysis

Once the profit measure or measures have been chosen, they must be computed for each of the comparables and for the controlled transaction. The number of years of financial data that should be considered is open to question. Para 3.77 of the OECD Guidelines states that multiple-year data will be useful to take the effects on profits of product life cycles and short-term economic conditions into account. Further, the UAE FTA is yet to provide guidance note on determination of appropriate time period.

(f) Determining the inter-quartile range

The inter-quartile range (25th percentile and 75th percentile) is used globally by countries for determining arm's length range from application of a transfer pricing method. In India, the percentile range (35th percentile and 65th percentile) is used as the arm's length range (prior to percentile range, arithmetic mean/average was used to arrive at arm's length range). The UAE is yet to prescribe the manner of computation of arm's length range.

(g) Determining the "average" or the "range"

An average can be computed in several ways using multiple-year data. Margins can be computed for each company, across time, with a simple average being calculated. Alternatively, margins can be computed using a weighted average, so that years with higher sales will have more weight. By contrast, a yearly average of all comparables (either simple or weighted) could be computed, with these averages then averaged across time. The method of averaging depends to some degree on the reasons for using multiple-year data. If the overall business cycle is considered, averaging the individual results for each year may be the preferred method. In this case, the company-to-company differences within a year are suppressed, so that the overall pattern of profitability across time becomes clearer. Averaging results within a year is not as meaningful if the profitability of companies within an industry is highly affected by the product life cycle and different companies are in different portions of the product life cycle in any given year. The two techniques will give the same answer if simple averages are employed.

(h) Multiple year data

Para 3.75 of the ***OECD Guidelines 2022*** states that examining of multiple year data is often useful in a comparability analysis, but it is not a systematic requirement. Multiple year data should be used where they add value to the transfer pricing analysis. It would not be appropriate to set prescriptive guidance as to the number of years to be covered by multiple year analyses.

Para 3.76 indicates that in order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price.

3.78. Multiple year data can also improve the process of selecting third party comparables e.g. by identifying results that may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed, in some cases leading to the rejection of the comparable, or to detect anomalies in third party information.

3.79. The use of multiple year data does not necessarily imply the use of multiple year averages. Multiple year data and averages can however be used in some circumstances to improve reliability of the range.

According to the para 3.5.2.32 of the ***UN TP Manual 2021****,* Examining multiple year data may be useful in a comparability analysis but it is not a systematic requirement. Multiple year data may be used where they add value and make the transfer pricing analysis more reliable. Circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's industry or the effects of life cycles for a particular product or intangible. However, the existence of any such cycle needs to be aptly demonstrated by the taxpayer.

2.6.4. Issues in application of TNMM

There are also a number of issues to the TNMM. Perhaps the greatest issue is that the net margin of a taxpayer can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect, on price or gross margins. These aspects make accurate and reliable determinations of arm's length net margins difficult.

(a) Availability of data

Application of any arm's length method requires information on uncontrolled transactions that may not be available at the time of the controlled transactions. This may make it particularly difficult for taxpayers that attempt to apply the TNMM at the time of the controlled transactions. In addition, taxpayers may not have access to enough specific information on the profits attributable to uncontrolled transactions to make a valid application of the method. It also may be difficult to ascertain revenue and operating expenses related to the controlled transactions to establish the financial return used as the profit measure for the transactions. Tax authorities may have more information available to them from examinations of other taxpayers. However, as with any other method, it would be unfair to apply the TNMM on the basis of such data use of secret data is generally not allowed by the Tax Authorities.

(b) Other factors may influence the prices

One other issue that arises for the TNMM is that the method is typically applied to only one of the related parties. This one-sided aspect does not distinguish the method from most other methods, given that the resale price and CPMs also have this feature. However, the fact that many factors unrelated to transfer prices can affect net margins and can render the TNMM less reliable heightens the concerns over a one-sided analysis. A one-sided analysis may not take into account the overall profitability of the MNE group from the controlled transactions for purposes of comparability. A one-sided analysis potentially can attribute to one member of an MNE group a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. While the impact on the profits of the other parties to a transaction is not always a conclusive factor in determining the pricing of a transaction, it may act as a counter-check of the conclusions reached.

The following table summarises the application of method and its preferences on a very general basis:

Transactions	Method				
	CUP Method	**Resale Price Method**	**Cost-plus Method**	**Transactional Net Margin Method**	**Profit Split Method**
Commodities/Oil	√				
Payment of Interest	√				
Distribution of goods		√			
Provision of Services			√	√	
Contract manufacturing			√	√	
Manufacturing			√	√	
Payment of Royalty	√				
Multiple transactions involving intangibles					√
Management Charges	No Specified Method Benefit test and acceptable allocation				
Sales of shares, Intangible Assets (trademark, brand name etc.)	No Specified Method Can rely on valuation report under the other method				

2.7. Other Method as per Article 34 of the Law

The introduction of the Other Method as the sixth method allows the use of 'any method' which takes into account (i) the price which has been charged or paid or (ii) would have been charged or paid for the same or similar uncontrolled transactions, with or between non- related parties, under similar circumstances, considering all the relevant facts.

The various data which may possibly be used for comparability purposes under this method could be:

(a) Third party quotations;

(b) Valuation reports;

(c) Tender/Bid documents;

(d) Documents relating to the negotiations;

(e) Standard rate cards;

(f) Commercial & economic business models; etc.

It is relevant to note that the text of Article 34 does not describe any methodology but only provides an enabling provision to use any method that has been used or may be used to arrive at price of a transaction undertaken between unrelated parties. Hence, it provides flexibility to determine the price in complex transactions where third party comparable prices or transactions may not exist. The wide coverage of the Other Method would provide flexibility in establishing arm's length prices, particularly in cases where the application of the five specific methods is not possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions such as intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation/splitting, guarantees provided and received, etc. However, it would be necessary to justify and document reasons for rejection of all other five methods while selecting the 'Other Method' as the most appropriate method.

The OECD Guidelines also permits the use of any other method and state that the taxpayer retain the freedom to apply methods not described in OECD Guidelines to establish prices, provided those prices satisfy the arm's length principle.

Chapter 18

Documentation and Drafting

This chapter covers the following:

- **Transfer Pricing Report/Local File**
- **Master File**
- **Country by Country ('CbC') Reporting**

1. Introduction

Globalisation and economic growth have led to opening up of economy for multinational organisations which has resulted in increase in number and quantum of transactions between related parties i.e. transactions between different entities of the same business group. This has necessitated the creation of statute to ensure that the prices at which the aforesaid transactions are taking place, allocate a fair or reasonable portion of profits to each transacting entity so as to avoid leakage of revenue. Transfer Pricing regulations aim to meet the aforesaid objective by stipulating that the taxpayer need to maintain adequate documentation which clearly justifies the prices paid/charged in an intra group transaction.

The UAE Transfer Pricing Documentation Requirements

Article 55 of the UAE CT Law prescribes following transfer pricing documentation requirements:

The Authority may, by notice or through a decision issued by the Authority, require a Taxable Person to file together with their Tax Return a disclosure containing information regarding the Taxable Person's transactions and arrangements with its Related Parties and Connected Persons in the form prescribed by the Authority.

If a Taxable Person's transactions with its Related Parties and Connected Persons for a Tax Period meet the conditions prescribed by the Minister, the Taxable Person must maintain both a master file and a local file in the form prescribed by the Authority.

The documentation must be submitted to the Authority within (30) thirty days following a request by the Authority, or by any such other later date as directed by the Authority.

Upon request by the Authority, a Taxable Person shall provide the Authority with any information to support the arm's length nature of the Taxable Person's transactions or arrangements with its Related Parties and Connected Persons, within (30) thirty days following the request by the Authority, or by any such other later date as directed by the Authority.

Thresholds for applicability, forms/content, penalties for non-compliance are yet to be clarified by the UAE FTA in relation to the disclosure form, local file and master file prescribed as part of transfer pricing documentation.

The key objectives of requiring the taxpayer to maintain above transfer pricing documentation are as follows:

- To ensure fair allocation of revenue between different jurisdictions;
- To provide tax administrations with the information necessary to conduct an informed transfer pricing assessment/audit;
- To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transacting between related party and/ or connected person.

2. Transfer Pricing Report/Local File

Typically, the structure of a TP Report is as follows:

- Executive Summary
- Group Overview
- Industry Overview
- Functional Analysis
- Selection of tested party
- Selection of the most appropriate method
- Economic analysis
- Conclusion
- Appendices

The structure of TP Study is diagrammatically presented below:

2.1 Executive Summary

The Executive summary section of the TP report captures high level analysis of the entire TP Study and summarises the results of benchmarking analysis (discussed later in the chapter) performed to determine arm's length price of the related party transaction(s) undertaken during the relevant period.

Key elements of Executive summary:

While drafting executive summary, following pointers should be kept in mind for enhancing its effectiveness and ensuring completeness:

- *Objective*

  The objective of executive summary is to provide broad overview of the key contents of the TP Study and review the transactions between related party and/ or connected person are as per TP regulations made under.

- *Scope*

  Executive summary provides a brief description/overview of the business profile of the overall group as well as the taxpayer including the related parties/connected persons with which the taxpayer has undertaken transactions with. Further, this section includes the nature of the related party transactions along with the results of the benchmarking analysis.

- *Key Takeaway*

  The executive summary should be concise and at the same time capture the crux/brief summary of the entire TP Study including nature of the related party transactions, transacting parties involved, value of transactions, selection of the tested party, selection of the most appropriate method and the results of the benchmarking analysis.

2.2 Group Overview

This section includes a brief description of the Group's as well as the taxpayer's business operations. The key points to be included in this section are:

- Brief description of the Group's business activities/operations/division;
- Brief overview/description of the nature of business operations of the taxpayer;
- Brief details of related parties with whom the transactions have been entered into;
- Factual information such as turnover of the Group during relevant period, number of employees engaged by the Group and the shareholding structure of the Group;
- Information pertaining to various products and services offered by the Group;
- Data pertaining to jurisdictions where the Group has business operations i.e. geographical presence of the Group;

- Significant development(s) during the year;

How to source the aforesaid information?

- The annual report of the Group is considered to be the most reliable and authentic source for information pertaining to the nature of business operations, shareholding structure, products and services offered, etc.
- Inquiries made to client regarding, business operations, shareholding and group structure and related party transactions undertaken
- In case of unavailability of annual report, reliance could be placed upon other sources such as website of the Group, reference websites[1], publicly available transfer pricing databases etc.

The Group overview could be illustrated by way of the following example:

> Related Party 1, a bicycle manufacturer in Country 1, sells bicycles to Related Party 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.
>
> In the instant case, the Group overview would include the following broad headings:
>
> *Shareholding structure*
>
> *Brief description of the business operations of the Group*– including range of products/services offered, geographical presence, sales trend during past years, etc.
>
> *Brief description of business operations of Related Party 1 and Related Party 2* – including details of products/services offered, date of incorporation, regional presence, shareholding pattern/structure, etc.

2.3 Industry Overview

This section provides an understanding of the taxpayer/company's relative positioning in the industry vis-à-vis other players and overall justification of the taxpayer's financial results. The key objectives of industry overview are:

- General overview of the industry in which client is operating
- Determine the taxpayer's position within the industry;
- Provide information about the market share of the client;
- Establish linkage of industry overview with functional and economic analysis;
- Highlight the key growth drivers of the industry;

[1]Website information is dynamic and appropriate backup should be maintained by the tax payer in the form of web-links, date on which data has been extracted, file notes, etc.

- Determining threats/challenges and opportunities pertaining to the industry; and
- Provide information about past trends and future projections of the industry.

Some of the points to be kept in mind while preparing industry overview are:

- It is advisable to provide a brief overview of the global scenario and then follow it up with conditions prevailing in the UAE/GCC/Middle East in which taxpayer is operating;
- Always mention the source[2] from where the data is obtained;
- The industry overview should be kept as crisp/short as possible and at the same time include the complete overview of the industry;
- Contradictory statements should not be included, especially if there is a disconnect with functional analysis the same should be addressed; and
- Use of too many technical jargons and figures should be avoided.

The industry overview could be illustrated by way of following example:

Continuing the same example as above, where Related Party 1, a bicycle manufacturer in Country 1, sells bicycles to Related Party 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2, the following broad heads could be included while drafting the industry overview:

Industry structure – Types of bicycles produced and sold in the market, market size, demand-supply gap analysis, etc.

Characteristics of bicycle industry – Distribution channels, brief overview of legal regulations affecting the industry, factors affecting demand, sales trend of each category of bicycles relating to past 5-6 years, factors affecting demand, etc.

Key growth drivers of the industry and the potential regulatory as well as competitive threats affecting the industry, complete SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the industry.

Way forward – Future projections pertaining to industry growth and potential challenges anticipated.

2.4 Functional Analysis

2.4.1 What is Functional Analysis?

Functional Analysis refers to mapping of the economically relevant facts and characteristics of intercompany transactions with regard to their FAR (Functions, assets and risks). It seeks to identify the economically significant functions undertaken, assets used and risk assumed by

[2] Appropriate backup of the source information must be maintained

the parties to the transactions.

The profits that a company earns are dependent on:

- the business environment it operates in;
- the strategy it pursues in that environment;
- the functions performed;
- the assets employed; and
- the risks undertaken.

Functional analysis facilitates understanding of the economic value added by each entity which helps in characterization of the parties to the transaction. The primary objective of undertaking FAR analysis is to ensure that each entity is rewarded appropriately, commensurate to the functions undertaken, assets deployed and risks assumed – *which is the essence of the arm's length principle*. Functional analysis is the most critical exercise which determines the correct characterisation of the entity on which the selection of tested party (discussed in detail in subsequent sections) is dependant, and for the selection of most appropriate benchmarking method and for carrying out the benchmarking analysis to determine the ALP.

To understand the FAR of a transaction, interviews of the key persons of the entity and of the related party should be carried out. The questions asked should be in respect of the transaction, the tested party as well as of the related parties involved.

The OECD TP Guidelines further states as below:

"In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important."[3]

The actual contributions, capabilities, and other features of the parties can influence the options realistically available to them. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. For example, a related party provides logistics services to the group. The logistics company is required to operate warehouses with spare capacity and in several locations in order to be able to cope in the event that supply is disrupted at any one location. The option of greater efficiency through consolidation of locations and reduction in excess capacity is not available. Its functions and assets may, therefore, be different to those of an independent logistics company if that independent service provider did not offer the same capabilities to reduce the risk of disruption to supply.

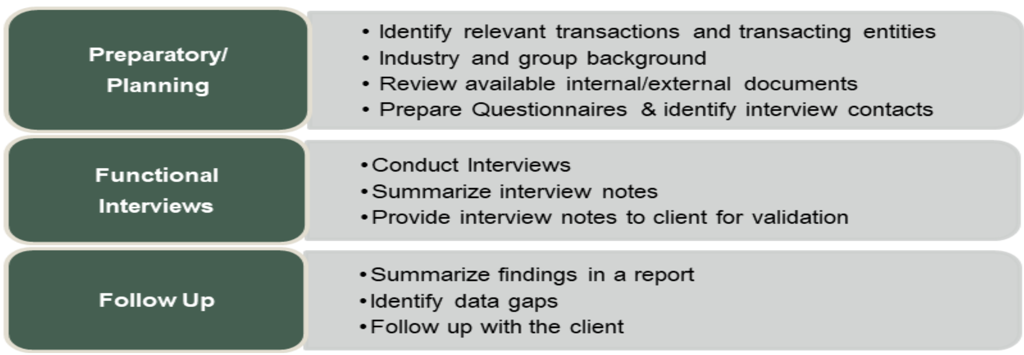
The functional analysis should consider the type of assets employed, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections, etc.

Controlled and uncontrolled transactions, entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered; as the assumption or allocation of risks would influence the conditions of transactions between the related parties. Usually, in the open market, the assumption of increased risk also is expected to be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually assumed.

In view of above discussion, the key steps involved in carrying out functional analysis are discussed hereunder.

2.4.2 Key steps involved in Functional Analysis

The key steps involved in functional analysis have been shown in the diagram below:



[3]Source: Para 1.51 of revised Chapter 1 of OECD Guidelines, 2022

2.4.3 Documentation for Functional Analysis involves:

- Complete record of the interviews
- Functional analysis documentation should contain
  - A detailed description of the functional analysis;
  - Interview notes kept as back-up;
- Review of other documentation as back-up, such as agreements, invoices, process charts, statement of work, etc.
- The functional analysis should direct the reader unambiguously to the correct conclusion about who performs the key functions and bears the related risks.

2.4.4 Guidelines for drafting Functional Analysis

- Focus on functional analysis from related party transactions as well as a business segment perspective;
- Create platform for aggregation, if applicable;
- Facts and background of such transaction(s) including the pricing policy;
- Group Transfer Pricing Policy; and
- Unique business strategy, like launch of new product, termination of contract; etc.;

The various aspects covering functional analysis i.e., functions performed, assets employed and risk assumed are discussed in detail below:

(a) Functions Performed

- Description of functions performed by each transacting party;
- Study the entire value chain of the business:
  - Flow charts depicting the value chain, identifying the key value drivers;
  - Identifying unique intangible assets owned including contribution made by each party towards enhancement and maintenance of intangibles;
  - Identifying the non-routine value addition; and
  - Reference to agreements and pricing mechanism, wherever available.

While conducting functional analysis it is also important to ensure that contracts between related entities are followed in practice having regard to the substance and capability of each entity.

(b) Assets Employed

The analysis of assets employed into tangible assets and intangible assets is of vital importance to determine intensity of functions and selection of most appropriate method.

The existence of intangible assets in the form of technical knowhow, trademarks, patents, etc. contribute to the supernormal growth in profits of an enterprise.

While evaluating intangibles, it is important to understand and differentiate between economic and legal owner as well as contribution made by each entity towards subsequent enhancement and maintenance of those intangibles.

However, an entity which owns only tangible assets and which are used in normal course of operations such as computers, furniture & fixture, plant and machinery, etc. is expected to earn routine/normal profits as earned by other companies engaged in similar business.

For example, a routine manufacturer of bicycles is expected to own the following assets:

Type of Tangible Assets	**Gross Block as on December 31, 2024(AED)**
Land	XX
Building	XX
Plant & Equipment	XX
Data processing equipment	XX
Furniture and Fixtures	XX
Office Equipment	XX
Leasehold Improvement	XX
Vehicle	XX
Total	XXXX

(c) Risks Assumed

The risks assumed by an entity has a direct correlation with the returns or the profit margins which an entity is expected to earn. A risk-insulated entity is generally assured of a fixed return in the form of cost-plus pricing model while an entity bearing significant risks is expected to earn higher profits. Typically, the various kinds of risks which an entity is exposed to are as follows[4]:

- Market risk – risk relating to increased competition and relative pricing pressures, change in demand patterns and needs of customers, inability to develop / penetrate in a market, etc.
- Inventory risk – risk associated with management of inventory in case of overstocking or slow/ non-moving inventory. As a result, the enterprise may be forced to bear a loss of margin on the inventory, or incur additional costs to dispose-of the same.
- Credit risk – risk relating to default in receivables by customers.

[4]This is an inclusive list and may vary from depending upon the facts and circumstances of the business

- Product / Service liability risk - risk associated with product failures including product / service non-performance to generally accepted or regulatory standards. This could result in product recalls and possible injuries to end-users.
- Technology risk – risk relating to inefficiencies arising from obsolete infrastructure and tools as well as obsolescence of processes.
- Foreign exchange risk – risk relating to the potential impact on profits that may arise because of changes in foreign exchange rates.
- Environmental risk – risk relating to potential harmful impact of the business operations on the environment.
- Political/Regulatory risk – risk associated with operating in geographical jurisdictions with unstable political regimes/ unfavourable government policies.
- R&D risk – risk associated with loss incurred due to unsuccessful R&D expenditure.
- Manpower risk – risk associated with losing trained personnel which contribute to the success of the enterprise.
- Capacity Utilisation risk – risk associated with loss of profits due to unutilised capacity.

A careful analysis of the risks assumed by the transacting entities would determine the true characteristics of each of the parties to the transaction. For instance, a distributor solely engaged in purchasing goods for the purpose of resale without performing any value addition would be characterised as a low risk distributor whereas a distributor who performs significant value addition in terms of packing goods, holding inventory, incurring advertisement and promotional expenditure, undertaking market risk, etc. would be characterised as a 'full-fledged distributor'.

To summarize, FAR analysis is central/ core to the benchmarking analysis which is required to be performed for determining arm's length price. FAR helps in:

- Determining the nature of functions performed by the taxpayer and related parties and/or connected person;
- On the basis of the above, determining true and correct characterization of the entities;
- Determining tested party
- Providing guidance on selection of most appropriate benchmarking method; and
- Determining parameters for establishing comparability.

FAR analysis could be better understood with the help of following example:

Continuing the same example as above, where Related Party 1, a bicycle manufacturer in Country 1, sells bicycles to Related Party 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

Assuming, that the related party transaction pertains to import of bicycles by Related Party 2 from Related Party 1 for the purpose of resale, the following key points should be considered while undertaking FAR analysis:

Functions performed by Related Party 1 and Related Party 2 –

- whether Related Party 2 holds inventory or imports bicycles based on confirmed orders from end customers,
- whether Related Party 2 incurs marketing expenditure for creating its own market in UAE or the customers are provided by Related Party 1, which of the key functions are performed by Related Party 1.

This section should include an analysis of entire value chain involved in the related party transaction pertaining to import of bicycles by Related Party 2 from Related Party 1.

Some of the key considerations or factors to be considered in the aforesaid exercise are as follows:

- Which entity is taking key decisions pertaining to purchase of finished goods, inventory management, etc.
- Entity responsible for packaging of goods, quality control, sales & marketing etc.

Assets employed by Related Party 1 and Related Party 2 –

- whether Related Party 2 employs routine assets in the nature of computers, furniture& fixtures, software, etc. or does it, own intangibles in the form of trademarks, know-how, patents, etc., and
- the nature of assets employed by Related Party 1.

Risks assumed by Related Party 1 and Related Party 2 –

- which of the two entities bears significant risks such as market risk, price risk, credit risk, inventory risk, etc.

The results of the above analysis would determine the characterisation of Related Party 2 into 'low risk distributor' or 'normal distributor' depending upon the intensity of functions performed, the type of assets employed and the level of risks assumed.

2.5 Selection of the Tested Party

Selection of the tested party is the first step while undertaking 'economic analysis' i.e. analysis of commercial and economic factors affecting related party transaction to determine arm's length price. Economic analysis involves detailed analysis of the transaction to be benchmarked and includes the following three steps:

- Selection of the tested party;

- Selection of the MAM; and
- Application of the MAM to determine the ALP.

Each of the three steps involved in performing economic analysis are discussed in subsequent section.

"As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparable(s) can be found, i.e. it will most often be the one that has the less complex functional analysis."[5]

"When applying a cost plus, resale price or transactional net margin method it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis. This can be illustrated as follows.

Assume that company A manufactures two types of products, P1 and P2, that it sells to company B, a related party in another country. Assume that A is found to manufacture P1 products using valuable, unique intangibles that belong to B and following technical specifications set by B. Assume that in this P1 transaction, A only performs simple functions and does not make any valuable, unique contribution in relation to the transaction. The tested party for this P1 transaction would most often be A.

Assume now that A is also manufacturing P2 products for which it owns and uses valuable unique intangibles such as valuable patents and trademarks, and for which B acts as a distributor. Assume that in this P2 transaction, B only performs simple functions and does not make any valuable, unique contribution in relation to the transaction. The tested party for the P2 transaction would most often be B."[6]

2.6 Selection of Most Appropriate Method

In order to benchmark the international/intra group transactions, a taxpayer has to choose/select the most appropriate method out of the six methods prescribed by the UAE TP regulations which are as follows:

- CUP Method;
- RPM;
- CPM;

[5]Para 3.18, of Chapter III of the OECD Guidelines, 2022

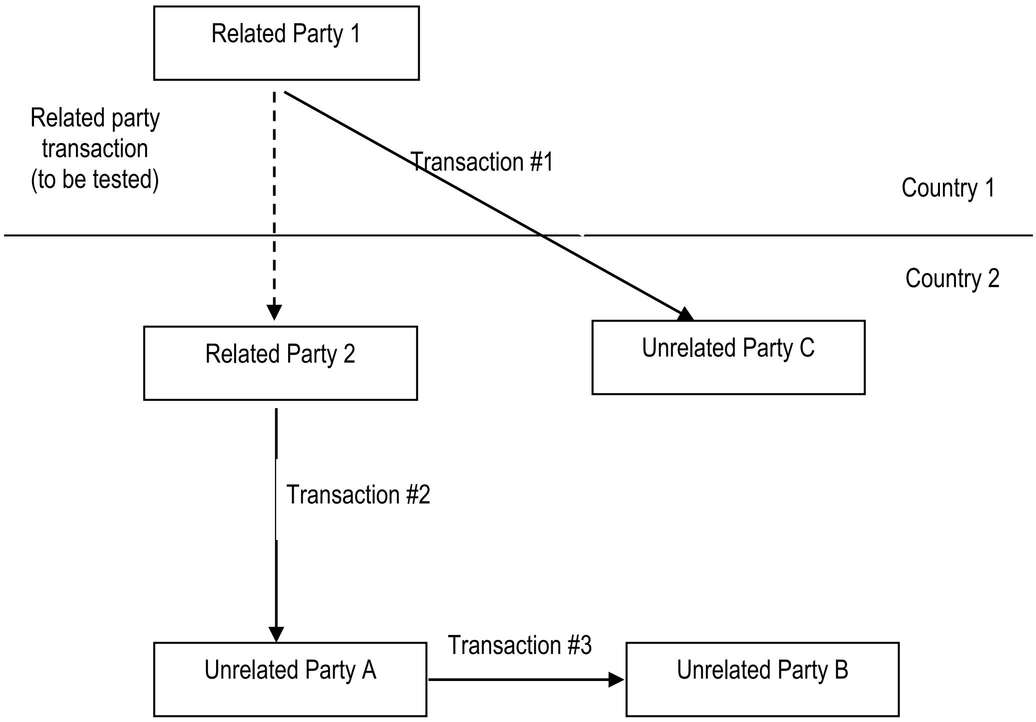
[6]Source: Para 3.18 & Para 3.19 of Chapter III of the OECD Guidelines, 2022

- PSM;
- TNMM; and
- Other Method

The selection of the most appropriate method depends upon the facts and circumstances of each case. Each method is described in detail as follows:

2.6.1 Comparable Uncontrolled Price Method

CUP method is the benchmarking approach which compares the prices charged/paid in a transaction between related parties and/ or connected persons with that of the transaction involving unrelated entities. The transactions that take place in an uncontrolled environment are known as ‘comparable uncontrolled transactions’. In practice, there are two types of comparable uncontrolled transactions. The first, known as an "Internal Comparable", is a transaction between one of the parties to the controlled transaction and an unrelated third party. The second, known as an "External Comparable", is a transaction between two unrelated third parties. The application of CUP method could be better understood with the help of following diagram[7]:



[7]Source: UN TP Manual 2021 (Para4.2.1.1), Figure 4.D.1

Facts of the case: The controlled transaction i.e. the transaction between related parties in the above diagram involves the transfer of bicycles between Related Party 1, a bicycle manufacturer in Country 1, and Related Party 2, a bicycle importer in Country 2, which purchases, imports and resells the bicycles to unrelated bicycle dealers in Country 2. Related Party 1 is the parent company of Related Party 2.

In applying the CUP method to determine whether the price charged for bicycles transferred in controlled is at arm's length, the following information is assumed to be available for consideration:

- The price charged for bicycles transferred in a comparable uncontrolled transaction between Related Party 1 and Unrelated Party C (i.e. transaction #1);
- The price charged for bicycles transferred in a comparable uncontrolled transaction between Related Party 2 and Unrelated Party A (i.e. transaction #2); and
- The price paid for bicycles transferred in a comparable uncontrolled transaction between Unrelated Party A and Unrelated Party B (i.e. transaction #3).

Comparable uncontrolled transactions, such as transaction #1 or #2, which involve a transaction between the tested party and an uncontrolled party, are referred to as internal comparable. Comparable uncontrolled transactions such as transaction #3, which involves a transaction between two parties neither of which is a related party, are called external comparable.

2.6.2 Resale Price Method

RPM is the benchmarking approach which compares the gross profits earned by the tested party with that of comparable companies engaged in similar business. RPM is generally applied in case of resellers/distributors that purchase the finished goods from group companies for the purpose of resale.

"The RPM analyses the price of a product that a related sales company (i.e. Related Party 2 in diagram below) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs and the risks it undertakes. The remainder of the products price is regarded as the arm's length price for the inter-company transactions between the sales company (i.e. Related Party 2) and a related company (i.e. Related Party 1). As the method is based on arm's length gross profits rather than directly determining arm's length prices (as with the CUP Method), the RPM requires less direct transactional (product) comparability than the CUP Method.

The concept could be better understood with the help of the following example:"[8]

Given price = US$100

Re-sale price margin (25%) = US$ 25

Arm's length price = US$ 75

"Consequently, under the RPM the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. Related Party 2) and a related company (i.e. Related Party 1) can be described in the following formula:

TP = RSP x (1-GPM), where:

TP = the Transfer Price of a product sold between a sales company and a related company;

RSP = the Resale Price at which a product is sold by a sales company to unrelated customers; and

GPM = the Gross Profit Margin that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold."[9]

The financial ratio analysed under the RPM is the gross profit margin. Gross profit is defined as net sales minus cost of goods sold. It is easiest to determine where the reseller does not add substantially to the value of the product.

In simpler words, under RPM, the gross margins (i.e., gross profit divided by sales) realized in a comparable uncontrolled transaction are compared to the gross margins realized in controlled transactions, to test whether the arm's-length standard is met. This method is generally used to measure the value of the distribution function and is normally used in transactions involving the purchase and resale of property where the distributor adds no substantial value to the property by either physically altering the property or by the use of an intangible. Repackaging, labelling, or minor assembly activities ordinarily do not constitute adding substantial value.

[8]Source: UN TP Manual 2021 (Para 4.3.1.2)

[9]Source: UN TP Manual 2021 (Para 4.3.1.3)

2.6.3 Cost Plus Method

"The CPM is typically applied in cases involving the inter-company sale of tangible property where the related party manufacturer performs limited manufacturing functions or in the case of intra-group provision of services. The method usually assumes the incurrence of low risks, because the level of the costs will then better reflect the value being added and hence the market price.

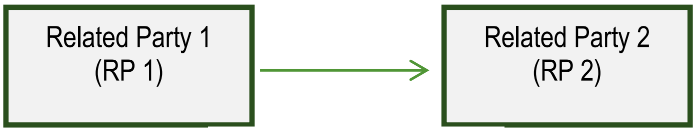
The CPM is also generally used in transactions involving a contract manufacturer, a toll manufacturer or a low-risk assembler which does not own product intangibles and incurs little risk. The related customer involved in the controlled transaction will generally be much more complex than the contract manufacturer in terms of functions performed (e.g. conducting marketing and selling functions, coordination of production and sales, giving instructions to the contract manufacturer about the quantity and quality of production, and purchasing raw materials in some cases), risks incurred (e.g. market risk, credit risk and inventory risk) and assets owned (product intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the TP analysis.

The CPM is usually not a suitable method to use in transactions involving a fully-fledged manufacturer which owns valuable product intangibles as it will be very difficult to locate independent manufacturers owning comparable product intangibles. That is, it will be hard to establish a profit mark-up that is required to remunerate the fully-fledged manufacturer for owning the product intangibles. In a typical transaction structure involving a fully-fledged manufacturer and related sales companies (e.g. commissionaires), the sales companies will normally be the least complex entities involved in the controlled transactions and will therefore be the tested party in the analysis. The RPM is typically more easily applied in such cases."

"The CPM is most often used to analyse transfer pricing issues involving tangible property or services. It is typically applied to manufacturing or assembling activities and relatively simple service providers. The method evaluates the arm's-length nature of an intragroup charge by reference to the gross profit mark-up on costs earned by independent suppliers of tangible property or services in comparable uncontrolled transactions. That is, it compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies engaged in comparable transactions".

The aforesaid method is explained with the help of following diagram:[10]

[10]Source: UN TP Manual 2021 (Para 4.4.1.3 and figure 4.D.3)



Arm's length price?

Cost of Related Party 1	= US$ 500
+Gross Profit Mark Up (50%)	= US$ 250
Arm's length price	= US$ 750

Like the RPM, the CPM is a gross margin method; that is, it attempts to derive an arm's length amount of gross profit, in this case through an arm's length mark-up on Cost of Goods Sold ('COGS').

"In the above example, Related Party 1, an electrical goods manufacturer in Country 1, manufactures under contract for Related Party 2. RP 2 instructs RP 1 on the quantity and quality of the goods to be produced. RP 1 will be guaranteed sales to RP 2 and will face little risk. As RP 1 is less complex in terms of functions, assets and risks than RP 2, the analysis under the CPM would focus on Related Party 1 as the tested party. Since Related Party 1 is a simple manufacturer, the Cost-Plus Method may be the best method of analysis in this case. The CPM analyses whether the gross profit mark-up earned by RP 1 is at arm's length by reference to the gross profit margins earned by companies manufacturing comparable goods for (or providing comparable services to) unrelated parties. The CPM thus does not directly test whether the transfer price is at arm's length by comparing prices. As such, it is a less direct (transactional) method as compared to the CUP Method."[11]

Under CPM, the profit level indicator, used for comparing with uncontrolled transactions, is gross profit/direct and indirect cost of production. This method may not be appropriate in the circumstances where the definition of gross profit is not harmonious for controlled as well as uncontrolled transactions. Gross profit margin is subject to cost classification between cost of goods sold and other operating cost. Slight variation in the classification of the above cost leads to variation in the gross profit margin. Further, gross profit margin is less tolerant than net profit margin for the functional and risk differences between controlled and uncontrolled transactions. Therefore, gross profit margin calls for greater reliable adjustment that may not be possible due to inadequacy of complete information regarding the uncontrolled transactions.

2.6.4 Profit Split Method

"As with any transfer pricing method, the profit split should be used where it is found to be the

[11]Source: UN TP Manual 2021 (Para 4.4.1.4.)

most appropriate method to the circumstances of the case. Primarily, this determination is based on the nature of the accurately delineated transaction in the context of its circumstances. The analysis to determine the accurately delineated transaction should consider the commercial and financial relations between the related parties, their functions performed, assets used or contributed, and risks assumed, and how the activities of the parties impact the transaction given the market context in which the transaction occurs.

While as noted above, the PSM can be a complex method to apply reliably, the determination of when it is the most appropriate method should be done as objectively as possible. That is, the profit split method should not simply be regarded as a method of last resort. Moreover, while the method may require relatively more, or more detailed information from the taxpayer and its associated enterprise(s) than other methods, where it is indeed found to be the most appropriate method, reasonable efforts should be made to gather such necessary information which, after all, will typically be in the hands of the MNE."[12]

"The PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

The PSM may be appropriate where:

- each related party to the transaction makes unique and valuable contributions; and/or
- the business operations of the related parties are so highly integrated that they cannot be reliably evaluated in isolation from each other; and/or
- the parties share the assumption of economically significant risk or separately assume closely related risks.

The PSM starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions. It then seeks to split those profits or losses between the associated enterprises involved on an economically valid basis in order to achieve an arm's length outcome for each party. Typically, the split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed.

The PSM is also referred to as the transactional profit split method. It can be distinguished from global formulary apportionment approaches in the following ways. The PSM typically does not start with the global or total combined profits of the entire MNE group. Rather, it begins from the relevant profits in relation to particular transactions between two or more related parties. Moreover, in order to comply with the arm's length principle, the way in which the method is applied should not be arbitrary, but rather should approximate the results

[12]Source: UN TP Manual 2021 (Para 4.6.3.1)

achieved had the parties been independent of each other. In particular, the factors by which the relevant profits are split between the related parties to the transaction are typically based on measures of their relative contributions to value creation rather than an arbitrary formula." [13]

2.6.5 Transactional Net Margin Method

"The TNMM compares the net profit margin (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm's length prices the TNMM is a less direct method than the CPM and Resale Price Method that compares gross margins. It is also an even more indirect method than the CUP Method that directly compares prices. Many factors may affect net profit margins but may have nothing to do with transfer pricing."[14]

TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that arguably will be affected by factors unrelated to arm's length pricing. Consequently, one might expect the TNMM to be a relatively disfavoured method. Nevertheless, TNMM is typically applied when two related parties engage in a continuing series of transactions and one of the parties controls intangible assets for which an arm's length return is not easily determined. Since TNMM is applied to the party performing routine manufacturing, distribution or other functions that do not involve control over such intangible assets, it allows the appropriate return to the party controlling unique or difficult-to value intangible assets to be determined indirectly.

The application of the transactional net margin method may be understood with the following example:

RP1 LLC., is a UAE Entity

RP1 LLC., manufactures compact disc (CD) writers and sells the same to RP2 Ltd., which is a related party of RP1 Ltd. RP1 LLC. acts as a distributor of CD writers in UAE.

Bases on detailed Functional analysis RP2 is selected as the tested party as it has simpler operations.

As RP1 LLC., does not have similar transaction with a non-related party, no internal CUP is available

RPM cannot be taken as most appropriate method as RP2 also performs certain value added function and accordingly TNMM is selected as the MAM.

As RP1 LLC., does not have information and data to identify a comparable company, it has used the databases in public domain for carrying out the search. Comparable search would aim to identify companies similar to RP2. Accordingly, if operating margin of comparable

[13]Source: UN TP Manual 2021 (Para 4.6.1.3 – Para 4.6.1.6)

[14]Source: UN TP Manual 2021 (Para 4.5.2.2)

selected is in line with margins earned by RP2, the transaction between RP1 and RP2 can be said to have been undertaken at arm's length.

2.6.6 Other Method

The Other Method is applied in cases where all the five methods could not be adopted as the most appropriate method. It is pertinent to note that CUP requires comparable pricing data emanating from actual transaction that has taken place in uncontrolled environment; however, other method allows the use of comparable pricing data based upon price quotations, market rates, etc. Possible approaches under this method could be use of valuation methodologies for determining arm's length price for transfer of business/ intangibles and technical valuation reports for determining arm's length price for purchase/ sale of fixed assets, etc.

Comparability criteria under various methods:

As discussed above, the comparability criteria would depend upon the most appropriate method selected for benchmarking the related party transaction.

Product comparability is most important in applying the CUP Method, as differences in products will result in different prices. The CPM and the RPM are less dependent on product comparability and focus on functional comparability because differences in functions that are reflected in differences in operating expenses may lead to a broad range of gross margins. However, the TNMM is even less dependent on product comparability and functional comparability than the traditional transaction methods, because net margins are less influenced by differences in products and functions. The TNMM focuses on broad product and functional comparability.

However, the comparability standard to be applied to the TNMM requires a high degree of similarity in several factors between the tested party and the independent enterprises that may adversely affect net margins. Net margins may be affected by factors that have no effect, or a less significant effect, on gross margins or prices due to the variation of operating expenses between companies. These factors may be unrelated to transfer pricing.

Application of most appropriate method – Case Study

"The process of selection of tested party and the most appropriate method is illustrated with the help of following example:

Given price	= US$ 10000
Cost of goods sold	= US$?
Gross Profit	= ?
Operating Expenses	= US$ 2000
Net Profit (5% of price)	= US$ 500

RP 1, a bicycle manufacturer in Country 1, sells bicycles to RP 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2. Assume that Related Party 1 is the more complex party, controlling a variety of technology and operating intangibles. The CUP Method would compare the price charged in the controlled transaction between RP 1 and RP 2 with the price charged in comparable uncontrolled transactions. If the CUP Method cannot be applied, the CPM and RPM may be considered.

The CPM is likely to be relatively unreliable in this case because it would treat the more complex entity, RP 1, as the tested party. Given that RP 1 owns valuable intangible property, the resale price could be considered. Under the RPM the sales company, the least complex of the two entities involved in the controlled transaction, will be the tested party. The analysis would entail a search for distributors which sell broadly similar products, which perform functions and incur risks comparable to those of RP 2, and for which appropriate data relating to gross profits can be obtained.

Sometimes it may be more reliable to choose the TNMM and compare net profits. If, for example, there is different reporting of the cost of goods sold and operating expenses for the tested party and the comparable distributors, so that the gross profit margins reported are not comparable and reliable adjustments cannot be made, the RPM may be relatively unreliable. However, this type of accounting inconsistency will not affect the reliability of the TNMM, as this method examines net profit margins instead of gross profit margins. Also, as further discussed below, the fact that the TNMM requires less product comparability than the traditional transaction methods (and as such has a greater tolerance to product differences and cost accounting differences compared to traditional transaction methods) can be a significant practical benefit of using TNMM. The application of the TNMM would entail an analysis of the least complex party — in this case the distributor. Such an analysis would entail a search for comparable distributors taking into account the comparability standard of this method. An application of the TNMM focusing on the related party manufacturer as the tested party could be, for example, the situation in which RP 1 is a contract manufacturer. In such a case, the contract manufacturer will typically be the least complex entity as MNEs often separate the ownership of valuable technology intangibles from the manufacturing function. The CPM would normally be considered if the CUP Method cannot be applied. However, due to the accounting inconsistency mentioned above, it may be appropriate to apply the TNMM using a financial ratio based on net profit margin that is appropriate for a manufacturer (e.g. return on total costs)."

Selection of Most Appropriate Profit Level Indicator

Under profit based methods, the gross/net profits relative to an appropriate base earned by the tested party and comparables is compared to determine the arm's length nature of the related party transaction.

Several PLIs are allowed under the TNMM, typically based on operating profit. A PLI is a measure of a company's profitability that is used to compare comparables with the tested party. A PLI may express profitability in relation to (i) sales, (ii) costs or expenses, or (iii) assets. More specifically, the PLI can be the operating profit relative to an appropriate base (e.g. costs, sales or assets). With the help of "profit level indicators" the net profitability of the controlled transaction is compared to the net profitability of the uncontrolled transactions.

"The denominator should be reasonably independent from controlled transactions, otherwise there would be no objective starting point. For instance, when analysing a transaction consisting in the purchase of goods by a distributor from an AE for resale to independent customers, one could not weight the net profit indicator against the cost of goods sold because these costs are the controlled costs for which consistency with the arm's length principle is being tested. Similarly, for a controlled transaction pertaining to the provision of services to an associated enterprise, one could not weight the net profit indicator against the revenue from the sale of services because these are the controlled sales for which consistency with the arm's length principle is being tested. Where the denominator is materially affected by controlled transaction costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to an AE), caution should be exercised to ensure that said controlled transaction costs do not materially distort the analysis and in particular that they are in accordance with the arm's length principle."[15]

The following table briefly summarises the various PLIs used while undertaking benchmarking of related party transaction:

Overview of Various Profit Level Indicators	
Return on Assets (ROA)	Operating profit divided by the operating assets (normally only tangible assets)
Return on Capital Employed (ROCE)	Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments
Net Operating Profit Margin (NPM)	Operating profit divided by sales or operating revenue
Net Cost Plus Mark-up (NCP)	Operating profit divided by Operating costs

[15]Source: Para 2.94 of Chapter II of OECD Guidelines, 2022

Overview of Various Profit Level Indicators	
Gross Profit Margin	Gross profit divided by Sales
Berry Ratio	Gross profit divided by value added expenses

The selection of most appropriate PLI could be illustrated with the help of following case study:

Continuing the same case study as discussed under the heading 'Application of most appropriate method – Case Study', the related party transaction pertains to import of bicycles by Related Party 2 from Related Party 1.

As discussed earlier, while selecting PLI, the denominator should be the one which is uncontrolled or is least tainted. In the present case, the related party transaction pertains to purchase of bicycles, hence, the most appropriate PLI would be Net Operating Profit as a percentage of Sales.

For determination of arm's length price, the PLI of tested party is compared with that of comparables. If the net operating profit relative to sales earned by tested party is equal to or greater than that of comparables, then the related party transaction is at arm's length.

2.7 Economic Analysis

Economic (or Benchmarking) analysis means analysing or comparing the transfer price i.e. prices set in controlled environment with that of uncontrolled environment. This would involve the following:

- Application of the MAM

  After reviewing all the transfer pricing methods, based on facts and circumstances, the most appropriate method should be selected which provides the most reliable measure of an arm's length result for the transaction.

- Search for uncontrolled comparable transactions and determination of ALP

  Based on the most appropriate method selected for determining the arm's length price, the next step is search for uncontrolled comparable prices/profit margins and arriving at the arm's length price which is the primary objective of preparing TP study.

Typical process followed while performing comparability analysis

"Generally, benchmarking process involves following steps:

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer's circumstances.

Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

Step 5: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).

Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors discussed earlier in this module.

Step 8: Determination of and making comparability adjustments where appropriate.

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration."[16]

How to find comparable uncontrolled transactions?

"A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent enterprises, neither of which is a party to the controlled transaction ("external comparable")."[17]

There are various sources of information that can be used to identify potential external comparables which are described below:

Databases

A common source of information is commercial databases, which have been developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis.

Some of the common databases used for finding comparable companies are listed below:

Provider	Database	Content
Bloomberg	Bloomberg Reference Data Services	Financial markets data
Bureau Van Dijk	Orbis Worldwide	Company financial information

[16]Source: Para 3.4 of Chapter III of OECD Guidelines, 2022 [Page 150]

[17]Source: Para 3.24 of Chapter III of OECD Guidelines, 2022 [Page 156]

Provider	Database	Content
	Osiris Worldwide	(Private & Listed Companies)
	Oriana & Amadeus	
	TP Catalyst	
	Zephyr	M&A Information
Capital Market Publishers India	Capitaline TP	Company financial information (Private & Listed Companies)
Centre for Monitoring Indian Economy	Prowess	
Accord Fintech	Ace TP	
Invotex Group	Royalty Connection Worldwide (US)	Intangibles License Agreements (Sourced from US SEC)
RoyaltyStat	License Agreement Database	
Royaltysource	RoyaltySource	
Royaltyrange	Royaltyrange	Royalty rate reports
Provider	Database	Content
S&P	Capital IQ – Financials	Company financial information (Private & Listed Companies)
	Compustat – North America	Company financial information (Listed Companies)
	Compustat Global	
	Credit Analytics	Risk of default models (Credit Score)
Thomson Reuters	Dealscan (Worldwide)	Financial transactions data (loans)
	Eikon (Worldwide)	Financial markets data
	Lipper (US)	Fund management data
	Worldwide public company data (Worldwide)	Company financial information (Listed Companies)
	Worldwide private company data (Worldwide)	Company financial information (Listed Companies)
	Worldwide intangibles data (Worldwide)	Intangibles license agreements and royalty rates

If required, the following adjustments could be carried out in the comparability data to account for differences in:

- The type and quality of products;
- Delivery terms;
- Volume of sales and related discounts;
- Product characteristics;
- Contractual terms;
- Risk incurred; and
- Geographical factors

The entire benchmarking process is illustrated with the help of following example:

Facts of the case: RP 1, a bicycle manufacturer in Country 1, sells bicycles to RP 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

As discussed earlier, RP 2 is selected as the tested party and TNMM is selected as the most appropriate method. The most appropriate PLI is 'Operating Profit/Sales'.

For benchmarking the related party transaction pertaining to import of bicycle by RP 2, the following steps need to be undertaken:

- **Selection of time period:**

  For instance, the Indian Regulations prescribe the use of current year data in which the transaction has been undertaken. However, if the data for current year is not available for comparable companies, the taxpayer may consider data for up to previous two years. It can be further explained as, the related party transaction pertaining to import of bicycles was undertaken in financial year 2021-22, however, data for comparable companies is not available in public domain for the relevant year, then the taxpayer may consider data for financial years 2019-20 and 2020-21 and compute the arithmetic mean to determine the arm's length price.

- **Undertaking search for comparables:**

  Assuming that in the above case study, Related Party 2 i.e. the tested party is situated in India, the search for comparable companies engaged in the business of distribution of bicycles could be undertaken by using databases such as TP Catalyst., Oriana, Osiris, Orbis (Bureau van Dijk), EdgarStat, RoyaltyStat, Amadeus Global etc. The selection of comparables would involve application of common filters such as:

Quantitative filters:

- Financial data not available for relevant fiscal years
- Ceased business operations or currently inactive
- Sick companies
- Turnover limit (upper and lower caps)
- Significant Related Party Transactions

Qualitative filters:

- Non comparable functions or activities
- Revenue - non comparable activities
- Segmental information not available
- Persistent operating losses
- Exceptional year of operations

If required, the appropriate adjustments could be carried out to account for differences in the type and quality of products, risk incurred etc.

2.8 Conclusion

The conclusion section of TP report captures high level summary of the TP study, primarily including the transactions involved, MAM and PLI used and the results of the benchmarking analysis. The margins of the tested party must fall within the range of the third party comparables or higher than the arithmetic mean of comparable companies.

In case the tested party is incurring losses, the justification for the same is included in this section. The UAE FTA is yet to prescribe the manner of computation of arm's length range (inter-quartile/percentile/arithmetic mean etc.).

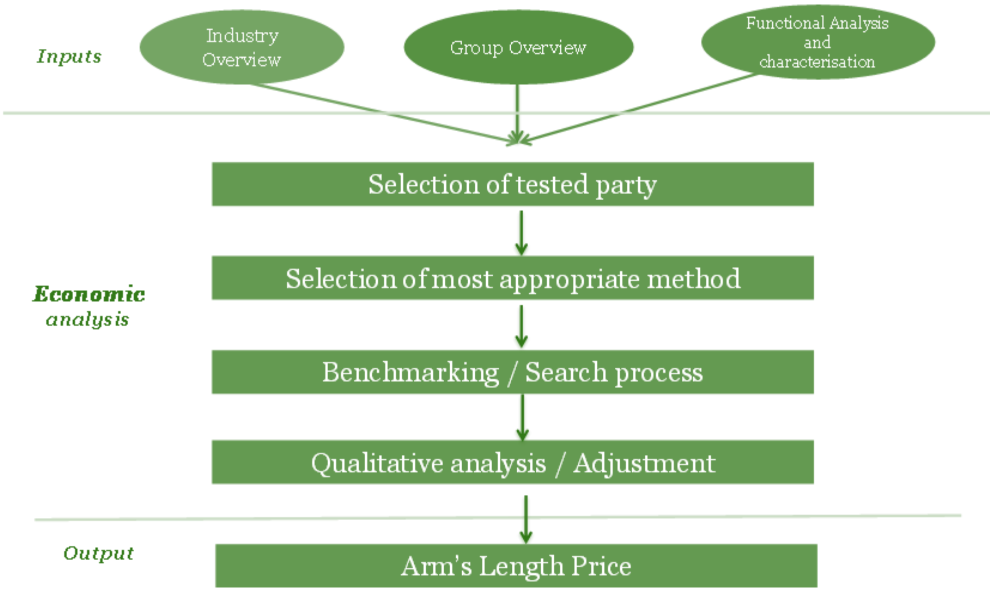
2.9 Appendices

At the end of the TP report, following could be annexed as Appendices:

- Abbreviations
- UAE TP regulations
- Details of related party transaction
- Details of Databases used, if any
- Business Description of comparable companies
- Segmented Financial Information, if applicable

2.10 Summary of Entire TP Study

The entire TP Study could be summarised with the help of following diagram:



2.11 Things to Remember

Basic checks to be performed while/after preparing TP study:

- Perform a spell check after preparing the first draft of the TP Study;
- Check header and footers;
- Ensure that full forms of all the abbreviations used are defined;
- Update the 'Table of Contents' after editing the document so that the index is always updated
- Reconfirm executive summary results with economic analysis and financial results;
- Financial results should tally with signed financials/segment provided by client;
- Cross check value of transactions with Disclosure Form;
- If the report is draft ensure there is 'draft' written on cover page and reflected on each page; and
- Share pdf version of the report with the client.

3. Master File

The UAE FTA is yet to prescribe the threshold, form and contents of Master File. Till such time, reliance can be drawn from OECD TP guidelines which are relied upon by the UAE.

As per para 5.18 of the OECD Guidelines 2022, the master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk. In general, the master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context. It is not intended to require exhaustive listings of minutiae (e.g. a listing of every patent owned by members of the MNE group) as this would be both unnecessarily burdensome and inconsistent with the objectives of the master file. In producing the master file, including lists of important agreements, intangibles and transactions, taxpayers should use prudent business judgment in determining the appropriate level of detail for the information supplied, keeping in mind the objective of the master file to provide tax administrations a high-level overview of the MNE group's global operations and policies. When the requirements of the master file can be fully satisfied by specific cross-references to other existing documents, such cross-references, together with copies of the relevant documents, should be deemed to satisfy the relevant requirement. For purposes of producing the master file, information is considered important if its omission would affect the reliability of the transfer pricing outcomes.

As per para 5.19 of the OECD Guidelines 2022, the information required in the master file provides a "blueprint" of the MNE group and contains relevant information that can be broken down into five categories: a) the MNE group's organisational structure; b) a description of the MNE group's business or businesses; c) the MNE group's intangibles; d) the MNE group's intercompany financial activities; and e) the MNE group's financial and tax positions.

As per para 5.20 of the OECD Guidelines 2022, taxpayers should present the information in the master file for the MNE group as a whole. However, organisation of the information presented by line of business is permitted where well justified by the facts, e.g. where the structure of the MNE group is such that some significant business lines operate largely independently or are recently acquired. Where line of business presentation is used, care should be taken to assure that centralised group functions and transactions between business lines are properly described in the master file. Even where line of business presentation is selected, the entire master file consisting of all business lines should be available to each jurisdiction in order to assure that an appropriate overview of the MNE group's global business is provided.

Annexure I to Chapter V of the *OECD Guidelines 2022*, sets out the information to be included in the master file.

The following information should be included in the master file:

Organisational structure

Chart illustrating the MNE group's legal and ownership structure and geographical location of operating entities.

Description of MNE group's business(es)

General written description of the MNE group's business including:

- o Important drivers of business profit;
- o A description of the supply chain for the group's five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5% of group turnover. The required description could take the form of a chart or a diagram;
- o A list and brief description of important service arrangements between members of the MNE group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services;
- o A description of the main geographic markets for the group's products and services that are referred to in the second bullet point above;
- o A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used;
- o A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

MNE group's intangibles

- o A general description of the MNE group's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.
- o A list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities legally own them.
- o A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and licence agreements.
- o A general description of the group's transfer pricing policies related to R&D and intangibles.
- o A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, jurisdictions, and compensation involved

MNE group's intercompany financial activities

- o A general description of how the MNE group is financed, including important financing arrangements with unrelated lenders.
- o The identification of any members of the MNE group that provide a central financing function

for the group, including the jurisdiction under whose laws the entity is organised and the place of effective management of such entities.

- o A general description of the MNE group's general transfer pricing policies related to financing arrangements between associated enterprises.

MNE group's financial and tax positions

- o The MNE group's annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
- o A list and brief description of the MNE group's existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among jurisdictions.

4. Country by Country ('CbC') Reporting

BEPS Action 13 deals with implementing Country by Country Reporting (CbCR). CbCR is expected to give tax administrations a global picture of where MNEs' profits, tax and economic activities are reported. The objective is to enable tax administration to use this information:

- To assess high-level TP risk;
- To assess other BEPS- related risks; and
- For economic & statistical analysis

The purpose of CbCR is to eliminate any gap in information between the taxpayers and tax administrations with regards to information on where the economic value is generated within the MNE Group and whether it matches where profits are allocated and taxes are paid on a global level.

In the year 2018, UAE joined the BEPS Inclusive Framework and has committed to implement the four BEPS minimum standards (i.e., BEPS Action Plan 5, 6, 13 and 14).

In the year 2019, UAE introduced CbCR regulations under The Cabinet Resolution No. (32) of 2019 on April 30, 2019, with the objective to enhance international cooperation and increase tax transparency. The UAE CbCR regulations were effective from January 1, 2019.

In the year 2020, UAE amended the CbCR regulations under The Cabinet Resolution No. (44) of 2020 on June 04, 2020 which replaces the existing Cabinet Resolution of 2019, to comply with OECD standards. The requirements are now restricted to the UAE headquartered MNE Groups and were effective for financial years starting on or after January 1, 2019.

Applicability of CbCR:

CbCR requirements are applicable to ultimate parent entities of UAE-headquartered MNE Groups whose consolidated group **revenue is exceeding AED 3.15 billion** in the financial year preceding the financial reporting year concerned.

CbCR filing requirements include the following:

- o CbCR notification has to be filed before end of the financial year
- o CbC Report has to be filed within 12 months from the end of the financial year

For instance, the 'financial reporting years' starting on or after January 1st 2019, accordingly, the CbC report must be submitted by December 31st 2020 at the latest.

Snapshot of updated UAE CbCR Legislation

CbCR Requirements	CABINET RESOLUTION NO (32) OF 2019	CABINET RESOLUTION NO (44) OF 2020
CbC Report & CbCR Notification	**All UAE resident entities** of covered MNE Groups (**whether headquartered in UAE or outside UAE**) required to submit the Report & Notification if thresholds are met.	**Only Ultimate Parent Entities** of the MNE Groups headquartered in the UAE are required to submit the Report & Notification if thresholds are met.
Surrogate parent entity (SPE) filing	Non-UAE headquartered MNE Groups had option assign a group entity in UAE to file CbC report on behalf of the Group in certain cases (e.g. Group does not have CbCR legislation in country of headquarter).	SPE filing is not allowed in the UAE.
Secondary filing	UAE group entities of non-UAE headquartered Groups were required to file CbC report in the UAE in certain cases (e.g. no exchange relationship between UAE and headquarter jurisdiction).	Secondary filing is not required in the UAE, thus legislation is now more business friendly

Consequences for non-compliance

Non-compliance	Penalties prescribed
Failure to file CbCR / CbCR notification in time	An administrative fine of upto AED 1,000,000 (plus AED 10,000 for each day of failure up to a maximum of AED 250,000)
Failure to provide full and accurate information in the CbCR / CbCR notification	An administrative fine of no less than AED 50,000 and not exceeding AED 500,000 is applicable
Failure to maintain information and documentation for five years	AED 100,000
Failure to provide any other information requested	AED 100,000

Definition of MNE Group, Ultimate Parent Entity and Constituent Entity

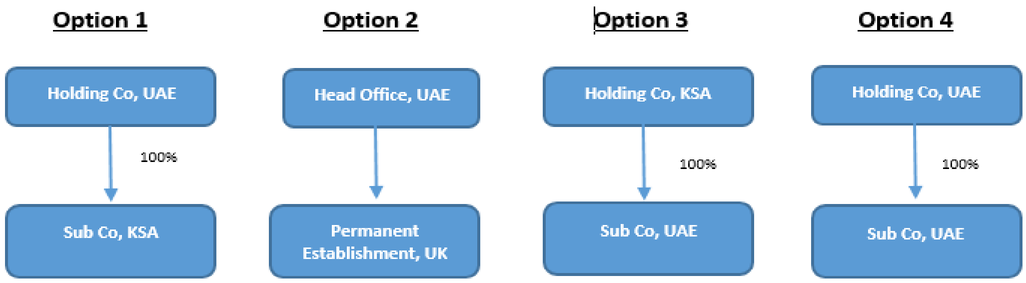
MNE Group

Any group that includes:

- Two or more companies the tax residence of which is located in different jurisdictions, or
- including one single company having its tax residence in one country and being subject to tax with respect to the activity it carries out through a permanent entity located in another country.

In simpler terms, MNE Group is the group which consists of two or more enterprises that are residents for tax purposes in different jurisdictions.

Example:



<u>Option 1</u> and **<u>Option 3</u>:** It is a part of MNE Group, since tax residence of both the companies are located in different jurisdictions.

<u>Option 2</u>: It is a part of MNE Group, since one single company having its tax residence in one country and being subject to tax w.r.t the activity carries out through permanent entity located in another country.

<u>Option 4</u>: It is not a part of MNE Group, since tax residence of both the companies are **not** located in different jurisdictions.

Ultimate Parent Entity

The Constituent Entity in the MNE Group that meets the following criteria:

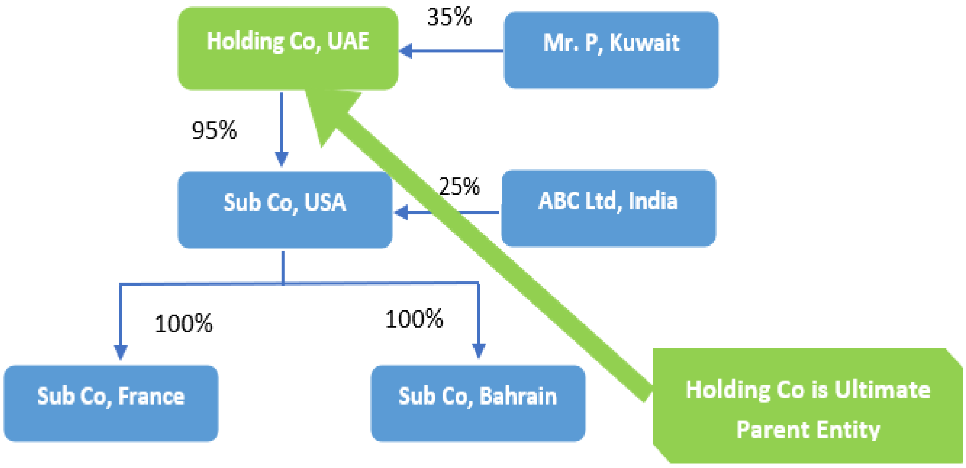
- Owns directly or indirectly a sufficient interest in one or more Constituent Entities of such MNE Group such as it is required to prepare Consolidated Financial Statements under the accounting principles generally applicable in its jurisdiction tax residence, or be so required if its equity interests were traded on a public securities exchange in its jurisdiction tax residence;
- Its Group does not include any other Constituent Entity that owns directly or indirectly an interest described in above in such Entity.

In simple terms, Constituent entity which owns directly or indirectly a sufficient interest in other Constituent Entities such that it is required to prepare Consolidated Financials;

and

There is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest in the above Constituent entity

Example 1:



Constituent Entity

Means any of the following:

— Any separate business unit of an MNE Group that is included in the Consolidated Financial Statements of the MNE Group for the purposes of preparing the financial reports, or would be so included therein if equity interests therein were traded on a public securities exchange;

— Any business unit that is excluded from the MNE Group's Consolidated Financial Statements solely on size or materiality grounds.

Any permanent establishment pertaining to any separate business unit of the MNE Group referred to in Clauses above, provided that the said business unit prepares separate financial statements for such permanent establishment for the purposes of financial reporting preparation, regulatory, tax reporting, or internal management control purposes.

In simple terms, any separate business unit of MNE Group that is included in the Consolidated Financial Statements on a line-by-line basis (including units excluded solely on size or materiality grounds); **or**

Any permanent establishment of any separate business unit of the MNE Group, if separate financial statements prepared for any purpose.

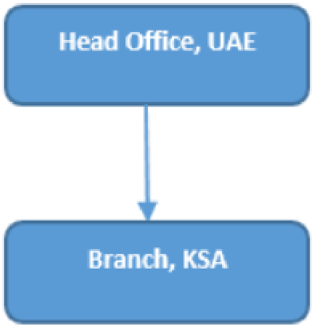
Example 1:

Particulars	Holding Co	Sub Co	Inter-Co	Consolidated
Revenue	100	40	(10)	130
Cost	80	25	(9)	96
Profit	20	15	(1)	34
Share of profit from PQR Co.				5

Sub Co is a constituent Entity, but PQR Co. is not constituent entity

Example 2:

Head Office and Branch to be considered as two separate constituent entities



Details of information and documentation prescribed to be furnished as part of CbC reporting

CbC Notification

CbC notification is an advance notice about the applicability of CbCR requirements for the relevant year. Notification includes details of Ultimate Parent Entity including entity name, trade license, year-end etc.

The notification must be filed on or before the last day of the MNE Group's financial year. It must be filed by the Ultimate Parent Entities of MNE Groups based in the UAE. through the online portal (https://cbcrportal.mof.gov.ae/).

CbC Report

Action Plan 13 provides that the CbC reporting template requires MNEs to report the amount of revenue, profits, income tax paid and accrued, employees, stated capital, retained earnings and tangible assets annually for each tax jurisdiction where they do business. In addition, MNEs are required to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activity each entity conducts.

The CbC reporting template is divided into three tables:

Contents of CbCR

Table 1: Contains the quantitative information per tax jurisdiction such as unrelated party and related party revenues, stated capital, taxes accrued and paid, employee count, etc.

Table 2: Contains the qualitative information per constituent entity on the main business activities undertaken during the year.

Table 3: Contains any additional information necessary to facilitate the understanding of Tables 1 and 2 (e.g. assumptions on exchange rates, source of data, etc.)

Further, guidance on preparation of the three tables are provided below:

Table 1: Overview of allocation of income, taxes and business activities by tax jurisdiction Table

Tax jurisdiction	Revenues			Profit (loss) before income tax	Income tax paid (on cash basis)	Income taxes accrued – current year	Stated capital	Accumulated earnings	Number of full time employees	Tangible assets (other than cash and cash equivalents)
	Unrelated party	Related party	Total							

Key Points for Consideration (Table 1)

- Information to be reported on an aggregated basis and not a consolidated basis within a jurisdiction
- Whole amounts should be reported. No rounding off in thousands, millions, etc.
- Revenues should include extraordinary income and gain from investment activity, but exclude dividends from other constituent entities.
- Related parties mean the constituent entities of the MNE Group.
- Income tax accrued includes current year taxes accrued, whereas income tax paid includes any taxes paid during the year (advance tax, withholding taxes (WHT), prior year taxes arising from dispute, taxes paid under protest, etc.). Tax refunds should be reduced from tax paid (if refunds included as revenue), a note should be included in Table 3.

- For PEs, stated capital and accumulated earnings to be reported under legal entity and not PE.
- Employees should be reported as of year-end on Full Time Equivalent basis. Independent contractors may be included

Table 2: List of all constituent group entities include each aggregation per tax jurisdiction

Tax jurisdiction	Constituent entities resident in tax jurisdiction	Tax jurisdiction of incorporation if different from residence	Main business activities (Refer key below)												
			1	2	3	4	5	6	7	8	9	10	11	12	13
	1				√		√								
	2						√								
	1										√				
	2													√	

Business Activity:

1. Research and Development
2. Holding or managing Intellectual Property
3. Purchasing or Procurement
4. Manufacturing or Production
5. Sales, Marketing or Distribution
6. Administrative, Management or Support Services
7. Provision of services to unrelated parties
8. Internal Group Finance
9. Regulated Financial Service
10. Insurance
11. Holding shares or Other Equity Instruments
12. Dormant
13. Others

Key Points for Consideration (Table 2)

- All the constituent entities to be listed tax jurisdiction wise
- In case jurisdiction of incorporation is different than the tax residence jurisdiction, jurisdiction of incorporation to be reported
- Main business activities performed by each constituent entity to be indicated
- In case the activity selected is 'Other', short description to be provided.
- Two additional columns - 'TIN' and 'Address' mandatorily required as per OECD xml schema, but not included in Action 13 report.

Table 3: Additional Information

Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in Table 1 and Table 2 of the Country-by-Country Report

The disclosures are based on the facts of each case. Certain examples of Table 3 disclosures are provided below:

- Data source
- Reporting periods of constituent entities, if different from Group reporting year
- If tax refunds included in 'revenue' instead of deduction from 'income tax paid'
- Description of 'Other' activities selected in Table 2
- Whether any part year information is included (In case of mergers /demergers)
- Reasons in case Tax ID numbers of certain entities are not available
- Assumptions made with respect to computation of full-time equivalent employees
- If accumulated earnings include negative figures
- Exchange Rates
- Explanations about any inconsistencies on a year-on-year basis

Template note for source of information as per OECD Source of Information

Information has been obtained from the MNE Group's consolidation package with the exception of the following:

- [Specified items for jurisdictions 1, 2 and 3] were obtained from entity financial statements prepared in accordance with local GAAP.
- [Specified items for jurisdictions 4, 5 and 6] were obtained from regulatory financial statements prepared in accordance with local law.

- [Specified items for jurisdictions 2, 4 and 6] were obtained from internal management accounts.

Since the CbC report for [previous reporting fiscal year], the source of data used for [specified items for jurisdiction 4] has changed from [previous source] to [current source]. [Description of the reasons and consequences of this change].

General Guidance on contents required under CbC Report:

Data Source:

- Consolidation reporting packages or Statutory financial statements or Internal management accounts
- The source should be **consistent year on year;**

Currency

- CbCR should be in the stated functional currency of the MNE Group (e.g. AED or USD)
- Conversions, if any, should be made at average exchange rate during the year, with the source mentioned in Table 3

Year of data to be included in the CbCR

- For Ultimate Parent Entity–Group financial year
- For other constituent entities- Group financial year or local financial year immediately preceding the Group financial year. E.g. if Group financial year ends December 31, 2019, the financial year end for other constituent entities can be anywhere between Jan 1, 2019 to Dec 31, 2019.

Specific Guidance on contents required under CbC Report:

Specific guidance are being prescribed under respective contents of Table and detailed explanation available under the UAE CbC Reporting Legislation issued as:' Guidance on preparation and submission of reports'.

OECD resources for further information

The OECD resources updated from time to time, can be used as reference to ensure a consistent and standard approach to CbC Reporting across all implementing countries. The UAE CbCR legislation is broadly aligned to the OECD recommendations. However, it should be noted that in case of conflicts between the OECD legislation / guidance / resources and the UAE CbCR legislation, the UAE CbCR legislation takes precedence.

Impact of UAE CbCR legislation

Key Benefits:

- Reporting CbCR information to the UAE MoF (rather than to foreign tax authorities), thereby
- Extensive network of UAE exchange of information framework will ensure minimum secondary filing requirements in other jurisdictions
- Groups to get a bird eye view of operations through CbCR information, where risks can be identified and where Groups can take proactive steps to mitigate such risks preserving confidentiality on such (potentially sensitive) information to be within the UAE only

Key Challenges:

- Additional administrative and compliance burden, only for those UAE headquartered businesses that are not already subject to CbCR requirements elsewhere;
- Increased oversight from international bodies on how UAE headquartered groups conduct their businesses

It would be prudent for MNEs to ensure a robust and contemporaneous compliance in UAE with TP/BEPS (i.e., filing all the relevant forms in UAE relating to disclosure form and three-tiered documentation – local file, master file and CbCR). This is considering that non-compliance in itself could be viewed negatively by the tax authorities.

Also, it would be pertinent to ensure that the information disclosed in disclosure form, local file, master file and country-by-country report adequately factors a 360-degree view and supports the transfer pricing and other tax positions of MNEs and demonstrates the compliance of the MNEs with UAE and other countries transfer pricing regulations.

Chapter 19

BEPS Action Plan 8-10

This chapter covers the following:

- **BEPS Action Plan 8-10: Aligning Transfer Pricing Outcomes with Value Creation**
- **Transfer Pricing and Royalties and Services**
- **Business Restructuring**
- **Practical Example**

1. Introduction

As part of the BEPS package, the Action Plan 8-10 reports enhance the guidance on the arm's length principle to ensure that what dictates results is the economic rather than the paper reality. In this regard, the work under Actions Plan 8-10 seeks to align transfer pricing outcomes with the value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle.

The guidance provided under Actions 8-10 to determine the transfer pricing outcomes in accordance with the actual conduct of related parties in the context of the contractual terms of the transaction.

1.1 BEPS Action Plan 8-10[1]

The Action Plan 8-10 especially include adjustments of the OECD Transfer Pricing Guidelines and assure that transfer pricing outcomes are in line with value creation.

In glance, Action Plan-8,9 and 10 are explained below:

Action 8- Intangibles

Work under Action plan 8, consider transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.

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[1] BEPS Action Plan: https://www.oecd-ilibrary.org/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en

Develop rules to prevent BEPS by moving intangibles among group members. This will involve:

(i) adopting a broad and clearly delineated definition of intangibles;

(ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;

(iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and

(iv) updating the guidance on cost contribution arrangements.

Identifying Intangibles-

The guidance[2] defines an **intangible** for transfer pricing purposes as something that:

i) is not a *physical nor a financial asset;*

ii) is capable of being owned or controlled for use in commercial activities; and

iii) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. w

The broad definition is not dependent on accounting or legal definitions. A transfer pricing analysis should consider whether an intangible exists and whether it has been used or transferred. For example, not all research and development expenditure produces or enhances an intangible and not all marketing activities result in the creation or enhancement of an intangible.

'The availability and extent of legal, contractual or other protection' is not a necessary condition for an item to be an intangible, although it may affect the value of an item and the returns that should be attributed to it. Similarly, separate transferability is not a pre-requisite.

Specifically, intangibles for transfer pricing purposes include: patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts and government licences, licences and similar, goodwill and going concern value. Group synergies, market specific characteristics (e.g., local consumer purchasing power and location savings) and an assembled workforce are not intangibles as they are not owned and controlled by a single enterprise.

In transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in

[2] Chapter VI of the OECD's TP Guidelines for Multinational Enterprises and Tax Administrations

connection with the development, enhancement, maintenance, protection and exploitation of the intangibles and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value. While it may be appropriate to aggregate intangibles for the purpose of determining arm's length conditions for the use or transfer of the intangibles in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions. A thorough functional analysis, including an analysis of the importance of identified relevant intangibles in the MNE's global business, should support the determination of arm's length conditions.

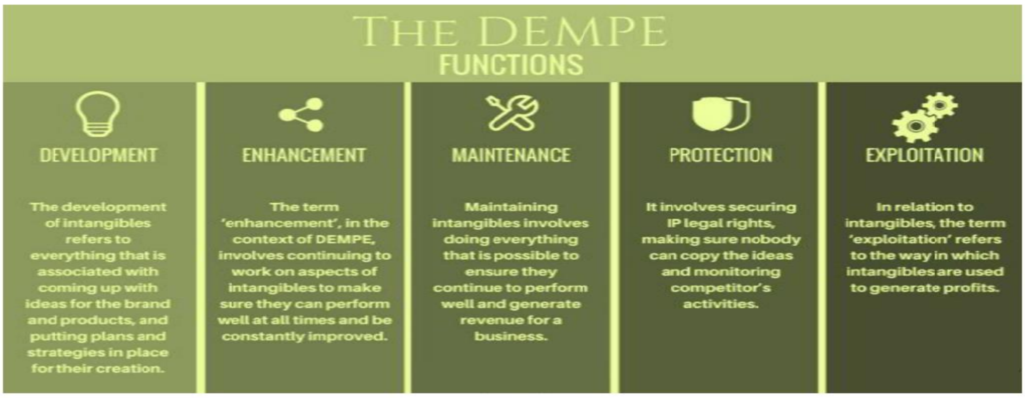
Categories of Intangibles

Certain categories of intangibles are, however, commonly referred to in discussions of transfer pricing matters. To facilitate discussions, definitions of two such commonly used terms, "marketing intangibles" and "trade intangibles".

- **Marketing Intangibles-** An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.
- **Trade Intangibles-** A commercial intangible other than a marketing intangible.

It should be emphasised that generic references to marketing or trade intangibles do not relieve taxpayers or tax administrations from their obligation in a transfer pricing analysis to identify relevant intangibles with specificity, nor does the use of those terms suggest that a different approach should be applied in determining arm's length conditions for transactions that involve either marketing intangibles or trade intangibles.

Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE functions)-



In transfer pricing cases involving intangibles, the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is crucial. A related issue is which entity or entities within the group should ultimately bear the costs, investments and other burdens associated with the development, enhancement, maintenance, protection and exploitation of intangibles. Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner's MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle. This section confirms that the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles according to the principles described in Chapters of OECD Guidelines.

The framework for analysing transactions involving intangibles between related parties and/ or connected persons requires taking the following steps:

Step 1: Identify the intangibles used or transferred in the transaction with specificity and the specific economically significant risks associated with the development, enhancement, maintenance, protection, and exploitation of the intangibles;

Step 2: Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts, and other indicia of legal ownership, and the contractual rights and obligations, including contractual assumption of risks in the relations between the related parties and/ or connected persons;

Step 3: Identify the parties performing functions, using assets, and managing risks related to developing, enhancing, maintaining, protecting, and exploiting the intangibles by means of the functional analysis, and in particular which parties control any outsourced functions, and control specific, economically significant risks;

Step 4: Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assuming economically significant risks, controls the risks and has the financial capacity to assume the risks relating to the development, enhancement, maintenance, protection, and exploitation of the intangibles;

Step 5: Define the actual controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles, the other relevant contractual relations under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets and risks, taking into account the framework for analysing and allocating risk. under Chapters of OECD Guidelines;

Step 6: Where possible, determine arm's length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed, unless the guidance provided in the Chapters of OECD Guidelines.

Transactions involving the use or transfer of intangibles-

In addition to identifying with specificity the intangibles involved in a particular transfer pricing issue, and identifying the owner of such intangibles, it is necessary to identify and properly characterise, at the beginning of any transfer pricing analysis involving intangibles, the specific controlled transactions involving intangibles.

There are two general types of transactions where the identification and examination of intangibles will be relevant for transfer pricing purposes. These are: (i) transactions involving transfers of intangibles or rights in intangibles; and (ii) transactions involving the use of intangibles in connection with the sale of goods or the provision of services

Supplemental guidance for determining arm's length conditions in cases involving intangibles-

After identifying the relevant transactions involving intangibles, specifically identifying the intangibles involved in those transactions, identifying which entity or entities legally own the intangibles as well as those that contribute to the value of the intangibles, it should be possible to identify arm's length conditions for the relevant transactions.

Evaluation of the Intangibles

OECD states that one-sided methods including the RPM and the TNMM, are generally not reliable methods for directly valuing intangibles as they usually allocate all residual profit, after a limited return to those providing the relevant functions, to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies and take these factors into account in determining the material contribution of each party to the creation of intangible's value, instead of purely split only in intangibles and routine functions. As such, OECD agrees that the transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method while valuation techniques can also be useful tools.

On the other hand, OECD recognized that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible. Under such circumstances, transactional profit split method and/or valuation techniques may be the most appropriate TP method to set the arm's-length price for the transactions involving intangibles. OECD reiterates that the application of the transactional profit split method should be in line with a full functional analysis that considers the functions performed, risks assumed and assets used by each of the parties over the supply chain.

Regarding the application of the valuation techniques, OECD points out that the following factors should be appropriately considered:

- Accuracy of financial projections;
- rates;
- Discount rates;
- Useful life of intangibles and terminal values;
- Assumptions regarding taxes; and
- Form of payment.

OECD further stresses that a price for a transaction involving intangibles can often be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimize resource allocations. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the criterion for non-recognition, or whether the conditions of the transaction should otherwise be adjusted.

Pricing Guidance on Intangibles of Highly Uncertain at the Time of Transaction and Hard-to-value Intangibles (HTVI)

OECD states that tax authorities should recognize the mechanism which independent taxpayers might also adopt for evaluating intangibles that is of highly uncertainty at the time of the transaction, which include:

- Adopt shorter-term agreements;
- Include price adjustment clauses in the terms of the agreement;
- Adopt a payment structure involving contingent payments to protect against subsequent developments that might not be sufficiently predictable; and
- Re-negotiation of the pricing arrangements when there is changes on fundamental assumptions for the pricing.

The use or transfer of intangibles may raise challenging issues regarding comparability, selection of transfer pricing methods, and determination of arm's length conditions for transactions.

The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between related parties and/ or connected person, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

Transactions involving the transfer or the use of HTVI may exhibit one or more of the following features:

- The intangible is only partially developed at the time of the transfer.
- The intangible is not expected to be exploited commercially until several years following the transaction.
- The intangible does not itself fall within the definition of HTVI but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.
- The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.
- The intangible, meeting the definition of HTVI, has been transferred to a related parties and/or connected person for a lump sum payment.
- The intangible is either used in connection with or developed under a Cost Contribution Arrangements (CCA) or similar arrangements.

OECD agrees that in these circumstances, the tax administration can consider ex post outcomes as presumptive evidence about the appropriateness of the ex-ante pricing arrangements. However, in circumstances where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, tax administrations will not be entitled to make adjustments to the ex-ante pricing arrangements based on ex-post outcomes.

Cost contribution arrangements (CCA)

Cost Contribution Arrangements (CCAs) are special contractual arrangements among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants. If contributions to and benefits of the CCA are not valued appropriately, this will lead to profits being shifted away from the location where the value is created through the economic activities performed.

Action 8 of the BEPS Action Plan covers the transfer pricing of intangibles and requires the development of rules to prevent BEPS by moving intangibles among group members without arm's length compensation, as well as an update to the guidance on CCAs.

Parties performing activities under arrangements with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed a CCA. The guidance ensures that CCAs cannot be used to circumvent the new guidance on the application of the arm's length principle in relation to transactions involving the assumption of risks, or on intangibles. The analysis of CCAs follows the framework set out in that guidance to ensure that:

- The same analytical framework for delineating the actual transaction, including allocating risk, is applicable to CCAs as to other kinds of contractual arrangements.
- The same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements.
- The analysis of CCAs is based on the actual arrangements undertaken by associated enterprises and not on contractual terms that do not reflect economic reality.
- An associated enterprise can only be a participant to the CCA if there is a reasonable expectation that it will benefit from the objectives of the CCA activity and it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks.
- Contributions made to a CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to non-arm's length results.

The OECD Guidance ensures that CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created.

Action 9- Risk and capital

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.

Work under Action 9 considered the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. Work under Action 9 also addressed the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.

The stated purpose of Action Plan 9 is to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The OECD dedicated extensive work to this issue, also because free capital movement and freedom of contract allows MNE's to easily shift capital and risks between group companies.

Action Plan 9 provides detailed guidance on:

i. The identification of economically significant risks,

ii. the determination of contractual allocation of these risks and

iii. the functions relating to these risks.

In order to have a clear picture on the before mentioned points, an exact and detailed functional analysis has to be performed. From a transfer pricing point of view, the risk should then be allocated to the party which controls the risk and has the financial capacity to assume the risk. Thus, it is essential identifying which entities have the capability to manage these risks, i.e. the functional substance (in other words: key personnel) of a company is crucial. A pure financing company, providing funding but not exercising control over the financial risks associated with the funding, is only entitled to a risk-free return.

Practical considerations

This means that contractual arrangements between affiliated entities will come under greater scrutiny. In line with the basic principle relevant when analyzing the ownership of intangible assets under Action Plan 8, also with respect to Risk and Capital the contractual agreement might form the starting point of the transfer pricing analysis, will however not be the decisive factor. Tax authorities are allowed to disregard the transaction for transfer pricing purposes if the contractual arrangement does not match the conduct of the parties.

As an example, affected arrangements could probably be Contract Research and Development ("R&D") Agreements, where a pure Funding Company is rewarded for the risk taking and capital endowment with the residual profit while the Contract R&D Company is remunerated on a cost-basis. If the Funding Company should not have the functional substance allowing to control the risk, tax authorities could reclassify the transaction as a pure finance transaction, granting a risk-free return to the Funding Company and allocating the residual profit to the Contract R&D Company.

From a practical point of view, it might thus be recommendable to accurately review actual contractual relationships within multinational enterprises under the guidance provided by Action Plan 9.

Action 10- Other high- risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to:

(i) *clarify the circumstances in which transactions can be recharacterised;*

(ii) *clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and*

(iii) *provide protection against common types of base eroding payments, such as management fees and head office expenses.*

Work under Action Plan 10, focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

Action 10 deals with details of Low Value-adding Intra-Group services, Commodity Transactions as well as the scope of work for guidance on the Transactional Profit Split Method. The Action Plan 8-10 should not be considered separately, but in fact in the entirety caused by the close link between them.

Low Value-adding Intra-Group Services

The Chapter of OECD Guidelines, introduces an elective, simplified approach for low-value adding services. On Low value-adding intra-group services of Chapter of the TP Guidelines provides guidance on achieving the necessary balance between appropriately allocating to MNE group members charges for intra-group services in accordance with the arm's length principle and the need to protect the tax base of payer countries. Simplified approach proposes which:

- Specifies a wide category of common intra-group services which command a very limited profit mark-up on costs;
- Applies a consistent allocation key for all recipients for those intra-group services; and
- Provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.

The approach aims to guarantee payer countries that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Moreover, the approach aims to guarantee that no overpricing takes place due to general agreement on the categories of costs included in the cost base and general agreement on the moderate mark-up of 5% that should be charged. Finally, the transparency of the approach makes clear to payer countries whether intermediary companies, that may have no or low functionality and may aim to inflate the intra-group service charges, have been interposed.

Intra-group services may vary considerably among MNE groups, as does the extent to which those services provide a benefit, or an expected benefit, to one or more group members. Each case is dependent upon its own facts and circumstances and the arrangements within the group. For example, in a decentralised group, the parent company may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in a centralised or integrated group, the board of directors and senior management of the parent company may make important decisions concerning the affairs of its subsidiaries, and the parent company may support the implementation of these decisions by performing general and administrative activities for its subsidiaries as well as operational activities such as treasury management, marketing, and supply chain management.

There are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle.

Commodity Transactions

Action Plan 10 covers additional guidance to Chapter of the OECD TP Guidelines and hereafter especially applicable to commodity transactions. The new guidance states that the Comparable Uncontrolled Price Method (CUP) is normally an appropriate transfer pricing method for commodity transactions between associate companies. The Report clarifies that the quoted prices obtained in public international or domestic markets can be used under the CUP method as a reference for the arm´s length price.

Moreover, the OECD alludes that a quoted price in this context also includes prices obtained from admitted and transparent price reporting or statistical agencies. In the case where there are differences between the conditions of the controlled and the uncontrolled transactions and where economically needed, pricing adjustments shall be performed. For documentation purposes especially with regard to Action 13 the taxpayer shall prepare a written document and include the price-setting policy of commodity transactions. Furthermore, a relevant factor for commodity transactions referred to the OECD Report is the pricing data or time period. Where the taxpayer can interfere reliable evidence of the pricing date agreed by the associated companies (e.g. contracts, proposals) and this is consistent with the actual conduct, tax administrations shall accept the price for the commodity transaction by reference to the pricing date. If the pricing date is inconsistent with the actual conduct, if there is no pricing date available or if the taxpayer does not provide reliable evidence of the pricing date, the tax administrations may consider the date of shipment or other equivalent document as substantiated. The work on this chapter is not finished yet. Further work mandated by the G20 Development Working Group are forthcoming.

Transactional Profit Split

Action Plan 10 underlines the importance of the clarification in application of the Transactional Profit Split Method in the context of global value chains. The scope of work contains the following topics:

- Most appropriate method (circumstances when the Transactional Profit Split Method is the most appropriate method)
- Highly integrated business operations
- Unique and valuable contributions
- Synergistic benefits
- Profit splitting factors
- Use of profit split to determine the TNMM range, royalty rates and other payment forms.

The revised Guidance on the Application of the Transactional Profit Split Method also released on June, 04 2018, main focus on the Implementation.

Detailed discussion on the transactional profit split method has been done under different chapter of study material.

2. Transfer Pricing- Royalties and Fees for Technical Services

In a globalised world, the transfer and sharing of intellectual property rights is crucial to the survival of modern industries and service sector in a highly competitive world. The present era is one in which capital is denoted by less of tangible assets like money and raw materials and more of intellectual property rights. An ideal tax system would be one which keeps abreast of technological developments having effect on it, all the while keeping a balance between providing maximum financial means to the Government and avoiding exploiting taxes on taxpayer.

The transfer pricing practice can cover not only goods and services but also intellectual property such as research, patents, and royalties. It can be used both domestically and across borders; when used internationally, it can take advantage of varying tax rates in different countries.

At this juncture, the pertinent questions would be having our tax system been mature enough to categorise and classify incomes arising by way of intellectual property and technology in accordance with time honoured principles of taxation or has it been befuddled by the intangible nature of the subject; and whether there is an effort by our taxation system to soften the rigours of taxation of cross-border journey of intellectual property.

Royalties arise from commercialization of intellectual property rights. Though Royalties and Fees for Technical Services (FTS) are often seen together in tax books as proverbial twins, there are some key differences between the two. While Royalty is associated with IPR, Fees for technical services are mostly associated with rendering of managerial, technical or consultancy services. The differences are more apparent if we consider what constitutes Royalties or FTS as per Tax Laws.

Royalties and Fees for Technical services arise from commercialization of intellectual property rights. The tax authorities are interested in classifying as much incomes as possible as royalties, because a fixed tax is imposed on royalties and fees for technical services; and taxpayer are interested in avoiding such classification since that which is not classified as royalty or fees for technical services is business income, which is taxed at a very low or nil rate.

Article 12 - Royalty and Fees for Technical Services

Article 12 deals with the law relating to the taxation of Royalties and Fees for Technical Services, which in some cases is also known as Fee for Included services and stated as below:

"1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-

mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."

For the purposes of this Article, the term "royalties" means:

a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work, including cinematograph films or work on films, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; and

b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than income derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic.

For the purposes of this Article, the term "fees for technical services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including the provisions of services of technical or other personnel) which:

a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment is received; or

b) are ancillary and subsidiary to the enjoyment of the property for which a payment is received; or

c) make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design.

The definitions of fees for technical services shall not include amounts paid:

a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property, other than property;

b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships, or aircraft in international traffic;

c) for teaching in or by educational institutions;

d) for services for the private use of the individual or individuals making the payment; or

e) to an employee of the person making the payments or to any individual or partnership for professional services as defined Article 15 (Independent personal services) of the OECD Convention.

The provisions of paragraphs (1) of this Article shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 (Business profits) or Article 15 (Independent personal services) of this Convention, as the case may be, shall apply.

3. Business Restructuring

It is highly essential for multinational enterprises to come up with different workable business strategies to compete in today's economy. One such strategy is business restructuring. Business restructuring is an activity wherein companies significantly modify their financial and operational aspects of a company. This tedious process requires proper documentation and might lead to changes in the Transfer Pricing model of the MNEs. Cross border transfer pricing leads to change in their Transfer pricing models eventually affecting their tax structure. Transfer pricing has become an important tax issues in the current globalized economy, especially for the tax administrators and taxpayers in terms of compliance. This is not only for the apparent tax revenue collection that may be affected but also because transfer pricing in itself is a complex procedure. Business restructuring is one area that can lead to great transfer pricing issues since it involves allocation of taxable profits for multinational enterprises and the countries in which the MNE has its enterprises.

Business restructuring- Transfer Pricing Perspective

There is no general or legal definition for the term business restructuring. From a transfer pricing perspective, business restructuring maybe said as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. It can also involve cross-border transfers of valuable intangibles. Business restructuring may also or alternatively involve the termination or substantial renegotiation of existing arrangements. A business restructuring typically leads to a reallocation of profits among the members of the MNE group, either immediately or in the future. Business restructurings can also be inclusive of the rationalisation, specialisation or de-specialisation of operations including the downsizing or closing of operations. The OECD Transfer Pricing guidelines recognize the methods by which business restructuring can be carried out.

A controlled transaction that leads to the cross-border reorganisation of the commercial or financial relations between related parties and/ or connected persons. For instance,

- The conversion of a full-time manufacturer into a contract manufacturer can be said to be a reorganisation for this matter.
- Amalgamation or merger of two related parties to form a single entity or demerger of a business unit of an enterprise with a related parties;

- A business restructuring for the purpose of transfer pricing could also involve cross-border transfers of something of value, even if it is not always the case,
- Termination or substantial renegotiation of existing arrangements
- Change in pricing policy, for example, change in mark-up on operating cost from 20% to 15% Change in remuneration model.
- Renewal of agreement with alterations in terms and conditions.

In analyzing if the business restructuring activities are relevant from the transfer pricing perspective, the following aspects may be considered by the taxpayer:

i). Reallocation of profit potential- upon reallocation of the profit potential, a compensation payment to the entity giving up such potential by means of transferred functions and/or risks may be warranted.

ii). Transfer of something of value- a transfer of something of value maybe a tangible asset, intangible asset and even transfer of rights of such assets

iii). Termination of existing agreements- If agreements are terminated or renegotiated to the harm the restructured party, an assessment whether an indemnification needs to be paid to ensure arm's length conditions must be effected in this regard. Hence, along with the terms and conditions of agreements between related parties, any change, renegotiation or termination of such contracts should also be carried out under arm's length conditions.

The OECD Model Convention on business restructuring

Article 9 of the OECD Model Tax Convention deals with adjustments to profits made for tax purposes between associated enterprises *(for UAE CT Law reference, read as related parties and/or connected persons)* on the arm's length terms. Business restructuring is accompanied by the reallocation of profits among the members of the MNE group either immediately or for a few years. The OECD guidelines insist that the arm's length principle and the Guidelines do not apply differently to restructuring or post restructuring transactions than to transactions that were structured as such from the beginning.

The OECD, in its report, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, provides strategies for the application of the arm's length principle for enterprises in terms of business restructuring. Analsying transfer pricing of business restructuring primarily involves accurately delineating the transactions that account for business restructuring by identifying the financial and commercial relations. This is then followed by looking into the conditions attaching those relations that lead to a transfer of value among the members of the MNE group. Such business transaction must be carried out according to the arm's length principle. The arm's length principle is an important tool for MNE and tax administrations when dealing with international taxation issues within the Transfer

Pricing area. The main purpose of applying the arm’s length principle is to find transactions between independent enterprises so called comparable uncontrolled transactions and determining if they differ from the controlled transactions found between related parties and/ or connected persons, even if there are no comparable transactions, a comparability analysis still needs to be performed in order to determine what independent enterprises would have done if they had been in a similar situation. The arm s length principle does not require compensation for a mere decrease in the expectation of an entity s future profits or for a mere transfer of FAR. The question of an exit charge arises only where there is a transfer of something of value –rights or other assets or a termination or substantial renegotiation that would be compensated between independent enterprises in comparable circumstances.

The onset delineating the transactions comprising the business restructuring between the MNEs is when the conditions of the business restructuring have been formally agreed in writing by the MNEs. The terms in the contract may describe the roles, responsibilities and rights of the restructured entity under the pre restructuring arrangement including the relevant situations that existing under contract and commercial law and the extent and manner to which those rights and obligations change due to the business restructuring that is carried out. However, where there are no written terms, or where the facts of the case and the conduct of the parties differ substantially from the terms agreed between them, the actual transactions comprising the business restructuring must be inferred from the facts as established, including the conduct of the parties. The focal point is what the parties actually do, their capabilities, and the type and nature of assets used or contributed by the parties in a pre-restructuring and post-restructuring situations.

The UN Practical Manual on Transfer Pricing (2021) is in line with the OECD Transfer Pricing Guidelines. The application of Article 9 of the UN Model Double Taxation Convention to business restructurings establishes that the arm’s length consideration for any kind of transaction be it a supply or acquisition or transfer of property is that which might reasonably be anticipated to be made between independent parties under an agreement dealing at arm’s length. Business restructurings predominantly affect developing countries. Recently, a number of large MNEs have either:

i) transferred their manufacturing facilities into low-cost countries, e.g. where the cost of labour of a skilled workforce is lower and/or

ii) similarly moved certain distribution functions and/or

iii) similarly moved valuable intangibles out of the jurisdiction where they were acquired, developed or exploited.

Article 27 of the Decree Law deals with the Business Restructuring Relief stated:

“1. No gain or loss needs to be taken into account in determining Taxable Income in any of the following circumstances:

a. *A Taxable Person transfers its entire Business or an independent part of its Business to another Person who is a Taxable Person or will become a Taxable Person as a result of the transfer in exchange for shares or other ownership interests of the Taxable Person that is the transferee.*

b. *One or more Taxable Persons transfer their entire Business to another Person who is a Taxable Person or will become a Taxable Person as a result of the transfer in exchange for shares or other ownership interests of the Taxable Person that is the transferee, and the Taxable Person or Taxable Persons that are the transferor cease to exist as a result of the transfer.*

2. Clause 1 of this Article applies where all of the following conditions are met:

a. *The transfer is undertaken in accordance with, and meets all the conditions imposed by, the applicable legislation of the State.*

b. *The Taxable Persons are Resident Persons, or Non-Resident Persons that have a Permanent Establishment in the State.*

c. *None of the Persons are an Exempt Person.*

d. *None of the Persons are a Qualifying Free Zone Person.*

e. *The Financial Year of each of the Taxable Persons ends on the same date.*

f. *The Taxable Persons prepare their financial statements using the same accounting standards.*

g. *The transfer under Clause 1 of this Article is undertaken for valid commercial or other non-fiscal reasons which reflect economic reality.*

3. For the purposes of this Decree-Law, where a Taxable Person applies Clause 1 of this Article, all of the following must be observed:

a. *The assets and liabilities transferred shall be treated as being transferred at their net book value at the time of transfer so that neither a gain nor a loss arises.*

b. *The value of the shares or ownership interests received under paragraph (a) of Clause 1 of this Article shall not exceed the net book value of the assets transferred and liabilities assumed, less the value of any other form of consideration received.*

c. *The value of the shares or ownership interests received under paragraph (b) of Clause 1 of this Article shall not exceed the book value of the shares or ownership interests surrendered, less the value of any other form of consideration received.*

d. *Any unutilised Tax Losses incurred by the Taxable Person that is the transferor prior to the Tax Period in which the transfer under Clause 1 of this Article completes may become carried forward Tax Losses of the Taxable Person that is the transferee, subject to conditions to be prescribed by the Minister.*

4. The provisions of this Article shall apply, as the context requires, where, in the case of a transfer under Clause 1 of this Article:

a. shares or ownership interests are received by a Person other than the Taxable Person that is the transferor;

b. shares or ownership interests are issued or granted by a Person other than the Taxable Person that is the transferee; or

c. no shares or ownership interests are received by the Taxable Person who is a partner in an Unincorporated Partnership that is treated as a Taxable Person under Clause 9 of Article 16 of this Decree-Law.

5. Where a Taxable Person transfers an independent part of its Business, paragraph (d) of Clause 3 of this Article shall apply only to those unutilised Tax Losses that can be reasonably attributed to the independent part of the Business being transferred.

6. The provision of Clause 1 of this Article shall not apply where, within (2) two years from the date of the transfer, any of the following occurs:

a. The shares or other ownership interests in the Taxable Person that is the transferor or the transferee are sold, transferred or otherwise disposed of, in whole or part, to a Person that is not a member of the Qualifying Group to which the relevant Taxable Persons belong.

b. There is a subsequent transfer or disposal of the Business or the independent part of the Businesses transferred under Clause 1 of this Article.

7. Where Clause 6 of this Article applies, the transfer of the Business or the independent part of the Business shall be treated as having taken place at Market Value at the date of the transfer."

4. Common MNE structure and Tax Planning in light of UAE CT Law and Transfer Pricing Provisions

The MNEs, as an institutional form, for governing transactions across borders, the opportunity to integrate knowledge from multiple geographic sources and the need to balance efficiency, flexibility and learning priorities. The structures of MNEs were initially designed to effectively implement set strategic priorities for internationalization. As MNEs mature and the world becomes more globalized, structural forms become less important, and decision processes, global project teams and individual cross-cultural skills become more critical.

Tax affects every business, for many companies, including multinational enterprises (MNEs), it is the single largest bill that they will pay each year. Where investments are made, how much is invested, how that investment is funded and where profits are recorded will all be influenced by the tax rates and tax systems faced by the MNE.

MNEs are able to plan their tax affairs by using a multitude of strategies to reduce their tax legally, which is known as “tax planning”. The term “tax planning” has recently become more widely used and is intended to encompass the broad range of activities undertaken by firms implementing a strategic approach to reducing their tax bill whilst staying within the bounds of what is legally acceptable. The terms “tax planning” and “tax avoidance” tend to be used interchangeably in the literature. **Tax Planning** means reducing tax liability by taking advantage of the legitimate concessions and exemptions provided in the tax law. It involves the process of arranging business operations in such a way that reduces tax liability. Example: Under Income Tax Act, 1961, Investment under section 54, 54EC etc. **Tax avoidance** means taking undue advantage of the loopholes, lacunae or drafting mistakes for reducing tax liability and thus avoiding payment of tax which is lawfully payable. Generally, it is done by twisting or interpreting the provisions of law and avoiding payment of tax. Tax avoidance takes into account the loopholes of law. Though it has a legal sanction, it means following the provisions of law in letter but killing the spirit of the law.

Profit and income shifting refer to the ability of MNEs to shift profits or income from higher to lower tax jurisdictions, thus eroding the tax base of the higher tax jurisdictions as outlined in the OECD’s Base Erosion and Profit Shifting (BEPS) work. Booking a greater share of their profits in low tax jurisdictions will consequently lead to a lower overall tax burden. Furthermore, tax competition between countries has intensified in recent years as countries compete to attract inward foreign direct investment (FDI). Tax rates have fallen across the OECD countries, which, combined with the continued availability of tax havens and/or Offshore Financial Centres (OFCs) have increased the opportunities for MNEs to profit shift.

Tax havens are defined as jurisdictions that offer the MNE a low or zero tax rate, stimulating MNEs to locate businesses there and thus reduce overall tax payments globally. OFCs or “conduits” refer to attractive intermediate destinations to transfer capital to other countries via the use of holding companies to manage interest payments or dividends without triggering taxation.

At the same time, for operational reasons, global value chains have become increasingly long and complex due to the organization of MNE activities. The rise of the digital economy and the multiplicity of locations used by MNEs provide more opportunities for profit shifting. As a consequence, corporate taxation and tax avoidance have been the focus of work from governments, international organizations and non-governmental organizations (NGOs).

The **key mechanisms used in MNE corporate tax planning** include the potential manipulation of transfer pricing in intra-company transactions, the use of internal debt in the capital structure, the location of economic activities, the use of tax havens and/or OFCs, the relocation of valuable intangible assets to low tax jurisdiction, and the accumulation of cash holdings in foreign subsidiaries.

Furthermore, some firm characteristics may also affect MNE tax avoidance aggressiveness include the degree of multinationality, size, profitability, the top management team.

Tax planning in UAE CT Law and Transfer Pricing Provision

MNEs are legally allowed to use the transfer pricing method for allocating earnings among their various subsidiary and affiliate companies that are part of the parent organization. However, companies at times can also use (or misuse) this practice by altering their taxable income, thus reducing their overall taxes. The transfer pricing mechanism is a way that companies can shift tax liabilities to low-cost tax jurisdictions.

To better understand how MNEs can tax planning, let's consider the following scenario:

An automobile manufacturer has two divisions: Division A, which manufactures software, and Division B, which manufactures cars. Division A sells the software to other carmakers as well as its parent company. Division B pays Division A for the software, typically at the prevailing market price that Division A charges other carmakers.

Let's say that Division A decides to charge a lower price to Division B instead of using the market price. As a result, Division A's sales or revenues are lower because of the lower pricing. On the other hand, Division B's costs of goods sold (COGS) are lower, increasing the division's profits. In short, Division A's revenues are lower by the same amount as Division B's cost savings—so there's **no financial impact on the overall corporation**.

However, let's say that Division A is in a higher tax country (example India, tax rate@ 30%) than Division B (example UAE, tax rate@ 9%). The overall company can save on taxes by making Division A less profitable and Division B more profitable. By making Division A charge lower prices and pass those savings on to Division B, boosting its profits through a lower COGS, Division B will be taxed at a lower rate. In other words, Division A's decision not to charge market pricing to Division B allows the overall company to evade taxes.

General Anti-Abuse Rules [GAAR] (Article 50)

Article 50 of the Decree Law deals with the General Anti Abuse Rules, states:

"1. This Article applies to a transaction or an arrangement if, having regard to all relevant circumstances, it can be reasonably concluded that:

a. *the entering into or carrying out of the transaction or arrangement, or any part of it, is not for a valid commercial or other non-fiscal reason which reflects economic reality; and*

b. *the main purpose or one of the main purposes of the transaction or arrangement, or any part of it, is to obtain a Corporate Tax advantage that is not consistent with the intention or purpose of this Decree-Law.*

2. For the purposes of this Article, a Corporate Tax advantage includes, but is not limited to the following:

a. *A refund or an increased refund of Corporate Tax.*

b. *Avoidance or reduction of Corporate Tax Payable.*

c. *Deferral of a payment of Corporate Tax or advancement of a refund of Corporate Tax.*

d. *Avoidance of an obligation to deduct or account for Corporate Tax.*

3. Where the provisions of this Article apply to a transaction or arrangement, the Authority may make a determination that one or more specified Corporate Tax advantages obtained as a result of the transaction or arrangement are to be counteracted or adjusted.

4. If a determination is made under Clause 3 of this Article, the Authority must issue an assessment giving effect to the determination, which may include:

a. *allowing or disallowing any exemption, deduction or relief in calculating the Taxable Income or the Corporate Tax Payable, or any part thereof;*

b. *allocating any such exemption, deduction or relief, or any part thereof, to any other Persons;*

c. *recharacterising for the purposes of this Decree-Law the nature of any payment or other amount, or any part thereof; or*

d. *disregarding the effect that would otherwise result from the application of other provisions of this Decree-Law, and can make compensating adjustments to the Corporate Tax liability of any other Person affected by the determination made by the Authority.*

5. For the purpose of determining whether this Article applies to a transaction or arrangement, the following must be considered:

a. *The manner in which the transaction or arrangement was entered into or carried out.*

b. *The form and substance of the transaction or arrangement.*

c. *The timing of the transaction or arrangement.*

d. *The result of the transaction or arrangement in relation to the application of this Decree-Law.*

e. *Any change in the financial position of the Taxable Person that has resulted, will result, or may reasonably be expected to result, from the transaction or arrangement.*

f. *Any change in the financial position of another Person that has resulted, will result, or may reasonably be expected to result, from the transaction or arrangement.*

g. *Whether the transaction or arrangement has created rights or obligations which would not normally be created between Persons dealing with each other at arm's length in respect of the relevant transaction or arrangement.*

h. *Any other relevant information and circumstances.*

6. In any proceeding concerning the application of this Article, the Authority must demonstrate that the determination made under Clause 3 of this Article is just and reasonable."

GAAR provision have been introduced under Article 50

In line with international best practice, the UAE CT Law includes GAAR under Article 50, which apply to transactions giving rise to a tax advantage where no valid commercial reason exists and where the tax advantage was the main or one of the main purposes of the transaction.

Where the GAAR applies, the Authority can make a determination that one or more specified CT advantages are to be counteracted or adjusted. If such a determination is made, the Authority must issue an assessment giving effect to the determination and can make compensating adjustments to the UAE CT liability of any other Person affected by the determination.

For the purpose of determining whether the GAAR applies to a transaction or arrangement, specific facts and circumstances should be analysed, such as form and substance of the transaction or arrangement, the manner in which the transaction or arrangement was entered into, the timing of the transaction or arrangement, whether the transaction or arrangement has created rights or obligations which would not normally be created between Persons dealing with each other at arm's length in respect of the relevant transaction or arrangement.

In any proceeding concerning the application of the GAAR, the Authority must demonstrate that the determination made is just and reasonable. Considering that GAAR aims to counteract any abusive tax arrangements, taxpayers should ensure that all their transactions have a bona fide business purpose and are properly documented.

Chapter 20

Potential Challenges in UAE CT and TP

This chapter covers the following:

- **Potential Challenges in UAE CT and TP**
- **Controversies**
- **MAP and APA**

1. Introduction

To cement UAE's position as an international hub for businesses and investments, on 9th December 2022, the UAE Ministry of Finance ('MoF') officially introduced a Corporate Tax ('CT') law under a Federal Decree -Law No. 47 ('The Decree') of 2022 on Taxation of Corporations and Businesses ('CT Regime'). The Decree is supplemented by Frequently Asked Questions (FAQs) to initially provide further details on specific matters pending publication of further guidance. Further guidance may be published in the form of Cabinet decisions and Executive Regulations. The new CT regime shall become applicable from 1 June 2023. Earlier, in April 2022, UAE MoF released a consultation paper to provide insight on the potential UAE CT regime.

With this introduction, UAE aims to reaffirm its commitment to meet international standards for tax transparency and to prevent harmful tax practices. MoF officially introduced a CT Law on Corporations and Businesses, resultant require maintenance of books of accounts and filing of returns with the authority on timely basis (specified under the UAE CT Law). To sustain in market, businessman be it individual or in the form of companies need to face challenges on how the CT Law will be implemented.

Potential Challenges in UAE Corporate Tax Law and Transfer Pricing

Corporate tax and transfer pricing disciplines are intertwined with each other in such a manner that no effective international tax strategy is complete without an in-depth understanding of the transfer pricing life cycle within MNEs.

In this chapter we will discuss, what are the potential challenges faced by a Taxable Person engaged in Business or Business Activities starting on or after 01 June 2023 on which corporate tax levied @9% exceeding AED 375,000.

Cross Functional Impact on a Business

At the outset, the new tax regime would certainly require a change in the mindset of the tax and finance department of any business. It will be important to examine any transaction or book entry from the point of view of CT from now on.

To some extent, businesses in the UAE generally geared up fairly robustly in the wake of the implementation of the value-added tax (VAT) and excise regimes.

Apart from the tax functions, the impact of the CT regime would also be felt in the general finance functions, supply chain functions, IT functions and legal functions. It will be imperative that the tax functions play an even more crucial role in driving the company's business decisions. Businesses will also be required to have a robust **record-keeping data** architecture in line with tax-data and tax-risk management best practices.

This is crucial for businesses because it can be foreseen that the UAE government will probably ensure that some of the tax technology related best practices from other countries be followed from the onset of the tax regime such as audits, compliances, assessments, etc.

Therefore, businesses would have to ensure that personnel are well trained and processes are well defined to be prepared for a digitally enabled tax function. Most importantly, businesses need to make sure that their data management is so robust that upon the onset of any regulatory change, the data can be conveniently shared with the Federal Tax Authority (FTA), rather than playing catch-up with the new rules.

Of course, it is not possible to know the extent to which the FTA would prioritize these functions while implementing the CT until more details emerge. Still, it is critical to be digitally enabled right from the start of the regime itself.

Companies must ensure that the mindset of tax professionals moves from a process-centric mindset (compliance, back-office activities, etc.) to a data-centric mindset (risk management, data management) to support business objectives.

Impact on Cost of Doing Business in UAE

In the UAE, the new headline CT rate is 9% for businesses generating a taxable income above AED 375,000, except for businesses located in the Free Zones that do not conduct business with the mainland. Separately, there will be another rate announced for those businesses which would fall under the scope of the OECD's Pillar Two reforms, i.e., multinational enterprises (MNEs) with global consolidated revenues above 750 million euros (AED 3.15 billion).

It must be appreciated that the 9% rate is still one of the most competitive globally. Even in the Middle East region, it is the lowest rate, not counting Bahrain which has still not introduced a CT regime. This would certainly reduce the impact of the tax on profit-making businesses in the UAE. It is also expected that the free zones will attract start-ups and scale-ups away from the mainland if they are profitable. This might, in turn, prompt even the free zones to drastically reduce charges like annual license fees, because of competition within the free zones to attract the maximum number of businesses. Indeed, exciting times lie ahead.

UAE CT and Transfer Pricing

With a TP regime in line with the OECD TP guidelines, the UAE will be part of a long list of countries that will adopt the arm's length principle. UAE has shown its commitment to introduce best practices of international taxation. UAE's infrastructure, political and economic stability and strategic location has always made UAE an attractive destination for investments, and a strong candidate for international hubs of MNEs. The implementation of a TP regime in line with OECD TP Guidelines strengthens UAE's position.

It is imperative to highlight that, UAE CT regime talks a lot about economic substance for availing benefits of various provisions. The regime also discusses specific and general anti abuse provisions. The same highlights UAE's commitment to the OECD's BEPS initiative. In our opinion, economic substance and transfer pricing is intertwined in the theme of UAE CT regime.

Accordingly, the implication of the new regime is far-reaching for MNEs doing business in UAE. MNEs will be required to gear up before the implementation of the new regime. MNEs are suggested to perform a high-level assessment of their Transfer Pricing Policies. For instance:

- Review the inter-company arrangement,
- Determine related parties and connected persons,
- Determine the transactions on which TP provision will apply,
- Prepare TP policy to ensure the inter-company transactions will meet the arm's length standard, etc.

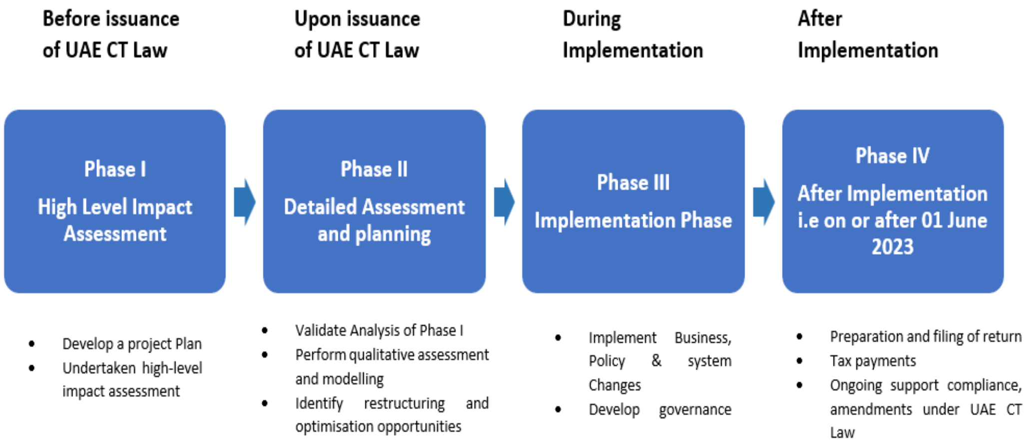
However, considering the short time frame left for implementation of the new regime, it is imperative to act fast on any measures that may be required to be implemented for effective TP Policies.

UAE Corporate Tax Implementation in the Businesses

The implementation of UAE CT Law should be well planned and documented out so that business can continue to function smoothly during and post implement.

How to proceed?

Implementation of UAE CT Law could be done in phased manner by a Taxable Person:



Phase I: Consist Impact Assessment i.e., High level assessment of the applicability of the CT regime on in-scope and exempt entities

Phase II: Consist Detailed Assessment on business based on final CT and TP regulations, review pricing of inter-company transactions and policies and highlight potential uncertain tax and TP positions.

Phase III: Consist Corporate Tax implementation includes following activities-

- Assistance in implementing Tax and TP policies and advising on structural changes to incorporate tax function.
- Evaluate and advise on system readiness
- Assistance in obtaining CT registration (individual or group)

Phase IV: Consist UAE CT compliance includes following activities-

- Assistance in preparation of CT return
- Assistance in filing of CT return electronically
- Assisting in preparation of TP local file/ master file/ CbCR (TP Documentation)
- Evaluate arm's length pricing of inter-company transactions

2. Controversies

Across the globe, transfer pricing disputes have increased following a waterfall of changes, e.g., BEPS, increased transparency, global compliance obligations, intangibility of value creation and digitized taxation. In the last couple of years, we have observed an increase in transfer pricing (TP) audits and disputes in many countries in the Middle East/ North Africa

(MENA) region, which have caught many MNEs by surprise, especially in countries where formal TP regulations are not in place yet.

The tax authorities in the region have increasingly been focusing on transfer pricing. The income tax legislations of most countries here require that transactions between related parties be at arm's length. In addition, Saudi Arabia, Qatar and Egypt have transfer pricing regulations already in place, requiring extensive documentation and compliance obligations. United Arab Emirates also recently introduced TP regulations, and we expect that many others will follow suit in the short to medium term.

Many disputes often start in another country/region and lead to a company in the region being asked to explain why it is in receipt of the 'residual profit,' especially if it has a zero corporate tax rate regime. Being able to articulate how each location contributes to value creation (and subsequent profit allocation) is critical in these cases, and this is typically achieved through a value chain analysis exercise. However, as digitization accelerates and technology evolves, attributing profit neatly to particular activities and jurisdictions becomes more difficult as organizations routinely work with digitized networks and dispersed workforces and customer bases.

TP audits and disputes in Oil & Gas and Infrastructure as well as in transactions involving goods and royalties are the most frequent ones we see originating from the MENA tax authorities (TAs). However, the local authorities are fast familiarizing themselves with other business models, thanks to the availability of TP documentation packages, and as such now launch enquiries confidently across other sectors. In some cases, a TP enquiry may lead to other enquiries e.g. WHT, Customs or VAT, or multi-faceted enquiries can start simultaneously. Although local TAs currently do not offer APAs as a solution, rulings can in some cases offer a degree of certainty to MNEs.

The MENA TAs have quickly learnt that transfer prices within arm's length ranges do not always lead to an arm's length result for the entity. For this reason, we are seeing an insistence from some TAs on understanding how the overall profit allocation to the local entity is commensurate with the functions, risks and assets of the entity and how it compares to the profit of other entities abroad in the same value chain.

Preparation of local TP documentation has not been a major issue for MNEs as the vast majority of them already had documented policies for the Group. Where we have seen nervousness from some taxpayers are in articulating their tax calculations and confirming that the policies were implemented as intended and documented. Processes and governance dealing with the annual TP cycle, as well as extraordinary events, e.g., restructurings, need to be part of good TP housekeeping for MNEs, and this certainly pays dividends when an audit or dispute arises.

3. Mutual Agreement Procedure (MAP) and Advance Pricing Agreements (APA)

3.1 Mutual Agreement Procedure [MAP]

Mutual Agreement Procedure is given in Article 25 of the OECD Model Tax Convention. MAP is the mechanism that Contracting States use to resolve any disputes or difficulties that arise in the course of implementing and applying the treaty. The MAP thereby ensures that these disputes will not frustrate the treaty's goal of preventing international double taxation. In order to achieve that goal, the competent authorities should make every effort to reach a timely agreement on each issue submitted to the MAP.

For example, the interest Article of a tax treaty may permit interest arising in one Contracting State and paid to, and beneficially owned by, a resident of the other Contracting State to be taxed in both these States, with the tax charged in the source State limited to an agreed-upon rate. Double taxation is then eliminated by the relief from double taxation Article, under which the residence State will generally allow a deduction or credit against its tax for the tax paid to the source State, to the extent that the source State properly taxed the interest income under the treaty.

Implementation of BEPS Action Plan there may be risk of uncertainty or unintended double taxation. The above issue should be resolved through proper implementation of tax treaties & resolution of disputes through MAP. BEPS Action Plan 14 making dispute resolution more effective through MAP.

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision. Successful MAPs also serve as precedence in case of subsequent applications

Article 25 of the OECD Model Tax Convention sets out three different areas where MAP are used (i.e. taxation not in accordance with the provisions of convention, interpretation and application of convention and the elimination of double taxation in cases not otherwise provided for in the Convention).

Paragraph 9 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by the competent authorities in resolving not only jurisdiction double taxation but also those of economic double taxation arising from transfer pricing arrangements.

Need for MAP

- MAP provides relief in cases of economic double taxation.
- MAP also provides relief in cases where automatic relief, such as tax credits, tax exemption etc. are not available.

Steps involved in the MAP application process

- Brief facts and background of the case must be summarized.
- Contention of the tax authority must be summarized in the application.
- The net tax and interest impact only by virtue of transfer pricing adjustment us computed.
- Take note of the transactions only relating to one country (in one application), e.g., USA, UK etc.
- All documents including tax returns, TP study, notices, submissions, order etc. must be furnished.
- Relevant juridicial precedence and their applicability to taxpayer's case must be demonstrated.

Drawbacks of the MAP process

- MAP may take too long to complete
- Taxpayer participation may be limited
- Time limit under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty.

Conclusions

While cross-border disputes have been raised, the Mutual Agreement Procedure is still underused, though the number of MAP cases has increased internationally. The chief reason it that it is due to the lack of understanding of the MAP process and perceived legal and practical obstacles. A critical defect of the MAP is that a taxpayer's participation is limited. Certain countries have signed up for compulsory arbitration under their MAP process. These countries may face higher pressure to resolve MAP cases because unresolved cases will be subject to binding arbitration by third parties. It is looked forward that the MAP process will become more effective as competent authorities interact more closely as a result of BEPS.

3.2 Advance Pricing Agreement (APA)

As per OECD transfer pricing guidelines, APA (or arrangements) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period. In other words, an APA is an agreement between board and taxpayer/ any person for determining ALP for specifying the manner of determining ALP in relation to international transaction.

Types of APA

The APA scheme envisages three types of APA:

- Unilateral APA
- Bilateral APA and
- Multilateral APA

Objectives of APA Program

The APA program is designed to:

- Reduce the risk of potential double taxation through bilateral and multi- lateral APA
- Reduce the burden of record keeping, as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement
- Impart flexibility in developing practical approaches for complex transfer pricing issues

Article 59 of UAE CT Law, states:

1. A Person may make an application to the Authority for a clarification regarding the application of this Decree-Law or the conclusion of an advance pricing agreement with respect to a transaction or an arrangement proposed or entered into by the Person.

2. The application under Clause 1 of this Article shall be made in the form and manner prescribed by the Authority.

In simple terms, A Person may make an application to the Authority for a clarification regarding the application of this Decree-Law or the conclusion of an advance pricing agreement with respect to a transaction or an arrangement proposed or entered into by the Person. Application form and manner prescribed by the Authority.