Stuart & Hamlyn

CHARTERED ACCOUNTANTS

Background

The Organisation for Economic Co-operation and Development (OECD) is a global Forum (having 140+ members countries) created in 1998. The OECD has been conducting reviews of preferential regimes in order to determine if such regimes could be harmful to the tax base of other jurisdictions. In 2015, the Base Erosion and Profit Shifting (BEPS project) was adopted to address two aspects: ***erosion of the tax base and profit shifting***.

BEPS 1.0 of OECD BEPS project: Under this project, the 15 final actions were published to equip governments with domestic and international rules to address tax avoidance,

BEPS 2.0 of OECD BEPS project has proposed – Pillar 1- allocation of taxing rights between jurisdictions and Pillar 2-Global minimum tax. Some member countries having no direct taxation announced Corporate Tax under Pillar 2.

Why UAE is introducing Corporate Tax?

Tax Transparency

Preventing harmful tax practices

Corporate Tax regime is based on international best practices, to strengthen the UAE’s position as a leading global hub for business and investment and accelerate the UAE’s development and transformation to achieve its strategic objectives.

UAE being member country of OECD projects has adopted proposal of Pillar 2 by announcing Corporate Tax on 31 January 2022.No reference was made yet to implement Pillar 1 proposals of OECD.

PCD covers ten (10) topics out of which three (3) topics are about “background of PCD” and rest seven(7) topics contain “proposals of CT for public comments”

When will the Corporate Tax regime become effective?

- The Corporate Tax regime will become effective for financial years starting on or after 1 June, 2023

Financial Year	Corporate Tax will be applicable from
June - May	01 June 2023
Jan - Dec	01 Jan 2024
Apr - Mar	01 Apr 2024

Slab Rate	Taxable Income
0%	up to AED 375,000;
9%	above AED 375,000

Example:

Tax on Income of AED 400,000

will be calculated as

Slab Rate	Taxable Income	Tax Amount
0%	up to AED 375,000	0
9%	above AED 375,000	AED2,250 Tax on AED 25,000 (i.e. AED 400,000 – AED 375,000)

- Source: https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-third-edition.pdf

Multinational enterprises (MNEs) with annual revenue over 750 million euros, under Global anti-Base Erosion Rules (Globe rules) Provide a global minimum tax of 15%.

Applicability of Corporate Tax in UAE.

Taxable Persons

NATURAL PERSONS - SCOPE

- Individuals engaged in business or commercial activity in the UAE

  a)Freelancers, sole establishments or proprietorships, partners in unincorporated partnerships
  b) Individuals earning 'business income'

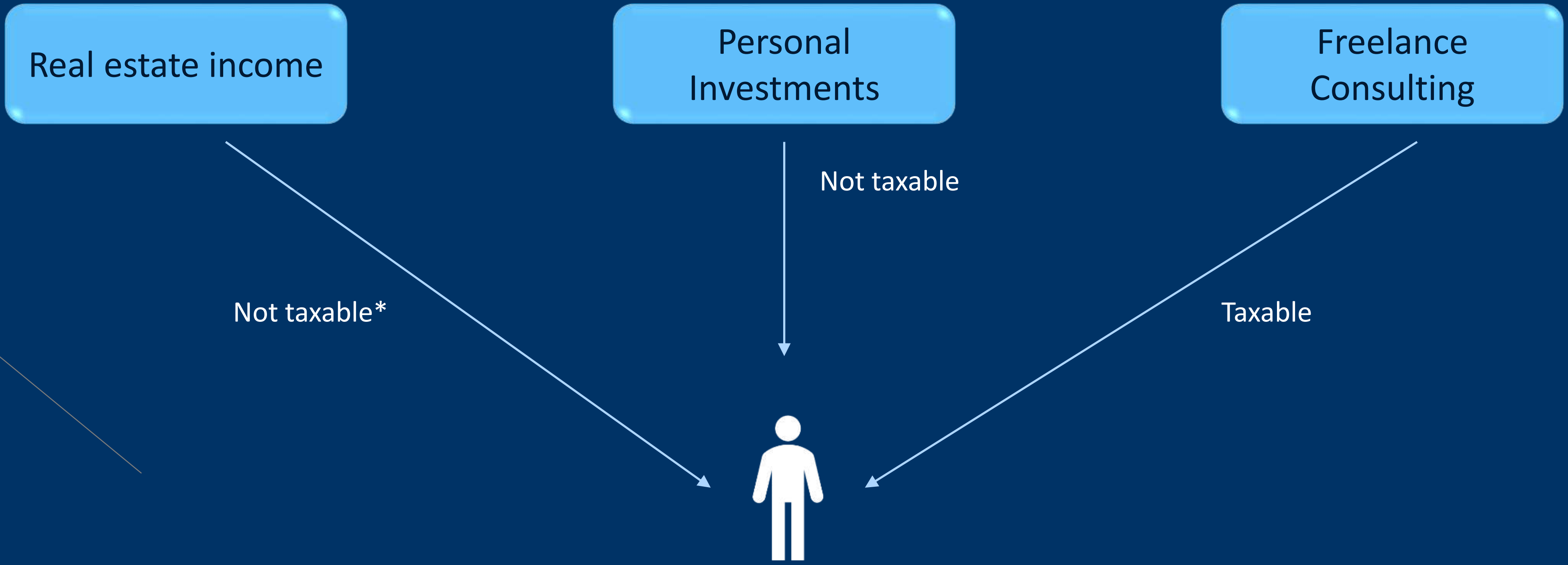
- When are you considered engaged in business?

  a)Requirement to obtain a Commercial license from the relevant competent authority
  b)Focus on DED license or FZ registration

- Exclusion: employment income, investment income, dividends, rental receipts, investments held through private/family trusts.

Taxable Persons

NATURAL PERSONS – INCOME IS SUBJECT TO CT



If not required to obtain a commercial license or permit

Taxable Persons

LEGAL PERSONS - SCOPE

- Legal entities incorporated in the UAE
  - a)Mainland entities
  - b)Free zone entities (no difference free zones’ and ‘financial free zones’)
- Foreign legal entities effectively managed and controlled in the UAE
- Foreign legal entities with a PE in the UAE
- Foreign legal entities earning UAE sourced income

Taxable Persons

LEGAL PERSONS – FISCALLY TRANSPARENT

- Limited and general partnerships, unincorporated JVs, associations of persons
- Domestic treatment: fiscally transparent, flow-through principle
  - Exception: no partners with unlimited liability
- Cross-border: align tax treatment with foreign jurisdiction

❖Following entities will be exempt from CT:

- The UAE Federal/ Emirate Government and their department, authorities or other public institutions
- A wholly owned Government-owned UAE company that carries out a sovereign or mandated activity, and that is listed in a Cabinet Decision
- A business engaged in the extraction of the natural resources that is subject to Emirate-level taxation
- A charity or another public benefit organization that is listed in a Cabinet Decision
- A public or regulated social security or retirement pension fund
- A regulated investment fund that has applied for an CT exemption
- UAE Real estate that are held through a private or Family trust on behalf of beneficiaries that are natural persons.

BASIS OF TAXATION- RESIDENCE BASED CT REGIME

Resident		Basis of Taxation
• Individuals carrying commercial activities in UAE	→	• Income from business or commercial activities in UAE
• Legal person incorporated in UAE • Foreign person controlled and managed from UAE	→	• Worldwide income

Non - Resident		Basis of Taxation
• Non-resident entities	→	• Income from a permanent establishment n UAE; and • UAE sourced income

Place of Effective Management

In order to understand the tax residential status of any company, it is important to briefly understand the concept of the place of effective management. The definition of place of effective management may mean a place where key management and commercial decision that are necessary for the conduct of the business of an entity as a whole are, in substance, made. The concept of the place of effective management is internationally accepted and various tax treaties entered speak about the concept of a place of effective management for the purpose of deciding the tax residential status of any company.

The activity threshold that will trigger a PE for a foreign company in the UAE will be determined by the following two main test: (Article 5 of the OECD Model Tax Convention)

- Fixed place of business test
- Dependent Agent test

Non-resident - UAE Permanent Establishment income

Fixed Place of Business test (FPB)

It is a place of management, a branch, an office (including temporary field office or employee's home office), a factory, a workshop, real property or building site where activities are carried on for over 6months and the same covers installations, structures used in the exploration of natural resources,mines, other places of extraction of natural resources, oil or gas wells.

Only exclusions are : Preparatory and auxiliary activities (like marketing related or seminar etc), storage for display or deliver goods etc.

Dependent Agent test (DA)

In the absence of a FPB, the activities of a so-called "Dependent Agent" in the UAE could still create a PE.

Who will be regarded as a DA of non-resident ?

UAE based persons or business travelers act on behalf of the foreign company in the UAE and have, and habitually exercise, the authority to conclude contracts in the name of foreign company.

Only exclusions are: An independent agent who carries business legally and economically in the ordinary course of their own business in the UAE and not working exclusively for the foreign company & Investment manager who provides discretionary investment management services to foreign customers.

Article 5 of the OECD Model Tax Convention--Principles

Paragraph 5(1)

As a primary criteria, fixed place of business will be considered as a PE

Paragraph 5(2)

This paragraph provides specific inclusion in a PE definition

Paragraph 5(3)

This paragraph provides when a building or construction or installation will be regarded as aa PE

Paragraph 5(4)

This paragraph provides specific exclusion in a PE definition

Paragraph 5(5)

Normally when dependent agent will be regarded as a PE

Paragraph 5(6)

Normally when independent agent will not be regarded as a PE

Paragraph 5(7)

This paragraph provides that holding-subsidiary relationship does not necessarily create a PE

Paragraph 5(8)

This paragraph provides when closely related enterprise will create a PE

Basis of Taxation

UAE SOURCED INCOME

- Subject to withholding tax at a rate of 0%
- Sourcing rules:

  a)Income earned from UAE resident person

  b)Payment attributed to UAE PE

  c)Income derived from activities/contracts performed in UAE, assets in UAE or rights used for economic purposes in UAE

- Same principles for mainland sourced income for FZ company

Our observations:

✓ The scope of CT regime in the UAE is wide and it has adopted a worldwide taxation basis. This means that CT will cover all sources of income earned from all over the world by a resident in the UAE with a few exceptions.

✓ Further, the scope of CT has been extended to cover foreign entities incorporated anywhere in the world but are effectively controlled and managed in the UAE (similar to Place of Effective Management concept under many foreign tax laws). This means that, foreign entities, for which key managerial and commercial decisions are taken in the UAE will be considered as residents in the UAE and will be taxed on their global income in the UAE. (There should have been a threshold to exempt small businesses for this purpose.)

It is interesting to note that foreign entities set up in tax havens (BVI, Cayman etc), which are effectively controlled in the UAE may now come under the scope of CT

The application of PE concept is generally challenging and prone to litigation. For instance, short term projects and activities conducted by foreign entities in UAE could be brought under the definition of fixed place PE by the tax authorities and thus subject to CT.

Residents of UAE conduct business by establishing legal entites outside UAE There is a possibility that these legal entity established outside the UAE may be taxable in both Jurisdictions and will have to determine the taxability based on the tie- braker rule of the Tax treaty between two jurisdictions Buisnessess established outside the UAE managed and controlled from the UAE may analyse the tax implications to optimise the tax expenses.

Extension of the concept of PE for a freezone to their mainland income is to be looked into and reviewed, especially in connection with income of the freelancer working from home / flexidesk options given by the freezones / employees of freezone person working from home etc. Though we expect further clarity in the final law on such situations, free zone persons working from mainland or working for mainland entities will have to lookout for tax implications on their transactions.

Tax implication for Free Zone

Topics Covered

- Who is a Free Zone Person (‘FZP’)?
- Applicability of Corporate Tax on Certain Transactions by FZP
- Impact on FZP

Importance of

Free Zones in the UAE

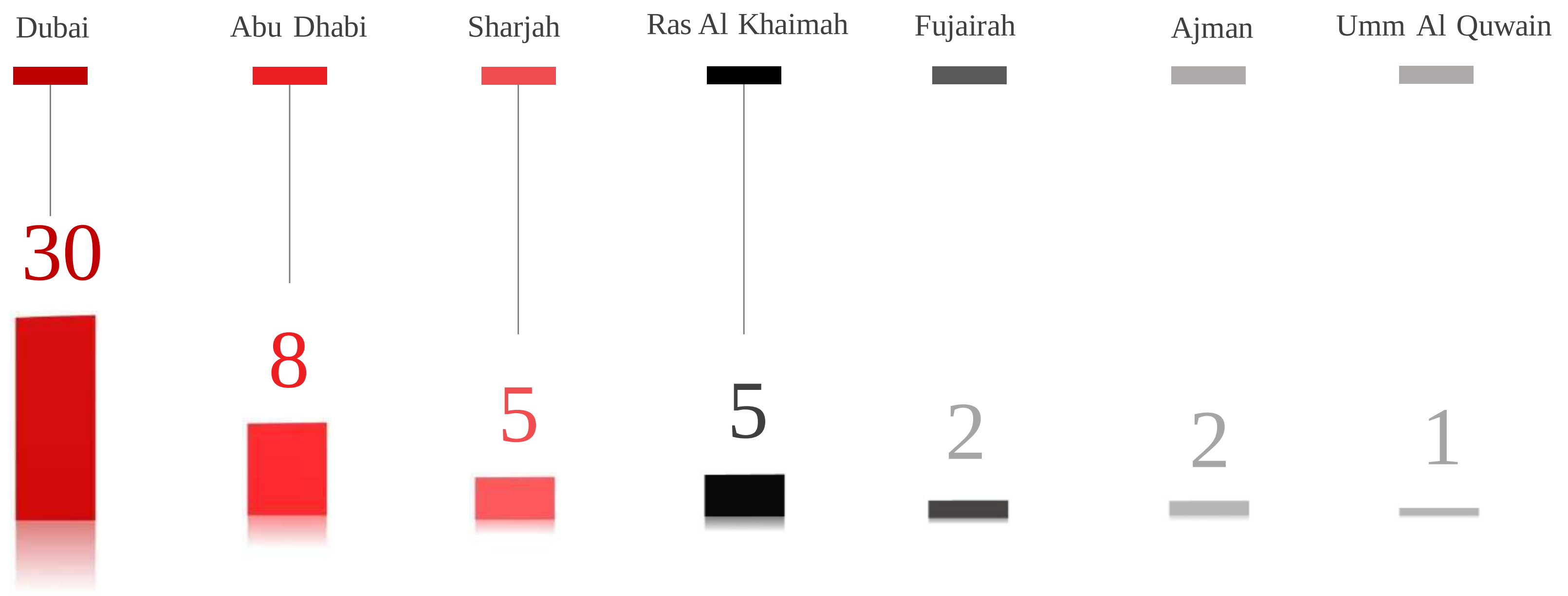
- Free Zones are important part of the UAE economy

- The UAE's National Economic Register (NER) said around **65,000 companies were registered** in the country's free-zones

- Free Zones the key sector - achieving the country's aim of encouraging **foreign direct investment**
- **Ease of doing business** is the most attractive part of Free Zones

Prepared based on the Public Consultation Document on UAE Corporate Tax released by the MoF on 28th April 2022

SPREAD OF FREE ZONES IN UAE



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Free Zone Persons

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FREE ZONE PERSONS

Who is a "Free Zone Person?"

Companies and Branches

registered in a Free Zone

Will all Free Zone Persons be eligible for Tax Benefits?

Free Zone Persons will be eligible for tax incentives of the Free Zone if it:

- Maintains adequate substance
- Complies with all regulatory requirements of Free Zone

Prepared based on the Public Consultation Document on UAE Corporate Tax released by the MoF on 28th April 2022.

FREE ZONE PERSONS

- Within the Scope of UAE CT
- Filing of Corporate Tax Return - MANDATORY
- Audited Financial Statements - MANDATORY
- Can elect to be subject to Regular Corporate Tax Rate - IRREVOCABLE

Applicability of Corporate Tax

On 10 types of Transactions Conducted by Free Zone Persons

Prepared based on the Public Consultation Document on UAE Corporate Tax released by the MoF on 28th April 2022

FREE ZONE

0%

Income earned from transactions with businesses located outside of the UAE

Outside of the UAE

2

0%

Income from
trading with businesses located
in the same Free Zone

0%

Income from **trading** **with businesses located in another Free Zone**

Prepared based on the Public Consultation Document on UAE Corporate Tax released by the MoF on 28th April 2022.

DESIGNATED
ZONE

0%

Income from the sale of goods to the UAE mainland businesses that are importer on record of those goods.

MAINLAND

FREE ZONE

MAINLAND BRANCH

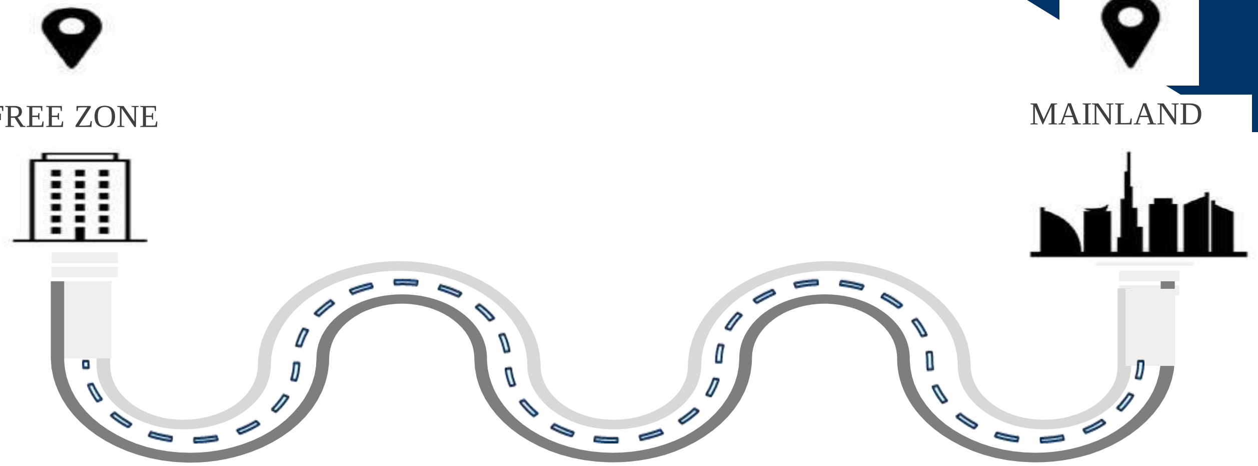
0%

Other Income earned by Free Zone Person

A Free Zone Person that has a branch in mainland UAE

9%

Mainland Sourced Income of the Branch



Income from transactions with Group Companies in the Mainland

0%

Income earned by Free Zone Person

?

Payment made by Mainland Group entity to FZP– Non-deductible Expense

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0%

Income from certain regulated financial services directed at foreign markets

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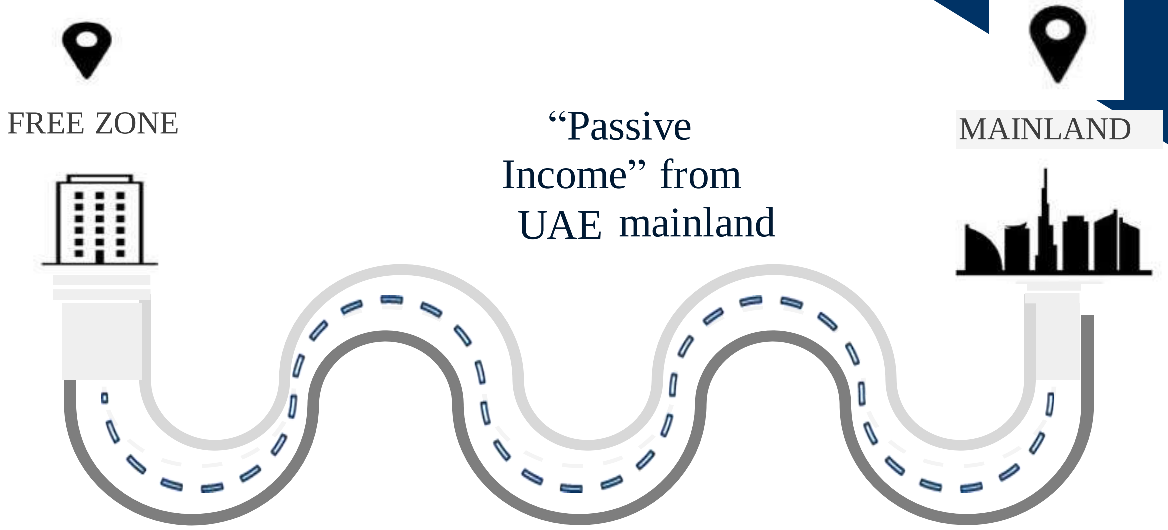

0%

“Passive Income” includes interest, royalties, and dividends and capital gains from owning shares in mainland UAE companies

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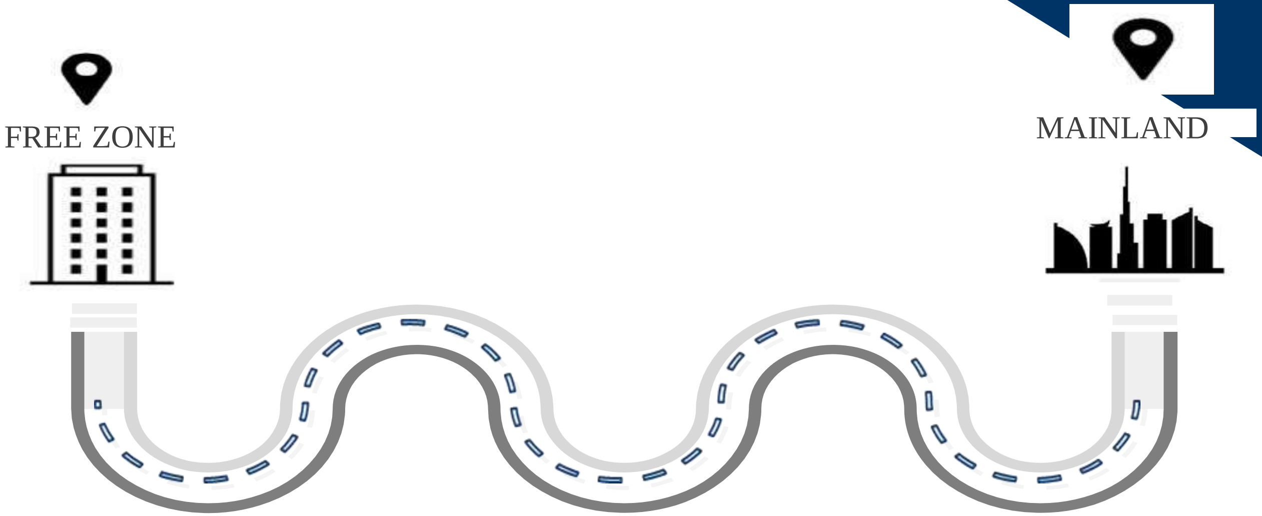

9%

If Free Zone Person has a PE in the mainland

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DISQUALIFY FROM 0%

If the Free Zone Person earns any other mainland sourced income[other than explained 9 cases]

Impact on Free Zone Persons

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IMPACT ON FREE ZONE PERSONS

01 Large MNEs' may have to pay higher rate of tax

02 Service sectors in the FZ

03 Who is a FZP ? - companies and branches that are registered in a Free Zone called "Free Zone Persons"

04 Free Zone Entity supplying to mainland group entity – Huge cost for the group entity

05 Evaluation of PE implications of FZPs conducting business in mainland

06 PE Implications for freelancer/sole owner of Free Zone business conducting business from mainland

07 Offshore Companies - properties in mainland and earning rental income

08 High Sea Sales - Mainland Vs. FZP

Our observations:

- ✓ Free zones companies that operate in mainland UAE through a branch will be taxed at the regular CT rate on its mainland sourced income. This means that Free zones companies will now have to maintain separate books of accounts for its branch pertaining to its mainland sourced income and allocate expenses accordingly.
- ✓ Also, free zones persons that transact with mainland without a branch and who wish to benefit from 0% CT regime will now have to consider setting up a branch in mainland for its mainland sourced income.
- ✓ Further, a considerable number of corporates in mainland will be affected as the they make extensive purchases from their group companies registered in Free zones and such payments will be not be allowed as a deduction under CT.
- ✓ One will need to review the Business models and revisit some of the existing structures
- ✓ The business will need to be in freezone for its business outside UAE or within freezone and need to have separate mainland entities to conduct business with Local entity. Any internal transactions could also pose the risk of benefit being withdrawn

Exemptions

There are also certain incomes which are specifically exempted-

➢ **Dividends and capital gains**:

- All **domestic dividends** earned from UAE companies will be exempt
- Dividends paid by **foreign companies** and capital gains from sale of shares in both UAE and foreign companies earned by a UAE business will be exempt from UAE CT subject to qualifying shareholdings (5% and above) and taxation of foreign subsidiary at minimum rate of 9%.

➢ **Foreign branch profits:** In line with the UAE double tax treaties, UAE companies can follow either of the following methods with respect to their foreign branch profits:

- Elect to claim exemption for their foreign branch profits (only if foreign branch is subject to a sufficient level of taxation) or
- Claim a foreign tax credit for taxes paid in foreign jurisdiction

➢ Income earned from operating or leasing aircrafts or ships used in international transportation by a non-resident subject to reciprocity principle

Our observations:

✓ The exemption in relation to dividend and Capital gains is a welcome step. The conditions attached that those dividend or capital gains are in relation to subsidiary which is being taxed at minimum 9% tax rate also brings in availability of benefits where income has already been subjected to tax.

✓ One would need to revisit the investments made through tax heavens as those will not be able to enjoy this exemption.

Transfer Pricing

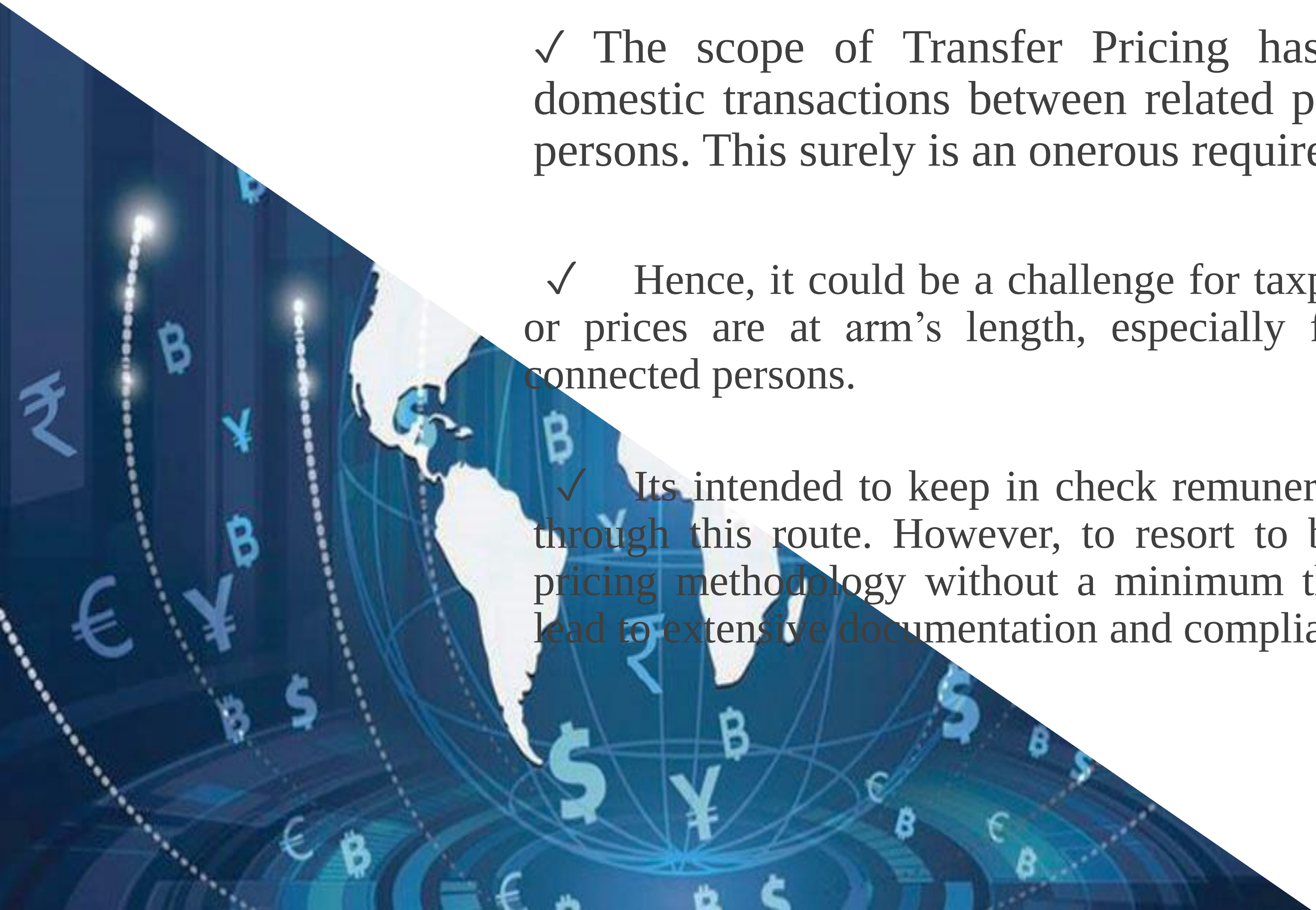
- ➢ The CT regime will have transfer pricing rules applicable to domestic as well as international transactions between “Related Parties” and “Connected Persons”

- ➢ Businesses will need to comply with transfer pricing rules and arm’s length principle as set out in the OECD Transfer Pricing Guidelines

- ➢ The arm’s length price will be usually determined using one of a set number of internationally recognized methods

- ➢ Business will have to maintain appropriate documentation including master and local files (as specified under OECD BEPS Action 13) where arm’s length value of their related party transactions exceeds a certain threshold (to be specified in due course)

Our observations:



✓ The scope of Transfer Pricing has been extended to cover domestic transactions between related parties as well as connected persons. This surely is an onerous requirement.

✓ Hence, it could be a challenge for taxpayer to justify if the quantum or prices are at arm's length, especially for transactions pertaining to connected persons.

✓ Its intended to keep in check remuneration to directors and owners through this route. However, to resort to benchmarking as per transfer pricing methodology without a minimum threshold being applied could lead to extensive documentation and compliance burden on tax payer.

Calculation of CT payable and Deductions

➢ The starting point for calculation of CT payable will be accounting **net profit (or loss)** (amount reported in the financial statements prepared in accordance with accounting standards acceptable in the UAE)

➢ Business will use their financial accounting period as their tax period

➢ CT will be charged on the annual taxable income of a business as follows-

Taxable Income	Applicable Tax Rate
Up to AED 3,75,000	0%
More than AED 3,75,000	9%

Payments made to 'connected persons' have been incurred wholly and exclusively for business purposes and Transfer pricing rules shall be a challenge.

- Cap on Interest expenses to 30% of EBITDA (As per action 4 of BEPS)
- Cap on Entertainment expenditure – 50% of the expenditure.
- NO deduction – Penalties, VAT recoverable, Donations to unapproved charities.

Tax Groups

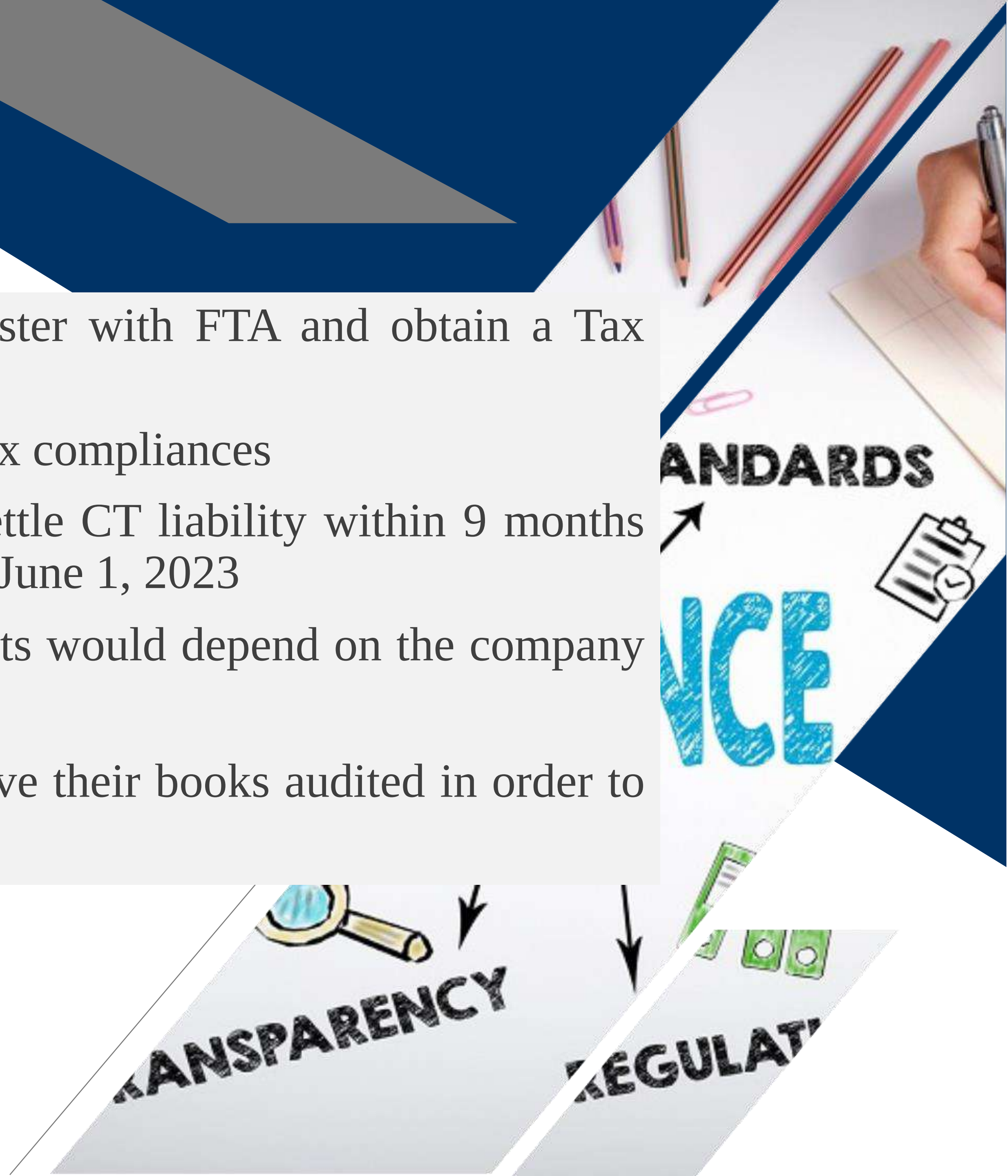
- If the parent holds 95% of the share capital & voting rights.
- Neither the parent, nor the subsidiary can be an exempt person, Free zone person that enjoys 0% CT.
- All group members should have same FY.
- Subsidiaries indirectly owns 95% can be part of the tax group.
- Apply to FTA for forming a tax group.
- Need to prepare a consolidated FS for the tax group.

Losses and Regrouping Relief

- ➢ Businesses will be allowed to offset losses of one period as against taxable income of a future period. However, the maximum loss which can be set off will be capped to 75% of the taxable income
- ➢ Losses will be allowed to be carried forward indefinitely subject to certain conditions
- ➢ Group companies (holding at least 95%) can elect to form a ‘Tax Group’ to optimize overall compliance and tax cost
- ➢ Group companies (holding at least 75%) will be allowed to transfer losses from one group company to another profitable group company subject to certain conditions
- ➢ Restructuring or Reorganising within a group (eg. merger) will be considered tax neutral on fulfillment of certain conditions. Such relief will be ‘clawed back’ if conditions are violated.

CT Compliance

- ➢ Any person subject to CT will need to register with FTA and obtain a Tax Registration number
- ➢ There will be no advance tax or withholding tax compliances
- ➢ Taxpayers will have to file CT returns and settle CT liability within 9 months from the end of relevant tax period, starting from June 1, 2023
- ➢ The requirement of audited financial statements would depend on the company laws and regulations as applicable to a business
- ➢ Free zones will be mandatorily required to have their books audited in order to benefit from the 0% CT regime

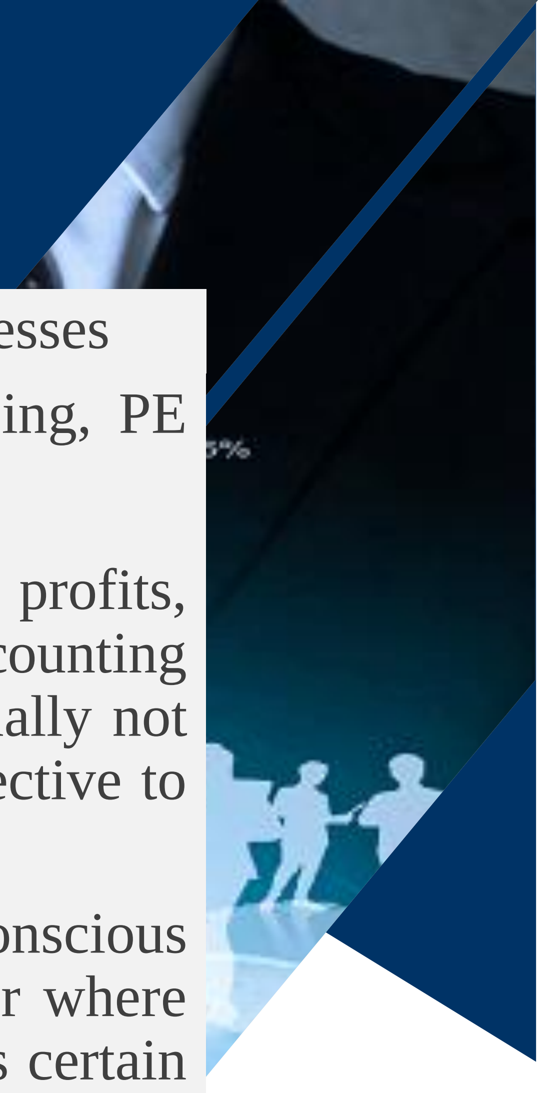


Summary

✓ While the intent is to keep compliance simple and provide relief to small businesses – some of the provisions if implemented as it is e.g. domestic transfer pricing, PE determination, etc. could be more cumbersome and prone to litigation.

✓ Its very positive that there are minimum adjustment between book and tax profits, however there should have been a basic consistency in either adoption of accounting policy or certification requirements to ensure that tax payers who are intentionally not availing undue benefit by frequently changing accounting policies with an objective to report lower profits on regular basis.

✓ Since Freezone Person can avail 0% CT regime – there will be conscious reorganization of businesses to divide their business and organize in a manner where such benefit could be availed. The current manner of providing this benefit has certain shortcomings.



Way Forward

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REVIEW STEPS

Prior to Implementation of Corporate Tax

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REVIEW - prior to implementation of CT

8 STEPS

1. Review of legal structure of the entity
2. Study on election to form Tax Group
3. Review of transactions between ML & FZ
4. Review of inter/intra group transactions
5. Review of Pricing due to applicability of TP on Related Party Transactions
6. Identifying the disallowable expenses
7. Special attention to ‘Connected party’ Transactions
8. Bottom line profitability impact assessment

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METHODOLOGY ADOPTED

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METHODOLOGY WE ADOPT

01	02	03	04
Initial Review	Detailed Review and Impact Assessment	Guidance for Implementation	Ongoing support
Now	After issuance of the Corporate Tax Law & Regulations	Before Corporate Tax Effective Date	After Effective Date of Corporate Tax

Scope of work

Scope of work	Steps	Deliverable
Step 1. Preliminary analysis about CT impact on your Entity	UAE CT law/regulations are yet to be published. Prior to the issuance of the CT Law, S&H will analyse the impact of the introduction of CT to the target entity. The analysis would cover the following: • Prepare an information Requested List (IRL) and review information provided. The information requested may include the following: o Copy of the document incorporation in you're the territory you are incorporated and the exemptions granted. o Copy of Trade license o Copy of latest financial statement. • Analysis of potential implication for your entity from the introduction of CT in the UAE. Our analysis would cover the following: o Treatment of FZ as per the FAQ: ▪ Applicability of CT as a main rule ▪ Possibility to continue benefiting from current exemptions and requirements o Based on our conclusions, we will comment on the compliance obligations of your entity o High-level comments on material risks identified that may affect your entity Tax position once the CT Law is published.	A detailed report, considering our findings about the CT impact based on the FAQ published by the ministry .

Cont’d..

Scope of work	Steps	Deliverable

Step 2: Update analysis once CT Law is introduced	Once the CT Law is issued, we will review the relevant provisions and update the analysis made in Step 1. Under this step, we shall update our conclusion as per the CT Law once the law is published. Our work at this step will depend on the actual provisions of the CT Law, However, it would preliminarily include the following:
	
	• Review the relevant provisions and determine how these would affect the Step 1 conclusions
	• Update our Step 1 analysis. This may include the following:
	  ○ Verify that your entity meets the conditions required by the CT Law for the applicability of FZ exemption.
	  ○ Conclusion 1-If it is concluded that your entity would be able to benefit from the exemption, we would comment on any resulting obligations such as:
	▪ Registration and compliance obligations
	▪ Maintaining books and records, as well as any other supporting documentation that may be required to support that status as a FZ exemption
	▪ Any other obligation set forth by the CT Law
	  ○ Conclusion 2- If it is concluded that entity will not benefit from the FZ exemption, we will need to perform a more comprehensive assessment to determine the impact as a separate assignment and a separate proposal shall be submitted.
		Our deliverable will be in the form of an update impact Assessment Report (Conclusion 1.)

Review now and be prepared well in advance.

cument on UAE Corporate Tax released by the MoF on 28th April 2022

Disclaimer:

It would be pertinent to highlight that these are initial thoughts. Further, since the draft is public consultation document and not law, we have not yet delved into this from Interpretation perspective as various words and terms are mentioned in generic sense and without proper definitions. This could have significant impact on some of the observations made above. This document is only an attempt to highlight likely impact based on our experience and may not be used as a basis for a particular set of facts and any of these should not be applied generally.

Thank You!

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