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TRANSFER PRICING ALERT

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UAE Transfer Pricing Guide

Overview

The Federal Tax Authority ('FTA') has released the Transfer Pricing Guide ('TP Guide') which has been designed to provide detailed guidance to the Taxpayers and address common questions that businesses might have regarding the UAE Transfer Pricing ('TP') Regulations.

In detail

The TP Guide provides a detailed background on the concept of Transfer Pricing, its scope (i.e., Transactions as well as Persons covered under the ambit of UAE TP regulations) and the manner in which UAE businesses can implement TP policies. The TP Guide emphasises on the fact that, in order to be compliant with the 'Arm's Length Principle' ('ALP'), any transaction between Related Parties or Connected Persons should be reflective of 'Market Price', similar to that undertaken between independent parties.

It has been clarified that TP rules not only apply to MNE groups but also to domestic groups (including free zone entities), with no presence outside UAE. Further, UAE businesses are required to ensure arm's length pricing of all related party transactions. However, TP compliance and documentation would only be required subject to meeting the prescribed thresholds.

Application of ALP

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

- **Step 1** – Identify related parties, connected persons, relevant transactions and arrangements and perform a comparability analysis
- **Step 2** – Selection of the most appropriate TP method
- **Step 3** – Determination of arm's length price

Related Parties and Control

With respect to the additional clarification in identifying the relationship between entities, the TP Guide cites examples of 'control through significant influence' being exercised by way of the following arrangements:

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

Dhruva Analysis

The examples on 'control through significant influence' clearly demonstrate that the intention of Law is not merely restricted to establishing relationship by means of voting, share of profit or determining the composition of the board, but is much wider in its scope and needs to be comprehensively analysed on a case-to-case basis.

Benchmarking requirement and TP methods

With reference to undertaking a comparability analysis, the TP Guide emphasises on the importance of conducting a detailed Functions, Assets and Risk based analysis ('FAR analysis'), to accurately delineate the controlled transactions. The TP Guide also provides for practical guidance with respect to undertaking a FAR analysis and the steps involved in applying the various TP methods.

Tabulated below are some keys aspects related to benchmarking requirement and TP methods:

- **Local vs. regional comparables:** Order for identifying comparables must be followed by the Taxpayer (i.e., Domestic, Regional (Middle East) and then Foreign comparables), subject to necessary adjustments to account for geographic and other differences.
- **Single-year vs. multiple year analysis for benchmarking:** Multiple-year analysis for comparable companies is acceptable (preferably three years). While using three-year data, at least two years' data should be available in order to accept a comparable company.
- **Range:** The interquartile range is considered appropriate for arriving at the Arm's Length Price. While determining the Arm's Length Price, functional profile of the Taxpayer/ controlled transaction needs to be considered, in order to arrive at the appropriate data point in the aforesaid range.
- **Fresh benchmarking vs. roll forwards and updating financials:** It is recommended to perform the comparability analysis on three years recurring basis if there is no change in conditions and circumstances of the Taxpayer and its controlled transactions. However, a financial update of the comparability analysis would have to be performed on an annual basis.
- **Number of TP Methods:** TP Law provides for five approved methods to determine the arm's length result of transactions, along with the use of a method, other than the approved methods. Combination of two or more methods is also permissible to justify Arm's Length Price.
- **Method preference:** No order of preference has been defined. However, other method can be used only if none of the five approved methods seem appropriate.
- **Transaction by transaction vs. combined transaction approach:** A transaction by transaction approach is preferred over an aggregate/ combined transaction approach. Company-wide approach can be used either for inter-linked transactions or to corroborate the primary approach.

- **Comparability adjustments:** Adjustments with respect to accounting consistency, segmentation of financial data, working capital and FAR are allowed to eliminate any material differences between the transactions being compared.
- **Other considerations:** Extreme results like loss making comparables should trigger further investigation before establishing comparability. Guidance on use of qualitative and quantitative filters has been provided in the TP Guide

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The benchmarking requirements and the applicability of TP methods is in line with the globally recognized OECD TP Guidelines.

The TP Guide highlights the need for analyzing the actual conduct of parties to ensure that the same is consistent with the contractual arrangement. Accordingly, Taxpayers would be required to determine the contribution of each entity in the value chain to conclude on the characterization.

While there is no general hierarchy with regard to the use of TP methods, however, the TP Guide provides a preference for use of certain TP method for specific kind of transactions (e.g., CUP method for commodity and RPM for resellers). In such an instance, it becomes important for Taxpayers to have a reasonable justification in place in case they choose to adopt a method which is different from that preferred by the FTA.

Transfer Pricing Documentation

Transfer Pricing documentation needs to be prepared and maintained by Taxpayers on a contemporaneous basis. Tabulated below is the compliance applicable to Taxpayers in UAE:

Compliance	Key considerations
Master File	Threshold based applicability. However, no compliance to be undertaken for UAE headquartered group, that is not an MNE group
Local File	Threshold based applicability, irrespective of the jurisdiction of the Taxpayer's group (i.e., MNE/ non MNE)
Country by Country Report ('CbCR')	Threshold based applicability. However, no compliance to be undertaken for non-UAE headquartered groups
CbCR notification	Applicable, if CbCR compliance is being undertaken (as stated above). Ultimate parent entity to file the CbCR notification
TP disclosure form	Threshold and format to be prescribed by the FTA in due course. Nature and value of transaction, details of related parties, and TP method relied upon to be included.

Taxable person not meeting the prescribed threshold for maintenance of TP documentation (like Local File or Master File) or entities exempt from TP documentation (e.g., entities claiming small business relief) are nonetheless required to maintain records to support the arm's length nature of the transaction and are required to produce the said information within 30 days of request from the FTA.

The TP Guide provides in detail the contents to be covered under the Master File and Local File which are in line with requirements under Annexure I and II to Chapter V of the OCED TP Guidelines respectively.

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While it is evident that Transfer Pricing provisions are applicable to domestic as well as cross-border transactions, it would be worthwhile to see if the FTA releases a transaction-based or a revenue-based materiality threshold for disclosure of controlled transactions in the Transfer Pricing disclosure form.

Special considerations for Specific transactions

TP Guide provides detailed guidance with respect to determining the Arm's Length Price for certain specific categories of transactions:

- **Financial transactions:** Includes treasury functions, intra-group loans, cash pooling, hedging, guarantees, captive insurance. Guidance in relation to preferred TP method, the factors to be considered while conducting benchmarking (e.g., issue date, currency, tenor, jurisdiction and credit rating of the borrower, implicit support – if any, interest rate type, industry etc.) and the steps for determining the Arm's Length Price have been provided.
- **Intra group services**: Includes services typically available externally from third parties but provided internally by one or more group members for the benefit of other group members. Guidance provided with respect to 'Need-benefit' test to demonstrate the actual receipt of services. Drawing reference to Chapter VII of the OCED TP Guidelines, the TP Guide prescribes a Safe Harbour margin of 5% with regard to arriving at the arm's length compensation for low-value adding intra-group services.
- **Intangibles:** The most crucial step while analyzing transaction involving intangibles, is to identify the entity performing the Development, Enhancement, Protection and Exploitation ('DEMPE') of intangibles along with distinguishing its legal owner from economic owner. The TP Guide provides a six-step approach while benchmarking the transactions involving intangibles. Further, considering the uniqueness and complexity involved around intangibles, the Taxpayers have been provided an option to choose an alternate method other than the prescribed TP method like market appraisal, valuation reports, especially when it's a one-off transaction.
- **Cost contribution arrangements ('CCAs'):** In order to benchmark CCAs, the TP Guide highlights that the most crucial step is to calculate the value of each participant's contribution to the joint activity and finally to determine whether the allocation of CCA contributions align with the expected benefits.

- **Business Restructuring:** With regard to benchmarking such transactions, an understanding of the commercial and financial relation between the entities involved is important, coupled with the expected benefits that ought to flow as a result of the restructuring exercise. The TP Guide specifies that Arm's Length Price should not be confined to post restructuring controlled transactions but also to additional transactions forming part of the restructuring.
- **Permanent Establishment ('PE'):** For Transfer Pricing purposes, a PE is treated as a separate and independent entity (from its parent entity) and thus, transactions between Related Parties or Connected persons with a PE need to comply with ALP. Benchmarking a PE transaction involves undertaking a thorough FAR analysis to identify the activities performed by the PE vs. the parent, in order to determine the compensation/ profits attributable to the PE.
- **Inter-company balances:** With regard to cash/ bank settlement between related parties it has been clarified that amounts remaining outstanding beyond a reasonable period could result in the re-characterization of such credit into an advancement of loan. Such a transaction would be subjected to TP provisions and would warrant an arm's length interest rate to be levied.

Dhruva Analysis

The Guidance provided with respect to specific transactions follows the principles laid out in the OECD TP Guidelines with the primary focus being on undertaking a detailed FAR analysis. The TP Guide provides a step-by-step approach with regard to benchmarking each of the aforementioned transactions which is a welcome step for the taxpayers considering that such transactions are, globally, challenged by Revenue Authorities.

Taxpayers need to re-look at their related party balances to ensure that the credit period extended, and the actual realization is in line with the contractual arrangement/ industry practice. Upon commencement of the Tax period, any related party balance outstanding beyond a reasonable credit period could take the colour of a loan and attract notional interest.

Transfer Pricing audits

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

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

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

Dhruva Analysis

The option to make appropriate TP adjustments before the filing of the Tax return is a welcome move. Taxpayers will have the flexibility to relook at their Transfer Prices and ensure that the tax filings are in line with ALP. This will greatly reduce TP disputes.

Conclusion:

The TP Guide is a comprehensive document and provides clarity on many operational aspects of TP provisions in the UAE.

Alignment with global best practices demonstrates UAE's commitment towards a transparent tax regime.

More clarity could have been provided by the TP Guide on transactions with connected persons like remuneration to KMPs, dividend, capital contribution etc.

As the TP Regulations evolve in the region, the TP guide would act as a key reference point for Taxpayers and will play a crucial role in minimizing TP disputes

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