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TAX ALERT

UNITED ARAB EMIRATES: SUMMARY OF PUBLIC CONSULTATION DOCUMENT ISSUED IN RELATION TO THE IMPLEMENTATION OF CORPORATE TAX IN THE UAE

On 31 January 2022, the UAE Ministry of Finance announced the introduction of Federal Corporate Tax (CT) in UAE with effect from 01 June 2023.

Following the announcement, the Federal Tax Authority of the United Arab Emirates (the "FTA") has, on 28 April 2022, issued a public consultation document covering various aspects of the proposed CT law and have invited the business community and other stakeholders to provide their comments before 19 May 2022.

It should be noted that the content of the public consultation document is not intended to reflect the final view of the UAE government. Therefore, the positions outlined in the consultation document and this alert should not be relied upon to make firm decisions at this stage.

In this alert, we have summarised the key features of the public consultation paper below.

We have also included a comparative table with the salient features of the tax regime in Mauritius, another key international financial centre particularly for investments in the African continent.

Taxable persons

Natural persons

The introduction of corporate tax will not entail the introduction of tax on income for natural person, namely individuals.

Corporate tax will apply to individuals only in the case:

(i) of sole proprietorships or proprietorships and individual partners in an unincorporated partnership that conducts business in the UAE; and

(ii) she/he engages in business or commercial activities which require obtaining a commercial license or equivalent permit from the relevant authorities in the UAE, e.g. the Department of Economic Development or Freezone authorities.

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 Corporate Tax 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.

Commentary

This is a welcome clarification from the FTA which gives a clear delineation between tax on businesses and corporates and tax (or rather, the lack thereof) on income derived by individuals.

Legal persons

Corporate tax will apply to companies and other Legal Persons incorporated in the UAE as well as foreign legal entities that have a Permanent Establishment [1] in the UAE or that earn UAE sourced income.[2]

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.

For the application of Corporate Tax, 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.[3] This concept is in line with the definition of "tax residency" under the OECD Model Conventions.

Commentary

The application of Corporate Tax is broadly in line with OECD principles and international standards. Limited partnerships will be treated as transparent for tax purposes, but not limited liability partnerships (which have separate legal personality).

Exempt persons

The following are exempt from corporate tax, either by way of application or automatically:

1. Federal and Emirate Governments and their authorities and other public institution;
2. Wholly-owned, Government-owned UAE companies that carry out the sovereign or mandated activity and that are listed in a cabinet decision;
3. Businesses engaged in the extraction and exploitation of UAE natural resources that are subject to Emirate level taxation;
4. Charities and other public benefit organizations that are listed in a Cabinet Decision;
5. Public and regulated private social security and retirement pension funds;
6. Investment funds, subject to meeting the conditions below:
    - The investment fund is regulated by a regulatory authority in the UAE that is recognised by the Ministry of Finance (e.g., the Securities and Commodities Authority, the Financial Services Regulatory Authority, the Dubai Financial Services Authority);
    - No group of five (5) or fewer investors (and their Related Parties1) has a 50% or greater economic interest in the investment fund;
    - No single investor (and their Related Parties1) has a 20% or greater economic interest in the investment fund;
    - Interests in the investment fund can be freely traded on a stock exchange in the UAE (or a recognised foreign stock exchange), or are widely marketed and made available to the intended categories of investors.

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1 *The PE concept under the proposed Corporate Tax law has been designed on the basis of the OECD Model Tax Convention. The activity threshold that will trigger a PE for a foreign Company in the UAE will be determined by the fixed place of business test and the Dependent agent test.*

2 *Income will generally be considered UAE sourced if the income is earned from a UAE generated person, if the payment is attributed to a PE of a foreign company in the UAE, 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. The same principles will be applied to determine if a Freezone Company earns income from a source in mainland UAE.*

3 *Determining whether an entity is effectively managed and controlled in the UAE would typically look at where the directors or other decision makers of the company make the key management and commercial decisions.*

Commentary

The tax exemption on investment funds is a notable (and perhaps, necessary) exemption, with the result that the UAE will continue to be a competitive jurisdiction of choice for the establishment of investment funds.

Free Zones

Whilst companies and branches registered in Free Zones will be within the scope of Corporate Tax and subject to tax return filing requirements, they would be subject to 0% corporate tax rate if they maintain adequate substance and complies with all regulatory requirements.

Income earned by a Free Zone Company from transactions with businesses in mainland UAE will be subject to the normal corporate tax rate except if:

(a) The income from mainland UAE is limited to passive income such as interest and royalties, dividends, capital gains tax from owning shares in mainland UAE companies.

(b) The income is from group companies located in mainland UAE.
However, expenses incurred and payable by mainland group company to a group company located in a Freezone will not be deductible for the purpose of calculation of taxable profit of the mainland group company.

A Free Zone company that has a branch in mainland UAE will be taxed at a normal corporate tax rate on its mainland source income while continuing to benefit from the 0% rate on its other income earned from business within the freezone and outside the UAE.

Commentary

The introduction of corporate tax in the UAE should therefore have limited impact on companies set up in free zones, which would continue to enjoy a 0% tax rate in their foreign source income, subject to certain substance conditions being met. We would expect these substance conditions to be in line with the BEPS Action Point 5 recommendations. It is interesting to note that this would effectively result in tax ring-fencing between free zone companies and domestic companies.

Commentary (Continued)

However, the substance requirements should ensure that a company's tax base is located where the value is created. In addition, it would be important to track the impact of the global minimum tax on relevant companies operating in the free zones.

Basis of taxation

- A company incorporated in the UAE will automatically be considered as a "resident" company for corporate tax purposes.
- If a company is incorporated outside the UAE but is effectively managed and controlled in the UAE, it will be considered as tax resident in the UAE.
- A UAE resident company will be subject to corporate tax on its worldwide income. However, certain foreign income such as Income from foreign branches and qualifying foreign shareholdings will be exempt of corporate tax.
- Taxes paid at source, in the foreign jurisdiction, can be deducted as credit against the tax payable in the UAE.

Calculation of taxable income

Basis of calculating taxable income

- Accounting net profit (or loss) as stated in financial statements will be considered as a starting point for determining taxable income.
- Financial statements should be prepared using accounting standards that are generally acceptable in the UAE. Although International Financial Reporting Standards are the most commonly used standards in the UAE, companies will be allowed to use alternative financial reporting standards and mechanisms for determining taxable income.
- A Company's tax period will be the same as its financial accounting period.
- Unrealised gains or losses on revaluation will be taken into account when calculating taxable income only if the unrealised gains or losses relate

to revaluation of revenue items such as stock. Unrealised gains or losses on revaluation capital items such as PPE will not be taken into account for the purpose of calculation taxable income.

Participation exemption

- Capital gains on sale of shares in a foreign subsidiary and dividends paid by a foreign subsidiary are exempt provided that the shareholding is at least 5% and that the subsidiary subject to CT of at least 9% in the country where it is registered.

- Capital gains on the disposal of shares in a Free Zone Company will be exempt if it is a holding company and that substantially all of its income is derived from shareholdings in subsidiary companies that meet the participation exemption condition mentioned above.

- Dividends from UAE companies, including Freezone companies, are exempt from CT in the UAE.

Foreign branch exemption

Where a UAE company has a foreign branch, it is possible to elect to:

a)claim a foreign tax credit for taxes paid in the foreign country; or

b)claim an exemption for excluding foreign branch profits when calculating CT.

Interest Capping Rules

- The amount of interest expenses that can be deducted will be capped at 30% of the EBITDA adjusted for CT purposes. Safe harbour or de minimis threshold maybe introduced to reduce administrative burden.

- The interest capping will not apply to banks, insurance businesses and other regulated financial services entities.

- Consolidated groups will be allowed to apply a different interest capping threshold.

- Interest paid on related party borrowings will be required to be at arm's length.

Non-deductible expenses

- Only up to 50% of the total expenditure on entertainment will be allowed for deduction in calculating the taxable income.

- Deductions for penalties, recoverable VAT and donations to unapproved organizations/charities will not be allowed.

Losses

- Businesses will be allowed to offset losses incurred against the taxable income of future periods, up to a maximum of 75% of the taxable income in each of the future periods.

- Businesses will be allowed to carry forward tax losses indefinitely provided the same shareholder owns at least 50% of the share capital.

- In the event of a change in ownership, tax losses may still be available provided the new owners carry out same/similar business.

Commentary

- *Taxable income would appear to also include capital gains, with a participation exemption on gains on certain disposals of shares.*

- *Rules will be introduced to minimise excessive interest deduction and to restrict deductibility of expenses.*

Groups

Tax Groups

The UAE CT regulations will allow group of companies to form a tax group and file a single tax return for the entire group, subject to the following conditions:

a)There is a common parent company holding 95% of share capital in the group companies;

b)None of the companies within the group are exempt persons or are registered in Free zone and availing benefit of 0% CT rate;

c)All group members must use the same financial year.

Transfer of losses for group of companies that do not meet the 95% common shareholding

- Groups of companies that do not meet the 95% common shareholding criteria, may transfer tax losses to another group company with profits, provided the companies are at least 75% commonly owned.
- Tax losses will be limited to 75% of the taxable income of the company receiving the transferred losses in the relevant period.
- No losses may be transferred from exempt companies or from those which benefit from a 0% Free Zone CT regime.

Group Relief

- Intra-group transfer relief will be available for transfers of assets and liabilities between UAE resident companies that are at least 75% commonly owned, provided the asset/liability remains within the same group for a minimum of three years.
- To facilitate mergers, spin-offs and other corporate restructuring transactions, the CT regulations will exempt or allow for a deferral of CT where a whole business, or independent parts of a business, are transferred in exchange for shares or other ownership interests.
- Any relief will be 'clawed back' if within three years of the restructuring, there is a subsequent transfer of the business to a third party.

Commentary

The concept of tax groups and group relief are rules which will further consolidate the simplicity, effectiveness and competitiveness of the proposed tax framework. Once again, these are tried and tested concepts which should find a fairly easy application and implementation in the UAE.

Transfer Pricing

All Related Party[4] transactions and transactions with Connected Persons[5] will need to comply with transfer pricing rules and the arm's length principle as set out in the OECD Transfer Pricing Guidelines.

Transfer Pricing documentation

- Business will be required to submit a disclosure containing information regarding their transactions with Related Parties and Connected Persons.
- A business will also need to maintain a master and local file (with format and content consistent with the requirements prescribed under OECD BEPS Action 13) where the arm's length value of their Related Party transactions exceeds a certain threshold in the relevant tax period.

Calculation of corporate tax liability

Corporate tax rate

The Corporate Tax rates are as follows:

- 0% for taxable income not exceeding AED 375,000
- 9% for taxable income exceeding AED 375,000

However, the different rate for large multinationals (with consolidated turnover exceeding AED 3.15 billion) has not been prescribed.

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4 *A related party is an individual or entity who has a pre-existing relationship with a business that is within the scope of the UAE CT regime through ownership, control or kinship (in the case of natural persons).*

5 *Connected Persons are different from Related Parties. A person will be considered as 'connected' to a business that is within the scope of the UAE CT regime if he or she is:*

i. An individual who directly or indirectly has an ownership interest in, or controls, the taxable person;
ii. A director or officer of the taxable person;
iii. An individual related to the owner, director or officer of the taxable person to the fourth degree of kinship or affiliation, including by birth, marriage, adoption or guardianship;
iv. Where the taxable person is a partner in an unincorporated partnership, any other partner in the same partnership.

Foreign Tax Credit

Foreign Tax Credit available will be the lower of:

a)The amount of tax that paid in the foreign jurisdiction; or
b)The UAE CT payable on the foreign sourced income.

Any unutilised Foreign Tax Credit will not be able to be carried forward or back to other tax periods, nor refunded.

International tax developments

- The UAE is working with other members of the G20 Inclusive Framework to implement the Pillar 2 proposals. Further announcements will be made on how the Pillar Two rules will be embedded into the UAE corporate tax regime will be made in due course.

- The introduction of the corporate tax in the UAE will not impact the existing country-by-country reporting requirements and relevant regulations.

Administration

Registration

A business subject to CT will need to register with the Federal Tax Authority (FTA) and obtain a Tax Registration Number within a prescribed period.

Filing and payment

- A business will only need to prepare and file one tax return and other related supporting schedules with the FTA for each tax period. There will be no requirement for a business to file a provisional CT return and make advance payments of CT.

- Each tax return and related supporting schedules will need to be submitted to the FTA within nine months of the end of the relevant Tax Period.

- Payments to settle a taxpayer's CT liability for a Tax Period will need to be made within nine months of the end of the relevant Tax Period.

Assessment

The UAE CT regime will be based on a self-assessment principle.

Clarifications

Where there is uncertainty in relation to a proposed or entered into arrangement or transaction, a business may apply to the FTA for a clarification with regards to the correct or intended CT treatment.

Document requirements

- A business will be required to maintain financial and other records that explain the information contained within the CT return and other documents submitted to the FTA.

- The UAE CT regime will require a Free Zone company to have audited financial statements if it wants to benefit from the 0% CT regime.

Transition rules

The UAE CT regime is not intending to require businesses to restate their balance sheet upon entering into the CT regime: a taxable person's opening balance sheet for CT purposes would generally be their closing balance sheet for financial reporting purposes for the period that ends immediately before their first tax period begins.

Comparative table: UAE corporate tax versus Mauritius corporate tax regimes

Issue	UAE	Mauritius
Headline tax rate	0% on taxable income up to AED 375,000 9% on taxable income above AED 375,000	15%
Taxable persons	Legal entities and licensed sole traders	Legal entities and individuals
Basis of taxation	Worldwide income	Worldwide income (subject to remittance basis on foreign source income for individuals)
Determination of tax residency	Incorporation OR place of effective management	Central management and control
Free zones	Yes (0% rate on foreign source income)	No
Tax treatment of investment funds	Exempt (subject to conditions)	Maximum effective tax rate 3% (subject to substance conditions)
Tax treatment of domestic dividends	Exempt	Exempt
Tax treatment of foreign dividends	Participation exemption available (subject to conditions)	Partial exemption regime (3%) OR foreign tax credit available
Tax treatment of capital gains	Participation exemption available (subject to conditions)	No tax on capital gains
Foreign branch profits	Can elect for exemption	Partial exemption (3% effective tax rate)
Availability of foreign tax credit	Yes (subject to conditions)	Yes (subject to conditions)
Interest deductibility	Yes, subject to interest capping rules	Yes, subject to anti-avoidance rules
Expense deductibility	Yes (subject to conditions)	Yes (subject to conditions)
Transfer pricing legislation	Yes	Arm's length provisions/no transfer pricing regulations or guidance
Losses carry forward	Yes (subject to conditions), can be carried forward indefinitely	Yes (subject to conditions), maximum of 5 years for carry forward
Tax grouping for filing of returns	Yes	No
Group relief	Yes	No
Filing of tax return	Once a year	Once a year, subject to advance quarterly payments
Self-assessment	Yes	Yes
Deadline for tax liability	9 months after end of tax period	6 months after end of tax period (for legal entities)

This tax alert is issued jointly by DTOS UAE (member of the DTOS Group) and Prism Chambers.

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