Summary of Transfer Pricing Guide Released in October 2023

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A. Background

The Federal Decree Law No. 47 of 2022 ('CT Law') became effective on 25 October 2022 and will apply to taxable persons for financial years commencing on or after 1 June 2023. The CT Law also introduces the Transfer Pricing rules and regulations. Pursuant to law, the FTA has released the TP Guide in October 2023 which has been issued to provide detailed guidance to the Taxpayers in relation to TP compliances and TP documentation and intends to address common queries that taxpayers might have in relation to TP regulations.

B. Summary of TP Guide

1. Transfer Pricing Principles and Fundamentals

1.1. What is Transfer Pricing?

Transfer Pricing (‘TP’) refers to the pricing of transactions between Related Parties (‘RPs’) and Connected Persons (‘CPs’) that are influenced by the relationship between transacting parties.

1.2. The concept of Arm’s Length Principle

- The Arm's Length Principle, in simple terms, means that the transaction between RP and CP should be priced in the same manner as if it is a transaction between independent parties under comparable circumstances.
- The Arm’s Length Principle needs to be applied with respect to domestic as well as cross-border controlled transactions.
- Comparison of the Controlled Transaction(s) with comparable uncontrolled transactions is named as “comparability analysis” and is at the heart of the application of the Arm’s Length Principle.

1.3. Controlled Transaction

A “Controlled Transaction” is a transaction or arrangement between RPs or CPs.

1.4. Related Parties and Control

- The TP guide states that Kinship includes common blood ties as determined by the ancestors or common ancestors of the individual. The degrees of kinship or affiliation have been explained in Para 4.4.1.2 of the guide.
- A natural person and juridical person can be RPs by way of ownership (direct or indirect), which can be sole ownership or together with its RPs.
- The TP guide gives examples of arrangements where control can be established through significant influence:
    - Debt constituting 50% of the total capital of the borrower;
    - Royalty agreement which gives right to 50% of profits;
    - Key role in taking decision even when the shareholding is less than 50%

1.5. Connected Persons

- The definition of CP in the TP guide is in line with the definition of CP as per Article 36 of the CT Law.
- All payments to CP are deductible only to the extent it corresponds with the market value of the service and it is exclusively for the purpose of business.

1.6. International agreements for the avoidance of double taxation

The TP guide clarifies that in the event of differences between the UAE TP regulations and an international agreement in force in the UAE, the provisions of the international agreement will prevail

2. Application of Arms Length Principle

The TP guide sets out three key steps for application of Arm's length principle to controlled transactions:

- Identify RPs, CPs, relevant transactions and arrangements and perform a comparability analysis.
- Selection of the most appropriate TP method.
- Determination of the Arm's Length Price ('ALP')

2.1. Identify Related Parties, Connected Persons, relevant transactions and arrangements and perform a comparability analysis

A comparability analysis refers to the comparison of a controlled transaction with comparable uncontrolled transaction(s).

A comparability analysis has two key aspects:

- Identifying the RPs, CPs, commercial or financial relations and the conditions and economically relevant circumstances attaching to those relations.
- Comparison of economically relevant characteristics and conditions of controlled transactions with uncontrolled transactions

2.1.1 Identification of commercial and financial relations

The CT guide lists out the steps to be followed for understanding these relations:

- Conducting a broad-based analysis of the industry sector of the Group;
- Obtaining a clear overview of the Group;
- Analysing what each RP does and their commercial and financial relations as expressed in transactions between them;
- Accurately delineating the actual transaction(s) between the RP or CP (important for selecting the most appropriate TP method).

2.1.2 Functional Analysis

A Functional Analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the RPs or CPs in a Controlled Transaction.

- The six-step framework for analysing the risks in a controlled transaction given in the TP guide has been reproduced below:

Step 1 — Identify economically significant risks with specificity

Step 2 — Determine contractual assumption of risks by Related Parties based on the terms of the underlying intercompany agreement(s)

Step 3 — Undertake a Functional Analysis to determine how the Related Parties in the Controlled Transaction operate in relation to assumption and management of the economically significant risks

Step 4 — Determine whether the contractual assumption of risk is consistent with the conduct of the Related Parties, by assessing whether:
i. the Related Parties operate in line with the relevant contractual terms; and
ii. the Related Party assuming the risk [contractually] exercises control and has the financial capacity to assume the risk

IF YES → Step 6

IF NOT → **Step 5** — Allocate the risk in accordance with control and financial capacity (i.e., Step 4(ii))

Step 6 — Determine the Arm's Length Price for the Controlled Transaction, taking into account the financial and other consequences of risk assumption, as appropriately allocated, compensating for risk management functions.

- A functional analysis typically begins by undertaking an interview with the relevant department and personnels through questionnaires. The TP guide provides samples of functional questionnaires for taxable persons engaged in different industries.

2.2. Selection of most appropriate TP method

The five TP methods that has been explained in the TP guide is in line with the TP methods given under Article 34(3) of the CT Law.

2.2.1 The Comparable Uncontrolled Price Method ('CUP method')

- 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.
- The TP guide clarifies that if the CUP method and another TP method can be applied in an equally reliable way while benchmarking a transaction, the CUP method should be the preferred method.

2.2.2 The Resale Price Method ('RPM')

The RPM is based on the price at which a product, that has been purchased from a Related Party, is resold to an independent party.

When applying RPM, the following factors is to be considered:

- Operational comparability
- Comparability of FAR
- The impact of accounting practices

2.2.3 The Cost Plus Method ('CPM')

- The CPM considers the direct and indirect costs incurred by a supplier in supplying goods or services in a Controlled Transaction and applies an appropriate mark-up to these costs based on the functions performed by the supplier and the profit that would have been earned from an arm's length transaction depending on the market conditions.
- The CPM is most useful where semi-finished goods are sold between Related Parties or Connected Persons as well as where the controlled transaction is provision of services.
- When applying CPM, product comparability is to be considered instead of operational comparability in addition to other factors considered for RPM.

2.2.4 The Transactional Net Margin Method ('TNMM')

- The TNMM examines the net profit earned from a Controlled Transaction relative to an appropriate base (for eg., cost, sales etc)
- Even though it is preferred that TNMM be applied at a transaction level, TNMM may also be applied on an aggregate basis if the transactions are closely linked/related to each other.

2.2.5 The Profit Split Method ('PSM')

- PSM seeks to determine the division of profits that independent parties would have expected to realise from engaging in comparable transactions.

- In general, the PSM may be used in the absence of comparables indicating that an alternative Transfer Pricing method is the most appropriate method. The specific cases where PSM can be used is explained under Para 5.2.1.8.1 of the TP guide.

2.2.6 Other TP methods

- Other method can be used only if none of the five approved methods seem appropriate.

- The taxable person should maintain adequate documentation for selecting any other method.

2.2.7 Selection of most appropriate method ('MAM')

Following factors should be considered while determining the MAM:

- Strength and weakness of the methods
- Appropriateness of the method
- Availability of reliable information
- Degree of comparability between controlled transaction and independent transaction

2.3. Determination of ALP

2.3.1 Choice of tested party

- The use of CPM, RPM and TNMM requires the taxable person to decide the party for which a financial indicator is tested. Generally, the tested party is usually the participant in a transaction for which:

  - Profitability can be ascertained most reliably and
  - Reliable data on comparables can be found.

- Usually, the party with less complex functional analysis i.e. smaller scope of functions, least intangibles and less complex operations is used as the tested party.

2.3.2 Comparable uncontrolled transaction

A comparable uncontrolled transaction can be either a comparable transaction between one party to the controlled transaction and an independent party (internal comparable), or between two independent parties, neither of which is a party to the Controlled Transaction (external comparable).

2.3.3 Selection of potential comparables

- Additive approach and Deductive approach are used for identification of potentially comparable uncontrolled transactions (explained under Para 5.3.2.4 of the TP guide)
- Once the potential comparables are identified, both quantitative and qualitative criteria are used to include or reject potential comparables identified. The filters used will be dependent on the nature and facts of each transaction. Guidance on use of qualitative and quantitative filters has been provided in the TP Guide.

2.3.4 Comparability adjustments

- Comparability adjustments are carried out to eliminate the impact of differences due to different accounting practices, segmentation of financial data and for differences in capital, functions, assets and risks.
- Comparability adjustments should be considered only if they are expected to increase the reliability of the results.

2.3.5 Determining arm's length range

- Generally, after applying the most appropriate TP method, the resultant may be a range of financial results or indicators (known as arm's length range)
- The interquartile range is considered appropriate for arriving at the Arm's Length Price. While determining ALP, the functional profile of taxable person needs to be taken into consideration, in order to arrive at the appropriate data point in the aforesaid range.

2.3.6 Other considerations

- The TP guide provides guidance on the order that a taxable person should follow for identifying comparables (local, regional, then other regions).
- Use of multiple-year data and averages generally improves the reliability of the range of financial results, especially where transactional profit methods are applied.
- The examination of multiple-year data is typically done for 3 years inclusive of the year in which the transaction is undertaken. When using a 3-year period, at least 2 years of data should be available in order to accept the comparable company.
- A financial update of the comparability analysis would have to be performed on an annual basis. In case of change in circumstances of RPs or controlled transaction, then the full analysis on selection of comparables needs to be undertaken in the year of change.

3. Transfer Pricing Documentation

Taxable Persons are required to maintain contemporaneous TP documentation of their controlled transactions and such documentation is to be maintained either at the time of the Controlled Transaction or, by the time the Taxable Person submits its Tax Return for the relevant Tax Period.

3.1. Master File ('MF') and Local File ('LF')

- The requirement for maintenance of MF and LF applies to businesses only if meets the threshold limits specified in MD No. 97 of 2023.
- However, taxable person not meeting the prescribed threshold for maintenance MF or LF or entities exempt from TP documentation are required to maintain certain information and are required to produce the said information within 30 days of request from the FTA. Examples of such information include:
    - information to support the arm's length nature of the transaction;
    - any other information that the FTA deems necessary to assess the arm's length nature of the transaction;
    - information used for application of the chosen method.
- The TP guide provides an exception for maintenance of Master File by which, any taxable person that is part of a UAE headquartered group that is not an MNE Group is not required to maintain a MF, but LF must be maintained.
- The TP Guide provides in detail the contents to be covered in MF and LF which are in line with requirements Chapter V of the OCED TP Guidelines.

3.2. Country-by-Country Reporting ('CbCR')

- The UAE CbCR requirements are applicable to MNE Groups headquartered in the UAE with consolidated Group revenue not less than AED 3.15 billion.
- The Ultimate Parent Entity will be required to submit a CbCR notification no later than the last day of the Fiscal Year. The Ultimate Parent Entity is also required to file the CbCR no later than 12 months after the last day of each reporting year of the MNE Group in the UAE.

3.3. TP disclosure form

All taxable persons who undertake transactions with RPs or CPs (domestic or foreign) in the reporting tax period and are above a materiality threshold are required to prepare and submit a general TP disclosure form, alongside their tax return within 9 months from the end of relevant tax period.

4. Special Consideration for Specific Cases

4.1. Financial Transactions

4.1.1 Treasury functions

- If it involves only central treasury function without bearing any risk, then it will classify as intra group services.
- If it is acting as a inhouse bank which bears and manages significant contingent liability risk, then ALP should be separately considered.

4.1.2 Intra-group loans

- Since large volume of data is available for third party loans, CUP method is often applied to benchmark intra-group loans.
- The CUP method for benchmarking intra-group loans involve analysing the terms of loan, analysing borrower’s credit rating, searching for third party loans with similar terms and making comparability adjustments, if needed.

4.1.3 Cash pooling

- If the cash pool leader performs routine functions such as co-ordination, forecasting etc., then it will receive a commensurate remuneration as a routine service provider.
- In case of more complex cash pools, where the leader assumes responsibilities such as risk management, then the leader is expected to receive more than a routine reward.

4.1.4 Hedging

- Where the centralised treasury function arranges a hedging contract in the name of the operating entity, that centralised treasury function can be seen as providing a service to the operating entity, for which it should receive compensation on arm’s length terms.

4.1.5 Financial Guarantees

- Pricing of related party guarantee involves calculating the difference in the guaranteed party’s cost of borrowing without the guarantee as compared to its actual cost of borrowing with the guarantee (known as “interest savings approach”).

4.1.6 Captive insurance

- CUP method may be used for pricing captive insurance arrangement if there are internal comparables or if external comparables are available.

- Actuarial analysis may also be used for determining an arm's length premium for insuring a particular risk, provided, the other five TP methods are not suitable or inconclusive.

4.2. Intra-group services

The analysis of TP considerations for intra-group services, involves two main areas:

- whether intra-group services have in fact been provided.
- whether the charge for the intra-group service is in accordance with the arm's length principle.

4.2.1 Shareholder activities

- The guide has explained shareholder activity as one that a Group member performs solely because of its ownership interest in one or more other Group members.

- These types of activities would not classify as intra-group services, and thus would not justify a charge to other group members.

4.2.2 Passthrough cost/ reimbursement of expenses

- The guide states that a taxable person shall reimburse the expense on a cost-to-cost basis without any mark-up provided that:

  - the acquired goods or services are requested by and for the benefit of the RPs or CPs

  - the taxable person is merely paying the agent and does not enhance the value of the acquired goods or services in the process whatsoever; and

  - the cost of the acquired goods or services is the legal or contractual liability of the RPs or CPs

4.2.3 Duplication

- Generally, in case of duplication of services, no service is considered to be provided since there is no commercial or practical necessity.

- Duplication of service is allowed in the following cases:

  - Where the duplication of services is only temporary
  - Where the duplication is undertaken to reduce the risk of a wrong business decision

4.2.4 Incidental benefits

- In some cases, an intra-group service relates only to some group members but incidentally provides benefits to other Group members.

- Generally, these services would not be classified as intra-group service because the activities producing the benefits were never intended for them and would not be ones for which an independent party ordinarily would be willing to pay.

4.2.5 Centralised services

- These types of activities ordinarily will be considered intra-group services because they are the type of activities that independent parties would be willing to pay for or perform in-house.

4.2.6 Determination of arm's length range for intra-group service

- The determination of the Arm's Length Price in relation to intra-group services should be considered both from the perspective of the service provider and the service recipient.

- The CUP method or CPM or TNMM are commonly used for pricing intra-group services.

- Para 7.2.3.3 of the TP guide explains the situations where direct charge and indirect charge method is to be applied for determining ALP.

- Drawing reference to Chapter VII of the OCED TP Guidelines, the TP guide clarifies that a simplified approach can be adopted in case of low value-adding intra-group services which may be charged out at a cost-plus 5% mark-up without the need for a detailed benchmarking analysis.

4.3. Intangibles

- The most important aspect while benchmarking a transaction involving intangibles is identification of party performing the Development, Enhancement, Maintenance, Protection and Exploitation ('DEMPE') of intangibles.

- The process of distinguishing the economic and legal owner is also a crucial task in benchmarking transactions involving intangibles.

- The TP guides sets out a six-step framework for analysing transactions involving intangibles:

  a. Identification of intangibles
  b. Identification of full contractual arrangements
  c. Identification of entities performing DEMPE functions
  d. Confirming the consistency between terms of contract and actual conduct of parties
  e. Characterisation of actual controlled transaction
  f. Determination of ALP

4.4. Cost Contribution Arrangements ('CCAs')

- CCAs are contractual agreements entered into by RPs or CPs within an MNE Group.
- The two types of CCAs have been explained under Para 7.4.2 of the TP guide.
- The key step in benchmarking a CCA 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 expected benefits.

4.5. Business Restructuring

- Business Restructuring refers to the reorganisation of the commercial or financial relations between RPs or CPs, including the termination or substantial renegotiation of existing arrangements.
- The application of the Arm's Length Principle to a Business Restructuring starts with the identification of:
  - the commercial or financial relations between the RPs or CPs involved in the Business Restructuring
  - the conditions and economically relevant circumstances in relation to those relations
- In situations where reliable comparable uncontrolled transactions cannot be identified, it may be possible to use valuation techniques to estimate the arm's length price for the determined controlled transaction.
- The TP Guide clearly states that ALP should not be restricted to post restructuring controlled transactions but also to additional transactions forming part of the restructuring.

4.6. Permanent Establishment

- Transactions between RP or CP where one of the parties is a PE would need to be conducted in line with the Arm's Length Principle.
- The Arm's Length Principle requires treating a PE as if it is a separate entity that operates independently from other parts of the Group and the parent to whom the PE belongs.

4.7. Outstanding intercompany balances

- It is generally expected that any outstanding amount resulting out of intercompany transactions is consistently settled as per the internal policy of the MNE Group.
- The TP guide clarifies that if the actual settlement period exceeds the period agreed upon on a regular basis, the extended credit period could be regarded as an advancement of loan. As a result, a compensation in the form of a fee or interest could be charged so that it is in accordance with the ALP principles.

5. Transfer Pricing Audit and Risk Assessment

5.1. Burden of Proof

The burden of proof falls on the Taxable Person to maintain sufficient supporting documentation as well as to make timely submissions to the FTA in order to support the position taken in the tax return.

5.2. TP Adjustments

TP adjustments are designed to ensure that the taxable outcome of the Controlled Transaction is aligned with the Arm's Length Principle.

TP adjustments can be initiated by both Taxable Persons and the FTA.

5.3. Non-recognition

Where the arrangements made in relation to the Controlled Transaction differ from those which would have been adopted by independent parties, the FTA may, if deemed appropriate, adjust or disregard the Controlled Transaction and replace it with an alternative transaction.

The failure to recognise a Controlled Transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the Arm's Length Principle.

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