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Introduction of Corporate Tax in the UAE

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On January 31, 2022 the Ministry of Finance of the United Arab Emirates (UAE) announced the introduction of a federal Corporate Tax ("**CT**") on business profits, effective from the financial year beginning June 1, 2023. Pursuant to the aforementioned announcement, the Ministry of Finance published a consultation document to collect and appraise the responses of stakeholders ("**Consultation Document**") with regards to the most prominent features of the legislation and its implementation, ahead of the release of the draft CT legislation. The formal responses to the Consultation Document should be submitted using this form by **May 19, 2022**. The Consultation Document can be viewed here.

In this client alert, we provide a summary of the key policy drivers, the key features of the proposed regime, and high level commentary contextualising the potential effects of the legislative reforms on our clients.

Background

The UAE currently does not have a federal CT regime. CT is determined at an Emirate level through tax decrees. Currently, at an Emirate level, the UAE only levies corporate tax on oil and gas companies and branches of foreign banks. Furthermore, the UAE benefits from the presence of more than 40 free zones, which have their own rules and regulations. Such zones generally afford companies incorporated therein significant tax benefits, making the UAE an attractive jurisdiction from a tax perspective. Additionally, the UAE does not levy income tax on employment-based income.

Key Policy Drivers

The UAE, as a member of the OECD inclusive framework, is introducing the federal CT regime as a stepping stone to the execution of its commitment to the global minimum effective tax rate concept proposed by Pillar II of the OECD Base Erosion and Profit Shifting project ("**OECD BEPS**").[1] The responsible body of oversight has been designated as the Federal Tax Authority ("**FTA**"). In introducing CT, the UAE aims to further its objectives of accelerating its development and transformation by introducing "*a competitive CT regime that adheres to international standards, together with the UAE's extensive network of double tax treaties,* [which] *will cement the UAE's position as a leading jurisdiction for business and investment*".[2] The introduction of CT is also perceived as an important step in diversifying the UAE Government's budget revenue away from revenues that today are mainly generated from the hydrocarbon industry. The Consultation Document offers assurances that the CT regime will build on international best practices as opposed to introducing new concepts, in order to ensure the seamless integration and cooperation of the regime with existing international frameworks.

The Consultation Document indicates that the UAE Government has been guided by a set of key principles in its legislative undertaking. Such principles include: (1) flexibility and alignment with modern business practices, ensuring adaptability to changing socio-economic circumstances; (2) certainty and simplicity of the tax rules to support businesses' accurate decision-making and cost-effective operation; (3) neutrality and

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equity, ensuring fair taxation treatment to different types of businesses; and (4) transparency.

The Consultation Document heavily emphasises the UAE's ongoing commitment to execute BEPS 2.0, noting that "*further announcements on how the Pillar Two rules will be embedded into the UAE CT regime will be made in due course*."[3] No further practical guidance is otherwise offered in the Consultation Document. In this regard, international entities which may be subject to Pillar II are advised to keep a close eye on developments in the law that are likely to apply to them, to the extent they are taxable entities subject to the UAE CT regime.

Key Features of the Corporate Tax Regime

Taxable Persons

Subject to certain exemptions discussed below, CT will be levied on UAE-incorporated companies such as LLCs, PSCs, PJSCs, and any other legal entities with a distinct legal personality, including, for example, LLPs and partnerships limited by shares.

In line with tax measures in other jurisdictions, CT will be levied on foreign legal entities: (1) with a permanent establishment ("**PE**") in the UAE, and that earn UAE sourced income, or (2) that are tax resident by way of management and control in the UAE.

Unincorporated partnerships and other unincorporated ventures will be deemed 'transparent' for UAE CT purposes. Income of such entities may be taxed in the hands of their partners or members. Helpfully, in order to tackle the discrepancies in the classification of partnerships (transparent vs opaque) in different jurisdictions, the UAE CT treatment of foreign unincorporated partnerships will defer to the tax treatment of the partnership in the relevant foreign jurisdiction.

Companies and branches registered in free zones will also fall within the scope of the CT regime, and will be subject to tax return filing requirements. In order to honour existing tax arrangements within free zones, such entities will be subject to a 0% CT rate provided that they maintain adequate substance and comply with all regulatory requirements. A free zone person with a branch in mainland UAE will be taxed at a regular CT rate on mainland source income while continuing to benefit from the 0% CT rate on its "other income". 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 (meaning interest and royalties, and dividends and capital gains from owning shares in mainland UAE companies). The 0% CT rate will also apply to any transactions between free zone entities and their group companies in mainland UAE. However, payments made to free zone entities by a mainland group company will not be tax deductible. Furthermore, the Consultation Document notes that, 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. Once the draft law is released, we expect that free zone registered entities will need to evaluate their existing position and whether they will continue to benefit from the tax exemptions, or whether their position will change in light of the CT law.

Income tax will not be payable by natural persons, provided that they do not engage in business or commercial activity in the UAE. Taxable natural persons operating through sole establishments or proprietorships or as individual partners in an unincorporated partnership, conducting business in the UAE, will be subject to the CT regime. The Consultation Document indicates that it remains to be the case that employment based income obtained in the UAE will not be subject to income tax.

Applicable Rates

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

- 0%, for taxable income not exceeding AED 375,000;
- 9%, for taxable income exceeding AED 375,000; and
- a different tax rate (not yet specified) for large multinationals that meet specific criteria set with reference to Pillar II of the OECD BEPS.[4] In light of the Consultation Document's emphasis on the UAE's commitment to implementing the BEPS 2.0 measures, we expect that the rate will be fixed with reference to the rate finally determined by the OECD.

Exempt Entities

The following list of entities will be exempt from CT, either automatically or by way of application (the method is still undetermined):

1. the federal UAE Government and Emirate Governments and their departments, authorities and other public institutions;
2. wholly Government-owned UAE companies that carry out a 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 (e.g. upstream oil and gas companies);
4. charities and other public benefit organisations that are listed in a Cabinet Decision issued at the request of the Ministry of Finance, upon application of the relevant entity;
5. public and regulated private social security and retirement pension funds; and
6. investment funds, as they are typically organised as 'flow-through' limited partnerships. Furthermore, regulated investment funds and Real Estate Investment Trusts can apply to the FTA to be exempt from CT subject to meeting certain requirements.[5]

Residency

As previously indicated, tax residency is a pivotal factor in determining whether business profits will be subject to CT in the UAE. In furtherance of its objective of achieving certainty, the UAE relies on international principles in determining tax residency.

The Consultation Document notes that a legal person that is incorporated in the UAE will automatically be considered a 'resident' person for UAE CT purposes. Equally, 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 foreign company may be treated as a resident person if it is effectively "managed and controlled" in the UAE. This will be a question of fact, but the Consultation Document indicates this would "*typically look at where the directors or other decision makers of the company make the key management and commercial decisions*".[6]

UAE resident legal persons will be taxed in the UAE on their worldwide income. Natural persons will only be taxed on income earned from their business activities 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. Where income earned from abroad is not exempt, income taxes paid in the foreign jurisdiction can be credited against the CT payable in the UAE on the relevant income to prevent double taxation.

Non-Residents

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Non-residents will be subject to UAE CT on taxable income (1) from a PE in the UAE, and (2) which is sourced in the UAE. The Consultation Document indicates that the law is to refer to the definition of PE outlined in Article 5 of the OECD Model Tax Convention, and the intention is for foreign companies and advisors to be entitled to rely on OECD Commentary when assessing whether they have a PE in the UAE. Thus, the existence of a PE in the UAE will be determined by reference to whether either there is a "fixed place of business" of, or a "dependent agent" habitually exercising the authority to conclude contracts on behalf of, the non-resident person in the UAE.

Significantly, the Consultation Document notes that the UAE CT regime will allow regulated UAE investment managers to provide discretionary investment management services to foreign customers without triggering a UAE PE for the foreign investor or the foreign investment fund – this investment management exemption will "*be subject to conditions that are comparable to similar regimes in leading financial centres*".[7]

Calculating Taxable Income

The UAE CT regime proposes to use the accounting net profit (or loss) position in the financial statements of a business as the starting point for determining taxable income. IFRS standards are typically used by businesses in the UAE and will form the basis for such assessment, but the CT law will allow for alternative financial reporting standards.

Exemptions & Deductions

The CT law will include a participation exemption from CT on dividends received, and capital gains earned from the sale of shares of a subsidiary company. The UAE CT regime will exempt all domestic dividends earned from UAE companies, including dividends paid by a free zone registered entity benefitting from the 0% CT regime. The main condition to benefit from the participation exemption is that the UAE shareholder company must own at least 5% of the shares of the subsidiary company. This participation requirement remains competitive in comparison with other jurisdictions. For example, the participation exemption in the UK (the "substantial shareholding exemption") requires (amongst other things) the shareholder to own at least 10% of the ordinary shares in the subsidiary for a consecutive period of at least 12 months.

In order to remain an attractive tax jurisdiction for international businesses, the UAE will allow for foreign branches of UAE companies (subject to certain conditions) to either (i) claim a foreign tax credit for taxes paid in the foreign branch country, or (ii) elect to claim an irrevocable exemption for their foreign branch profits.

Interest and other financing costs will be deductible for CT purposes. However, the deductibility of interest will be capped at 30% of a business' earnings before interest, tax, depreciation, and amortisation (EBITDA), in line with Action 4 of the OECD BEPS project, in order to disincentivise businesses from using excessive levels of debt financing (as opposed to equity financing) in pursuance of a tax benefit. Interest capping rules will not apply to banks, insurance business and other financial services entities.

Losses

In line with international best practices, a business will be able to offset a loss incurred in one period against the taxable income of future periods, up to a maximum of 75% of the taxable income in each of those future periods.

Tax losses will be able to be carried forward indefinitely provided the same shareholders hold at least 50% of the share capital from the start of the period when a loss is incurred to the end of the period in which a loss is offset against the taxable income.

Groups

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A UAE resident group of companies will be able to elect to form a tax group, capable of being treated as a single taxable person (or a fiscal unity) if the parent company holds at least 95% of the share capital and voting rights of its subsidiaries. To form a tax group, neither the parent company nor any of the subsidiaries can be an exempt person or a free zone entity benefitting from the 0% CT rate, and all group members must use the same financial year. For other groups of companies which do not meet the 95% threshold, the CT regime will allow the transfer of losses between group companies, provided that they are at least 75% commonly owned.

Whilst no clear indications are given as to the features of the proposed law in respect of business reorganisations, the Consultation Document asserts that such reorganisations are to be undertaken on a tax neutral basis.[8] 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 assets and/or liabilities being transferred remain within the same group for a minimum of three years.

To further facilitate corporate restructuring transactions, the UAE CT regime will exempt or allow for a deferral of taxation where a whole business, or independent parts of a business, are transferred in exchange for shares or other ownership interests.

Such features are positive and welcome additions to the CT rules, particularly if other aspects of the CT regime prompt corporate restructurings (please see below with regards to transfer pricing). Furthermore, group relief is often sought to assist the financing of further mergers and acquisitions, potentially leading to increased activity in the UAE.

Transfer Pricing

Transfer pricing rules are expected to apply to transactions between related and connected persons, in accordance with the principles of the OECD Transfer Pricing Rules. Therefore, transactions between related or connected parties must be conducted on an arm's-length basis.

Large business groups, particularly family-owned conglomerates with cross-border operations may need to rethink their group structures and assess their intra-group transactions from a transfer pricing perspective, to ensure that their transactions are indeed conducted on an arm's-length basis.

Tax Credits

As noted above, UAE resident companies will be subject to UAE CT on their worldwide income, which includes foreign sourced income that may have been subject to tax of a similar nature to CT in another country. To avoid double taxation, the UAE CT regime will allow a credit for a foreign tax paid in a foreign jurisdiction against the UAE CT liability on the foreign-sourced income that has not been otherwise exempted.

Administrative Aspects

A business subject to CT will need to register with the FTA and obtain a tax registration number within a period of time to be prescribed in the law. The FTA can also automatically register a business for CT purposes if the person does not voluntarily do so. Businesses can also deregister if they cease to be subject to CT. To reduce administrative efforts and costs, businesses will only need to prepare and file one tax return (and other related supporting schedules) with the FTA for each tax period. A CT return must be filed, and any CT payment made, within nine months of the end of the relevant tax period.

Conclusion

The introduction of CT in the UAE logically follows from the UAE's role as a member of the OECD inclusive framework, particularly in light of discussions on the global minimum

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tax proposed by Pillar II. The proposed tax rate of 9% still remains highly competitive in comparison to other jurisdictions. In addition, it can be seen from the Consultation Document that the proposed CT regime is based on well-recognised and practiced international principles, making the cost and process of implementing the law relatively efficient for businesses subject to similar regimes in other jurisdictions. The law will seemingly also maintain some of the most distinct tax benefits of the UAE, for example, the tax benefits afforded to free zone registered entities. Inevitably, once the regime takes effect, different businesses might want to reconsider their corporate structures in order to avail themselves of the available tax benefits.

We would be happy to help clients consider and review their current corporate structures to assess the impact of the proposed UAE CT rules, and also discuss any opportunities resulting therefrom.

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[1] For further information regarding Pillar I and Pillar II of the OECD Base Erosion and Profit Shifting project, please refer to our UK Tax Quarterly Update – February 2022 (pp. 12-16) here.

[2] Consultation Document, ¶ 2.2.

[3] Consultation Document, Section 9.3.

[4] https://u.ae/en/information-and-services/finance-and-investment/taxation/corporate-tax.

[5] Consultation Document, Sections 3.3 and 3.7.

[6] Consultation Document, ¶ 4.4.

[7] Consultation Document, ¶ 4.21.

[8] Consultation Document, Section 6.3

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Gibson Dunn's lawyers are available to assist in addressing any questions that you may have regarding the issues discussed in this update. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Tax or Corporate practice groups, or the following authors:

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