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Economic Substance in the United Arab Emirates

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Shiv Mahalingham, of The Cragus Group, considers how the introduction of economic substance regulations in the United Arab Emirates is allowing multinational corporations the opportunity to consider their regional strategy.

The United Arab Emirates (UAE) is a substantial economy in the Middle East (circa $400 billion GDP) and an important regional financial center. Even in the current environment, there continues to be a flow of investment activity with multinational corporations (MNCs) looking to access the large skilled workforce, strong and stable regulatory framework and fiscal advantages.

This article sets out the importance of combining the annual review of economic substance with transfer pricing and other areas of international tax law to look for opportunities as well as managing risk and compliance.

A Brief Reminder of the Economic Substance Regulations and BEPS Action 5

The (recently updated) Economic Substance Regulations in the UAE maintain a good deal of consistency with OECD BEPS Action 5. The 2015 final report on Action 5 (countering harmful tax practices more effectively) confirmed that the lack of transparency and lack of substance are two critical issues to resolve. The Action 5 objective is clear to address:

”preferential regimes that risk being used for artificial profit shifting and the lack of transparency in connection with certain rulings.”

Note that the lack of transparency in certain rulings is an area that requires commitment from the tax administration to share information in relation to a unilateral tax ruling in one territory that may have an impact in another territory.

The lack of substance point relates to MNCs that may try to avail themselves of a tax benefit by shifting profits artificially without economic substance to a low tax or otherwise preferential tax regime. This highlights that the BEPS minimum standards fall upon both tax administrations and MNCs to address the manner in which they operate (i.e. this is not just a commitment for MNCs).

By way of reminder, under the UAE Economic Substance Regulations and in line with Action 5, it is important to demonstrate economic substance if a UAE entity is engaged in any of the following activities:

1. banking business
2. insurance business
3. investment fund management business
4. lease–finance business
5. headquarters business
6. shipping business
7. holding company business
8. intellectual property (IP) business
9. distribution and service center business

MNCs are required to review and assess economic substance each year and demonstrate the minimum required core income generating activities (CIGA). By way of example, a headquarter business will be required to:

1. take relevant management decisions;
2. incur operating expenditures on behalf of group entities;
3. coordinate group activities.

Economic Substance and Transfer Pricing

There is a clear segue from the above core income-generating activities into transfer pricing and BEPS which has the underlying principle that greater substance in a particular jurisdiction will support higher profits in that jurisdiction at arm's length (and conversely reduced substance will support lower profits). It is likely that UAE operations will include a great deal more than the core income generating activities and these operations can be priced at arm's length to justify the level of profits in the UAE.

Business Restructuring and Operational Changes in the Current Environment

The OECD Transfer Pricing Guidelines set out the important elements to consider when engaging in business restructuring to include:

1. MNCs are free to organize their business as they see fit;
2. there must be valid business reasons to support substance and profits in low tax areas;
3. it is important to ensure that all parties (MNC group companies) are operating/transacting at arm's length.

Minimum Substance Versus Maximum

The Action 5 Economic Substance Regulations confirm that the CIGA activities in question should be undertaken in the location in question and employees/expenditures related to the activities should be adequate and identifiable to be able to perform such activities.

It is important to consider risk and general transfer pricing principles in addition to Action 5 (which should be considered the minimum level of substance and not the maximum):

1. Which are the economically significant risks?
2. Which entities have contractual assumption of the risk?
3. Who is assuming and managing the risk?
4. Who is able to (financially) bear the risk?

There is also recent case law support for supporting economic substance in a low tax regime.

Contracting and Permanent Establishments

It is important to ensure that the contracting process and local substance outside of the UAE is managed to reduce potential permanent establishment challenges. Transfer pricing and economic substance are more concerned with economic rather than legal principles but these are of equal importance in a sustainable structure.

Improved Tax Treaty Framework in the UAE

MNCs operating in the UAE now have increased transparency and exchange of information provisions through:

1. economic substance reporting and automatic notifications for non-compliance;
2. country-by-country reporting;
3. improved tax treaty network.

The UAE has more than 90 tax treaties in force with more being negotiated. Whilst increased transparency and scrutiny is apparent, the new tax treaty network will result in many important benefits including potential reductions in withholding taxation and a forum for discussing/agreeing taxation disputes. It is important to factor this into the MNC’s regional footprint.

No More “Blacklisting” for the UAE?

The EU is an important investment partner for the MENA region and there has been an active review of jurisdictions including the Gulf Cooperation Council (GCC) to assess the overall fairness of these tax systems.

The overall goal of the EU “Blacklist” initiative is to improve tax governance (globally), and to ensure that the EU’s international trading partners such as the GCC member states respect the same standards adopted by EU member states.

The EU literature on the subject details the fact that the Blacklist is a result of a thorough screening and dialogue process with non-EU countries, to assess them against agreed criteria for good governance. These criteria relate to tax transparency, fair taxation, the implementation of OECD BEPS measures and substance requirements for zero-tax and low tax countries. The specific criteria were agreed by EU member states at the November 2016 ECOFIN and used as the basis for a screening "scoreboard."

Readers will recollect that Bahrain and the UAE were added to the Blacklist in December 2017 and Oman in March 2019. To date, KSA, Qatar and Kuwait have not been added to the Blacklist (most notably because the tax rates in these locations are in the 10%–20% range). Bahrain and the UAE were subsequently removed from the Blacklist following a spate of BEPS regulations being introduced and Oman is the only GCC member state that remains on the Blacklist. This has paved the way for renewed investment opportunities from the EU and other trade partners who have been observing this saga unfold.

In Summary

Economic substance in the UAE can support profits (or losses) in the UAE at arm's length. Experience has shown that the potential cash tax savings of a robust and tailored transfer pricing policy are significant whilst ensuring compliance with BEPS regulations and reduced transfer pricing audit challenges and adjustments.

It is important to differentiate between (i) harmful tax planning practices/tax avoidance targeted by BEPS; and (ii) tax mitigation through accepted practices. Examples of the latter may include deducting allowable businesses expenses when calculating taxable profits or may also include choosing to establish a regional hub in the UAE for commercial reasons such as access to an Arabic financial center and skilled workforce.

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