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Economic Substance Requirements and Transfer Pricing: best friends?

CONTEXT

In the evolving global tax landscape, the United Arab Emirates (UAE) has taken significant strides to align with the international tax standards. Central to these efforts, are the economic substance requirements (ESR) and transfer pricing (TP) regulations, both designed to ensure that profits are taxed where economic activities and value creation occur.

This article delves into the technical interplay between ESR and TP in the UAE context and draws on the importance of the compliance requirements for both.

Understanding the Economic Substance Requirements in the UAE

- The UAE introduced the Economic Substance Regulations (ESR) in 2019 [1], in response to the OECD's Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and EU's demands to curb harmful tax practices.

- The ESR regulations require UAE onshore and free zone companies and certain other business forms undertaking “Relevant Activities” to maintain and demonstrate an adequate “economic presence” in the UAE relative to their activities (“Economic Substance Test”). Relevant activities include activities such as banking, insurance, fund management, shipping, lease-finance, headquarters, holding company, intellectual property, distribution and service centers.

- Key aspects of ESR include:
  - **Core Income-Generating Activities (CIGAs)**: Entities must determine whether they have undertaken CIGAs in the UAE during the relevant ESR reporting period. In doing so, qualifying entities must demonstrate that their income-generating activities are substantial and effectively conducted in the UAE. Depending on the CIGAs concerned, qualifying entities must demonstrate that they have conducted actual operational activities, including hiring and employing adequate staff, having physical offices, and conducting management functions
  - **Reporting and Compliance**: entities must conduct an ESR assessment on an annual basis. Qualifying entities must annually file an ESR Notification and, where required, an Economic Substance Report to the UAE Ministry of Finance, demonstrating compliance with the UAE ESR requirements.

The role of Transfer Pricing in the UAE

While the UAE has traditionally not had transfer pricing regulations, its commitment to the OECD BEPS Action Plan has led to the introduction of TP rules as part of the Corporate Tax Law [2], effective from June 1, 2023.

(1) *The UAE issued Economic Substance Regulations (Cabinet of Ministers Resolution No. 31 of 2019) on 30 April 2019. Amendments to the UAE ESR Regulations were made by Cabinet of Ministers Resolution No. (57) of 2020 on 10 August 2020, and updated Guidance was issued on 19 August 2020 (Ministerial Decision No. (100) of 2020.*

(2) Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses.

Transfer Pricing rules are designed to ensure that transactions between related parties are conducted at arm's length, reflecting the true economic value of transactions as if they were between unrelated parties.

In summary, the key components of the Transfer Pricing regulations include:

- **Arm's Length Principle**: Transactions between related parties must be priced as if they were conducted between independent entities in comparable circumstances.

- **Profit attribution in alignment with the value creation**: Attribution of profits within a business value chain should be in line with the value creation. That is, the more an entity contributes to a value chain in terms of functions, risks and assets, the more it is entitled to profit allocation.

- **Documentation Requirements**: UAE entities, meeting certain conditions, must prepare and maintain comprehensive Transfer Pricing documentation, including a master file, local file, and Country-by-Country Reporting (CbCR) for large MNE groups.

Interconnection between Economic Substance Requirements and Transfer Pricing in the UAE

The link between ESR and TP is particularly significant in the UAE, given the jurisdiction's recent regulatory developments. Here's a closer look at how these frameworks intersect:

1. **Substance over form**: Both sets of rules emphasize the need for economic substance over mere legal form. Transfer Pricing regulations require transactions to reflect the economic conduct of the parties in respect of the intercompany transaction they participate into. In parallel, the economic substance rules demand that the entity's presence in a jurisdiction reflects genuine economic activity.

2. **Preventing profit shifting**: Economic substance requirements complement Transfer Pricing rules by ensuring that profits reported in a jurisdiction correspond to real economic activities conducted there. This alignment prevents multinational groups from using artificial (non-substantial) tax arrangements to shift profits from one jurisdiction to another, without a corresponding real economic activity in place.

3. Enhanced Compliance and Reporting: Both ESR and TP regulations necessitate robust compliance frameworks. Entities that fall in scope of the ESR and/or TP regulations, must file annual reports for ESR and maintain detailed TP documentation. The overlap in documentation requirements means that entities must ensure consistency in reporting economic activities and related party transactions.

4. Jurisdictional Consistency: ESR regulations ensure that entities are not merely established in a jurisdiction for tax benefits. At the same time, Transfer Pricing rules ensure that inter-company pricing reflects economic realities and that transactional structures are not merely put in place by multinational groups to leverage on tax benefits that are available in a specific jurisdiction without having regard to the substance of their local activities in said jurisdiction.

Key takeaways for UAE businesses

The introduction of ESR and TP regulations marks a significant shift in the UAE's tax framework, aligning it with global standards. For businesses operating in the UAE, understanding and integrating these requirements is crucial. Moreover, in cases where both ESR and TP documentation requirement apply, close attention needs to be paid to the following:

- **Qualitative alignment**: ensuring consistency between the ESR (notification and report) and the Transfer Pricing documentation. Especially as it comes to the description of functions, risks and assets in both the Transfer Pricing local file as well as the Master File. The narrative around the core economic role and activities of the qualifying UAE entities should not carry any contradiction between both the ESR and TP reporting.

- **Quantitative alignment**: ensuring consistency between the amounts and group counterparties reported for intercompany transactions in both the ESR and TP reporting. Certain CIGAs, for example Service and Distribution Centres, are strictly related to transactions or activities with group companies. Hence it is important, to ensure consistency in terms of financial data reported.

As the UAE continues to evolve as a major business hub, these regulations will play a pivotal role in maintaining its reputation as a compliant and attractive jurisdiction for multinational enterprises. It is hence crucial for UAE business to continue complying with these regulations.

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