Transfer Pricing Guide

Corporate Tax Guide | CTGTP1

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1. Glossary

1.1. Definitions

Arm's Length Price: The price determined for a specific business transaction in accordance with the Arm's Length Principle.

Arm's Length Principle: The international standard that the Organisation for Economic Co-operation and Development (OECD) member countries and many other jurisdictions have agreed to use for determining transfer prices for tax purposes. The principle is set forth in Article 9 of the OECD Model Tax Convention as follows:
where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (OECD, 2017)

Business: Any activity conducted regularly, on an ongoing and independent basis by any Person and in any location, such as industrial, commercial, agricultural, vocational, professional, service or excavation activities or any other activity related to the use of tangible or intangible properties.

Business Activity: Any transaction or activity, or series of transactions or series of activities conducted by a Person in the course of its Business.

Business Restructuring: A cross-border or domestic reorganisation of the commercial or financial relations between Related Parties or Connected Persons, including the termination or substantial renegotiation of existing arrangements.

Comparable Uncontrolled Price Method: A Transfer Pricing method that compares the price 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.

Comparable Uncontrolled Transaction: A transaction between two independent parties that is comparable to the transaction under examination ("Controlled Transaction"). It 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").

Connected Person: Any Person affiliated with a Taxable Person as determined in Clause 2 of Article 36 of the Corporate Tax Law.

Consolidated Financial Statements: The financial statements of the MNE Group in which the assets, liabilities, revenues, expenses, and cash flows of the Ultimate Parent Entity and Constituent Entities are presented as those of a single economic entity.

Constituent Company: Means under Article 1 of the Cabinet Resolution No. 44 of 2020 any of the following:

1. Any separate business unit of an MNE Group that is included in the Consolidated Financial Statements of the MNE Group for the purposes of preparing the financial reports, or would be so included therein if equity interests therein were traded on a public securities exchange;
2. Any business unit that is excluded from the MNE Group's Consolidated Financial Statements solely on size or materiality grounds;
3. Any permanent establishment pertaining to any separate business unit of the MNE Group referred to in Clauses (1) or (2) above, provided that the said business unit prepares separate financial statements for such permanent establishment for the purposes of financial reporting preparation, regulatory, tax reporting, or internal management control purposes.

Control: The direction and influence over one Person by another Person in accordance with Clause 2 of Article 35 of the Corporate Tax Law.

Controlled Transactions: Transactions or arrangements between two parties that are Related Parties or Connected Persons.

Corporate Tax: The tax regime imposed by the Corporate Tax Law on juridical persons and Business income.

Corporate Tax Law: Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses.

Cost Plus Method: A Transfer Pricing method using the costs incurred by the supplier of goods (or services) in a Controlled Transaction. An appropriate cost-plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. The amount after adding the cost-plus mark-up to the above costs may be regarded as an Arm's Length Price of the original Controlled Transaction.

Country-by-Country Report: A report that declares annually the details of each tax jurisdiction in which a Multinational Enterprise Group ("MNE") does business. This includes the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs

to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

Country-by-Country Reporting: An obligation to submit a Country-by-Country Report as introduced by Action 13 of the Base Erosion and Profit Shifting ("BEPS") initiative led by the Organisation for Economic Co-operation and Development ("OECD") and the Group of Twenty ("G20") industrialised nations. This is enforced in the UAE via Cabinet Resolution No. 44 of 2020 on Organising Reports submitted by Multinational Companies.

Double Taxation Agreement: An international agreement signed by two or more countries for the avoidance of double taxation and the prevention of fiscal evasion on income and capital.

Exempt Person: A Person exempt from Corporate Tax under Article 4 of the Corporate Tax Law.

Fiscal Year: The annual accounting period in respect to which the Reporting Entity prepares the financial statements.

Free Zone: A designated and defined geographic area within the UAE that is specified in a decision issued by the Cabinet at the suggestion of the Minister.

Free Zone Person: A juridical person incorporated, established or otherwise registered in a Free Zone, including a branch of a Non-Resident Person registered in a Free Zone.

Federal Tax Authority: The authority in charge of administration, collection and enforcement of federal taxes in the UAE.

Functional Analysis: The analysis aimed at identifying the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.

Group: Two or more companies related through ownership or control in accordance with Article 1 of the Cabinet Resolution No. 44 of 2020, such that it either is required to prepare Consolidated Financial Statements for the purposes of preparing financial reports under the applicable accounting principles or would be so required if the equity interests in any of the companies were traded on a public securities exchange.

Guide: Refers to the present Transfer Pricing Guide published by the FTA.

Local File: A Transfer Pricing documentation which contains detailed information on all Controlled Transactions of the Taxable Person and other information about the Business of the Taxable Person.

Market Value: The price which could be agreed in an arm's-length free market transaction between Persons who are not Related Parties or Connected Persons in similar circumstances.

Master File: A Transfer Pricing documentation which provides an overview of the MNE Group Business, including the nature of its global Business operations, its overall Transfer Pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant Transfer Pricing risk.

Minister: Minister of Finance.

MNE Group: Any Group that meets the criteria prescribed in Article 1 of Cabinet Resolution No. 44 of 2020:

1. Two or more companies the tax residence of which is located in different jurisdictions, or including one single company having its tax residence in one country and being subject to tax with respect to the activity it carries out through a permanent entity located in another country; and
2. Which has a total consolidated Group revenue that is equal to or more than AED 3,150,000,000 (UAE Dirham Three Billion One Hundred and Fifty Million) during the Fiscal Year immediately preceding the reporting Fiscal Year as indicated in its Consolidated Financial Statements for that preceding Fiscal Year.

OECD Model Convention: The 2017 version of the OECD Model Tax Convention on Income and Capital.

Natural Person: Individual human being (distinct from a juridical person).

Non-Resident Person: The Taxable Person specified in Article 11(4) of the Corporate Tax Law.

OECD Transfer Pricing Guidelines: The 2022 version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Person: Any Natural Person or Juridical Person.

Profit Split Method: A Transfer Pricing method that identifies the relevant profits to be split for the Related Parties or Connected Persons from a Controlled Transaction (or Controlled Transactions that can be aggregated) and then splits those profits

between the Related Parties or Connected Persons on an economically valid basis that approximates the division of profits that would have been agreed at arm's length.

Recognised Stock Exchange: Any stock exchange established in the UAE that is licensed and regulated by the relevant competent authority, or any stock exchange established outside the UAE of equal standing.

Related Party: Any Person associated with a Taxable Person as determined in Article 35(1) of the Corporate Tax Law.

Reporting Entity: The Ultimate Parent Entity of an MNE Group in accordance with Article 1 of the Cabinet Resolution No. 44 of 2020 whose tax residence is located in the UAE and is required to submit a Country-by-Country Report on behalf of the MNE Group.

Resale Price Margin: The margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

Resale Price Method: A Transfer Pricing method based on the price at which a product that has been purchased from a Related Party is resold to an Independent Party. The resale price is reduced by the Resale Price Margin. What is left after subtracting the Resale Price Margin can be regarded, after adjustment for other costs associated with the purchase of the product (for example, custom duties), as an Arm's Length Price of the original transfer of property between the Related Parties or Connected Persons.

Resident Person: The Taxable Person specified in Article 11(3) of the Corporate Tax Law.

Tax Period: The period for which a Tax Return is required to be filed.

Tax Return: Information filed with the FTA for Corporate Tax purposes in the form and manner as prescribed by the FTA, including any schedule or attachment thereto, and any amendment thereof.

Taxable Income: The income that is subject to Corporate Tax under the Corporate Tax Law.

Taxable Person: A Person that is subject to Corporate Tax under the Corporate Tax Law.

Transactional Net Margin Method: A Transfer Pricing method that examines the net profit margin relative to an appropriate base (for example, costs, sales, assets) that a Taxable Person realises from a Controlled Transaction (or transactions that are appropriate to be aggregated).

Transfer Pricing: Rules on setting of arm's length prices for Controlled Transactions, including but not limited to the provision or receipt of goods, services, loans and intangibles.

Ultimate Parent Entity: The Constituent Company in the MNE Group that meets the following criteria stated in Article 1 of the Cabinet Resolution No. 44 of 2020:

1. Owns directly or indirectly a sufficient interest in one or more Constituent Companies of such MNE Group as is required to prepare Consolidated Financial Statements under the accounting principles generally applicable in its jurisdiction tax residence, or be so required if its equity interests were traded on a public securities exchange in its jurisdiction tax residence; and
2. Its Group does not include any other Constituent Company that owns directly or indirectly an interest described in Clause (1) above in such entity.

1.2. Acronyms and Abbreviations

AED: United Arab Emirates Dirham

BEPS: Base Erosion and Profit Shifting

CbCR: Country-by-Country Reporting

CCA: Cost Contribution Arrangement

CPM: Cost Plus Method

CUP: Comparable Uncontrolled Price

DEMPE: Development, Enhancement, Maintenance, Protection and Exploitation

DTA: Double Taxation Agreement

FTA: Federal Tax Authority

MNE: Multinational Enterprise

OECD: Organisation for Economic Co-operation and Development

PE: Permanent Establishment

PSM: Profit Split Method

RPM: Resale Price Method

R&D: Research and Development

TNMM: Transactional Net Margin Method

TP: Transfer Pricing

UAE: United Arab Emirates

2. Introduction

2.1. Overview

Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses ("Corporate Tax Law") was issued on 3 October 2022 and was published in Issue #737 of the Official Gazette of the United Arab Emirates ("UAE") on 10 October 2022.

The Corporate Tax Law provides the legislative basis for imposing a federal tax on corporations and Business profits ("Corporate Tax") in the UAE.

The provisions of the Corporate Tax Law shall apply to Tax Periods commencing on or after 1 June 2023.

2.2. Purpose of this guide

This guide is designed to provide general guidance on the Transfer Pricing regime in the UAE with a view to making the provisions of the Transfer Pricing regulations as understandable as possible to readers. It provides readers with:

- an overview of the Transfer Pricing rules and procedures, including the determination of the Related Party transactions, whether transactions are done on an Arm's Length basis, and other related compliance requirements including Transfer Pricing documentation; and
- assistance with the most common questions businesses might have to reduce uncertainties for Taxable Persons in relation to the implementation and application of the Transfer Pricing provisions of the Corporate Tax Law.

2.3. Who should read this guide?

This guide should be read by any juridical or natural person who wants to know more about the Transfer Pricing regime in the UAE. It is intended to be read in conjunction with the Corporate Tax Law, the implementing decisions and other relevant guidance published by the FTA.

2.4. How to use this guide

The relevant articles of the Corporate Tax Law and the implementing decisions are indicated in each section of the guide.

It is recommended that the guide is read in its entirety to provide a complete understanding of the definitions and interactions of the different rules. Further guidance on some of the areas covered in this guide can be found in other topic-specific guides.

In some instances, simple examples are used to illustrate how key elements of the Transfer Pricing regime applies to juridical and natural persons. The examples in the guide:

- show how these elements operate in isolation and do not show the interactions with other provisions of the Transfer Pricing regime that may occur. They do not, and are not intended to, cover the full facts of the hypothetical scenarios used nor all aspects of the Transfer Pricing regime, and should not be relied upon for legal or tax advice purposes; and
- are only meant for providing the readers with general information on the subject matter of this guide. They are exclusively intended to explain the rules related to the subject matter of this guide and do not relate at all to the tax or legal position of any specific juridical or natural person.

2.5. Legislative references

In this guide, the following legislation will be referred to as follows:

- Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses is referred to as "Corporate Tax Law";
- Federal Law No. 5 of 1985 on the Civil Transactions Law of the United Arab Emirates is referred to as "Federal Law No. 5 of 1985".
- Cabinet Resolution No. 44 of 2020 on Organising Reports Submitted by Multinational Companies as "Cabinet Resolution No. 44 of 2020"; and
- Ministerial Decision No. 97 of 2023 on Requirements for Maintaining Transfer Pricing Documentation for the Purposes of Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses is referred to as "Ministerial Decision No. 97 of 2023".[1]

2.6. Status of this guide

This guidance is not a legally binding document, but is intended to provide assistance in understanding the provisions relating to the Corporate Tax regime in the UAE. The information provided in this guide should not be interpreted as legal or tax advice. It is not meant to be comprehensive and does not provide a definitive answer in every case. It is based on the legislation as it stood when the guide was published. Each person's own specific circumstances should be considered.

The Corporate Tax Law, the implementing decisions and the guidance materials referred to in this document will set out the principles and rules that govern the application of Corporate Tax. Nothing in this publication modifies or is intended to modify the requirements of any legislation.

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[1] The Master File and Local File requirements, along with the existing Country-by-Country reporting requirements detailed in Cabinet Resolution No. 44 of 2020 form the three-tiered approach to Transfer Pricing documentation.

This Guide takes into consideration the guidance provided by the January 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Transfer Pricing Guidelines"). However, Taxable Persons should rely primarily on the Corporate Tax Law, the Ministerial Decision No. 97 of 2023, and this Guide for Transfer Pricing matters involving the UAE. This Guide should be primary source of guidance for Transfer Pricing related matters prevailing over international standards, however, if a certain aspect is not covered, taxpayers are encouraged to refer to OECD Transfer Pricing Guidelines if an issue is not addressed herein. Furthermore, the following reports have been considered:

- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of 2022, referred to as "OECD Transfer Pricing Guidelines";[2]
- OECD Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, referred to as "BEPS Action 13";
- OECD 2010 report on the Attribution of Profits to Permanent Establishments issued by the OECD for further guidance;[3]
- OECD Model Tax Convention on Income and Capital of 2017, referred to as "OECD Model Convention";[4] and
- OECD 2018 Additional Guidance on the Attribution of Profits to Permanent Establishments.[5]

The FTA reiterates the need for keeping supporting documentation to justify the application of the chosen Transfer Pricing method or of the relevant rules for the specific taxable person.

This document is subject to change without notice.

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[2] Available at: https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm.

[3] Available at: https://www.oecd.org/ctp/transfer-pricing/45689524.pdf.

[4] Available at: https://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm

[5] Available at: https://www.oecd.org/tax/transfer-pricing/additional-guidance-attribution-of-profits-to-permanent-establishments-BEPS-action-7.pdf

3. Transfer Pricing at a glance

Transfer Pricing refers to the pricing of transactions between Related Parties or Connected Persons, and has become increasingly important due to globalisation and cross border trade activities by enterprises. The significance of Transfer Pricing has resulted in the introduction of Transfer Pricing legislation in many countries. Organisations such as the OECD and the United Nations ("UN") have published detailed Transfer Pricing guidelines proposing how to govern transactions between Related Parties from a tax perspective and recommended documentation standards.

Whilst the Transfer Pricing policy of a Group may not have an overall impact on that Group's consolidated profits, the pricing of its Controlled Transactions can lead to the underpayment of tax in one or more jurisdiction. In particular, transactions and arrangements between Group entities can be used to artificially shift profits from Group entities in higher tax jurisdictions to lower tax jurisdictions, and from high-tax entities to low or no-tax entities, resulting in an overall lower tax burden for the Group.

To prevent such price distortions, tax administrations may assess the prices of transactions between Related Parties or Connected Persons to verify if the transactions have been priced at Market Value. Tax administrations may perform a Transfer Pricing adjustment if a transaction is not found to be reflective of the Market Value or Arm's Length Price.

Such adjustments can result in double taxation for MNE Groups operating in multiple jurisdictions. However, the Mutual Agreement Procedure ("MAP") article in Double Tax Agreements allows competent authorities in partner jurisdictions to interact with the intent to resolve international tax disputes involving cases of double taxation where the same profits have been taxed in two jurisdictions. The objective of the MAP process is to negotiate an arm's length position that is acceptable to both competent authorities and seek to avoid double taxation. This procedure will be further detailed in separate guidance.

To reduce the risk of audits and double taxation, when transacting with Related Parties or Connected Persons, Taxable Persons should ensure the transfer price between the parties is at arm's length (i.e. as if they were independent parties negotiating freely) and maintain supporting Transfer Pricing documentation.

Transfer Pricing rules in the UAE apply not only to MNE Groups, but also to any transactions and arrangements with Related Parties or Connected Persons in domestic groups. All these transactions need to meet the arm's length principle. In addition, transactions above the materiality threshold to be set through an FTA

Decision[6] will need to be disclosed for the purposes of Transfer Pricing ("TP") Documentation.

[6] FTA Decision to be published.

4. Transfer Pricing Principles and Fundamentals

4.1. Overview

The purpose of this section is to introduce the concept of Transfer Pricing as well as clarify the Persons and transactions in scope for the application of the Arm's Length Principle in the UAE.

4.2. What is Transfer Pricing

Transfer Pricing is primarily a tax concept, but which also has important accounting and risk-related implications. It refers to the pricing of transactions or arrangements between Related Parties or Connected Persons that are influenced by the relationship between the transacting parties. Transactions that occur between Related Parties or Connected Persons may include but are not limited to the trade of services, tangible goods, intangibles, financial transactions as well as certain transactions involving a Permanent Establishment (PE).

When independent parties transact with each other, the conditions of their commercial and financial relations (for example, the price of goods transferred, or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces and negotiations. On the other hand, Related Parties or Connected Persons may not be subject to the same external market forces in their dealings and may be influenced by the relationship between the parties involved. As a result, Related Parties or Connected Persons can use non-arm's length pricing in their Controlled Transactions in order to alter the profits reported in the relevant jurisdiction or entity and thus optimise the resulting tax liabilities.

The internationally recognised standard in pricing such transactions is the Arm's Length Principle, which requires that Controlled Transactions be conducted at open market value as would be the case between independent parties.

Given the above, the Transfer Pricing provisions of the Corporate Tax Law and the Ministerial Decision No. 97 of 2023 were introduced to ensure that the 'Related Parties' and 'Connected Persons' are setting the conditions of their Controlled Transactions in a manner that is similar to those between independent parties in comparable circumstances.

4.3. The Arm's Length Principle

The Arm's Length Principle, as introduced in the UAE under Article 34 of the Corporate Tax Law, requires that transactions and arrangements between Related Parties or Connected Persons are priced as if the transactions or arrangements had occurred between independent parties under similar circumstances. It is central to the Arm's

Length Principle to consider what price two independent parties would have agreed in similar circumstances, and that this should be based, wherever possible, on direct or indirect evidence of how independent parties would have behaved.

It is important to note that the absence of a formal pricing arrangement or legal agreement between the transacting Related Parties or Connected Persons does not mean that there is no such arrangement in place. In instances where a transfer of property takes place or a service is provided without a formal arrangement or without remuneration or at remuneration below Market Value, the Arm’s Length Principle should always be applied to determine whether such a transaction or arrangement would have taken place between independent parties under similar circumstances and at what value.

The Arm’s Length Principle treats Related Parties and Connected Persons, such as for example, members of a Group, as if they were operating as separate entities rather than as inseparable parts of a single unified Business. Since the separate entity approach treats these members as if they were independent parties, attention is focused on the nature of the Controlled Transactions and on whether the conditions differ from the conditions that would be observed in Comparable Uncontrolled Transactions. Such a comparison of the Controlled Transaction(s) with Comparable Uncontrolled Transactions is named as a “comparability analysis” and is at the heart of the application of the Arm’s Length Principle (see further in section 5).

In other words, the Corporate Tax Law requires Related Parties or Connected Persons to earn their “fair share” of profits based on the Arm’s Length Principle. Thus, after applying the Arm’s Length Principle, each Related Party or Connected Person should record operating profits in line with their respective functions, assets, and risks and contributions to the value chain across the Group.

Under the Corporate Tax Law and this Guide, the Arm’s Length Principle needs to be applied with respect to domestic as well as cross-border Controlled Transactions.

Example 1: Transactions between Related Parties

AB Group is a furniture company group with two subsidiaries: Company A, a sawmill located in the UAE, and Company B, a manufacturing company located in Country B where corporate profits are taxed at 5%.

Company B purchases a ton of timber from Company A at a price of AED 15,000. The cost for Company A to produce a ton of timber is AED 15,000. The market price for a ton of timber is AED 20,000.

	Production cost	Sale price from Company A to Company B (related parties)	Market price
Company A (AED)	15,000	15,000	20,000

Company A has made no profit on the sale to Company B, whereas it would have made a profit of AED 5,000 had it sold its timber to a third party, resulting in an overall decrease in profit of AED 5,000 compared to if Company B had paid under an Arm's Length Price transaction.

Company B subsequently sells the goods manufactured using the timber to a third party for AED 30,000. Company B has decreased its cost of sales by AED 5,000 by purchasing at the internal transfer price from Company A as opposed to the market price from a third party. Hence, Company B has increased its profits by AED 5,000.

However, whilst Company A has seen a fall in its profit of AED 5,000 and Company B has seen an increase in its profit of AED 5,000, the overall impact on the Group's earnings is nil, as both transactions occurred within the Group and related party transactions are generally eliminated while preparing consolidated financial statements.

	Sale below market price		**Sale at market price**	
	Company A	**Company B**	**Company A**	**Company B**
Profit (AED)	0	15,000	5,000	10,000
Tax rate in jurisdiction	9%	5%	9%[7]	5%
Tax paid (AED)	0	750	450	500
Total tax paid (AED)	750		950	

Although the overall profit of the Group company has not changed, the application of Transfer Pricing and the structure of AB Company Group has resulted in total tax paid of AED 750, consisting of 0 AED for Company A and 750 AED for Company B.

Whereas if the transaction was conducted at Market Value, the total tax payable would be AED 950, comprised of AED 450 by Company A and AED 500 by Company B.

[7] For the purposes of the example, the headline rate of 9% was applied on the entire Taxable Income.

Therefore, the non-arm's length pricing of goods transferred between Related Parties has shifted profits between jurisdictions, resulting in a tax benefit for this Group. These transactions would need to be adjusted in line with the Arm's Length Principle and reflect the Market Value. As a consequence, the total tax payable by AB Group will increase.

4.4. Scope of the Transfer Pricing rules

The Transfer Pricing provisions in the UAE apply to transactions or arrangements between Persons who are Related Parties or Connected Persons.

Exempt entities or entities which have elected for the small business relief, as well as standalone entities with no Related Party transactions are subject to Transfer Pricing rules and need to meet the Arm's Length Principle in case of Controlled Transactions but are not required to prepare and keep TP Documentation.

4.4.1. Related Parties and Connected Persons

4.4.1.1. Related Parties

Transfer Pricing rules apply to Related Parties, which are defined under Article 35 of the Corporate Tax Law as any associated Persons, according to a specified degree of association. This association means pre-existing relationship with another Person through kinship (in case of natural persons), ownership or Control, regardless of whether that other Person is resident or not in the UAE.

The criteria for determining association between Related Parties have been categorised and detailed below:

4.4.1.2. Kinship or affiliation

The definition of kinship or affiliation covers the relationship of two or more individuals who are related up to the fourth degree of kinship or affiliation, including by way of adoption of guardianship.

In the context of the UAE[8], kinship includes common blood ties as determined by the ancestors or common ancestors of the individual, where an ancestor or common ancestor may include guardians or adoptive parents, and affiliation covers relationship by marriage, or if one natural person's spouse is related by kinship to the other Natural Person.

[8] Federal Law No. 5 of 1985 on the Issuance of Civil Transactions Law, and its amendments.

Degrees of kinship or affiliation include:

- The first-degree of kinship and affiliation: a Natural Person's parents and children, as well as the parents and children of their spouse.
- The second-degree of kinship and affiliation: additionally, includes a Natural Person's grandparents, grandchildren, and siblings, as well as the grandparents, grandchildren, and siblings of their spouse.
- The third-degree of kinship and affiliation: additionally, includes a Natural Person's great-grandparents, great-grandchildren, uncles, aunts, nieces and nephews, as well as the great-grandparents, great grandchildren, uncles, aunts, nieces and nephews of their spouse.
- The fourth-degree of kinship and affiliation: additionally, includes a Natural Person's great-great-grandparents, great-great-grandchildren, grand uncle, grand aunt, grandniece, grandnephew and first cousins, as well as the great-great-grandparents, great-great-grandchildren, grand uncle, grand aunt, grandniece, grandnephew and first cousins of their spouse.

4.4.1.3. Ownership

A Natural Person and a juridical person are Related Parties by way of ownership where the individual, or one or more Related Parties of the individual, are shareholders in the juridical person, and the individual, alone or together with its Related Parties, directly or indirectly owns a 50% or greater ownership interest in the juridical person.

Two or more juridical persons are Related Parties by way of ownership if:

- a juridical person, alone or together with its Related Parties, directly or indirectly owns a 50% or greater ownership interest in the other juridical person; or
- any Person, alone or together with its Related Parties, directly or indirectly owns a 50% or greater ownership interest in such two or more juridical persons.
- as per Article 35(1)(b)(1) of the Corporate Tax Law, the Natural Person or one or more Related Parties of the Natural Person are shareholders in the juridical person, and the Natural Person, alone or together with its Related Parties, directly or indirectly owns a 50% (fifty percent) or greater ownership interest in the juridical person. Likewise, as per Article 35(1)(c)(1); one juridical person, alone or together with its Related Parties, directly or indirectly owns a 50% (fifty percent) or greater ownership interest in the other juridical person.

Example 2: Computation of indirect holding

Company A holds 100% ownership interest in Company B.
Company B holds 90% ownership interest in Company C.
Company C holds 80% ownership interest in Company D.

Based on Article 35(1)(c)(1), Company B is a Related Party of Company A. This is because Company A directly owns a 50% or greater ownership interest in Company B.

Two or more juridical persons can also be considered as Related Parties where one juridical person, alone or together with its Related Parties, directly or indirectly owns a 50% or greater ownership interest in the other juridical person.

In the above case, Company A indirectly has an ownership interest in Company D. The percentage of ownership interest of Company A in Company D is 100% X 90% X 80% = 72%. As the indirect ownership interest is more than 50%, Company D is a Related Party of Company A.

4.4.1.4. Control

Persons may also be considered as Related Parties through direct or indirect 'Control'. Control is the direction and influence over one Person by another Person and can be determined in several ways including but not limited to instances where:[9]

- a Person can exercise 50% or more of the voting rights of another Person;
- a Person can determine the composition of 50% or more of the board of directors of another Person;
- a Person can receive 50% or more of the profits of another Person; or
- a Person can determine, or exercise significant influence over, the conduct of the Business and affairs of another Person.

Most of these determinants, in particular the 50% threshold, are indicators of common parent-subsidiary relationships. However, the ability of a Person to exercise 'significant influence' over another Person consists of the exercise of influence and direction on the conduct of a Business and may require consideration of different factors and circumstances that are specific to the scenario being tested.

The following examples illustrate how a Person can have Control by exercising significant influence over the actions of another Person, however, the underlying facts and circumstances need to be considered on a case-by-case basis when determining the existence of Control.

[9] Article 35(2) of the Corporate Tax Law.

Example 3: Significant influence based on debt

Company X is part of an MNE Group headquartered in the UAE. It conducts Business with an independent third-party Company Z and both have developed a strong commercial relationship over the years.

Company Z decides to expand its Business and instead of approaching a bank, it approaches Company X for a loan. Company X agrees to provide a loan.

The Balance Sheet of Company Z before the loan is shown below:

Equity and liabilities (i.e. capital)	Amount in AED million	Assets	Amount in AED million
Share capital	100	Fixed Assets	70
Liabilities		Cash and cash equivalent	30
Total capital	**100**	**Total**	**100**

The Balance Sheet of Company Z after the loan is shown below:

Equity and liabilities (i.e. capital)	Amount in AED million	Assets	Amount in AED million
Share capital	100	Fixed Assets	140
Loan from Company X	100	Cash and cash equivalent	60
Total capital	**200**	**Total assets**	**200**

In the above case, the loan from Company X constitutes 50% of the total capital of Company Z. It was also noted that after receiving this loan, Company Z registered an increase in its fixed assets and cash. A further fact-finding exercise suggests that Company X (by virtue of the loan) has started exercising significant influence over Company Z through the development of business strategy, design product portfolio and pricing, determining target customer base, and other activities, which are core to Company Z's Business.

Based on the facts, it can be reasonably established that Company X is able to exercise significant influence and as a result both Company X and Company Z can be regarded as Related Parties.

Example 4: Establishing Control – Entitlement to Profit Share

Company A, a company resident in the UAE, has licensed a software to Company B, resident in country Y, which allows it to operate and run its day-to-day business activities in country Y.

Company A and Company B signed a royalty agreement, which entitles Company A to 50% of profits generated by Company B from the use of the software in country Y as remuneration for the use of the software.

Under Article 35(2)(c) of the Corporate Tax Law, control can be established where a Person is entitled to 50% or more profits of another Person. Thus, Company A is deemed to have Control over Company B as Company A is entitled to 50% of Company B's profits.

Example 5: Establishing Control - Majority interest

Company X is a UAE company that is 51% owned by Company A (a UAE company) and 49% by Company Y (a foreign company).

While Company A owns a majority interest in Company X, the management of day-to-day operations, development of strategies, and formulation of the key market decisions are the functions of Company Y.

Based on the above, it can be established that Company Y has Control over Company X even though its shareholding is below 50% due to the key role in market decisions.

In this case, both Company A and Company Y would be considered Related Parties of Company X through ownership and Control, respectively.

4.4.1.5. Related Parties – additional criteria

"Related party" also means any of the following ties:

- a Person and its Permanent Establishment ("PE") or Foreign PE,[10] meaning that Transfer Pricing rules apply to transactions between a Person and their PE or Foreign PE;
- two or more Persons that are partners in the same Unincorporated Partnership; and
- a Person who is the trustee, founder, settlor or beneficiary of a trust or foundation and the trust or foundation, including the trust's or foundation's Related Parties.

[10] A permanent establishment has the meaning referenced in Article 14 of the Corporate Tax Law.

4.4.1.6. Connected Persons

Where a Person is considered to be a Connected Person of a Taxable Person, all payments or benefits provided by the Taxable Person to the Connected Person are deductible for Corporate Tax purposes only to the extent that they correspond to the Arm's Length Price of the service or benefit provided and they are incurred wholly and exclusively for the purposes of the Taxable Person's Business.

A Person is considered a Connected Person of a Taxable Person if that Person is:[11]

- an individual, who directly or indirectly owns an ownership interest in the Taxable Person or Controls such Taxable Person, or a Related Party of such individual;
- a director or officer of the Taxable Person, or a Related Party of the said director or officer; or
- a partner in an Unincorporated Partnership, and any Related Parties of such partner.

Article 36(6) of the Corporate Tax Law specifies the categories of Taxable Persons where the deduction of payments or benefits provided to their Connected Persons is not restricted to the Arm's Length Price. These Taxable Persons would include any of the following:

- a Taxable Person whose shares are traded on a recognised stock exchange;
- a Taxable Person that is subject to the regulatory oversight of a competent authority in the UAE; and
- any other Person as may be determined in a decision to be issued by the Cabinet.

4.4.1.7. International agreements for the avoidance of double taxation

The domestic legislative basis for Transfer Pricing in the UAE can be found under Articles 34 to 36 of the Corporate Tax Law. In addition, the UAE also has a well-established double taxation agreement network.

Under the terms of certain agreements entered by the UAE for the avoidance of double taxation, reference is made to "Associated Enterprises". The OECD Model Convention defines the term and sets out the conditions that should be observed in transactions that include these "Associated Enterprises".[12] In particular, the OECD Model Convention states that the transactions between those parties are to be conducted in a manner that is similar to those that would occur amongst independent parties in comparable circumstances.

[11] Article 36(2) of the Corporate Tax Law.

[12] For example, in Article 9 of the OECD Model Convention.

In the event of differences between the UAE Transfer Pricing regulations and an international agreement in force in the UAE, the provisions of the international agreement will prevail.

4.4.2. Controlled Transactions

A “Controlled Transaction” is a transaction or arrangement between Related Parties or Connected Persons. Controlled Transactions generally include the supply or transfer of tangible goods, provision and receipt of services, funding and other financial transactions, and commercial exploitation of intangible assets such as patents, brands and know-how.

For the purposes of the UAE Transfer Pricing rules, all cross border Controlled Transactions (i.e. transactions between the Person and its Related Parties or Connected Persons that are located in different tax jurisdictions) as well as domestic Controlled Transactions (i.e. transactions between Related Parties or Connected Persons located in the UAE, including transactions undertaken between Free Zone Persons) must follow the Arm’s Length Principle.

5. Application of the Arm's Length Principle

This section provides guidance on the three key steps in applying the Arm's Length Principle for Controlled Transactions:

Step 1: Identify Related Parties, Connected Persons, relevant transactions and arrangements and perform a comparability analysis accordingly.

Step 2: Selection of the most appropriate Transfer Pricing method.

Step 3: Determination of the Arm's Length Price

5.1. Step 1: Identify Related Parties, Connected Persons, relevant transactions and arrangements and perform a comparability analysis accordingly

As stated in Section 3, a comparability analysis is at the heart of the application of the Arm's Length Principle, which is based on a comparison of the conditions in a Controlled Transaction with the conditions that would have been met had the parties been independent and undertaking a comparable transaction under comparable circumstances.

A comparability analysis refers to the comparison of a Controlled Transaction with Comparable Uncontrolled Transaction(s). A Controlled Transaction and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (for example price or margin), or if reasonably accurate adjustments can eliminate the material effects of any such differences.

A comparability analysis includes two key aspects:

a. Identifying the Related Parties, Connected Persons, commercial or financial relations between the Related Parties or Connected Persons and the conditions and economically relevant circumstances attaching to those relations in order that the Controlled Transaction is accurately delineated.
b. Comparing the conditions and the economically relevant circumstances of the Controlled Transaction as accurately delineated with the conditions and the economically relevant circumstances of Comparable Uncontrolled Transactions.

"Accurate delineation" refers to the recognition of the actual Controlled Transaction based on actual conduct over contractual form by analysing the functions performed, risks assumed and assets used by each party to the transaction.

This section provides guidance on identifying the commercial or financial relations between Related Parties or Connected Persons and on accurately delineating the Controlled Transaction.

5.1.1. Identification of the commercial and financial relations

The application of the Arm's Length Principle depends on identifying the conditions that independent parties would have agreed to in Comparable Uncontrolled Transactions. The economically relevant characteristics and circumstances can impact the conditions of a transaction between independent parties. Therefore, it is also important to identify and consider the economically relevant characteristics of the conditions of the Controlled Transaction and the circumstances in which the Controlled Transaction takes place.

In order to understand these economically relevant characteristics, it is important to identify the commercial and financial relations between the Related Parties or Connected Persons. The typical process of identifying these relations and the related conditions and circumstances generally requires the following:

1. Conducting a broad-based analysis of the industry sector (for example, mining, pharmaceutical, luxury or fast-moving consumer goods) in which the Group operates and other factors affecting performance of any businesses operating in that sector, for example, competition, economic and regulatory factors.
2. Along with gaining an understanding of the relevant industry, it is important to have a clear overview of the Group and how the Group responds to the factors affecting performance in the industry (including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed).
3. Analysing what each Related Party does and their commercial or financial relations as expressed in the transactions between them.
4. Accurately delineating the actual transaction(s) between the Related Parties or Connected Persons through an analysis of the economically relevant characteristics (i.e. comparability factors) of the transaction. This will be essential in order to choose and apply the most appropriate Transfer Pricing method, in line with Article 34(5) of the Corporate Tax Law.

The economically relevant characteristics or the comparability factors are used in two phases of a Transfer Pricing analysis.

The first phase relates to the process of accurately characterising the Controlled Transaction by performing a comparability analysis, which involves establishing its terms, functions performed, assets used, and risks assumed by the Related Parties or Connected Persons, the nature of the products transferred or services provided, and the circumstances of the Related Parties or Connected Persons. The economic relevance of the comparability factors depends on the extent to which these

characteristics would be taken into account by independent parties when evaluating the terms of the same transaction were it to occur between them.

Independent parties, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a more attractive opportunity to meet their commercial objectives. In other words, independent parties would only enter into a transaction if it is not expected to make them worse off than their next best option. For example, one party is unlikely to accept a price offered for its product by an independent party if it knows that other potential customers are willing to pay more under similar conditions or are willing to pay the same under more beneficial conditions. In making such an assessment, it may be necessary or useful to assess the transaction in a broader context, since assessment of the options realistically available to third parties is not necessarily limited to a single transaction but may take into account a broader arrangement of economically-related transactions.

The second phase relates to the process for the comparability analysis (set out in Section 5.3) on the comparison analysis between the Controlled Transactions and uncontrolled transactions to aid in determining an Arm's Length Price for the Controlled Transaction. During the selection of comparables, differences in economically relevant characteristics between the controlled and uncontrolled transactions need to be taken into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability. These could be, for instance, unexpected situations such as the COVID-19 pandemic, Market Value fluctuations due to inflation or specificities due to a Related Party (newly established or loss-making due to specific circumstances).

After identifying the relevant commercial and financial relations, the comparability factors are analysed in detail below.

5.1.1.1. Contractual terms of the transaction

A transaction or arrangement is the expression of the commercial or financial relations between parties. Independent parties generally formalise transactions through written contracts which reflect the intention of the parties at the time the contract was concluded. Contracts typically include a description of responsibilities of the parties, its obligations and rights, assumption of identified risks, the pricing arrangements as well as terms and conditions associated with the goods or services covered.

When a Controlled Transaction has been formalised by Related Parties or Connected Persons through written contractual agreements, the agreement provides a starting point for delineating the transaction and determining how the responsibilities, risks,

and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract.

In general, the written contracts alone may not provide all the information necessary to perform a Transfer Pricing analysis, or may not provide information regarding the relevant contractual terms in sufficient detail. In addition, the intention of the parties and key features of the intercompany arrangements may also be found outside of written contracts, for example, in emails, meeting notes, and other written correspondences between the parties. In such cases, the economically relevant characteristics in the other four categories listed above (functions performed, characteristics, economic circumstances and business strategies) will provide an important understanding of the actual conduct of the Related Parties or Connected Persons in relation to the Controlled Transaction under review.

In certain cases, no written contract exists or there may be a conflict between the written contract and actual conduct of the Related Parties or Connected Persons. In such cases, the below needs to be taken into consideration to identify the commercial and the financial relations between Related Parties or Connected Persons:

- Where a transaction has been formalised by Related Parties or Connected Persons in a written contract, the starting point of any analysis should begin with the contract.
- Where the conduct of the Related Parties or Connected Persons is not consistent with the terms of the written contractual agreement, further analysis of the actual conduct should be undertaken. Where there are material differences between the contractual terms and the actual conduct, the actual transaction should be determined based on the actual conduct.
- Where no written contractual agreement exists, the actual transaction is determined from the evidence of actual conduct of the Related Parties or Connected Persons provided by identifying the economically relevant characteristics of the transaction, including what functions are actually performed, what assets are actually used, and what risks are actually assumed by each of the Related Parties or Connected Persons. This analysis is further described in Section 5.1.1.2.

In the event taxpayers decide to maintain written inter-company agreements, they may consider adopting a simplified approach of maintaining them based on certain materiality thresholds, criticality of transactions and arrangements, etc. such that the cost and administrative burden do not outweigh the benefits. Contractual terms that are specifically related to risks are further described under step 2 of the six-step risk framework for analysing the risks in a Controlled Transaction (see Section 5.1.1.2 below).

5.1.1.2. Functional Analysis

In transactions between two independent parties, compensation usually reflects the functions that each enterprise performs, the assets it uses, and the risks it assumes. The same principle needs to be applied to transactions between Related Parties or Connected Persons. As such, a comprehensive Functional Analysis of the Controlled Transaction is required as part of a comparability analysis to delineate the transaction and determine comparability between the Controlled Transaction and uncontrolled transactions.

A Functional Analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the Related Parties or Connected Persons in a Controlled Transaction. The Functional Analysis focuses on the functions performed by the parties and the capabilities they provide to the Controlled Transaction. These functions and capabilities will include operational activities such as procurement, marketing, sales as well as decision-making (for example, business strategy and risks).

The analysis also considers the type of assets,[13] as well as the nature of the assets used.[14]

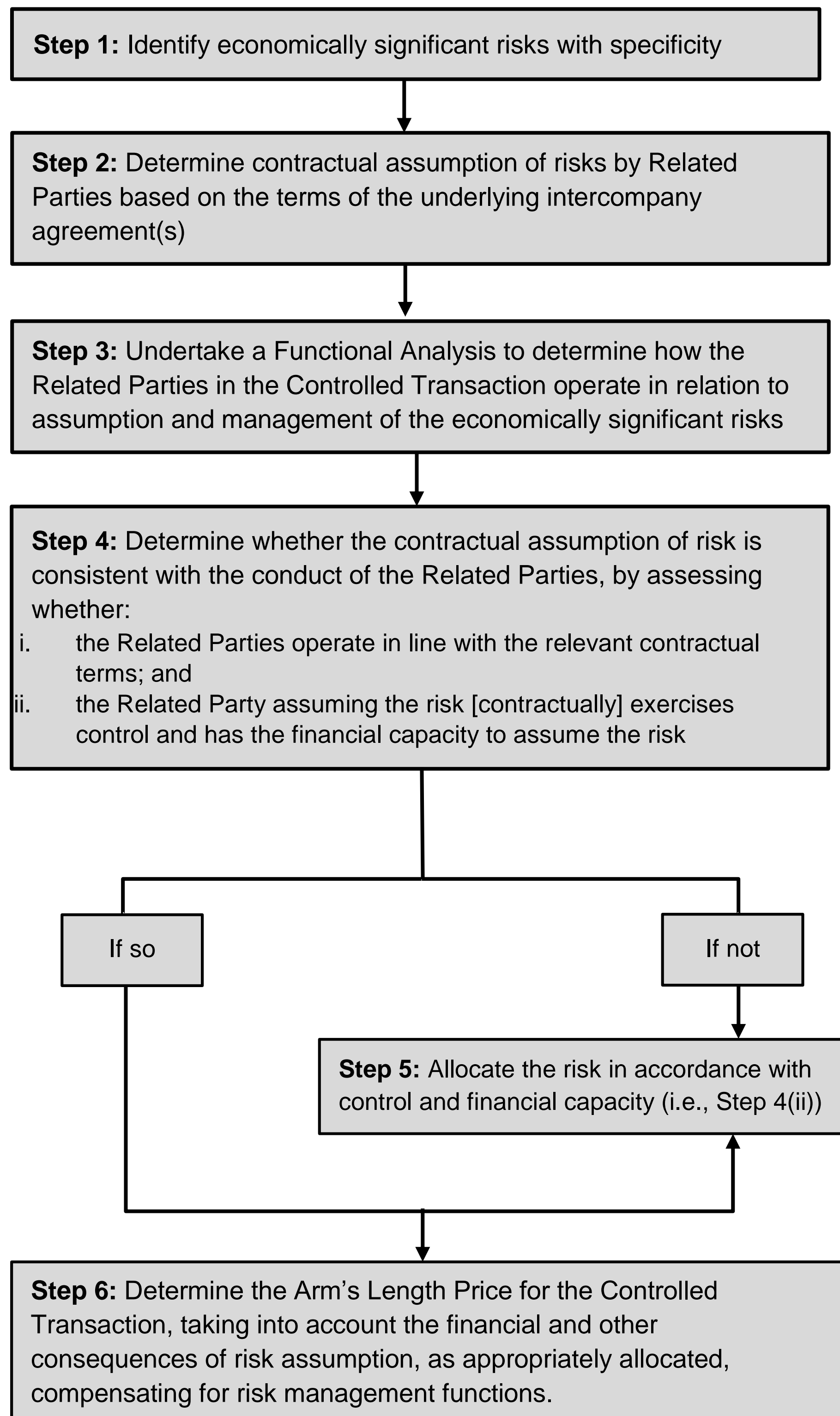
Further, the Functional Analysis will also consider the material risks assumed by each Related Party. Usually, in an open market, the assumption of increased risk would also be compensated by an increase in the expected return. Similarly, the actual assumption and allocation of risks between two Related Parties or Connected Persons would likely affect the pricing of the transaction, so the comparable transactions would also need to reflect the increased risk.

[13] Such as plant and equipment, valuable intangibles, financial assets, etc.

[14] Such as the age, market value, location, property right protections available, etc.

Six-step risk framework

There is a six-step process for analysing the risks in a Controlled Transaction, in order to accurately delineate the actual transaction in respect to those risks. This process is summarised as follows:



Before detailing this six-step process, the following terms need to be defined and understood:

- **Risk management:** This refers to the function of assessing and responding to risk associated with a commercial activity. Risk management comprises three elements:
  i. the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function,
  ii. the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and
  iii. the capability to mitigate risk, that is, the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

- **Financial capacity to assume risk:** This can be defined as having the capital or funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if it materializes. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise.

- **Control over risk:** This involves the first two elements of risk management, that is (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. Therefore, in order to exercise control over a risk, a party requires both capability and functional performance.

The six-step risk framework is further detailed below.

<u>Step 1: Identify economically significant risks with specificity</u>

There are many definitions of risk, but in the Transfer Pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business. In all of a company's operations, in every step taken to exploit opportunities, uncertainty exists, and risk is assumed. A company is likely to direct much attention to identifying uncertainties it encounters, in evaluating whether and how business opportunities should be pursued in view of their inherent risks, and in developing appropriate risk mitigation strategies which are important to shareholders seeking their required rate of return. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. The downside impact of risk occurs

when the anticipated favourable outcomes fail to materialise. For example, a product may fail to attract as much consumer demand as projected in practice.

Risks can be categorised in various ways, but a relevant framework in a Transfer Pricing analysis is to consider the sources of uncertainty. Examples of these risk categories include strategic, operational, financial, transactional or hazard risks.

It is important to ensure that risks are not vaguely described or undifferentiated in the contract or arrangement as this may lead to difficulties in making appropriate allocations of these risks in a Transfer Pricing analysis.

Step 2: Identify the contractual assumption of risk

The identity of the party or parties assuming risks is generally set out in written contracts between the parties to a transaction. A written contract typically sets out an intended assumption of risk by the parties, but some risks may be explicitly assumed. For example, a distributor might contractually assume accounts receivable risk, inventory risk, and credit risks associated with the distributor’s sales to unrelated customers. Other risks related to that particular type of transaction might be implicitly assumed. For example, in the case of a contract that guarantees a certain level of remuneration to one of the parties would also implicitly pass on the outcome of some risks to that other party, such as unanticipated profits or losses.

The assumption of risk has a significant effect on determining the Arm’s Length Price between Related Parties or Connected Persons, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. The remaining steps of the risk framework focus on determining how the parties actually manage and control risks, which determines the assumption of risks by the parties, and impacting the selection of the most appropriate Transfer Pricing method to be applied in a particular transaction.

Step 3: Functional Analysis in relation to risk

In this step, the focus is on the functions relating to the risk undertaken by the Related Parties or Connected Persons. The analysis provides information about how the Related Parties or Connected Persons operate with respect to the assumption and management of the specific, economically significant risks, and in particular which parties perform control functions and risk mitigation functions, encounter upside or downside consequences of risk outcomes, and have the financial capacity to assume the risk in the context of the Controlled Transaction.

Step 4: Risk analysis

Carrying out steps 1-3 above involves gathering of information relating to the assumption and management of risks in the Controlled Transaction. The next step is to analyse the information collected and to determine whether the contractual assumption of risk is consistent with the actual conduct of the parties and the other facts of the case by evaluating whether:

i. the Related Parties or Connected Persons follow the contractual terms; and
ii. the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk.

The significance of step 4 will depend on whether the risk analysis leads to significant findings that have not been identified before. Where a party contractually assuming a risk applies that contractual assumption in its conduct, and also both exercises control over the risk and has the financial capacity to assume the risk, then the next step to consider is step 6 (disregarding step 5 on allocation of risk).

Where differences exist between contractual terms related to risk and the actual conduct of the Related Parties or Connected Persons which are economically significant and would be taken into account by third parties in pricing the transaction, the Related Parties' or Connected Persons' actual conduct should generally be taken as the best evidence concerning the intention of the Related Parties or Connected Persons in relation to the assumption of risk. In such a case, it is necessary to review the allocation of risk (step 5 of this risk framework).

Step 5: Allocation of risk

If it is established that the Related Parties or Connected Persons contractually assuming the risk do not exercise control over it or do not have the financial capacity to assume such risk (under step 4(ii)), then the risk should be allocated to the party exercising control and having the financial capacity to assume it. If multiple Related Parties or Connected Persons are identified as exercising control and having the financial capacity to assume the risk, then the risk should be allocated to the Related Parties or group of Related Parties exercising control over the risk in a predominant manner. When allocating the risk, the other parties performing risk control activities should be remunerated appropriately, considering the importance of the risk control activities performed.

Step 6: Pricing Controlled Transactions considering the consequences of risk allocation

Once the above steps are completed, the Controlled Transaction should then be priced in accordance with the tools and methods set out in the following sections of this Guide and considering the financial and other consequences of risk-assumption,

and the remuneration for risk management. In order to be commercially reasonable, the assumption of a risk should be compensated with an appropriate return, and risk mitigation should be appropriately remunerated. Thus, a Person that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a Person that only assumes or only mitigates a risk but does not carry both.

Overall, when analysing risks, the FTA expects Persons to observe the following:
1. Conduct a thorough Functional Analysis to determine what risks have been assumed, what functions are performed that relate to or affect the assumption or impact of these risks and which party or parties to the transaction assume these risks. This is important even in cases where the effect of the risks assumed are not apparent in the financial statements as this does not necessarily indicate that the risks do not exist, but rather, it could mean that the risks have been effectively managed.
2. The pricing of the actual transaction should take into account the financial and other consequences of risk assumption, as well as the remuneration for risk management. A Person who assumes a risk is entitled to the upside benefits at the same time it incurs the downside costs.
3. To assume a risk for Transfer Pricing purposes, the Person needs to control and have the financial capacity to assume the risk.

5.1.1.3. Contribution to the value chain

Entities in a Group will generally conduct various activities and collaborate to deliver the relevant product or service to the Group’s customers. Some of the activities are more impactful and contribute greater value to the overall profit or success of the business, whereas other activities may be more routine or supportive in nature. As an example, activities that contribute to the intellectual property of a Group and to its value creation will typically be higher value functions than the back-office support functions. The manner in which value is added at each stage in creating a product or service is known as the value chain.

Different industries and business models will have different value chains and key value drivers. As part of the Functional Analysis, it is, therefore, important to understand the relative value and contributions of each Related Party to the overall value chain of a business and the relevant product or service.

The findings of the Functional Analysis define the roles of each Related Party and assign a functional characterisation, ranging from entrepreneurial to low or no-risk entities based on the functions performed, assets employed, and risks assumed by each party.

5.1.1.4. Practical guidance for undertaking a Functional Analysis

Understanding the functions performed, assets used, and risks assumed by the parties to the transaction through a Functional Analysis assists in understanding the contribution of these parties to the value chain and, therefore, in arriving at the appropriate compensation for their activities (see Section 5.3 for further details).

As a practical guide when conducting a Functional Analysis, a functional organisation chart could be prepared for each of the parties involved in the Controlled Transaction. This functional organisation chart should identify the relevant departments and personnel within the organisation together with the functions that they perform. For the personnel, stating the title is not sufficient; information is required on the functions performed (for example, via a job description) and the actual conduct of such personnel, and on how the compensation is structured etc.

A Functional Analysis may begin by undertaking an interview with the relevant departments and personnel, and questionnaires are generally used as an indicative guide to the interviews.

Example 6: Samples of Functional Questionnaires

Table 1 below shows an example of a sample list of questions that may be considered relevant for performing a Functional Analysis for a manufacturing entity. This list is not intended to be exhaustive and should be amended to cover the relevant aspects of the specific industry, characteristics of the Business of the Person, and the nature of the Controlled Transaction being analysed. Further, these types of questions are typically used as an indicative guide to undertaking Functional Analysis interviews, and are generally not followed verbatim during such interviews.

Table 1: Sample Functional Questionnaire - Functions (Manufacturer)

Functions	Questions
Planning	• Who is responsible for preparing and approving budgets? • Who is responsible for scheduling decisions? • Do distributors buy all products manufactured?
Manufacturing	• What is the manufacturing process? • What is being manufactured? • What equipment is used in the manufacturing process?
Procurement	• Where and how are raw materials purchased? • What materials or partly finished goods are purchased? • Who performs the procurement activities? Who approves the vendors?

	• What is the procurement process involved?
Sales	• What is the sales process including pre-sales and after sales activities? • How long is the sales process and how complex or simple is it? • Which party contracts with, and invoices the customers? • Which employees determine the projects and set the sales targets? If this is done by multiple employees in the team, please describe the role of each of these employees. • Which employees negotiate the sales contracts with customers? • What are the risks related to the demand of the products and which employees manage such risk? • What is the typical length of customer contracts?
Shipping	• Who pays freight charges for the products? • Which employee(s) is(are) responsible for negotiating with shippers and selection of shippers? • Who is responsible for the shipping deadline? • Who arranges for the shipping of the products?
Quality Control	• What form of quality control is applicable? • Which employees set the quality standards and procedures? • Who performs and bears the costs for the quality control? • How many products are rejected by customers due to the product being considered 'below standard'? • Which entity bears the loss in relation to defective products?
Warehousing	• Where and how is stock held? • Which employee(s) control(s) and manages the levels of inventory? • How many days of inventory are in general applicable? • What happens with excess stock and which Person bears the risks relating to excess stock?

In addition to the above functions, businesses may also employ tangible and intangible assets in their activities.

Continuing with the above example, a manufacturing entity may use the following assets that should be evaluated in a Functional Analysis:

Table 2: Sample Functional Questionnaire – Assets (Manufacturer)

Type	Description
Tangible (Routine and non-routine)	• Any heavy machinery or equipment? • Any plant? • Any warehouse? • Any office equipment or computers?
Intangible (Routine and non-routine)	• Any technology? • Any know-how? • Any software?

Finally, a manufacturing entity may also assume the following risks which would need to be considered as part of the 6-step risk framework:

Table 3: Sample Functional Questionnaire - Risks (Manufacturer)

Type	Description
Credit Risk	Credit risk can represent the financial loss that would be recognised at the reporting date if counter parties failed completely to meet their contractual payment obligations, for example, bad debt or overdue receivables from the manufacturer’s customers.
Foreign Exchange Risk	Foreign exchange risk occurs when there is a mismatch in the currency of the Controlled Transaction, reporting currency, or currency of significant revenues or expenses, for example, exchange rate movements resulting in material increase in cost of imported raw materials obtained in the foreign currency.
Market Risk	Market risk relates to market factors that may impact the profits of the business. Market risk may arise due to increased competition and relative pricing pressures of the manufactured product, change in demand patterns and needs of customers for the product manufactured, and the inability to develop/penetrate a market.
Inventory Risk	Inventory risk relates to the inventory held by a company that becomes obsolete or physically damaged before the manufactured product is sold.
Product Liability Risk	Product liability risk is associated with product failures including non-performance to generally accepted or regulatory standards. This could result in product recalls and possible injuries to end-users.

Below is an example of a high-level Functional Analysis of a manufacturer whose products are distributed by a Related Party. This example is illustrative and simplified (as compared to a full Functional Analysis) in order to highlight the key areas that are important in undertaking such an analysis.

Example 7: Functional Analysis of manufacturing entity Company A

Overview

The Functional Analysis example below focuses on Company A which is a manufacturer of microchips based in country X. Company A operates through a network of subsidiaries in multiple countries, engaged in the global distribution of microchips produced by Company A in country X.

Functions performed

Research and Development

Company A has an R&D department comprised of 50 full time employees, headed by a technical director who reports directly to Company A's board of directors based in country X. The department operates through teams engaged in technical functions related to the development, enhancement and maintenance of the hardware and software aspects of the microchips produced by Company A.

Sourcing

Company A has a procurement department staffed with 50 full time employees who have extensive experience in sourcing raw materials in the technology development industry. Working closely with the finance and legal department at Company A, this team undertakes end-to-end vendor due diligence and onboarding, including functions related to vendor identification, reviews, negotiations, selection and relationship management. In addition, the department manages purchase planning and scheduling, inbound logistics and preliminary quality and specification control in relation to the sourced raw materials.

Manufacturing

Company A owns and operates special purpose manufacturing assets and facilities for production of its branded microchips in country X. The facility is operated by a team of 3 engineers, 7 technicians and 40 assembly staff, led by the company's Director of Engineering. The facility incorporates patented production processes based on in-house designed components, which gives Company A its competitive advantage and differentiates its products in the market. Capacity utilisation and

production planning is managed by Company A's Director of Engineering in alignment with the company's board of directors.

Inventory management

Company A owns and operates a warehouse for storage of raw materials and finished products in country X. Company A has developed inventory management policies implemented at the level of country X, as well as in the overseas territories where the distribution subsidiaries are located. The policy features standard operating procedures for stock management, re-orders, planning and risk management. Company A monitors performance of the distributors in terms of compliance with the inventory management policies. Three employees of Company A are responsible for inventory management.

Quality control

Company A's preliminary controls are undertaken by its procurement team at the point of raw material sourcing. Subsequent controls are integrated into the manufacturing process, with sample tests and technical evaluations of semi-finished and finished products conducted before they are transferred to the packaging lines. Company A's quality control framework also includes reporting standards and procedures which must be completed before batches are shipped out to the distributors. 5 employees of Company A perform the quality control function.

Logistics

Company A enters into long term multi-territory contracts to work with third party transportation and logistics services providers who provide outbound logistics support in transporting the finished goods to the distributors. The selection of other in-country logistics service providers subcontracted by the distributors is subject to review and approval of Company A. Company A also bears insurance costs related to global freight risk. 10 employees of Company A perform the logistics function.

Marketing

Company A's marketing team develops the group marketing strategy and identifies and targets new customers through tailored promotions for each country. Company A has three full time employees in the marketing team. The distributors provide on-ground market intelligence which may inform Company A's product customisations for their respective markets. Local campaigns are run on marketing materials centrally prepared in line with the global brand guidelines set and periodically reviewed by Company A.

Sales and distribution

All of Company A's products are sold through its network of Related Party and third-party distributors in both wholesale and retail channels. Sales are store-led and are also made through third party online marketplaces. 30 individuals employed by Company A are responsible for this function.

Sales projections and targets

Company A develops the global sales strategy, budget and targets, taking into account local market inputs from the distributors who provide information on market developments in their respective territories. Company A may revise the targets during a given period at its discretion. 10 individuals employed by Company A are responsible for this function.

Pricing

Company A is responsible for determining the pricing policy and profit margins at which its products are sold. Pricing is determined based on various market forces, costs incurred and global competitive landscape. Company A also sets the global discount policies and sales promotional offers whereby any local market deviations are subject to approval of the Commercial Director who is employed by Company A. 3 individuals employed by Company A are responsible for this function.

Working capital financing and management

Company A's finance department manages global cash flow and liquidity positions, determines sources and the nature of external financing. Company A also determines the receivables and collection policies implemented globally, monitors movements in distributors' inventory levels, holding costs and outstanding payables from a liquidity management perspective. 20 individuals employed by Company A are responsible for this function.

Customer relationships

Company A defines the guidelines and policies for key account management globally. Global priority accounts are directly maintained at the level of Company A, with local coordination and assistance provided by the distributors. Company A maintains direct lines of communication with its key accounts. The distributors manage routine customer enquiries and support related issues in line with the guidelines set by Company A. Critical customer concerns are directed upwards to Company A on case-by-case basis. Company A maintains a database of global customer lists.

After sales services

The distributors provide after-sales support services, mostly with regards to registering customer complaints / enquiries, provide support to customers with regard to defective product claims and product recalls. Significant complaints / claims are reported upwards. Company A bears the costs associated with customer claims and returns.

Assets employed

Tangible assets

Company A owns significant manufacturing and storage facilities including its factories, equipment and warehouses. The distributors operate through leasehold properties, utilising routine tangible assets such as office fixtures and related equipment.

Intangible assets

All patents and branding elements used by the group are developed by Company A and registered under the legal name of Company A. The distributors do not own any significant intangible assets.

Risks assumed

Market risk

This relates to the risks of losses arising from movements in the market variables like prices, volatility, increased competition in the marketplace, adverse demand conditions or the inability to develop markets or position products to service targeted customers.

Inventory risk

Inventory risk relates to the losses associated with carrying raw material or finished product inventory. Losses include obsolescence, shrinkage, destruction, or market collapse such that products are only saleable at prices that produce a loss.

R&D risk

This is the risk that the efforts devoted to the innovation, and improvement of its products and processes.

Forex risk

This is the risk of expected and unexpected gains or losses on foreign currency fluctuations.

Capacity utilisation risk

This risk is associated with inefficiency in utilising the production capacity which adversely affects the manufacturing process.

Product liability risk

Product liability risk refers to a supplier's exposure to losses due to failure of its products to perform as represented to customers.

Functional characterisation

Based on the above summary of functions performed, assets used and risks assumed, Company A can best be characterised as a full-fledged manufacturer, while the Related Party distributors can be characterised as a routine distributor.

5.1.1.5. Characteristics of property or services

Differences in specific characteristics of property or services often account for the differences in their value in the open market. Comparisons of these features may be useful in delineating the transaction and determining the comparability of Controlled and uncontrolled transactions. Nevertheless, the importance given to this comparability factor depends on the Transfer Pricing method used.

In general, similarity in characteristics of the property or services will matter most when comparing prices of Controlled Transactions and uncontrolled transactions using the Comparable Uncontrolled Price ("CUP") method, which is a traditional transaction Transfer Pricing method and one of the five internationally accepted Transfer Pricing methods (see further in Section 5.2.2) and less when comparing profit margins in other Transfer Pricing methods. This is because profit margins generally correlate more with the functions performed, assets used and risks assumed by the tested party. The tested party is the party chosen in the Controlled transaction to which a Transfer Pricing method is applied in the most reliable manner.

Characteristics of property or services that may be important to consider in a comparability analysis include the following:

- for tangible property, the physical features, quality and reliability, and the availability and volume of supply;

- for provision of services, the nature and extent of the services; and
- for intangible property (for example, patents, trademarks, know how), the type and nature of the intangible property, the duration and degree of protection, and the anticipated benefits from the use of the intangible property.

The fact that the specific characteristics of property or services have a more significant weight when applying some of the Transfer Pricing methods than others does not mean that these characteristics can be ignored when applying methods that measure profit margins, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party.

5.1.1.6. Economic circumstances

Arm’s length prices may vary across different markets even for transactions involving the same property or services. Therefore, to achieve comparability, it is required that the markets in which the independent and Related Parties or Connected Persons operate are comparable and that differences do not have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify relevant markets taking into account available substitute goods or services.

Economic circumstances that may be relevant to determining market comparability include geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability of substitute goods and services; and the levels of supply and demand in the market as a whole and within regions.

5.1.1.7. Business strategies

Business strategies outline the actions and decisions a company plans to take to reach its goals and objectives and must be examined when determining comparability for Transfer Pricing purposes. Business strategies take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business.

Business strategies could also include market penetration schemes. A Person seeking to penetrate a market or increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a Person seeking to enter a new market or expand its market share might temporarily incur higher costs and, hence, achieve lower profits levels than other Persons operating in the same market.

An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not in itself allow the strategy to be disregarded for Transfer Pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the business strategy is unsuccessful but nonetheless continues to run beyond what an independent party would expect, the arm's length nature of the business strategy may be questioned.

Following the guidance provided above, the Transfer Pricing analysis will identify the substance of the commercial or financial relations between the Related Parties or Connected Persons, and will accurately delineate the actual transaction by analysing the economically relevant characteristics or comparability factors.

5.1.2. Other considerations

Depending on the facts and circumstances, other factors may also be relevant in a comparability analysis. These factors may include government policies such as subsidies or price interventions, cost savings attributable to operating in a particular market, a unique assembled workforce, the impact of customs valuations, MNE group synergies. The impact of such factors on the price or profit of the Controlled or uncontrolled transaction should also be taken into consideration.

Special considerations should also be made when a Related Party consistently makes losses while the MNE Group as a whole is profitable. Parties to an MNE Group, such as independent parties, can sustain genuine losses, for a range of reasons, such as start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate factors. However, independent parties would not be prepared to tolerate losses that continue indefinitely. An independent party that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, Related Parties or Connected Persons that realise losses may remain in that loss-making business if the business is beneficial to the MNE Group as a whole.

In the case of an entity that is consistently realising losses while the MNE Group as a whole is profitable, the facts around its operations and conduct as well as its Controlled Transactions need to be further analysed to confirm whether the entity is receiving adequate compensation from the MNE Group in relation to the benefits derived from its activities. To confirm this, the FTA expects the Person to submit (when requested) documentation which demonstrates that the losses are not due to the impact of non-arm's length Controlled Transactions.[15]

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[15] Article 55(4) of the Corporate Tax Law.

There are many factors which may result in losses. Thus, the FTA may request any additional documentation to understand the circumstances resulting in the losses as it sees fit.

5.2. Step 2: Selection of the most appropriate Transfer Pricing method

5.2.1. Transfer Pricing methods

Transfer Pricing methods are used to establish whether Controlled Transactions are conducted at arm's length. Transfer Pricing methods provide clear guidelines for MNEs and tax authorities in determining the appropriate pricing of Controlled Transactions. These methods apply the findings from the comparability analysis (see Section 5.1) to evaluate the transfer prices or profits of the Related Parties or Connected Persons involved in a Controlled Transaction against the prices or profits of independent parties in Comparable Uncontrolled Transactions.

There are five internationally accepted Transfer Pricing methods detailed in the OECD Transfer Pricing Guidelines and internalised under Article 34(3) of the Corporate Tax Law.

The Comparable Uncontrolled Price (CUP) Method, the Resale price Method ("RPM") and the Cost plus Method ("CPM") are considered traditional transaction methods and regarded as the most direct means of establishing whether conditions in the commercial and financial relations between Related Parties or Connected Persons are at arm's length. This is because any difference in the price of a Controlled Transaction from the price in a Comparable Uncontrolled Transaction can normally be traced directly back to the commercial and financial relations between the parties and the arm's length conditions can be established by directly substituting the price in the Comparable Uncontrolled Transaction for the price of the Controlled Transaction.

The Transactional Net Margin Method ("TNMM") and the Profit Split Method ("PSM") are considered transactional profit methods, which are relevant in cases where each of the parties makes valuable and unique contributions in relation to the Controlled Transaction, or where the parties engage in highly integrated activities, and where there is limited or no publicly available data on third parties. In these situations, where both parties to a transaction contribute with unique and valuable functions, a two-sided method may be more appropriate than a one-sided method.

More details and examples for each method are provided below.

5.2.1.1. The Comparable Uncontrolled Price 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. Similar pricing between the Controlled Transaction and uncontrolled transaction(s) would indicate that the Controlled Transaction has taken place at arm’s length. On the other hand, if there are material differences in the pricing, this would likely indicate that the price of the Controlled Transaction should be adjusted to align with the price of the uncontrolled transaction between independent parties.

Given that the CUP method involves a comparison of prices charged in Related Party transactions and in comparable third-party transactions, it is typically the most direct way to apply the Arm's Length Principle where such data is available. However, the method is reliant on the comparability of available data relating to comparable transactions to ensure its effectiveness.

There is no absolute hierarchy in relation to applying traditional transaction methods. However, traditional transaction methods are regarded as the most direct way of establishing whether transactions and arrangement between Related Parties and Connected Persons are in accordance with the arm’s length standard.

While undertaking comparability analysis of the Controlled Transactions, if it is found that the Comparable Uncontrolled Price (“CUP”) method and another Transfer Pricing method can be applied in an equally reliable way, the CUP method should be the preferred Transfer Pricing method for determining the arm’s length result.

Where the CUP method is applied, the Controlled Transaction may be compared to an internal or an external Comparable Uncontrolled Transaction, depending on the circumstances:

- **Internal CUP:** where the Arm’s Length Price of a Controlled Transaction is determined by the price of a similar transaction between one of the Related Parties or Connected Persons and a third party(ies).
- **External CUP:** where the Arm’s Length Price of a Controlled Transaction is determined by the price of a similar transaction between two or more third parties.

An uncontrolled transaction is considered comparable to a Controlled Transaction where one of the following conditions is met:

- None of the differences that may exist between the Controlled Transaction and uncontrolled transaction or the parties undertaking those transactions could materially affect the market price of the transaction in the open market; or
- Where such differences exist, reasonably accurate adjustments can be made to eliminate any material effects on the price of the transaction resulting from such differences.

In this sense, a number of factors should be considered when determining the comparability of Controlled and uncontrolled transactions, which may include, but is not limited to:

- the type of good or service being transacted;
- the timing of the transaction; and
- the contractual terms of the transaction.

Example 8: Application of external CUP

Company S is the parent company of an MNE Group headquartered in the UAE. It is in the business of trading in listed securities on a UAE Recognised Stock Exchange.

It holds listed securities with a Market Value of AED 50 million, which it sells to a wholly owned subsidiary Company T in country X for AED 22 million. This is significantly lower than the Market Value.

In this case, the application of external CUP method is considered appropriate as it can reliably provide the arm's length result of the transaction between Company S and Company T by reference to the comparable uncontrolled arrangements represented by the quoted Market Value on the stock exchange. A sum of AED 28 million (i.e. AED 50 million – AED 22 million) should be added while calculating the Taxable Income of Company S.

Example 9: Comparability adjustment in applying the internal CUP method

Company A is a UAE based furniture manufacturer which produces and sells armchairs to a Related Party (Subsidiary Company B) and unrelated parties. The armchairs are of a similar type and quality. Other facts in relation to the transactions are summarised below:

- During the period, Company B purchased 100 armchairs from Company A at AED 500 per unit.
- During the same period, Company A sold 1,000 armchairs to an unrelated party (Company X) at AED 450 per unit, in line with Company A's discount policy - a discount of 10% for orders exceeding 500 units (AED 50 discount per product; AED 450 being the discounted price).
- In this scenario, the internal CUP may be applied in determining the Arm's Length Price of the Controlled Transaction as follows:

Comparability factor	Status	Details

Type of good	Comparable	Company A sold similar armchairs to both Company B and the unrelated party.
Timing	Comparable	The Controlled and uncontrolled Transactions were undertaken during the same period.
Contractual Terms	Comparable	The discount policy applies to sales to Related Parties, Connected Persons and unrelated parties.
Quantity	Uncomparable	Company B's order quantity was significantly lower and did not qualify for the discount.
Price per unit	Uncomparable	While the discount policy is the same, the price has been impacted by the difference in quantity which determined the application of the discount.

The application of the quantity discount has materially affected the price from a comparability standpoint, but comparability adjustments can be made to neutralise this effect.

Based on the facts above, the below adjustment to the price of the Uncontrolled Comparable Transaction would be appropriate:

Details	Company B	Company X
Order quantity (units)	100	1,000
Price per unit	AED 500	AED 450
Comparability adjustment (Add back discount at 10%)	-	AED 50
Adjusted price per unit	AED 500	AED 500

As indicated in the earlier example material differences between the Controlled Transactions and the Comparable Uncontrolled Transactions may be addressed through adjustments. However, if a reasonably accurate adjustment cannot be made, the reliability of the CUP method would be reduced, and it might be necessary to select another method instead.

Depending on the facts and circumstances of the Controlled and uncontrolled transactions, certain differences such as geographical market, existence or utilisation of valuable intangibles, functional differences, and significant contractual differences may make it impossible to reliably make sufficient comparability adjustments. In these cases, it would also be appropriate to consider another direct method to price transactions or perform a corroborative analysis based on a distinct transactional method.

Application of the CUP method for commodity transactions

The CUP method is typically the most widely used Transfer Pricing method for establishing the Arm's Length Price for the transfer of commodities between Related Parties or Connected Persons.

The reference to commodities encompasses physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions. The term 'quoted price' refers to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies or from governmental price setting agencies. Such indexes are used as a reference by unrelated parties to determine prices in transactions between them.

In applying the CUP method for commodities, the economically relevant characteristics for comparison include, among others, the physical features and quality of the commodity, the contractual terms of the Controlled Transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms. For some commodities, certain economically relevant characteristics (for example, prompt delivery) may lead to a premium or a discount in the price applied. Where there are differences between the conditions of the Controlled Transaction and the conditions of the uncontrolled transactions or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made for comparability purposes.

Where the quoted price for the commodity is relied upon in determining the Arm's Length Price of a controlled commodity transaction, it is critical to examine the extent to which these quoted prices are commonly used in the ordinary course of business in the industry to agree prices for Uncontrolled Comparable Transactions. Other comparability factors and economically relevant characteristics which may impact the price (including physical features, quality, quantity, timing, shipping terms etc.) should also be considered.

In addition, the market prices agreed to in uncontrolled commodity transactions are typically inextricably linked to the specific time or date of the underlying transactions. Therefore, the specific time and date of the quoted price linked to the transaction is a key factor when analysing the price for commodities in Related Party transactions including when applying the CUP method to price a controlled commodity transaction. The Person should provide reliable evidence that the date and time of the quoted prices relied upon for benchmarking purposes are comparable to the date and time of the Controlled Transaction. Such evidence may include proposals and acceptances,

contracts, data downloads from commodity exchanges or other documents setting out the terms of the arrangements.

5.2.1.2. The Resale Price Method

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. The resale price would be reduced by the gross “Resale Price Margin”, as well as any other costs associated with the transaction, to provide an Arm’s Length Price for the original transaction between the Related Parties or Connected Persons. The “Resale Price Margin” represents the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), to make an appropriate profit.

Typically, the RPM is applied to the reseller involved in the Controlled Transaction to compare the margins of the reseller in the Controlled Transaction to the margins earned in a comparable uncontrolled transaction, where the reseller adds relatively little value to the property being transacted. The more value the reseller adds to the property, the less appropriate it would be to apply the RPM to determine the Arm’s Length Price of the transaction. This is especially so where the reseller contributes significantly to creating or maintaining intangible properties, such as trademarks or trade names or other marketing intangibles, in its activities. Thus, when applying the RPM, the tested party would ideally not own valuable intangible property.

Given the above, the RPM is often the most appropriate method where it is applied to distribution and marketing operations.

In applying the RPM, the reseller should select a Comparable Uncontrolled Transaction in which the Resale Price Margin earned by the independent reseller(s) can be reliably identified. The identified margins could serve as a benchmark to determine an arm’s length Resale Price Margin in that Controlled Transaction.

Where the RPM is applied as a one-sided method, the Controlled Transaction may be compared to an internal or an external Comparable Uncontrolled Transaction depending on the circumstances:

- **Internal comparable:** where the arm’s length Resale Price Margin of the reseller in the Controlled Transaction is determined by the Resale Price Margin of a similar transaction between the same reseller and an independent party.
- **External comparable:** where the arm’s length Resale Price Margin of a Controlled Transaction is determined by the Resale Price Margin of a similar transaction between two independent parties.

An uncontrolled transaction is comparable to a Controlled Transaction (i.e. it is a Comparable Uncontrolled Transaction) for the purposes of the RPM if one of the two following conditions is met:

- None of the differences that may exist between the controlled and uncontrolled transaction or the parties undertaking those transactions could materially affect the Resale Price Margin in the open market; or
- Where such differences are observed, reasonably accurate adjustments may be made to eliminate any material effects resulting from such differences.

In making comparisons for the purposes of the RPM, generally fewer adjustments are needed to account for differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price. While less product comparability may be required in using the RPM, it remains the case that closer comparability of products will produce better results.

A Resale Price Margin is more accurate where it is realised within a short time of the reseller's purchase of the goods. The more time that elapses between the original purchase and the resale, the more likely it is that other factors - changes in market, in rates of exchange, in costs etc - will need to be taken into account in any comparison.

Where the reseller is clearly carrying on a substantial commercial activity in addition to the resale activity itself, then a reasonably substantial Resale Price Margin might be expected. The Resale Price Margin should also be expected to vary according to whether the reseller has the exclusive right to resell the goods. Exclusive rights arrangements are found in transactions between independent parties in practice and tend to influence the margin.

Further, when applying the RPM, the following should be considered:

Operational comparability

When the Resale Price Margin used is that of an independent party in a comparable transaction, the reliability of the RPM may be affected if there are material differences in the ways the Related Parties or Connected Persons and independent parties carry out their business. Such differences could include those that affect the level of costs taken into account (for example, the differences could include the effect of management efficiency on levels and ranges of inventory maintenance), which may well have an impact on the profitability of an enterprise but may not have an impact on the price it buys and sells its goods and services for on the open market. Thus, material operational differences in the way the business is carried out should be analysed in determining whether an uncontrolled transaction is comparable for the purposes of applying the RPM.

Comparability of functions performed, assets used and risks assumed

The nature of the functions performed, assets used, and risks assumed in any transaction can substantially affect the amount of gross margin earned in that transaction. Accordingly, for the purposes of using the RPM, it is recommended to evaluate the comparability of these factors in both the Controlled Transaction and the selected Comparable Uncontrolled Transaction. If any material differences are noted, necessary adjustments should be made to account for such differences.

The impact of accounting practices

Measurement and recognition of the items that impact the way the Resale Price Margin is calculated may differ from one enterprise to another due to varying accounting practices. For example, while an item of cost may be accounted for as an operating expense in the Controlled Transaction, the same item of cost may be accounted for as cost of sales in the uncontrolled transaction. Where such differences exist, using the Resale Price Margin without making the appropriate adjustments is likely to result in miscalculated profit margins. Necessary adjustments should be made to eliminate the effect of any material accounting practice differences.

Example 10: Application of the RPM

Company A, a Free Zone entity incorporated in the UAE, sells goods to a Related Party based in the UAE mainland, Company B, at a price of AED 450.

An independent entity, Company X, purchases similar goods from third parties for AED 400.

Both Company X and Company B subsequently resold to third party customers at a price of AED 500.

Income statement [Extract]	Company B	Company X
Sales Price (AED)	500	500
Purchase Price (AED)	(450)	(400)
Gross Profit (AED)	50	100
Resale Price Margin	10%	20%

Company B's profit on the resale of the goods is AED 50, hence the Resale Price Margin is 10%. Had Company B purchased the goods from a third party, the profit on resale would have been AED 100 and the Resale Price Margin would have been 20%.

In the absence of any differences in the economic conditions of the controlled and independent transactions, the difference in the Resale Price Margin demonstrates that the Controlled Transaction between Company A and Company B did not occur at arm's length.

However, the Functional Analysis of the Controlled Transaction shows that Company A performs additional logistics functions, the costs of which are reflected in the price (AED 450) offered to Company B. Further investigation shows that the third-party supplier does not perform these additional logistics functions. It is also observed that Company X bears logistics costs (AED 50) and records these as operating expenses. As such, comparability adjustments may be introduced as follows:

Income statement [Extract]	Company B	Company X
Sales Price (AED)	500	500
Purchase Price (AED)	(450)	(400)
Comparability adjustment:		
logistics cost	-	(50)
Gross Profit (AED)	50	50
Resale Price Margin	10%	10%

The above highlights the importance of focusing on the Functional Analysis under the RPM. In this case, the gross resale margin of 10% is considered to be at arm's length as the difference (i.e. logistics cost) is the economically relevant characteristic impacting the independent transaction price and the Controlled Transaction price and has been adjusted accordingly.

5.2.1.3. The Cost Plus Method

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. What is arrived at after adding the cost-plus mark-up to the direct and indirect costs of the supplier is then considered the Arm's Length Price of the original transaction.

The CPM is most useful where semi-finished goods are sold between Related Parties or Connected Persons, where Related Parties or Connected Persons have concluded joint facility agreements or long-term buy-and-supply arrangements, as well as where the Controlled Transaction is the provision of services.

Where the CPM is applied, the Controlled Transaction may be compared to an internal or an external Comparable Uncontrolled Transaction depending on the circumstances:

- **Internal comparable:** where the cost-plus mark-up of the supplier in the Controlled Transaction is determined by reference to the cost-plus mark-up that the same supplier earns in a similar transaction with an independent party; or
- **External comparable:** where the cost-plus mark-up of the supplier in the Controlled Transaction is determined by reference to the cost-plus mark-up that would have been earned in comparable transactions between two independent parties.

An uncontrolled transaction can be considered comparable to the Controlled Transaction for the purposes of applying the CPM if one of the following two conditions is met:

- None of the differences that may exist between the Controlled and uncontrolled transaction or the parties undertaking those transactions could materially affect the cost-plus mark-up in the open market; or
- Where such differences are observed, accurate adjustments to eliminate any material effects resulting from such differences were reasonably performed.

When applying the CPM, the following aspects should be considered:

Product comparability

As with the RPM, fewer adjustments may be necessary to account for product/service differences under the CPM than under the CUP method.

Comparability of functions performed, assets used and risks assumed

Similar to the RPM, for the purposes of the CPM, all comparability factors should be considered to the extent relevant. When there are differences that materially affect the cost-plus mark-ups earned in the controlled and uncontrolled transactions, reasonably accurate adjustments should be made to account for such differences.

Comparability of cost base

Applying the CPM requires the comparability of both the cost-plus mark-up and cost base in the Controlled Transactions and uncontrolled transactions. If the Controlled and uncontrolled transactions are not comparable in all aspects (including the cost base) and the differences have a material effect on the price or margin, adjustments should be made to eliminate the effects of those differences. Where the independent party adopts a definition of cost base or a method to compute cost that is different from that of the Related Party, the cost base of the independent party should be adjusted accordingly to ensure comparability.

In applying the CPM, direct and indirect costs of producing a good or providing a service are normally used to compute the cost base. Such costs are limited to the costs of the supplier of goods or services and should take into account the supplier's Functional Analysis.

The impact of accounting practices

As applicable for the RPM, a Related Party using the CPM should ensure that the accounting practices followed in both the Controlled Transaction and the selected Comparable Uncontrolled Transaction are consistent. If this is not the case, appropriate adjustments for accounting practice differences in both the Controlled Transaction and the selected Comparable Uncontrolled Transaction may be required.

Example 11: Application of the CPM

Company A and its subsidiary Company B are Related Parties and part of the same MNE Group. Company B manufactures and sells semi-finished goods to Company A.

The direct and indirect product costs per unit incurred by Company B in the production of the semi-finished goods amounts to AED 10,000. Company B sells the goods to Company A for AED 10,500 per unit (i.e. at a cost-plus mark-up of 5%).

Comparable independent manufacturers produce similar products. Based on the comparability analysis undertaken, it is established that the comparable independent manufacturers are earning a cost-plus mark-up ranging from 10% to 16%.

Accordingly, the cost-plus mark-up achieved by Company B of 5% is considered not to be at arm's length as this mark-up falls below the benchmark range of 10% to 16%.

However, further investigation of the independent comparables' operating models indicate that the comparable manufacturers do not incur or record significant freight and insurance costs, whereas, Company B's additional cost per unit is attributable to freight and insurance at AED 800. The foregoing is indicative of circumstances that significantly impact the cost-plus mark-up.

As the impact can be reliably measured and supported with evidence from financial statements, and other sources, as applicable, of Company B, as well as of the independent manufacturers, comparability adjustments may be required as follows:

	Company B [P&L extract per unit]
Selling price	10,500
Cost	(10,000)
Comparability adjustment: Add back – Freight & Insurance costs	800
Gross profit	1,300
Cost-plus mark-up	14%

The above highlights the importance of undertaking a comprehensive Functional Analysis under the CPM and ensuring comparability of the cost base to which the cost-plus mark-up is applied. In this case, the cost-plus mark-up of 14% is considered at arm's length as reliable adjustments have been made to eliminate the impact of the difference (i.e. freight and insurance costs) in the economically relevant characteristics between the Controlled and uncontrolled transactions. These adjustments are justified due to the specific conditions of the transaction.

5.2.1.4. The Transactional Net Margin Method

The TNMM examines the net profit earned from a Controlled Transaction relative to an appropriate base, such as the costs, sales or assets. In this way, the TNMM operates similarly to the CPM and RPM and should be applied in a similar manner.

In applying the TNMM, the net profit margin earned in the Controlled Transaction should be established by reference to the net profit margin earned in internal or external Comparable Uncontrolled Transactions depending on the circumstances:

- **Internal comparable:** where the net profit margin in the Controlled Transaction is determined by the net profit margin of a similar transaction between one of the Related Parties or Connected Persons and a third party.
- **External comparable:** where the net profit margin of a Controlled Transaction is determined by the net profit margin of a similar transaction between two third parties.

Additional guidance on the application of the TNMM is provided below.

5.2.1.5. The comparability standard applied to the TNMM

A comparability analysis must be performed in all cases in order to select and apply the most appropriate Transfer Pricing method, including the TNMM.

Net profit indicators are the ratio of net profit to an appropriate base (for example costs, sales, assets) and are less adversely affected by differences in products and functions compared to price and gross margins. However, there are various other factors that can significantly influence net profit indicators because of the potential for variation of

operating expenses across enterprises. These factors include treatment across enterprises of operating expenses and non-operating expenses, capacity utilisation, threat of new entrants, competitive position, management efficiency and individual strategies, threat of substitute products, varying cost structures (as reflected, for example, in the age of plant and equipment), differences in the cost of capital (for example self-financing versus borrowing), and the degree of business experience (for example whether the business is in a start-up phase or is mature).

The above, and other relevant, factors need to be accounted for in order to achieve reliable comparability.

Any differences between Related Parties or Connected Persons and independent parties resulting from the above factors may have material effects on the profitability of transactions and would require reliable and accurate adjustments for the TNMM to produce a reliable measure of arm's length net margins.

5.2.1.6. Profit level indicators

The ratio of net profit and the appropriate base used in the TNMM is commonly known as the net profit indicator or profit level indicator.

In order to apply the TNMM, a net profit indicator should be selected to determine the net profitability of the Controlled Transaction. A net profit indicator expresses profitability in relation to an appropriate base such as:

(i) sales,
(ii) costs or expenses, or
(iii) assets.

Therefore, when applying the TNMM, the net profitability of the Controlled Transaction is compared to the net profitability of the uncontrolled transaction(s), using a net profit indicator.

In addition to being less affected by transactional differences than is the case with CUP method, net profit level indicators may also be more tolerant to some functional differences between the Controlled and uncontrolled transactions than gross profit margins (used in RPM and CPM). Differences in the functions performed between parties are often reflected in variations in operating expenses. Consequently, this may lead to a wide range of gross profit margins but still broadly similar levels of net profit level indicators. In addition, there may be lack of clarity in the public data with respect to the classification of expenses as gross or operating profits may make it difficult to evaluate the comparability of gross margins, while the use of profit level indicators may avoid the problem.

The following non-exhaustive examples of profit level indicators that may be considered when applying the TNMM are:

Net profit indicator	Numerator	Denominator
Operating margin or return on sales	Operating profit	Sales
Net cost-plus or full cost mark-up	Operating profit	Total costs
Return on assets or return on capital employed	Operating profit	Operating assets
Berry ratio	Gross profit	Operating expenses

As a general rule, the denominator of the net margin indicator should be set on an uncontrolled base and should reflect the relevant driver or measure of value creation as it relates to the functions performed by the tested party, taking into account the risks assumed and assets used. For example, sales may be an appropriate base for distribution activities, full costs or operating expenses may be an appropriate base for a service or manufacturing activity, and operating assets may be an appropriate base for capital-intensive activities such as certain manufacturing activities. Other bases can also be appropriate depending on the circumstances of the case.

The selection of the most appropriate profit level indicator depends on the facts and circumstances of the Controlled Transaction and the following factors should be considered:

1. Strengths and weaknesses of the various possible net profit indicators;
2. The appropriateness of the profit level indicator in view of the nature of the Controlled Transaction as determined through a Functional Analysis;
3. The availability of reliable information needed to apply the TNMM based on that indicator; and
4. The degree of comparability between Controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate differences between them when applying the TNMM based on that indicator.

5.2.1.7. Aggregation of transactions and company-wide analysis using TNMM

Although it is preferred that the TNMM be applied at a transactional level, it may be possible to apply the TNMM on an aggregate basis when the aggregate activities / transactions are sufficiently interlinked from economical or commercial standpoints, for example, when similar sales functions are conducted for products in similar product lines.

Applying the TNMM on a company-wide basis becomes less reliable when the party being examined is engaged in various different Controlled Transactions or functions or operates different business segments that cannot be appropriately compared on an aggregate basis with those of an independent party. Therefore, Taxable Persons should seek to apply the TNMM on a transactional basis and not on a company-wide basis whereby the method is used to analyse only the profits of the Related Parties or Connected Persons that are attributable to simpler Controlled Transactions, functions or segments that are not interlinked. Depending on the facts of each case, a company-wide analysis may not be sufficient as a basis for a comprehensive Transfer Pricing analysis. However, Taxable Persons may opt to apply the TNMM, or any other method, on a company-wide basis to corroborate the results obtained from the separate analyses performed on a transactional basis.

Example 12: Application of the TNMM

A subsidiary Company B is a UAE distributor of coffee machines. All of Company B's coffee machines are produced by an overseas Related Party, Parent Co, which owns a household electrical appliances brand name. All of Company B's merchandise is purchased from its Parent Co. Company B holds limited amounts of buffer inventory and the associated holding costs are determined to be immaterial. Parent Co provides a product warranty to customers of Company B.

After performing the appropriate Functional Analysis, Company B was able to identify a series of UAE distributors of home electrical appliances as suitable comparable companies.

However, following a review of the financial information of the potential comparable companies, it is evident that a number of them record higher levels of inventory holding/warehousing expenses. While Company B's inventory holding cost constitutes less than 1% of its operating expenses, reliable market evidence indicates that independent distributors of household electrical appliances in the UAE incur inventory holding costs at an average of 15% of operating expenses. However, the available financial information of the potential comparable companies is not detailed enough to determine the classification of the inventory holding costs. As such, it may be more reliable to examine the net operating margins in this case. Considering the relevant factors above, it is determined that the TNMM, based on a return on sales as the profit level indicator is the most appropriate method to apply in this case.

The potential comparables earn operating profit margins of 10%.

An analysis of Company B's financials is summarised below:

Company B's revenue	5,000
Company B's total purchase costs (i.e. transfer price[16])	(4,500)
Other operating expenses	(400)
Total costs	(4,900)
Operating profit	100
Operating margin (operating profit/revenue)	2%

Note that this example is for illustration purposes. Where significant differences are observed in working capital related items, consideration should be given to the impact of such differences on the profits recorded in the financials of the potential comparable companies. Where such material differences significantly impact profits, further adjustments (such as working capital adjustments) should be considered to ensure the reliability of the analysis.

5.2.1.8. The Profit Split Method

The Profit Split Method (PSM) seeks to determine the division of profits that independent parties would have expected to realise from engaging in comparable transactions. This method first identifies the combined profits of the Related Parties or Connected Persons from a Controlled Transaction(s) and splits those profits on an economically valid basis. The resulting split should approximate the division of profits that would have been anticipated and reflected in an agreement made at arm's length between independent parties.

Further guidance on the use and application of the PSM is provided below. However, this Guide does not seek to provide an exhaustive catalogue of ways in which the PSM may be applied. Application of the method will depend on the facts and circumstances of the case and the information available, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the Related Parties or Connected Persons been independent parties.

5.2.1.8.1. Appropriate use of the PSM

The PSM is particularly relevant in the following cases:

- Where the Related Parties or Connected Persons engage in highly integrated business operations for which a one-sided method would not be appropriate. A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot

[16] Being the amount of the Controlled Transaction paid by Sub Company B to Parent Company.

reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks.
- Where each of the parties to a Controlled Transaction make unique and valuable contributions or use unique and valuable intangibles in relation to the Controlled Transaction. Contributions are 'unique and valuable' where they are not comparable to contributions made by independent parties in comparable circumstances, and they represent a key source of actual or potential economic benefits in the business operations.
- Where each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction.

In general, the PSM may be used in the absence of comparables indicating that an alternative Transfer Pricing method is the most appropriate method. However, the lack of comparables alone is insufficient to warrant the use of the PSM, and each of the above situations would need to be considered in determining whether the PSM is the most appropriate Transfer Pricing method.

5.2.1.9. Application of the PSM

There are two steps in the application of the PSM:
1. The first step is to determine the consolidated total profits earned by the Related Parties or Connected Persons from a Controlled Transaction. The profit to be split is generally the operating profit before interest and taxes.
2. The second step is to split the profit between the Related Parties or Connected Persons on an economically valid basis based on the relative value of their contributions to the Controlled Transaction(s), considering the functions performed, the assets used, and the risks assumed by each Related Party, in relation to what independent parties would have received. In general, the determination of the relevant profits to be split and of the profit splitting factors should be:
    - consistent with the Functional Analysis of the Controlled Transaction under review, and in particular reflect the assumption of the economically significant risks by the parties, and
    - capable of being measured in a reliable manner.

Where comparable data does exist, it could be useful in determining the division of profit that would have been achieved between independent parties in comparable circumstances. However, in those cases where there is no direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the total profit may be split / allocated using one of the following approaches:
- Contribution analysis approach: where the total operating profit earned by the Related Parties or Connected Persons from a Controlled Transaction is divided between the Related Parties or Connected Persons based on the relative value of

the contributions made by each of the Related Parties or Connected Persons participating in the Controlled Transaction.

- Residual analysis approach: This approach splits the total profit in two steps:
  - Step 1 - Each Related Party to the Controlled Transaction is allocated an arm's length return for the routine functions that it performs (for example, routine services or distribution). Typically, the return for routine contributions may be determined based on the TNMM or any other Transfer Pricing method.
  - Step 2 - The residual profit (i.e. the profit remaining after the allocation of the return for routine contributions) is split using a contribution analysis or other allocation approach based on the underlying facts and circumstances of the Controlled Transaction. The relevant non-routine contributions (i.e. the unique and valuable contributions or assets, high level of integration or the shared assumption of economically significant risks) should be identified through a Functional Analysis of each Related Party.

These approaches are not necessarily exhaustive or mutually exclusive. Alternative ways may be used to split profit, as long as there is reasonable evidence that the selected approach produces a reliable arm's length result.

The approach followed in splitting the profit should be verifiable and based on internal accounting data or on publicly available and measurable market data. In practice, internal data such as relevant assets, costs, and headcount may be used as allocation keys to split the profit. For self-developed assets, which may not be on the balance sheet, valuation techniques such as discounted cash flow may be used. If more than one allocation key is used to split the profit between the Related Parties or Connected Persons, it is necessary to determine the relative contribution of each allocation key in earning the combined profits. The measure of profits to be split will depend on the risks the parties share.

In many cases, operating profit may be the most appropriate measure of profits to be split because the parties share the risks of the entire business. However, if the parties share only the risks associated with the volume of sales and production of the products, and they do not share the risks associated with selling the products in the marketplace, then a split of gross profit may be appropriate.

The profits to be split may include actual profits or anticipated profits, or a combination thereof. Guidance on when it is appropriate to split actual vs. anticipated profits is provided below:

- The splitting of actual profits is appropriate when all the relevant parties share the assumption of the same economically significant risks or separately assume closely related ones. This type of risk assumption may arise if the business operations are highly integrated and / or each party makes unique and valuable contributions.

- A split of anticipated profits, in contrast, would be more appropriate if one of the parties does not share in the assumption of all of the economically significant risks, which might exist after entering into the transaction.

The division of the relevant profits under the PSM is achieved using one or more profit splitting factors. The Functional Analysis and a contextual analysis (for example, of the industry and business environment) are essential to the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used. The determination of the appropriate profit splitting factor(s) should reflect the key contributions to value in relation to the transaction. Whether actual or anticipated profits are split, the basis for splitting profits must be determined on the basis of the information known or reasonably available at the time the Related Parties or Connected Persons entered into the Controlled Transaction.

It is generally difficult to access reliable publicly available data on what profit split independent parties would agree upon under comparable facts and circumstances. Further, issues may arise in measuring the relevant financial data (for example, costs or asset base) which are used for the actual application of the PSM. Finally, the splitting factors which could be applied are in principle subject to judgment.

Example 13: Application of the PSM (residual analysis approach)

Company A is a seller of electric vehicles in the UAE. A subsidiary Company B is an overseas subsidiary of Company A. Both companies have collaborated in the development of a powerful rechargeable battery, as well as in design technology for the manufacturing of electric vehicles. Company A holds the patent for the manufacturing technology.

Company B is the only manufacturer licensed by Company A to use the special rechargeable battery. Company A purchases all of the electric vehicles manufactured by Company B and sells them to third parties.

Both companies contribute to the success of the electric vehicles through their efforts in (i) the development of the powerful rechargeable battery; and (ii) design technology. Due to the unique nature of the intellectual property contributions of the companies, the Group is unable to find sufficiently comparable independent companies for benchmarking purposes.

The companies are able to obtain reliable data on independent electric vehicle contract manufacturers and wholesalers, who do not own any unique intangible assets in the automotive industry. The independent contract manufacturers achieve a mark-up of 15% while the wholesalers achieve a gross margin of 25%.

Company A's and Company B's respective share of profit may be determined in two stages using the PSM (residual analysis approach). See below.

Stage 1 – Determining the return for routine contributions

The simplified P&L extracts of Company A and Company B are shown below:

	Sub Company B (AED)	**Company A (AED)**
Sales	100	130
Cost of goods sold	(55)	(100)
Gross profit	45	30
Operating expenses	(5)	(10)
Operating profit	40	20

Group total operating profit = AED 60

<u>Company B</u>
Cost of goods sold AED 55.00
Cost-plus mark-up - contract manufacturers (15% x AED 55) <u>AED 8.25</u>
Compensation for routine manufacturing AED 63.25

===========
<u>Company A</u>
Sales to third party customers AED 130
Resale margin % - independent wholesalers (no intangibles) <u>25%</u>
Resale margin (or gross profit) AED 32.50

===========

The returns attributable to the companies for their routine contributions may be calculated as follows:

	Company B (AED) ***Routine manufacturing***	**Company A (AED)** ***Routine wholesale***
Sales	63.25	-
Cost of goods sold	(55)	-
Gross profit	8.25	32.50
Operating expenses	(5)	(10)
Operating margin	3.25	22.5

The total operating profit attributable to routine contributions of the Group is AED 3.25 + AED 22.5 = AED 25.75.

Stage 2: Splitting the residual profit

The residual profit of the Group = AED 60 – AED 25.75 = AED 34.25.

Contribution analysis

Based on internal accounting records, the companies are able to accurately identify their respective costs incurred in relation to their joint efforts in research and development ("R&D") and investments in design technology. For illustrative purposes of this example, these expenses are considered appropriate measures of the companies' non-routine contribution towards the residual profits generated by the Group.

The R&D expenses and design technology expenses incurred by each company are as follows:

	Design technology	**R&D**
Company A	AED 8 (80%)	AED 12 (75%)
Company B	AED 2 (20%)	AED 3 (25%)
	AED 10 (100%)	AED 15 (100%)
	============	===========

Leveraging information available within the Group, as corroborated by publicly available industry and market data, it is determined that R&D drives up to 80% of the value created in the EV industry. As such, weights may be attributed to the R&D and design technology contributions in the ratio of 4:1.

Based on relative contribution of the companies, the residual profit may be split as follows:

	Design technology	**R&D**	**TOTAL**
Weights	1 (20%)	4 (80%)	100%
Allocable residual profit	AED 6.85 (20% of AED 34.25)	AED 27.4 (80% of 34.25)	AED 34.25
Company A	AED 5.48 (80% of 6.85)	AED 20.55 (75% of 27.4)	AED 26.03
Company B	AED 1.37 (20% of 6.85)	AED 6.85 (25% of 27.4)	AED 8.22

Company A's share of residual profit AED 26.03
=========

Company B's share of residual profit AED 8.22
=========

Therefore, the adjusted operating profits of each company are as follows:

Company A = AED 26.03 + AED 22.50 = AED 48.53

Company B = AED 8.22 + AED 3.25 = AED 11.47

The adjusted tax accounts are as follows:

	Company B (AED)	Company A (AED)
Sales	71.47	130
Cost of goods sold	(55)	(71.47)
Gross margin	16.47	58.53
Operating expenses	(5)	(10)
Operating margin	11.47	48.53

Hence, the arm's length transfer price determined using the PSM (residual analysis approach) should be AED 71.47.

5.2.1.10. Other Transfer Pricing methods

Article 34(4) of the Corporate Tax Law stipulates that the Arm's Length Price may be calculated using methods other than the five Transfer Pricing methods listed in the Corporate Tax Law, if none of the five recognised methods can be reasonably or reliably applied, and provided these other methods satisfy the Arm's Length Principle.

Where an alternative Transfer Pricing method has been used, adequate supporting documentation explaining the reason(s) for selecting the method including reasonable sufficient economical and commercial rationale, as well as clear disclosures of the underlying empirical analysis performed in applying the method must be provided. For example, a Person engaged in a real estate development project obtained under a term lease from a Related Party may opt to apply a Discounted Cash Flow ("DCF") approach in demonstrating the arm's length nature of the controlled lease payments if none of the five recognised Transfer Pricing methods can be reasonably applied to determine an arm's length result. Where the facts and circumstances of the case, as well as the functional and comparability analyses establish that the DCF is appropriate, the Person may proceed to apply the DCF approach. However, supporting documentation should be kept in any case (pursuant to Article 55(4) of the Corporate Tax Law) to corroborate the reason for selection of this approach, relevant variables, presentation of the quantitative analysis and other relevant information and supporting documentation.

Example 14: **Arm's Length Pricing in case of no added value**

Company A is part of an MNE Group in the UAE. It incurs hotel and travel expenses for the employees of its Related Party Company B from country X visiting UAE for a conference.

These expenses are paid by Company A directly to third-party vendors on behalf of Company B and recovered on a cost-to-cost basis. Company A does not provide any further value-add or services to Company B.

Treating the expenses incurred by Company A on behalf of Company B as pass-through costs to which no profit element or mark-up is attributed in consistency with the Arm's Length Principle is the correct approach since there is no value added by Company A.

5.2.2. Selection of the most appropriate method

The selection of a Transfer Pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take into account the following:

- The strengths and weaknesses of the five recognised Transfer Pricing methods.
- The appropriateness of the method considered in view of the nature of the Controlled Transaction as determined in a Functional Analysis.
- The availability of reliable information (in particular on uncontrolled comparables) needed to apply each method. It is especially important to assess whether publicly available data can be drawn from commercial databases or other publicly available sources.
- The degree of comparability between the Controlled Transactions and independent transactions, including the accuracy of any resulting adjustments that may be required to eliminate differences between the transactions.

The FTA's preferred approach is for Transfer Pricing methods to be applied on a transactional level where possible, which means that the most appropriate method should be applied to each relevant transaction. However, there may be situations where the Transfer Pricing methods could be applied on an aggregated basis, for example applying the TNMM on a company-wide basis to test the overall profitability.

5.2.3. Using a combination of Transfer Pricing methods

In most circumstances, the use of one of the recognised Transfer Pricing methods will provide a sufficient accurate basis for determining the Arm's Length Price of a transaction. However, there may be specific cases where the application of one of the Transfer Pricing methods proves inconclusive and a combination of methods may be the most accurate approach. Where a combination of methods is used to test the Arm's Length Principle, the primary aim should be to reach a conclusion that takes account of the facts, circumstances and available evidence of the case.

For example, a Person may have applied the RPM, but struggled to introduce reliable adjustments to account for key differences observed between the Controlled and

uncontrolled transaction. In such a case, the Person may opt to introduce a corroborative analysis by also applying the TNMM to demonstrate that the outcome of the Controlled Transaction is in line with the Arm's Length Principle by assessing the net margin of the tested party under an appropriate profit level indicator (as further discussed in Section 5.2.2).

5.3. Step 3: Determination of the Arm's Length Price

Once the most appropriate Transfer Pricing method has been identified, the method is applied on the tested party and on the data of Comparable Uncontrolled Transaction(s) to arrive at the Arm's Length Price.

5.3.1. Choice of the tested party

The use of CPM, RPM and TNMM requires a decision on which party to apply the Transfer Pricing method. When applying a CPM, RPM or TNMM, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested.

As a general rule, the tested party is the one to where:

- a Transfer Pricing method can be applied in the most reliable manner; and
- the most reliable comparables can be found.

The choice of the tested party should be consistent with the Functional Analysis of the Controlled Transaction. The party with the less complex Functional Analysis i.e. smaller scope of functions and less complex operations should be used as the tested party.

5.3.2. Comparable Uncontrolled Transactions

The economically relevant characteristics of the Controlled Transaction have to be compared with those of uncontrolled transactions that are regarded as potentially comparable in order to determine an Arm's Length Price for the 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).

5.3.2.1. Internal comparables

Internal comparables may have a more direct and closer relationship to the Controlled Transaction under review than external comparables. The financial analysis may be easier and more reliable as it will presumably rely on identical accounting standards and practices for the internal comparable and for the Controlled Transaction. In

addition, access to information on internal comparables may be both more complete and less costly.

However, internal comparables are not always more reliable and it is not the case that any transaction between the Person and an independent party can be regarded as a reliable comparable for Controlled Transactions carried on by the same Person. However, whenever reliable internal comparables exist, it may be unnecessary to search for external comparables.

5.3.2.2. External comparables and sources of information

There are various sources of information that can be used to identify potential external comparables. A common source of information is commercial databases which act as repositories for company accounts.

Commercial databases tend to provide access to a wide variety of potential comparables. Therefore, database searches typically start with a wide set of third-party data or companies that may be broadly comparable. These could be companies that operate in the same sector, perform similar broad functions and do not carry economic characteristics that are obviously different based on standard industry codes. The list of potential comparables is then refined using selection criteria and publicly available information (for example, from databases or reliable internet sites). Therefore, it is important that the database searches are systematically designed to develop search strategies that assist in screening the vast list of potential comparables in line with criteria that are relevant to the Controlled Transaction. It is best to seek quality over quantity of potential comparables when performing a database search and selecting comparables.

The information obtained from commercial databases may need to be refined with other publicly available information, depending on the facts and circumstances to enhance the reliability of the underlying data used in the comparability analysis.

A number of limitations to commercial databases are frequently identified. Because these commercial databases rely on publicly available information, they may not be available in all jurisdictions, since not all jurisdictions are aligned on what company data should be publicly available. Moreover, where information is available, the presentation and level of detail may vary from jurisdiction to jurisdiction because disclosure and filing requirements may differ depending on the legal form of the enterprise or the specific requirements of the jurisdiction. It is important that the identification of potential comparables is made with the objective of finding the most reliable data, recognising that they will not always be perfect. For instance, independent transactions may be scarce in certain markets and industries.

A pragmatic solution may need to be found, on a case-by-case basis, to address the limitations of the commercial databases, such as broadening the search and using information on uncontrolled transactions taking place –

- in the same industry and a comparable geographical market, but performed by third parties that may have different business strategies, business models or other slightly different economic circumstances;
- in the same industry but in other similar geographical markets; or
- in the same geographical market but in other industries.

The choice among these various options will depend on the facts and circumstances of the case, and in particular on the significance of the expected effects of comparability defects on the reliability of the analysis. However, even in cases where comparable data is scarce and imperfect, the selection of the most appropriate Transfer Pricing method (as per the guidance above) should be consistent with the Functional Analysis of the Related Parties or Connected Persons.

The FTA does not have a preference for any particular commercial database as long as it provides a reliable source of information that assists Taxable Persons in performing comparability analysis; provided that the order for applying comparables is followed (local, regional (Middle East), then other regions).

Whichever database the Taxable Person chooses to select comparables from, adequate documentation should be maintained to demonstrate the results of the comparability analysis. Where a Taxable Person has used a private database to support its transfer prices, the FTA may request access to the database in line with Article 55(4) of the Corporate Tax Law to review the Taxable Person's results and to better understand the conclusions reached.

5.3.2.3. Non-domestic comparables

As far as possible, Taxable Persons should use domestic comparables in their comparability analysis as these comparables generally have a higher degree of comparability in terms of their market and economic circumstances compared to foreign comparables. Where insufficient data is available at the domestic level, Taxable Persons can consider regional or global comparables.

5.3.2.4. Selection of potential comparables

The search for information on potentially Comparable Uncontrolled Transactions and the process of identifying comparables is dependent upon prior analysis of the Controlled Transaction and of the economically relevant characteristics or comparability factors. A methodical, consistent approach should provide some continuity or linkage in the whole analytical process, thereby maintaining a constant relationship amongst the various steps: from the preliminary analysis of the conditions

of the Controlled Transaction and the comparability analysis, to the selection of the Transfer Pricing method, through to the identification of potential comparables and ultimately a conclusion about whether the Controlled Transactions being examined are consistent with the Arm's Length Principle.

Broadly, there are two ways in which the identification of potentially comparable Uncontrolled Transactions can be conducted:

- **Additive approach:** This starts with identifying a list of independent parties that are believed to carry out potentially comparable transactions. Information is then collected on transactions conducted by these independent parties to confirm whether they are in effect acceptable comparables, based on the predetermined comparability criteria. In practice, the additive approach may include both internal and external comparables.
- **Deductive approach:** This starts with a wide set of companies that operate in the same sector of activity as the tested party, perform similar broad functions as the tested party and do not present economic characteristics that are obviously different. The list is then refined using selection criteria and publicly available information (for example from databases, internet sites, information on known competitors of the tested party). In practice, the deductive approach typically starts with a search on a database.

Once the potential comparables are identified, both quantitative and qualitative criteria are used to include or reject potential comparables identified. Qualitative criteria can be found in product portfolios and business strategies. Quantitative criteria includes:
- size criteria in terms of sales, assets or number of employees,
- intangible-related criteria such as ratios of net value of intangibles/total net assets value, or ratio of R&D/sales, where available,
- criteria related to the importance of export sales, where relevant,
- criteria related to inventories in absolute or relative value, where relevant, and
- other criteria to exclude independent parties that are in particular special situations such as start-up companies, bankrupted companies, etc. when such peculiar situations are obviously not appropriate comparisons.

The choice and application of selection criteria depends on the facts and circumstances of each particular case and the above list is neither limitative nor prescriptive.

The process followed to identify potential comparables is one of the most critical aspects of the comparability analysis and it should be transparent, systematic and verifiable. In particular, the choice of selection criteria has a significant influence on the outcome of the analysis and should reflect the most meaningful economic characteristics of the transactions compared. Complete elimination of subjective judgments from the selection of comparables would not be feasible, but much can be

done to increase objectivity and ensure transparency in the application of subjective judgments.

Taxable Persons should maintain appropriate supporting information that describe the criteria used to select potential comparables and the reasons for excluding some of the potential comparables. Such information can be used by the FTA to assess the reliability of the comparables used.

5.3.3. Comparability adjustments

Both for the general application of the Arm's Length Principle and more specifically in the context of each method, there may be a need to adjust the potential comparables for accuracy and reliability purposes. Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results.

Comparability adjustments include adjustments for accounting consistency designed to eliminate the impact of differences that may arise from differing accounting practices between the Controlled and uncontrolled transactions; segmentation of financial data to eliminate the material impact of differences of non-comparable transactions; and adjustments for differences in capital, functions, assets and risks.

For example, working capital cycles and the related costs tend to have significant implications on profitability in certain industries. Where such considerations are relevant, working capital adjustments designed to account for the impact of differing levels of accounts receivable, accounts payable and inventory may be undertaken to enhance the reliability of the arm's length analysis. Where undertaken, Taxable Persons are expected to provide adequate justification for all comparability adjustments.

Under Clause 8, 9 and 10 of Article 34 of the Corporate Tax Law, the FTA may make comparability adjustments to Taxable Persons' results where the results do not fall within the arm's length range.

5.3.4. Determining the arm's length range

As Transfer Pricing is not an exact science, it is generally difficult to arrive at a single figure (for example, price or margin) that is the most reliable to establish whether the conditions of a Controlled Transaction are at arm's length.

As per Article 34(7) of the Corporate Tax Law, the application of the selected Transfer Pricing method or combination of Transfer Pricing methods on the data of Comparable Uncontrolled Transactions may result in a range of financial results or indicators (for example, prices or margins) which are all relatively equally reliable and at the same time acceptable for establishing the arm's length result of a Controlled Transaction.

This range of figures is referred to as the “arm’s length range”, and arises either from applying the same Transfer Pricing method to multiple comparable data or from applying different Transfer Pricing methods.

5.3.4.1. Application of statistical measures to determine arm's length range

If the identified range of financial results or indicators includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (for example, the interquartile range or other percentiles) would be useful to enhance the reliability of the analysis. The use of statistical measures also prevents the impact of outliers and exceptional circumstances.

In this respect, the acceptance of the interquartile range is considered an appropriate approach to determine an arm’s length range of financial results or indicators because it provides a more robust measure of central tendency and variability compared to other statistical measures like the arithmetic mean or median. The interquartile range is obtained by dividing the dataset in four (4) equal parts. By doing so, three unique points amongst the dataset are derived, namely the lower quartile (the middle number/figure between the lowest value and the median), the median (the middle value of all observations) and the upper quartile (the middle number/figure between the median and the highest value). The interquartile range then represents all data between the lower quartile and the upper quartile.

Example 15: Use of the interquartile range

A search produces the below 3 year weighted average margins of the comparable companies:

Serial No.	Company Name	3-year weighted average margins
1	Comp 1	6.46%
2	Comp 2	8.70%
3	Comp 3	5.12%
4	Comp 4	0.83%
5	Comp 5	5.66%
6	Comp 6	7.00%
7	Comp 7	8.36%
8	Comp 8	1.80%
9	Comp 9	8.74%
10	Comp 10	3.69%
11	Comp 11	4.32%
12	Comp 12	13.90%
13	Comp 13	9.16%
14	Comp 14	3.83%

15	Comp 15	0.60%
16	Comp 16	4.34%

The above comparables are re-arranged based on ascending order of the 3-year weighted average margins of the comparable companies. This is to assist in better understanding of inter-quartile range.

Serial. No.	Company Name	3-year Weighted Average margins
1	Comp 15	0.60%
2	Comp 4	0.83%
3	Comp 8	1.80%
4	Comp 10	3.69%
5	Comp 14	3.83%
6	Comp 11	4.32%
7	Comp 16	4.34%
8	Comp 3	5.12%
9	Comp 5	5.66%
10	Comp 1	6.46%
11	Comp 6	7.00%
12	Comp 7	8.36%
13	Comp 2	8.70%
14	Comp 9	8.74%
15	Comp 13	9.16%
16	Comp 12	13.90%

The resulting full and interquartile range of the above observations is as follows:

Particulars	3-year weighted average margins
Count	16
Minimum	0.60%
Lower Quartile	3.80%
Median	5.39%
Upper Quartile	8.45%
Maximum	13.90%

The lower quartile, or first quartile (Q1) of 3.8%, is the value under which 25% of 3-year weighted average margins of the comparable companies are found when they are arranged in increasing order.

The median value is the value at the mid-point of the 3-year weighted average margins of the comparable companies. The upper quartile, or third quartile (Q3) of 8.45%, is the value under which 75% of 3-year weighted average margins of the comparable companies are found when arranged in increasing order.

As a result, the interquartile range lies between 3.80% and 8.45%, with a median of 5.39%.

A substantial deviation among points in the arm's length range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

5.3.4.2. Selecting the most appropriate point in the arm's length range

As per Article 34(7) of the Corporate Tax Law, any point within the arm's length range is acceptable in establishing the Arm's Length Price of the Controlled Transactions of a Taxable Person.

The FTA will consider the reliability of the arm's length range when assessing the appropriateness of the selected point in the range.

The FTA will also take into consideration the functional profile of the Taxpayer/Controlled Transaction when assessing the most appropriate point within the range. A point closer to the lower interquartile may be appropriate for a company performing very limited functions, holds no assets and assumes no risks. A point closer to the upper quartile may indicate high value functions, ability to assume risk and employ assets.

5.3.4.3. Extreme results

Extreme results could be produced in case the benchmarking brings about figures that fall in the extreme ends of the interquartile range. Extreme results might consist of losses or unusually high profits and can affect the financial indicators. Where one or more of the potential comparables have extreme results, further examination would be needed to understand the reasons for such extreme results. The reason might be a defect in comparability such as losses not reflecting normal business conditions, losses reflecting a level of risk that is not comparable to the one assumed in the Controlled Transaction, or exceptional conditions met by an otherwise comparable third party. An extreme result may be excluded on the basis that a previously overlooked significant comparability defect has been brought to light, not on the sole

basis that the results arising from the proposed “comparable” merely appear to be very different from the results observed in other proposed “comparables”.

Generally, a loss-making uncontrolled transaction or loss-making company should trigger further investigation in order to establish whether or not it can be comparable to the Controlled Transaction. Circumstances in which loss-making transactions/ enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the Taxable Person in its Controlled Transactions.

5.3.5. Other considerations

5.3.5.1. Timing of origin

In principle, information relating to the conditions of Comparable Uncontrolled Transactions undertaken or carried out during the same period of time as the Controlled Transaction (contemporaneous uncontrolled transactions) is expected to be the most reliable information to use in a comparability analysis. Such transactions better reflect how independent parties have behaved in an economic environment that is the same as the economic environment of the Taxable Person’s Controlled Transaction.

5.3.5.2. Timing of data collection

Taxable Persons may prepare Transfer Pricing documentation to demonstrate that they have made reasonable efforts to comply with the Arm’s Length Principle at different points of time. There are two general approaches:

- Arm’s length price-setting approach: where Transfer Pricing documentation is prepared at the time the Controlled Transactions were undertaken, or based on information that was reasonably available to the Taxable Person at that point. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the Controlled Transaction.
- Arm’s length outcome-testing approach: where the actual outcome of the Controlled Transactions is tested to demonstrate that the conditions of these transactions were consistent with the Arm’s Length Principle. Such a test typically takes place as part of the process for preparing the Tax Return at the end of the Tax Period.

It is recommended for Taxable Persons to ensure that the approaches are applied consistently and result in the same outcome for all the Related Parties or Connected Persons to the Controlled Transaction.

5.3.5.3. Multiple year data

In practice, examining multiple-year data is often useful in a comparability analysis. In order to obtain a complete understanding of the facts and circumstances surrounding the Controlled Transaction, it may be useful to examine data from both the year under examination and prior years. Looking at multiple years can reveal factors that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether reported losses on a Controlled Transaction are part of a history of losses on Comparable Uncontrolled Transactions. Further examination may then reveal that this is the result of particular economic conditions in a prior year that increased costs in the subsequent year.

Multiple-year data can improve the understanding of long-term arrangements, provide insights into relevant business and product life cycles of the comparables and improve the process of selecting third-party comparables.

Use of multiple-year data and averages generally improves the reliability of the range of financial results, especially where transactional profit methods are applied. As the use of multiple-year data may produce a broader set of financial results and indicators, statistical tools will be useful in analysing the results for purposes of determining the arm’s length range.

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.

5.3.5.4. Frequency of updating the search for comparables

Searches for comparables should be fully updated every three years with an annual financial update of the comparables in the interim years as a minimum requirement. In case of a change in circumstances of the Controlled Transaction or Related Parties (or Connected Persons), the full analysis on the selection of comparables needs to be undertaken in the year of the change in circumstances.

6. Transfer Pricing Documentation

6.1. Introduction

Article 55 of the Corporate Tax Law specifies the Transfer Pricing documentation obligations on a Taxable Person that enters into transactions with its Related Parties or Connected Persons.

Generally, Transfer Pricing documentation refers to a set of records prepared by Taxable Persons to demonstrate their compliance with the Arm's Length Principle in their Related Party transactions. The purpose of Transfer Pricing documentation is to provide the FTA with a clear and comprehensive understanding of the Taxable Person's Transfer Pricing policies and their application, to test the Transfer Pricing outcome for each relevant period under review.

This section provides an overview of several areas related to Transfer Pricing documentation, including:

- understanding the objectives and requirements of the Transfer Pricing documentation requirements in the UAE;
- General Transfer Pricing disclosure form;
- Master File;
- Local File; and
- Country-by-Country Reporting ("CbCR").

These different Transfer Pricing requirements may apply depending on the size of the business. A Master file and local file are required from businesses that are part of an MNE Group with consolidated revenue over 3.15 billion AED or where the Taxable Person's Revenue exceeds 200 million AED. CbCR also only applies to businesses that are part of an MNE Group with consolidated revenue over 3.15 billion AED[17].

As mentioned above, the purpose of the Transfer Pricing documentation is to provide an understanding of the Taxable Person's Transfer Pricing practices, and to test the outcomes with the Arm's Length Principle in relation to Controlled Transactions. Accordingly, and in addition to the above statutory requirements, Taxable Persons are encouraged to maintain and provide to the FTA when requested any additional documentation which supports the arm's length basis of the transaction.

Under Article 55(4) of the UAE Corporate Tax Law, the FTA may request certain information from Taxable Persons who are not required to maintain a Local File and Master File. Examples of the information that the FTA may request include-Information regarding transactions with Related Parties and Connected Persons;

- any information to support the arm's length nature of the transaction,

[17] See further in Ministerial Decision No. 97 of 2023.

- any other information that the FTA deems necessary to assess the arm's length nature of the transaction, and
- information used for application of the chosen method. Such additional documentation may include (but is not limited to) documentation supporting arm's length analysis of the Controlled Transaction (i.e. Functional Analysis, benchmarking studies, intercompany agreements, meeting minutes, evidence of decisions taken, emails, invoices, workpapers computing the transfer prices, among others).

The FTA expects the Person to prepare and maintain documentation explaining all relevant information used for the application of the chosen method. Taxable Persons should provide sufficiently detailed documentation to support the factors selected, weights assigned to the factors where multiple factors are used, as well as the details of the numerical adjustments performed. To the extent possible, the documentation should include reliable publicly available market references.

6.2. Objectives of Transfer Pricing documentation

Transfer Pricing documentation is prepared with the intention of serving three primary objectives:

1. ensuring that Taxable Persons appropriately consider Transfer Pricing requirements when setting prices and other terms for transactions between Related Parties or Connected Persons, and accurately report outcomes of these transactions on their Tax Returns;
2. providing the FTA with the necessary data to conduct a Transfer Pricing risk assessment and arrive at an informed position regarding the need for an audit; and
3. providing the FTA with the necessary information to facilitate a comprehensive audit of the Transfer Pricing practices of Persons subject to Corporate Tax in the UAE, while recognising the potential need for additional information as the audit progresses.

6.3. Contemporaneous Transfer Pricing documentation

Taxable Persons are required to maintain contemporaneous Transfer Pricing documentation of their controlled transactions to demonstrate compliance with Transfer Pricing regulations and maintain the integrity of their Corporate Tax positions.

The FTA expects that documentation is maintained either at the time of the Controlled Transaction or, by the time the Taxable Person submits its Tax Return for the Tax Period in which the Controlled Transaction is undertaken. As further described below, such documentation should contain an exhaustive and detailed description of the Controlled Transactions, the economic conditions surrounding them, and the analysis and conclusions that led to the determination of the transfer prices.

By maintaining contemporaneous Transfer Pricing documentation, Taxable Persons can demonstrate that their Transfer Pricing policies comply with the Arm's Length Principle. These policies and the supporting documentation should be prepared, regularly reviewed and reassessed at least annually to reflect changes in the Taxable Person's business or structure and the regulatory and wider business environment.

6.4. Summary of the UAE Transfer Pricing documentation requirements

The relevant UAE legislation has outlined five Transfer Pricing documentation requirements for certain Taxable Persons that are required to be prepared for each Tax Period:[18]

1. **Transfer Pricing disclosure form** which covers details of the Controlled Transactions during a Tax Period.
2. **Master File** which provides a high-level overview of the Group's business and the allocation of income and economic activity within a Group. It only applies to large businesses as set out in the Ministerial Decision No. 97 of 2023.
3. **Local File** which provides detailed information on operations of the local entity and analysis and testing of the outcomes of the Controlled Transactions against the Arm's Length Principle. It only applies to large businesses as set out in the Ministerial Decision No. 97 of 2023.
4. **Country-by-Country Report** which provides jurisdictional quantitative information about an MNE Group (above AED 3,150,000,000) as well as an overview of the different activities conducted by affiliates of an MNE Group, as set out in Cabinet Resolution No. 44 of 2020.
5. **Additional supporting information** upon request of the FTA, pursuant to Article 55(4) of the Corporate Tax Law.

These distinct types of Transfer Pricing documentation are further detailed below.

6.5. Transfer Pricing disclosure form

Pursuant to Article 55(1) of the Corporate Tax Law, all Taxable Persons who undertake transactions with Related Parties or Connected Persons (domestic or foreign) in the reporting Tax Period and are above a materiality threshold are required to prepare and submit a general Transfer Pricing disclosure form, alongside their Tax Return.

A sample of the Transfer Pricing disclosure form to be completed annually by Taxable Persons will be available in due course on the FTA's website. The Transfer Pricing disclosure form includes information on the broad categories of transactions and arrangements undertaken by the Taxable Person with its Related Parties or Connected Persons. Information provided in the disclosure form includes the nature

[18] Corporate Tax Law and the Cabinet Resolution No.44 of 2020

of the Controlled Transaction(s), the value of the Controlled Transaction(s), details of the Related Party(ies) and the Transfer Pricing method(s) used to determine the arm's length value of the Controlled Transactions.

The Transfer Pricing disclosure form is to be submitted alongside the Tax return within 9 months from the end of the relevant Tax Period.

6.6. Master File and Local File

Master File and Local File are part of the three-tiered standardised approach to Transfer Pricing documentation prescribed under the OECD Transfer Pricing Guidelines and BEPS Action 13 (together with Country-by-Country Reporting). The Master File is aimed at providing a high-level overview of the Transfer Pricing policies of an MNE Group, whereas the more detailed information is contained in the local file.

Keeping both a Master File and a Local File is a requirement for Taxable Persons that are a Constituent Company of an MNE Group that has a total consolidated group Revenue of AED 3,150,000,000 or more in the relevant Tax Period, or where the Taxable Person's Revenue in the relevant Tax Period is AED 200,000,000 or more.[19]

6.6.1. Master File

A Master File is a type of Transfer Pricing documentation that provides a high-level overview of the MNE Group's global business operations, Transfer Pricing policies, information on key value drivers, and a global allocation of income and economic activity. Its purpose is to assist the FTA in evaluating significant Transfer Pricing risks and determining the MNE Group's Transfer Pricing practices in their global economic, legal, financial, and tax context. The information required in a Master File provides a "blueprint" of the MNE Group and contains relevant information that can be broken down into the following five categories:

- the MNE Group's organisational structure;
- a description of the MNE Group's business(es);
- the MNE Group's intangibles (as defined in Chapter VI of the OECD Transfer Pricing Guidelines);
- the MNE Group's intercompany financial activities; and
- the MNE Group's financial and tax positions.

A Master File is required to be prepared for each Tax Period based on the specific facts and circumstances of the MNE Group's global business for that particular Fiscal Year.

[19] Article 2(1) of Ministerial Decision No. 97 of 2023.

6.6.1.1. Master File information

The Master File content follows the requirements under Annex I to Chapter V of the OECD Transfer Pricing Guidelines.

The Taxable Persons in scope should present the MNE Group information in a Master File in a consolidated format. The Master File must include information on:

Organisational structure:

- A chart illustrating the MNE Group's legal and ownership structure and geographical location of operating entities.

Description of MNE Group's business(es):

- A general written description of the MNEs business including:
  - Important drivers of business profit.
  - A description of the supply chain for the group's five largest products and/ or service offerings by turnover plus any other products and/or services amounting to more than 5% of group turnover. The required description could take the form of a chart or a diagram.
  - A list and brief description of important service arrangements between members of the MNE Group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and Transfer Pricing policies for allocating services costs and determining prices to be paid for intra-group services.
  - A description of the main geographic markets for the group's products and services that are referred to in the second bullet point above.
  - A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used.
  - A a description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

MNE Group's intangibles:

- A general description of the MNE Group's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.
- A list of intangibles or groups of intangibles of the MNE Group that are important for Transfer Pricing purposes and which entities legally own them.
- A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and license agreements.
- A general description of the group's Transfer Pricing policies related to R&D and intangibles.

- A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries and compensation involved.

MNE Group's intercompany financial activities:

- A general description of how the group is financed, including important financing arrangements with unrelated lenders.
- The identification of any members of the MNE Group that provide a central financing function for the group, including the country under whose laws the entity is organised and the place of effective management of such entities.
- A general description of the MNE Group's general Transfer Pricing policies related to financing arrangements between associated enterprises.

MNE Group's financial and tax positions:

- The MNE Group's annual consolidated financial statements for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
- A list and brief description of the MNE Group's existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

A presentation by line of business is permitted where well justified by the facts (for example, where the structure of the MNE Group is such that some significant business lines operate largely independently or were recently acquired). Where line of business presentation is used, care should be taken to assure that centralised Group functions and transactions between business lines are properly described in the Master File. Even where a line of business presentation is selected, the entire Master File consisting of all business lines should be available to each jurisdiction in order to assure that an appropriate overview of the MNE Group's global business is provided.

6.6.2. Local File

A Local File is a type of Transfer Pricing documentation that provides more detailed information relating to specific Controlled Transactions in the relevant Tax Period. It covers transactions taking place between local country affiliate and associated enterprises, including information on the identity of Related Parties or Connected Persons, relevant financial information regarding those specific transactions, a comparability analysis and the selection and application of the most appropriate Transfer Pricing method. It supplements a Master File and helps to ensure that the Taxable Person has complied with the Arm's Length Principle in its Transfer Pricing positions affecting a specific jurisdiction. A Local File focuses on information relevant to the Transfer Pricing analysis related to each specific transaction taking place between the Taxable Person and its Related Parties or Connected Persons in the relevant Tax Period.

The following categories of information are required in the Local File:
- Information on the local entity.
- Detailed information on each material category of controlled transactions in which the entity is involved, including a functional analysis of each, an indication of the most appropriate Transfer Pricing method (including which party is selected as the 'tested party') and the application of that method.
- Financial information.

The taxpayer is allowed to cross reference to the information contained in the master file.

While all Controlled Transactions need to be conducted in line with the Arm's Length Principle, the Ministerial Decision No. 97 of 2023 has set out scenarios where the following types of Controlled Transactions need to be documented by a Taxable Person in its Local File:
- Controlled Transactions entered into with a Non-Resident Person other than a PE of a Non-Resident Person that is subject to the same Corporate Tax rate as the Taxable Person (for example, cross border transactions).
- Controlled Transactions entered into with an Exempt Person (i.e. Persons not subject to Corporate Tax).
- Controlled Transactions entered into by a Taxable Person with a Resident Person that benefits from the small business relief.
- Controlled Transactions entered into by a Taxable Person with a Resident Person who is subject to a different Corporate Tax rate from that applicable to the Taxable Person (for example, transactions with a Qualifying Free Zone Person).

In addition to the above, it should be noted that the following Controlled Transactions are exempt from being included in a Local File:
1. Controlled Transactions entered into by the Taxable Person with Natural Persons (provided that they are acting as if they were independent of each other).
2. Controlled Transactions entered into by the Taxable Person with a juridical person that is considered to be a Related Party or a Connected Person solely by virtue of being a partner in an Unincorporated Partnership (provided that they are acting as if they were independent of each other).
3. Controlled Transactions with a PE of a Non-Resident Person provided that the PE is subject to the same Corporate Tax rate as the Taxable Person.

While the above transactions do not need to be documented in a Local File, these Controlled Transactions should nevertheless be undertaken on an arm's length basis. The Taxable Person should also be able to provide documentation to the FTA to support the arm's length nature of these transactions when requested.

The Master File and the Local File are to be prepared and maintained by the Taxable Persons as identified above contemporaneously. Such documentation may be requested to be provided to the FTA within 30 days, or by a longer period of time if agreed by the FTA.

6.6.2.1. Local File information

The Local File content follows the requirements under Annex II to Chapter V of the OECD Transfer Pricing Guidelines and must include the following information:

Local entity:

- A description of the management structure of the local entity, a local organisation chart, a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.
- A detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity.
- Identification of the key competitors.

Controlled transactions:
For each material category of controlled transactions in which the entity is involved:

- A description of the material-controlled transactions (for example procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licenses of intangibles) and the context in which such transactions take place.
- The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e. payments and receipts for products, services, royalties, interest, etc.) broken down by tax jurisdiction of the foreign payor or recipient.
- An identification of associated enterprises involved in each category of controlled transactions and the relationship amongst them.
- Copies of all material intercompany agreements concluded by the local entity.
- A detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, including any changes compared to prior years.
- An indication of the most appropriate Transfer Pricing method with regard to the category of transaction and the reasons for selecting that method.
- An indication of which associated enterprise is selected as the tested party, if applicable, and an explanation of the reasons for this selection.
- A summary of the important assumptions made in applying the Transfer Pricing methodology.

- If relevant, an explanation of the reasons for performing a multi-year analysis.
- A list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the Transfer Pricing analysis, including a description of the comparable search methodology and the source of such information.
- A description of any comparability adjustments performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both.
- A description of the reasons for concluding that relevant transactions were priced on an arm’s length basis based on the application of the selected Transfer Pricing method.
- A summary of financial information used in applying the Transfer Pricing method.
- A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party, and which are related to controlled transactions described above.

Financial information:

- Annual local entity financial accounts for the fiscal year concerned. If audited statements exist, they should be supplied and if not, existing unaudited statements should be supplied.
- Information and allocation schedules showing how the financial data used in applying the Transfer Pricing method may be tied to the annual financial statements.
- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.

6.6.3. Exceptions on maintenance of a Master File and a Local File

As per Ministerial Decision No. 97 of 2023, a Taxable Person is required to maintain both a master file and a local file if they meet either of the following conditions in the relevant Tax Period:

a) where the Taxable Person, for any time during the relevant Tax Period, is a Constituent Company of a Multinational Enterprises Group as defined in the Cabinet Resolution No. 44 of 2020 referred to above that has a total consolidated group Revenue of AED 3,150,000,000 (three billion one hundred and fifty million United Arab Emirates Dirham) or more in the relevant Tax Period; or

b) where the Taxable Person’s Revenue in the relevant Tax Period is AED 200,000,000 (two hundred million United Arab Emirates Dirham) or more.

However, as an exception, any Taxable Person that is part of a UAE headquartered group that is not an MNE Group (i.e. a group that does not have business establishments outside the UAE) is not required to maintain a Master File. However, they should maintain a Local File as per the above thresholds.

A Taxable Person not meeting either of the conditions is not required to maintain either a Master File or a Local File. In such cases, the Taxable Person is still required to maintain reasonable records to support the arm's length nature of the Taxable Person's transactions or arrangements with its Related Parties and Connected Persons. The FTA can request such information to be produced within (30) thirty days following a request by the FTA, or by any such other later date as the FTA directs.[20]

6.7. Country-by-Country Reporting (CbCR)

CbCR is the third tier of Transfer Pricing documentation set in BEPS Action 13.

CbCR is a standardised report which includes aggregate tax jurisdiction information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE Group operates. The report also requires a listing of all the Constituent Companies for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main Business Activities carried out by that Constituent Company.

The UAE introduced CbCR requirements through Cabinet Resolution No.44 of 2020. As per Cabinet Resolution No. 44 of 2020, the form of a CbCR follows the Standard Template attached in Annex (3) to Chapter (V) of the OECD Transfer Pricing Guidelines. Specifically, a CbCR includes the following three tables:

- Table 1 – Contains the quantitative information per tax jurisdiction such as unrelated party and related party revenues, stated capital, taxes accrued and paid, employee count, etc.
- Table 2 – Contains the qualitative information per Constituent Company on the main business activities undertaken during the year.
- Table 3 – Contains additional information necessary to facilitate the understanding of Tables 1 and 2 (for example, assumptions on exchange rates, source of data, etc.)

The UAE CbCR requirements are applicable to MNE Groups headquartered in the UAE with consolidated Group revenue equal to or above AED 3.15 billion (approximately EUR 750 million) during the Fiscal Year immediately preceding the reporting Fiscal Year.[21]

The Ultimate Parent Entity will be required to submit a CbCR notification in respect of each reporting Fiscal Year.[22] The CbCR notification needs to be submitted no later

[20] Article 55(4) of the Corporate Tax Law.
[21] Article 2(1)(a) of the Ministerial Decision No. 97 of 2023.
[22] Article 2(2) of Cabinet Resolution No. 44 of 2020.

than the last day of the Fiscal Year and it informs the FTA that the Ultimate Parent Entity is the reporting Entity which will file the CbCR.[23] 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.[24] Cabinet Resolution No. 44 of 2020 stated the requirements for CbCR and includes guidance on preparation and submission of the CbCR and the CbCR notification. Taxable Persons should refer to Cabinet Resolution No. 44 of 2020 for practical guidance on the preparation and filing of the CbCR and the CbCR notification.

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[23] Article 2(1) of Cabinet Resolution No. 44 of 2020.

[24] Article 4(1) of Cabinet Resolution No. 44 of 2020.

7. Special Considerations for Specific Cases

This section provides guidance on special considerations that Taxable Persons may encounter in determining arm's length conditions for transactions such as financial transactions, intra-group services and intangibles, as well as other considerations such as Cost Contribution Arrangements ("CCAs"), Business Restructuring, PEs, and Group synergies. These specific areas are relevant from a UAE perspective, as a financial and investment hub. This section also highlights some considerations on audit and risk assessments.

The guidance in this section should take into consideration the guidance provided in Section 5 of this Guide on the application of the Arm's Length Principle.

7.1. Financial transactions[25]

7.1.1. Introduction

This section provides guidance on determining whether the conditions for certain types of financial transactions between Related Parties or Connected Persons are consistent with the Arm's Length Principle. It should not be assumed that this section includes an exhaustive list of all financial transactions falling under the scope of the UAE Transfer Pricing rules. Taxable Persons are expected to conduct all financial Controlled Transactions in line with the Arm's Length Principle.

7.1.2. Treasury function

Generally, the goal of a treasury function in an MNE Group is to monitor and ensure financial stability. MNE Groups often set up dedicated treasury departments to manage and address the liquidity and financing needs of the Group. Treasury activities that are performed within MNE Groups are considered transactions between Related Parties or Connected Persons and are subject to Transfer Pricing requirements. A corporate treasury department may perform the following activities for the benefit of the Group:

- Optimising liquidity across the MNE Group to ensure that the business has sufficient cash available and that it is in the right place when it is needed and in the right currency. In certain cases, a central treasury team may act as the contact point to centralise the external borrowing of the MNE Group. External funds would then be made available within the MNE Group through intra-group lending.
- Cash management of the excess liquidity of the MNE Group in order to earn an investment return and preserve capital as needed.

[25] The following sections follow the guidance of Chapter X of the OECD Transfer Pricing Guidelines, with certain modifications to suit the domestic requirements.

- Managing financial risk through identification and analysis of, and responses to, the financial risks to which the business is exposed, including optimising the cost of capital to the advantage of the users of the MNE Group's treasury services.
- Raising debt (through bond issuances, bank loans or otherwise) and raising equity, and managing the relationship with the MNE Group's external bankers and with independent credit rating agencies.

When evaluating the Transfer Pricing issues related to treasury activities, it is important to accurately characterise and understand the actual transactions and determine what exactly the treasury functions that an entity is carrying out are before moving on to the pricing of the transactions.

7.1.2.1. Determining the arm's length remuneration for the treasury function

Often, the central treasury function is performing routine services without bearing or managing significant risks. In such cases, Taxable Persons may refer to Section 7.2 for further details on remunerating centralised services. However, it is important to separately consider the arm's length remuneration for cases where the treasury function is acting as an in-house bank that is bearing and managing significant contingent liability risk that may arise from Related Party loans, cash pooling or guarantees (further discussed below).

7.1.3. Intra-group loans

Intra-group loans are often made by a central treasury entity, but they may also arise in a variety of other scenarios such as loans from a parent company to an operating subsidiary, loans between operating subsidiaries, or shareholder loans made by investors to portfolio companies. In the case of loans provided by a centralised treasury entity, such transactions should typically be priced separately from the routine services that may also be performed by that entity.

7.1.3.1. Determining the arm's length pricing for intra-group loans

Given the abundance of data on third-party loans, it is often the case that the CUP method can be applied to price intra-group loans. For loans, the CUP method typically involves the following steps:

- Analysis of the terms of the loan relating to factors that may impact the pricing including issue date, tenor, country of the borrower, currency, options (for example, pre-payment option), interest rate type (for example, fixed vs. floating), etc.
- Analysis of the borrower's credit rating to understand the credit risk borne by the lender in extending the loan (factoring in implicit support from the group as further discussed below).
- Search for third-party loans with a similar credit rating and terms.

- Comparability adjustments if necessary and the calculation of the arm's length range.

The below sub-sections provide more details on conducting a credit rating analysis as well as performing a search for third-party loans.

7.1.3.2. Credit ratings

Credit rating is an opinion about an entity's general creditworthiness and capacity to meet its financial obligations. The creditworthiness of the borrower is one of the main factors that independent lenders take into consideration when the terms of the borrowing are being determined. Credit ratings can serve as a useful measure of creditworthiness and, therefore, help to identify potential comparables or to apply economic models in the context of intra-group loans.

Credit ratings can be determined for the overall creditworthiness of an MNE or the Ultimate Parent Entity of the MNE Group or for a specific issuance of debt. Based on prevailing facts and circumstances and provided there is comparability between the third-party debt issuance and the Controlled Transaction, when both MNE credit rating and financial instrument credit ratings are available, the rating of the particular financial instrument would be more appropriate to be used to price the controlled financial transaction.

Determining credit ratings requires consideration of both quantitative (for example, financial information of the borrower) and qualitative factors (for example, the industry and jurisdiction in which the borrower operates). An approach often used to determine a credit rating for a specific MNE is to replicate the process used to determine the credit rating of the MNE Group by applying the quantitative and qualitative analysis of the individual characteristics of the MNE using publicly available financial tools or independent credit rating agencies' methodology. This approach also takes into consideration the enhanced creditworthiness that an MNE may receive for being part of an MNE Group.

The credit rating methodology used in publicly available financial tools may differ significantly from the credit rating methodologies applied by independent credit rating agencies to determine official credit ratings and the impact of any such differences should be carefully considered. For instance, publicly available tools generally use only a limited sample of quantitative data to determine a credit rating. Official credit ratings published by independent credit rating agencies are derived from more rigorous analysis that includes quantitative analysis of historical and forecast entity performance, as well as detailed qualitative analysis of, for instance, management's ability to manage the entity, industry specific features and the entity's market share in its industry. For these reasons, the reliability of credit rating results derived from the use of publicly available financial tools may be limited when compared to independent

credit rating agencies. However, this may be improved if the analysis can demonstrate consistency of ratings using publicly available tools with those provided by independent credit rating agencies. For example, when deciding whether and on what terms to lend, banks and other lenders may rely on independent credit ratings. A third-party lender may take into account independent credit ratings in terms of fixing the level of interest on a particular loan (a higher rating resulting in a lower interest rate). Credit ratings are just one area of consideration when deciding whether and on what terms to provide lending. The same considerations apply equally to Related Party loans.

In general, a lower credit rating will indicate a greater risk of default and be expected to result in higher borrowing costs.

It is important that the MNE Group appropriately documents the reasoning behind the credit rating used when pricing intra-group loans and other controlled financial transactions.

Example 16: Impact of credit rating on arm's length rates

Company Y is a company operating in Information Technology hardware industry in the UAE. Company Y obtained a 5-year term loan of AED 100 million from a Related Party lender. Company Y has a credit rating of BBB. A search was conducted to identify the conditions applied in similar third-party loans and the following factors were taken into consideration for the search:

Amount: 100 million
Tenor: 5 years
Rank: Subordinated
Currency: AED
Country of the borrower: UAE
Industry of the borrower: Information Technology hardware
Credit rating of the borrower: BBB

Accordingly, the search identified similar loan agreements. The search revealed that the interest rate charged for comparable independent agreements is 5.5% per annum with the same or similar conditions as the tested transaction.

On this basis, it is concluded that 5.5% per annum is a reasonable arm's length interest rate applicable to the AED 100 million loan borrowed by Company Y.

Impact of different credit rating:

Keeping the above example with same factors except that the credit rating of the borrower (Company Y) is A instead of BBB. On a comparable search identified for

similar loan agreements, the interest rate charged for comparable independent agreements is 4% per annum with the same or similar conditions as the tested transaction.

As a result, it can be concluded that 4% is a reasonable arm's length interest rate applicable to the AED 100 million loan borrowed by Company Y.

7.1.3.3. Implicit support

The effect of Group membership is relevant for informing the conditions under which a Taxable Person would have borrowed from an independent lender at arm's length. In particular:

1. The external funding policies and practices of group management will assist in informing the form and terms and conditions of the debt the MNE would have entered into with an independent lender, including the pricing (i.e. interest rate paid), and all economically relevant characteristics such as the type of loan, its term, currency, security, covenants, business strategies, and so forth.
2. The entity may receive support from the Group to meet its financial obligations in the event of the entity getting into financial difficulty.

In the context of intra-group loans, this incidental benefit that the entity is assumed to receive solely by virtue of its Group affiliation, is referred to as 'implicit support'. The effect of potential Group support on the credit rating of an entity and any effect on that entity's ability to borrow or the interest rate paid on those borrowings would not require any payment or comparability adjustment.

Implicit support from a Group may affect the credit rating of the borrower or the rating of any debt which it issues. The relative status and strategic importance of an entity within the Group may help determine what impact that potential group support has on the credit rating of a debt issuer. The weaker the linkage of an entity to the Group, the less it would receive support. In the event that there is evidence that an entity is not likely to receive support from its Group, it may be appropriate to consider the entity on the basis of its own stand-alone credit rating only.

7.1.3.4. Performing a search for third-party loans

The arm's length interest rate for an intra-group loan can be benchmarked against publicly available data for other borrowers/third-party loans with the same credit rating as well as sufficiently similar terms and conditions and other comparability factors of the loans. In addition to credit quality, in performing a search for third-party loans, it is important to also consider key factors that would impact the pricing of the loan, such as the following:

- **The issue date** of the loan is an important factor in the pricing of the loan as interest rates may fluctuate significantly over time based on various macro-economic factors.
- **The currency** of the debt can impact the risk of the loan due to foreign exchange rate fluctuations. Certain currencies are generally considered lower risk (for example, the US Dollar ("USD") or those currencies pegged to the USD such as the AED) while other currencies are higher risk (for example, currencies undergoing or at risk of a devaluation).
- **The country of the borrower** can impact the risk of a loan due to the unique macro-economic factors of that country (for example, recession or high inflation), risk of capital controls being imposed, or political instability that could threaten the capital markets of a country.
- **The tenor** of a loan will impact the pricing of the loan as it will impact how long the lender's capital will be tied into this transaction. Under normal economic conditions, loans with a longer duration would typically require a higher interest rate to incentivise the lender to extend the loan for such a time period.
- **The options** of a loan may grant certain privileges to the lender or the borrower. For example, a pre-payment option that would allow the borrower to pay off the loan before the maturity date could add a premium to the loan due to the potential benefit provided to the borrower (for example, if interest rates are lowered, it would benefit the borrower to pay off the loan early, thereby disadvantaging the lender due to loss of interest income).
- There are **different types of rates** that may be applied to loans including fixed rate loans and floating rate loans. The interest rate of a fixed rate loan remains 'fixed' (i.e. constant) throughout the duration of the loan, whereas a floating rate loan will fluctuate based on an underlying market benchmark (for example LIBOR or EIBOR), thereby impacting the riskiness of the loan.
- **The industry** of the borrower may impact the riskiness of the loan. For example, some industries are considered to be more stable in nature or may involve significant physical capital that could reduce the risk to the lender (for example manufacturing), whereas the opposite may be true for other industries (for example technology).

The above guidance is not meant to be exhaustive, and other factors may also need to be considered in pricing an intra-group loan.

7.1.3.5. Comparability adjustments for third-party loans

In certain cases, when conducting a loan benchmarking analysis, it may not be possible to match all of the key comparability criteria of an intra-group loan. For example, certain countries do not have robust capital markets and, therefore, may not offer a sufficient number of third-party loans issued in their country or currency. As a result, comparability adjustments may be required to enhance the comparability and reliability of the third-party loan.

Example 17: Adjustments to reflect third-party rates

Company M borrows AED 100 million from a Related Party lender, and this debt has a tenor of 10 years. A search of the interest rate charged for comparable debt yields compared to debt transactions with tenors ranging from 5 to 9 years. As such, a comparability adjustment is required to reflect third-party rates for a 10-year loan. The adjustment is performed as follows:

1. Identify yields at the tenor of the intra-group loan (i.e. 10 years) using available data as of the data of the loan issuance such as a yield curve. This will be referred to as (A).
2. Identify yields at the tenor of each third-party loan using the same data source (for example, the yield curve as mentioned under step 1). This will be referred to as (B).
3. Calculate a tenor adjustment factor for each third-party loan by dividing the 10-year yield rate found in Step 1 by the yield at the tenor of each third-party loan from Step 2. This will be referred to as (C) (i.e. C = A / B).
4. Multiply the interest rate of each third-party loan (referred to as D) by the tenor adjustment factor calculated in Step 3 above to arrive at the tenor adjusted interest rate, i.e. C x D.

7.1.4. Cash Pooling

Cash pooling is a financial management technique used by companies to optimise their cash flow and efficiently manage liquidity within a group of related entities or subsidiaries. It involves the consolidation of cash balances from multiple accounts into a central pool, typically held by a parent company or a designated treasury entity. This centralisation allows companies to have a more holistic view of their cash position and utilise surplus funds more effectively. If operated efficiently it can reduce reliance on external borrowings and associated costs.

There are two basic types of cash pooling arrangements:

- Physical pooling
- Notional pooling

In a physical pooling arrangement, the bank account balances of all of the pooling members are transferred daily to a single central bank account owned by the cash pool leader, with the aim of bringing the individual pool members balances to a target balance.

In a notional pooling arrangement, some of the benefits of combining credit and debit balances of several accounts are achieved without any physical transfer of balances between the participating members' bank accounts. However, the bank may require

cross-guarantees from the pool participants to enable the right to set off between accounts if necessary.

Because there is no physical transfer of funds in a notional pooling arrangement, the transactional costs of operating a notional cash pool are likely to be less than the transactional costs of operating a physical cash pool. The functions carried out by the bank would be accounted for in the charges or interest rate of the bank. The cash pool leader would perform minimal functions and have little value to add, since the functions are primarily performed by the bank, which would need to be reflected in the intra-group pricing.

7.1.4.1. Determining the arm's length remuneration in a cash pooling arrangement

Cash pooling arrangements involve transactions between Related Parties or Connected Persons and hence it is important to ensure that the arrangement is conducted in line with the Arm's Length Principle.

The appropriate reward of a cash pool leader will depend on the facts and circumstances, the functions performed, the assets used and the risks assumed in facilitating a cash pooling arrangement. In general, a cash pool leader performs routine functions such as co-ordination, forecasting, reporting and basic analysis, and the expectation is that it will receive a commensurate renumeration as a routine service provider. In more complex cash pools, additional responsibilities could include risk management, interest optimisation and external banking relationships. These types of cash pools would expect to receive more than a routine reward. The level of remuneration for a cash pool function should be directly linked to the activities and services, assets used and risks assumed by the cash pool leader, and the appropriate Transfer Pricing method should be adopted after analysing the specific facts and circumstances.

The remuneration of the cash pool members will be calculated through the determination of the arm's length interest rates applicable to the debit and credit positions within the pool. This determination will allocate the synergy benefits arising from the cash pool arrangement amongst the pool members and it will generally be done once the remuneration of the cash pool leader has been calculated.

7.1.5. Hedging

An MNE Group may make use of hedging instruments by which risk is transferred within different group entities. The hedging activity may be centralised within the treasury entity. For example, currency risk of one entity may be managed via a currency hedge that is arranged by the treasury entity. As a result, whilst individual entities in the Group may not contractually enter into hedging arrangements in their

own name, their risk is nevertheless managed from the perspective of the Group as a whole.

Possible mechanisms by which an MNE Group may centralise the hedging of risk include:

- having a group treasury entity to perform the hedging function with the hedging contracts entered into in the name of the relevant operating companies or another MNE Group entity, and
- the MNE Group identifying and utilising natural hedges across the Group, in which case no formal hedging contracts are made.[26]

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 in line with Section 5 of this Guide.

7.1.6. Financial guarantees

A financial guarantee is a legally binding commitment, which requires the guarantor to meet certain financial obligations in the event of a default by the party being guaranteed.

Under certain circumstances, a guarantee may be provided by an entity on a loan taken out by its Related Party from an unrelated lender. As a first step in determining the arm's length conditions of a guarantee arrangement, it is necessary to understand the economic benefit received by the borrower beyond the one that results from any potential implicit support mentioned above. In particular, an entity may receive a lower interest rate or access to more funding due to a Related Party guarantee. This is a result of having explicit support via a formalised guarantee.

7.1.6.1. Pricing a related party guarantee

Pricing a Related Party guarantee is typically done by estimating the benefit recognised by the guaranteed party in receiving a lower interest rate on its borrowings as a result of the guarantee. This approach is referred to as the "interest savings approach" and is done by 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. Estimating the cost of borrowing should be done in line with the guidance in this section on pricing intra-group loans as detailed above in Section 7.1.3.

[26] A natural hedge is a risk management strategy used by businesses to offset or mitigate the impact of financial risks without resorting to explicit financial transactions or derivative instruments. The concept of a natural hedge is based on the idea that certain business activities or positions are naturally correlated with other activities or positions, leading to a self-balancing effect.

7.1.7. Captive insurance

A captive insurer is a function within a Group whose role is to insure certain risks of the Group. There are several benefits of captive insurance, including the ability to save on costs by retaining the risk within the Group and overcoming the challenge of obtaining insurance coverage for certain risks that are difficult to insure against in the open market. Captive insurers should operate genuine commercial enterprise if they are to be comparable to their independent counterparts. Indicators of commerciality may include the following:

- A diversification and pooling of risk in the captive insurer; and
- An improved capital position of the entities within the MNE Group as a result of diversification.

Furthermore, captive insurance arrangements should provide genuine insurance cover where the captive is assuming risk in exchange for premiums. Some indicators of genuine insurance activities include the following:

- The need to insure the risk;
- The captive insurer has the relevant skills and experience at its disposal to underwrite and manage the risk;
- There is a probability that the risk insured will materialise; and
- The captive insurer is comparable to independent insurers in terms of capital levels, operational framework and personnel.

7.1.7.1. Determination of Arm's Length Price of captive insurance

In pricing the captive insurance arrangement, it may be possible to apply the CUP method if there are internal comparables whereby the captive insurer has suitably similar business with unrelated customers, or if external comparables are available.

However, due to the unique nature of insurance arrangements, it is often difficult to apply the CUP method for captive insurance. Thus, it may be more reliable to evaluate the arm's length profitability of the captive insurance entity following the guidance in Section 5 of this Guide and applying the appropriate profit level indicator. Typically, such an analysis would take into account the profitability of claims and an appropriate return on capital.

Finally, an alternative method may be considered such as an actuarial analysis to determine an arm's length premium for insuring a particular risk. However, alternative methods come with unique challenges and should only be used where the five Transfer Pricing methods prescribed in Article 34(3) of the Corporate Tax Law are not suitable or inconclusive.

7.2. Intra-group services[27]

7.2.1. Introduction

This section focuses on services performed by one or more Group members that provide a benefit to other Group members and, whether such services are priced in accordance with the Arm's Length Principle.

In independent situations, a Person in need of a specific service may acquire that service from a third-party service provider or may perform the service itself in-house. In a similar way, a member of an MNE Group in need of a service may acquire it from independent service providers, from one of its Group members (i.e. intra-group) or perform the service itself.

Intra-group services often include those services that are typically available externally from third parties (such as legal and accounting services), in addition to those that are ordinarily performed internally (for example, by an enterprise itself, such as internal auditing or human resources). A service that qualifies as an intra-group service should be identified and remunerated in line with the Arm's Length Principle.

Further, the analysis of Transfer Pricing considerations for intra-group services, involves two main areas:

- whether intra-group services have in fact been provided; and
- whether the charge for the intra-group service is in accordance with the Arm's Length Principle.

7.2.2. Determining whether an intra-group service has been rendered

7.2.2.1. Benefits test

Under the Arm's Length Principle, the question whether an intra-group service has been rendered when an activity is performed for one or more Group members by another Group member should depend on whether the activity provides a respective Group member with economic or commercial value to enhance or maintain its business position. This can be determined by considering the following non-exhaustive factors:

- Whether the benefits have economic or commercial value such that an independent party in comparable circumstances would be willing to pay for the activity if performed by an independent party or would have undertaken to perform the activity for itself.

[27] The following sections follow the guidance of Chapter VII of the OECD Transfer Pricing Guidelines. Certain modifications have been made to suit the domestic requirements and views of the FTA.

- Whether activities are performed for another party which receives, or reasonably expects to receive, benefits from such activities. If so, there may be a service provided even if the expected benefits do not eventually materialise.
- Whether objectively there is any commercial or practical necessity for the activities to be performed for the service recipient and an independent party would be willing to pay the service provider for the performance of those activities. If not, the benefit may be too remote or incidental.
- Whether the benefits are identifiable and capable of being valued. Otherwise, there is no service provided.

7.2.2.2. Shareholder activities

Sometimes in an MNE Group, an intra-group activity is performed relating to Group members even though those Group members do not need the activity (and would not be willing to pay for it were they independent of the Group). Such an activity may be one that a Group member (usually a parent entity or a regional holding company) performs solely because of its ownership interest in one or more other Group members (i.e. in its capacity as shareholder). It may also be required to perform such activities for regulatory compliance reasons, which would also indicate these activities are performed in the service provider's capacity as a shareholder.

These types of activities would not be considered to be intra-group services, and thus would not justify a charge to other Group members. Instead, the costs associated with this type of activity should be borne and allocated/retained at the level of the shareholder. This type of activity would be referred to as a "shareholder activity".

The following are indicative examples of costs that may be associated with shareholder activities and should not be charged:

- Costs relating to the juridical structure of the parent entity itself, such as shareholder meetings, issuing of shares in the parent entity, stock exchange listing of the parent entity and costs of the supervisory board.
- Costs relating to reporting requirements (including financial reporting and audit) of the parent entity including the consolidation of reports, the parent entity's audit of the subsidiary's accounts carried out exclusively in the interest of the parent entity, and the preparation of Consolidated Financial Statements of the MNE Group.
- Costs of raising funds for the acquisition of its participations and costs relating to the parent entity's investor relations such as a communication strategy with shareholders of the parent entity, financial analysts, funds and other stakeholders in the parent entity.
- Costs relating to compliance of the parent entity with the relevant tax laws.
- Costs which are ancillary to the corporate governance of the MNE Group as a whole.

7.2.2.3. Treatment of pass-through cost / reimbursement of expenses

Sometimes, a Group company may arrange and pay for, on behalf of its Related Parties or Connected Persons, goods or services acquired from various vendors. These are generally called pass-through costs and are subject to reimbursement.

A question may arise as to whether the Group company arranging and paying for such goods or services should add a profit element to the amount paid to the vendors when recharging such costs to Related Parties or Connected Persons.

The Group service provider may pass on the costs from the vendors without a profit element or mark-up provided that:

- the acquired goods or services are requested by and for the benefit of the Related Parties or Connected Persons;
- the Group service provider is merely the paying 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 Related Parties or Connected Persons. This condition can be met even if the Group service provider is legally or contractually liable to pay for the acquired goods or services through an inter-company agreement.

The Group service provider should nonetheless consider charging an appropriate arm's length standard margin for its function in arranging and paying for the acquired goods or services on behalf of its Related Parties or Connected Persons. This should be based on (but not limited to) the aggregate costs of performing the function, and reflect the nature of its own services and extent of value-add generated for the Related Parties or Connected Persons.

Example 18: Treatment of pass-through cost as well as service cost

Company A is the parent company of an MNE Group headquartered in the UAE. It has wholly owned subsidiaries in countries X and Y. Company A has a centralised procurement team responsible for all procurement related activities for the Group.

The subsidiary in country X seeks support from the procurement team to arrange additional office premises. Based on the request, the procurement team invites bids and assists in the entire life cycle of leasing the office premises.

As part of the arrangement, the lease contract is signed between Company A and the leasing company, with lease rental payments to be paid directly by Company A to the leasing company.

In determining the arm's length charge, Company A should apply an arm's length mark-up to the costs incurred in providing procurement support during the arrangement of the lease. Company A is also expected to recover the lease rental cost from its subsidiary without a mark-up.

7.2.2.4. Duplication

Duplication of services occurs when a service is provided to a Related Party that has already incurred costs for the same activity performed either by itself or on its behalf by an independent provider. There is no commercial or practical necessity for such duplicative service and thus, applying the benefit test, no service is considered provided. While generally this is the case, there could be situations where duplication of service may be allowed:

- Where the duplication of services is only temporary, for example, where an MNE Group is reorganising to centralise its management functions.
- Where the duplication is undertaken to reduce the risk of a wrong business decision. For example, this situation may arise if a company receives in-house accounting advice from a Related Party on an issue but chooses to get a second opinion to minimise the risk of being penalised for failing to comply with accounting standards, the costs of the in-house accounting advice received should be borne by the company.

Any consideration of possible duplication of services needs to identify the nature of the services in detail, and the reason why the company appears to be duplicating costs contrary to efficient practices. The fact that a company, for example, may be performing marketing activities in-house and also is charged for marketing services from a Group company does not in itself determine duplication. In this example there may be differences if the local entity is executing a local marketing strategy and the Group company is executing a global marketing strategy which may be indicative of different marketing activities which are not duplicative.

The FTA expects a clear rationale for suffering any duplicative costs as a result of intra-group services. As such, the Taxable Person should maintain sufficient documentation to support the Taxable Person's position in suffering costs for what may appear to be duplicative services.

7.2.2.5. Incidental benefits

In certain situations, an intra-group service relates only to some Group members but incidentally provides benefits to other Group members. For example, comprehensive group-wide studies on structural changes could be made to reorganise the Group, studies exploring the benefits of acquiring new lines of business, or to terminate a division. These activities may constitute intra-group services to the particular Group

members who commissioned these studies. These Group members may incorporate the findings of the studies to support or reject key business decisions directly impacting their competitive advantage in the marketplace. As a secondary consideration, these studies may be made available to other Group members for their reference. These types of studies may also provide useful information such as highlighting operational inefficiencies or product lines with growth potential. For the Group entities that have been provided with the studies for their reference, the useful information is an incidental benefit, and it would not be appropriate to raise a charge as a provision of intra-group services. This is 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. However, each case must be determined according to its own facts and circumstances.

7.2.2.6. Intra-group services rising from several layers of management

An MNE Group can include several businesses and service lines. It can have several layers of management oversight and supervision for, for example, a global business leadership team overseeing business affairs globally at large, a regional business leadership team responsible for a particular region, and a local business leadership team responsible for a country. In other words, not all MNE Groups are vertically integrated and may instead have regional or divisional sub-groups with their own management and support structures.

The MNE Group may decide to perform an allocation of the cost of its global and regional business leadership teams across all the countries of operations.

While performing such an allocation, the MNE Group should apply the principles of the benefits test discussed in Section 7.2.2.1 of the guide.

In the event that a cost allocation does not pass the benefits test, such expenditure shall be adjusted while determining the Taxable Income of the Taxable Person in accordance with Article 20 of the Corporate Tax Law. Further a close evaluation should be undertaken to ensure that multiple layering in management does not result in duplication in allocation of cost to the members of the Group.

7.2.2.7. Centralised services

Other activities that may relate to the Group are those centralised in the parent entity, or in one or more Group service centres (such as a regional headquartered company) and made available to the Group (or multiple members thereof). The activities that are centralised depend on the kind of business and on the organisational structure of the Group. However, in general, they may comprise administrative services including but not limited to:

- planning and coordination;

- information technology and computer services;
- human resource services, recruitment and training;
- financial advice, financial services, budgetary control, accounting and audit;
- legal services;
- customer services; and
- other support functions such as distribution, procurement and marketing.

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.

Intra-group services can take many forms and can provide varying levels of benefit, it is, therefore, necessary to explore the actual facts and circumstances of the arrangement in order to determine the most appropriate Transfer Pricing method.

For a particular service arrangement, the terms of the activity can be set out in a detailed contract with the party commissioning the service. The activity may involve highly skilled personnel and vary considerably both in its nature and in its importance to the success of the activity. The actual arrangements can take a variety of forms from the undertaking of detailed programmes laid down by the principal party, extending to agreements where the research company has discretion to work within broadly defined parameters. Such an arrangement would constitute the rendering of a valuable/chargeable service.

A chargeable service may be provided even where there is no explicit agreement in place. For example, an MNE Group decides to centralise its global finance function. It will provide services which may include maintaining accounting records, preparing financial statements based on accounting records, reconciling financial data, preparing tax returns and computations and reclaim forms, performing operational and financial internal audits, and performing other services of a similar nature. The fact that a written service agreement does not exist between the service provider and a Group member does not automatically mean a service has not been provided or received. The conduct of the parties should be reviewed together with the need for the service and whether an operational burden which the Group member would have paid for or undertaken to address in-house has been removed through centralisation.

An obligation to pay for an intra-group service arises only where the benefits test is satisfied, which is determined by evaluating whether independent parties in comparable circumstances would have been willing to pay for the activity if performed by an independent service provider or would have performed the activity in-house.

Example 19: Treatment of costs related to specific regulatory requirements

Company A is a parent company of an MNE Group headquartered in country X. It is listed on a Recognised Stock Exchange in country X. It has a wholly owned subsidiary Company B in the UAE.

To comply with its regulatory requirements in country X, Company A conducts a special audit of the financial statements of Company B. This audit is separate and distinct from the audit that Company B performs under the UAE's applicable legislation. Further the special audit is not required under the UAE's applicable legislation.

Since the special audit is performed by A Co for complying with its own regulatory requirements in country X, A Co should bear the cost of the special audit and not pass it on to Company B in the UAE.

Example 20: Treatment of costs related to third-party service providers

Company B is a company that is part of an MNE Group headquartered in country A. It is listed on a Recognised Stock Exchange in country A. It has a wholly owned subsidiary Company Y in UAE.

Company B has certain financial reporting obligations in country A for, for example, preparation of consolidated financial statements. Generally, Company B hires an external third-party service provider to provide such services. However, as part of changes in the Group's internal policy, Company B asks Company Y to provide the services instead.

In this case, the service provided by Company Y should be subject to the benefits test. The benefits test would take into account, among other factors, whether Company Y provides any economic or commercial value to enhance the business position of Company B.

This can be determined by considering whether Persons who were not Related Parties or Connected Persons would be willing to pay for the activity if performed by an independent third party or performed in-house. If the activity is not one for which Persons who were not Related Parties or Connected Persons would have been willing to pay for, the activity ordinarily should not pass the benefits test. As can be observed, the analysis will depend on the actual facts and circumstances.

In this case it is assumed that Company B would have continued to hire an external third-party service provider to provide the services had the Group's internal policy not changed. Based on this fact, it can be reasonably concluded that the benefits

test is passed and Company Y can charge the associated cost as per the arm's length standard.

7.2.3. Determining the arm's length charge for intra-group services

7.2.3.1. Comparability analysis

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. In this respect, the comparability analysis should analyse relevant considerations such as the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

7.2.3.2. Selection of the most appropriate Transfer Pricing method

The method to be used to determine arm's length charge for intra-group services should be determined according to the guidance in Section 5 of this guide.

The Comparable Uncontrolled Price (CUP) method or a cost-based method (Cost Plus Method or Transactional Net Margin Method using a cost-based profit level indicator) are commonly used for pricing intra-group services. A CUP method is likely to be the most appropriate method where there is a comparable service provided between independent enterprises, or by the Related Party providing the services to an independent enterprise in comparable circumstances.

7.2.3.3. Direct and indirect charge methods

An MNE Group may be able to adopt direct charging arrangements, particularly where services similar to those rendered to Related Parties or Connected Persons are also rendered to independent parties. If specific services are provided not only to Related Parties or Connected Persons but also to independent parties in a comparable manner and as a significant part of its business, it could be presumed that the MNE has the ability to demonstrate a separate basis for the charge (for example, by recording the work done, the fee basis, or costs expended in fulfilling its third-party contracts). Thus, MNEs in such cases are encouraged to use the direct-charge method in relation to their intra-group transactions with their Related Parties.

However, this approach may not always be appropriate if, for example, the services to independent parties are merely occasional or marginal. The direct charge method may pose challenges in cases where there is a centralised management services activity performed for the benefit of multiple entities within a Group at the same time. MNE Groups may find they have to resort to cost allocation and apportionment methods,

which often necessitate some degree of estimation or approximation as a basis for calculating an arm's length adjustment. Where cost allocation and apportionment methods are used, these are considered indirect charge methods.

When using the indirect method, the Taxable Person needs to take into account the commercial features of the individual case (for example, whether the allocation key is reasonable under the circumstances). Further, the approach should contain safeguards against manipulation, follow sound accounting principles, and be capable of producing charges or allocations of costs that are linked to the actual or reasonably expected benefits to the recipient of the service.

The indirect charge method is generally not appropriate for specific services that form a main Business Activity of the enterprise or services that are provided not only to Related Parties or Connected Persons but also to independent parties.

7.2.3.4. Determination of the cost base

Where a cost-based method is determined to be the most appropriate method to the circumstances of the case, the relevant cost base should be determined. A summary of the approach for determining the cost base for centralised services is as follows:

1. The initial step is to calculate, on an annual basis, a pool of all costs incurred by all members of the Group in performing each category of the centralised intra-group services. The costs to be pooled are the direct and indirect costs of rendering the service as well as an appropriate level of operating expenses determined using an acceptable allocation key where relevant.
2. Secondly, the cost pool should exclude costs that are attributable to an in-house activity that benefits solely the company performing the activity (including shareholder activities performed by the shareholding company).
3. Thirdly, the MNE Group should identify and remove from the pooled costs any costs that are attributable to services performed by one Group member solely on behalf of one other Group member (as this would be charged directly to the specific beneficiary).
4. Lastly, the MNE Group needs to allocate the remaining pool of costs that is attributable to the services which are provided to multiple members of the MNE Group among benefitting members of the MNE Group. More than one allocation key can be applied for this purpose based on the nature of the service and the fact that the allocation key should reasonably be linked to the expected benefit, for example, the allocation key for services related to people might employ the share of total headcount and information technology services might employ the share of total users. The same allocation key or keys must be used on a consistent basis for all allocations of costs relating to the same category of services.

7.2.3.5. Profit mark-up

In determining the arm's length charge, the service provider should apply a mark-up to all costs that are not pass-through in nature.[28] The mark-up should be determined using comparable data. However, to reduce the compliance burden on Taxable Persons, this Guide adopt the simplified approach provided under Chapter VII of the OECD Transfer Pricing Guidelines, whereby certain low value-adding intra-group services may be charged out at a cost-plus 5% mark-up without the need for a detailed benchmarking analysis. In general, low value-adding intra-group services should meet the following criteria:

- the services are of a supportive nature;
- they are not part of the core business of the MNE Group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE Group);
- they do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- the services do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.
- accordingly, the following activities would not qualify for the safe harbour outlined in this section:
  - services constituting the core business of the MNE Group;
  - research and development services;
  - manufacturing and production services;
  - purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process;
  - sales, marketing and distribution activities;
  - financial transactions;
  - extraction, exploration, or processing of natural resources;
  - insurance and reinsurance; and
  - services of corporate senior management.

Below is an illustrative example of services that may be considered low value adding and thus qualify for the safe harbour.

Example 21: Analysis of low value adding intragroup services

ABC Group operates in the chemicals industry. It provides technical services to third party customers.

[28] Pass-through costs are expenses that are incurred on behalf of service recipients. The exact amount of the cost is then then passed on to the service recipients without any markup or profit margin

The Group has its regional headquarters based in the UAE. The regional headquarters employs teams that support the Group entities operating in the region. The two services provided by the regional headquarters are as follows:

- Technical services: This service includes guidance on testing and inspection techniques to be applied when servicing the third-party customers.
- Support services: This includes keeping books and records, processing invoices, recruitment and onboarding and IT.

In establishing its Transfer Pricing policy, the regional headquarters assessed whether the above services would qualify as low value adding intragroup services as follows:

Service	Conclusion	Transfer Pricing Policy
Technical services	This service is related to the core business activities of the entities and contributes economic value to the Group. Accordingly, it is not considered low value adding in nature and the safe harbour cannot be used as a Transfer Pricing policy.	A detailed comparability analysis showed that an appropriate arm's length mark-up on cost to be applied for similar services would fall in the range of 8% -12%.
Support services	This service is supportive in nature and does not result in direct revenue generation. Accordingly, the service can be considered low value in nature and the safe harbour may be applied.	5% mark-up on cost (in line with the safe harbour)

The initial step in applying a simplified approach to low value adding services is to categorise, calculate and pool all costs associated with the low value adding services. These costs should then be allocated amongst group members based on appropriate allocation keys. The appropriate allocation key will depend on the nature of the service. For example, IT services may be allocated on number of users or employee related costs may be allocated based on headcount. The pragmatic intent of using a safe harbour means a balance needs to be struck between theoretical sophistication and practical administration. The final step is to apply a profit mark-up, in the case of the low value adding services safe harbour the mark up shall be 5%.

Taxpayers should maintain sufficient documentation to support their conclusions that services included in the simplified approach are in fact low value adding in nature.

7.2.4. Documentation

The Taxable Person is expected to prepare and maintain supporting documentation to be provided to the FTA on request. The documentation should include a clear explanation of the intra-group services provided, the identity of the beneficiaries, a

summary of the benefits received, the approach adopted to determine and calculate the charges together with the justification for the choice of allocation key(s) used, an explanation of how the underlying costs relate to the service provided, and the support for any mark-up applied. This should form part of the Transfer Pricing documentation for each relevant Tax Period.

7.3. Intangibles[29]

7.3.1. Introduction

Questions regarding intangibles are perhaps the most complex in Transfer Pricing. This complexity is due to the unique characteristics of intangibles, the ease of transfer via a contractual arrangement, the difficulty in finding comparable arrangements due to their unique nature and the importance of intangibles in generating revenues for businesses.

The analysis of cases involving the use or transfer of intangibles should begin with a thorough identification of the commercial or financial relations between the Related Parties or Connected Persons and the conditions and economically relevant circumstances attached to those relations in order to accurately characterise the transaction involving the intangibles. It is especially important to understand the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain.

Such an analysis should include an examination of the actual conduct of the parties based on the functions performed, assets used, and risks assumed, including control of important functions and economically significant risks.

7.3.2. Identifying intangibles (Types of intangibles)

Intangibles are defined as something that is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Thus, there are various categories of assets under the concept of intangibles.

Distinctions can be made between trade intangibles and marketing intangibles, between routine and non-routine intangibles, and between other classes of intangibles.

[29] The following sections follow the guidance of Chapter VI of the OECD Transfer Pricing Guidelines. Certain modifications have been made to suit the domestic requirements and views of the FTA.

Some intangibles are considered to be "unique and valuable" intangibles, being classified as “hard-to-value”. Such intangibles are defined as those that (i) are not comparable to intangibles used by or available to parties in potentially comparable transactions, and (ii) whose use in business operations (for example, manufacturing, provision of services, marketing, sales, or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.

The approach to determine the arm's length conditions and price of intangibles is the same. The FTA expects the Transfer Pricing analysis to identify the relevant intangibles and determine the arm’s length conditions as set out in this Guide.

For illustrative purposes, below are some general examples of items that, under specific circumstances, may be considered intangibles. This list should not be used as a substitute for a detailed analysis and is not intended to be exhaustive.

Intangibles for Transfer Pricing purposes	● Patents ● Know-how and trade secrets ● Trademarks, trade names and brands ● Rights under contracts and government license ● Licenses and similar limited rights in intangibles
Not intangibles for Transfer Pricing purposes	● Group synergies ● Market specific characteristics ● Assembled workforce

7.3.3. Applying the Arm’s Length Principle with respect to intangibles

In Transfer Pricing cases involving intangibles, it is crucial to determine the entity or entities within an MNE Group that are entitled to share in the returns derived from exploiting the intangibles. The identification and examination of intangibles are relevant in two general types of transactions:

- Transactions involving the transfer of intangibles or rights in intangibles.
- Transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

The next step is to identify which entity or entities within the Group should ultimately bear the costs, investments and other burdens associated with the Development, Enhancement, Maintenance, Protection and Exploitation (“DEMPE”) of intangibles. Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the MNE Group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE Group performing such functions, using such assets,

and assuming such risks must be compensated for their contributions under the Arm's Length Principle. The ultimate allocation of costs and other burdens related to intangibles among members of the MNE Group, is accomplished by compensating members of the MNE Group for functions performed, assets used, and risks assumed in the DEMPE of the intangibles.

The framework for analysing transactions involving intangibles between Related Parties or Connected Persons requires taking the following steps:

1. Identify the intangibles used or transferred.
2. Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicators of legal ownership, and the contractual rights and obligations, including contractual assumption of risks in the relations between the Related Parties or Connected Persons.
3. Identify the parties performing functions, using assets, and managing risks related to DEMPE of the intangibles by means of the Functional Analysis, in order to determine the economic ownership of the intangibles.
4. Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assuming economically significant risks actually controls the risks in practice, and has the financial capacity to assume the risks relating to the DEMPE of the intangibles.
5. Characterise the actual Controlled Transactions related to the DEMPE of the intangibles in light of the legal ownership of the intangibles, the other relevant contractual relations under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets and risks.
6. Determine the Arm's Length Price for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed.

First: Identify the intangible used or transferred

In any Transfer Pricing analysis involving intangibles, it is essential to accurately identify the specific intangible used in Controlled Transactions such as trademarks, licenses etc. It is important to note that the analysis should not solely rely on accounting or legal definitions. Instead, the focus should be on determining the conditions that would be agreed upon between independent parties for a comparable transaction given that the legal definitions and ownership, as well as the accounting treatment may differ from the economic ownership and actual conditions of the transaction that form the basis of the Transfer Pricing analysis.

Second: Identify the full contractual arrangements

Next, it is important to examine the contractual arrangements and legal rights related to the intangible. The terms of a transaction can be found in written contracts, public records such as patent or trademark registrations, or in correspondence and other communications among the parties involved. Contracts define the roles, responsibilities, and rights of the parties in relation to intangibles. If there are no written terms or if the facts of the case and the actions of the parties differ from the written terms, the actual transaction must be inferred from the established facts and the conduct of the parties.

While determining legal ownership and contractual arrangements is an important first step in the analysis, for Transfer Pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE Group from exploiting the intangible. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE Group members through their functions performed, assets used, and risks assumed.

For example, in the case of an internally developed intangible, if the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE Group from the exploitation of the intangible other than arm’s length compensation, if any, for holding title.

Third: Identify the parties performing functions, using assets or managing (i.e. controlling) risks in relation to the DEMPE of the intangible

As previously stated, the determination that a specific member of the Group is the legal owner of intangible assets is not, by itself, conclusive that the legal owner is automatically entitled to any income generated by the business. Hence, a functional analysis is essential to determine which member(s) perform and control DEMPE functions, provide funding and assets, and assume associated risks.

The legal owner need not physically perform all the DEMPE functions related to an intangible. While some functions could be outsourced, overall control of these functions should be with the legal owner. In cases where such outsourcing occurs to Related Parties or Connected Persons, the legal owner of the intangible should compensate the entity performing the outsourced services functions on an arm's length basis.

The relative value of contributions to DEMPE of intangibles varies based on each specific case. MNE Group members with more significant contributions should receive proportionate remuneration including compensation for using the assets.

The level of risk assumed determines the reward that an MNE member is entitled to receive. It is important that the Group member(s) asserting entitlement to returns from assuming risk actually bear responsibility for the actions that need to be taken and the costs that may be incurred if the relevant risk materialises. Specific risks that may be significant in a Functional Analysis related to intangibles, include, but are not limited to:

- Risks on the development of intangibles;
- Infringement risk;
- Product liability risk;
- Exploitation risks.

The occurrence and significance of these risks will depend on the specific facts and circumstances involved.

Fourth: Confirm consistency between the contractual arrangements and the conduct of the parties and determine whether the parties assuming the economically significant risks also control the risk in relation to the DEMPE of the intangible

Based on the outcome of Steps 1 to 3, an analysis should be undertaken to confirm whether there is consistency between the contractual agreements and the conduct of the parties involved in the transaction. If the contractual arrangements and conduct are consistent, the contractual agreements can serve as the basis for determining the Controlled Transactions. However, if there is a disparity between the contractual arrangements and the conduct of the Related Parties or Connected Persons, the conduct of the Related Parties or Connected Persons should be considered as the basis for determining the actual Controlled Transactions and their nature. This determination should be supported by conducting a thorough and detailed Functional Analysis, with a specific focus on the intangible aspects.

Fifth: Characterise the actual Controlled Transactions related to the DEMPE of the intangibles in light of the legal ownership of the intangibles, the other relevant contractual relations under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets and risks

The clear determination of the actual Controlled Transactions should follow from the steps outlined above and the framework provided in section 5 of this guide. Once the actual Controlled Transactions have been determined, the pricing can be analysed.

Sixth: Determine the Arm's Length Price for the use or transfer of intangibles

After identifying the relevant transactions involving intangibles, specifically identifying the intangibles involved in those transactions, and identifying which entity or entities legally own the intangibles as well as those that contribute to the value of the

intangibles, it should be possible to identify arm's length conditions for the relevant transactions.

When performing a comparability analysis to a transaction involving intangibles, the options realistically available to each of the parties to the transaction must be considered. While it is important to consider the perspectives of both parties to the transaction, the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to the realistically available options of the other party.

It should also be borne in mind that intangibles often have unique characteristics, and as a result have the potential for generating returns and creating future benefits that could differ widely. In conducting a comparability analysis with regard to a transfer of intangibles, it is therefore essential to consider the unique features of the intangibles.

In selecting the most appropriate Transfer Pricing method in a case involving the use or transfer of intangibles or rights in intangibles, attention should be given to (i) the nature of the relevant intangibles, (ii) the difficulty of identifying Comparable Uncontrolled Transactions and intangibles in many, if not most, cases, and (iii) the difficulty of applying certain Transfer Pricing methods in the case of intangibles.

In the case of a transfer of an intangible or rights in an intangible that provides the business with a unique competitive advantage in the market, purportedly comparable intangibles or transactions should be carefully scrutinised. It is critical to assess whether potential comparables in fact exhibit similar profit potential.

Depending on the specific facts, any of the five prescribed Transfer Pricing methods described in section 5 of this guide might constitute the most appropriate method to the circumstances of the case where the transaction involves a controlled transfer of one or more intangibles. If none of the approved methods can be reliably applied, the use of other alternative methods may also be considered, pursuant to Article 34(4) of the Corporate Tax Law (for example, market appraisal or valuation especially in cases where there is a unique intangible or one-off transaction of an intangible).

The following example incorporates the above steps.

Example 22: Analysing transactions involving intangibles between Related Parties or Connected Persons

An MNE Group comprised of Company X and Company Y decides to develop an intellectual property ("IP") asset, which is anticipated to be highly profitable based on Company Y's current IP asset yield, its expertise in developing IP assets and experience in finding niche IP areas to exploit.

The intangible is expected to take 5 years of development before it can be commercially exploited. The intangible is expected to have a valuable life of 5 years. Under the development agreement between Company X and Company Y, Company Y will perform and control all activities related to the DEMPE of the IP asset. Company X will provide all funding related to development of the IP and will become the legal owner of the IP.

Once developed, Company Y will license the asset from Company X and pay a license fee based on comparable market data. During the development phase of the IP asset the contractual terms are adhered to, and no inconsistencies are observed between the Related Parties actions and the contractual terms.

A Functional Analysis finds that although Company X is the legal owner and entitled to book revenues generated from the IP asset, its contribution does not go beyond the provision of funding for the development of the intangible. The analysis shows that Company X contractually assumes the financial risk and has the capacity to assume that risk. Beyond that, Company Y exercises control over the risk, manages the risk, provides the expertise and through its experience and track record significantly de-risks the project for Company X.

Therefore, taking the above into account it is determined that the arm’s length profit on Company X’s financial contribution should be a risk adjusted return to capital. The remainder of the profits generated from the use of the IP asset should be recognised by Company Y. The arrangement going forward should be formalised in a legally binding agreement and documentation to support the transaction should be maintained.

7.4. Cost Contribution Arrangements[30]

7.4.1. Introduction

Cost Contribution Arrangements (CCAs) are contractual agreements entered into by Related Parties or Connected Persons within an MNE Group. A CCA is neither a distinct legal entity nor a fixed business location for all participants.

The objective of CCAs is to share the contributions and risks of joint projects involving the development, production, or acquisition of intangible or tangible assets, or the performance of services, with the anticipated benefits derived from their contributions shared equitably among the parties. In certain situations, one or more members of an MNE Group may perform services that benefit some or all of the other Group members, either immediately (for example, centralised administrative services) or in the future (for example, by contributing to the development of intangibles).

For instance, Company A and Company B may enter into a CCA to develop a new product collaboratively, with Company A contributing design expertise and Company B manufacturing expertise. By sharing the costs and risks of the project, both businesses can benefit from the resultant product without bearing the entire development and production burden.

7.4.2. Types of Cost Contribution Arrangements

Commonly encountered CCAs fall into two categories: those established for the collaborative development, production or acquisition of intangible or tangible assets ("development CCAs"); and those established for the acquisition of services ("services CCA's").

Although each particular CCA should be considered on its own facts and circumstances, key differences between these two types of CCAs will generally be that development CCAs are expected to create ongoing, future benefits for participants, while services CCAs will create current benefits only.

Development CCAs, in particular with respect to intangibles, often involve significant risks associated with what may be uncertain and distant benefits, while services CCAs often offer more certain and less risky benefits. These distinctions are useful because the complexity of development CCAs may require more refined guidance, particularly on the valuation of contributions, than may be required for services CCAs.

[30] The following sections follow the guidance of Chapter VIII of the OECD Transfer Pricing Guidelines. Certain modifications have been made to suit the domestic requirements and views of the FTA.

Under a development CCA, each participant has an entitlement to rights in the developed intangible(s) or tangible asset(s). In relation to intangibles, such rights often take the form of separate rights to exploit the intangible in a specific geographic location or for a particular application. The separate rights obtained may comprise legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property, while the other participants have certain rights to use or exploit the property. In cases where a participant has such rights in any property developed by the CCA, there is no need for a royalty payment or other additional consideration for the use of the developed property consistent with the interest to which the participant is entitled under the CCA (however, the participant's contributions may need to be adjusted if they are not proportionate to their expected benefits as per the guidance below). An example of this would be a Group of pharmaceutical companies engaging in a CCA to share the costs and risks associated with developing a new drug. Each participant contributes to the drug's development costs proportionally to their anticipated benefits from the commercialisation of the drug.

Service sharing arrangements are established for sharing in the costs and benefits of intercompany services. In this type of CCA, the participants share the costs and risks of acquiring services that generate mutual benefits. An example of this would include a Group of companies in the same industry, for instance, that may engage in a CCA to share the costs and risks associated with developing a common information technology system. Each participant contributes to the costs of providing the services to their expected benefits from the services.

While each CCA should be evaluated based on its own facts and circumstances, some benefits of a CCA activity will be known in advance, whereas other benefits, for example, the outcome of R&D activities, will be uncertain. Some types of CCA activities will produce benefits in the short term, while others will have a longer timeframe or may not be successful at all. Nevertheless, in a CCA, there is always an expected benefit that each participant seeks from its contribution, including the attendant rights to have the CCA properly administered. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is interlinked with that of other participants (for example, because legal ownership of a developed intangible property is vested in only one of them but all of them have effective ownership control).

7.4.3. Applying the Arm's Length Principle to a Cost Contribution Arrangement

The Arm's Length Principle requires that CCA participants' contributions match what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement. Contributions to a CCA differ from previous intra-group transfers of property or services because participants expect

mutual and proportionate benefit from pooling resources and abilities. Participants also agree to share the risks and benefits of accomplishing CCA results.

Accordingly, the key step in applying the Arm's Length Principle in 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 (as adjusted for any balancing payments made among participants) align with their respective share of expected benefits. It should be recognised that these determinations are likely to bear a degree of uncertainty, particularly in relation to development CCAs.

In addition, particularly for the development of CCAs, the participants agree to share the upside and downside consequences of risks associated with achieving the anticipated CCA outcomes. As a result, there is a distinction between the intra-group licensing of an intangible where the licensor has borne the development risk on its own and expects compensation through the licensing fees it will receive once the intangible has been fully developed, and a development CCA in which all parties make contributions and share in the consequences of risks materialising in relation to the development of the intangible and decide that each of them, through those contributions, acquires a right in the intangible.

The expectation of mutual and proportionate benefit is fundamental to the acceptance by independent enterprises of an arrangement for sharing the consequences of risks materialising and pooling resources and skills. To apply the Arm's Length Principle to a CCA, the steps below should be followed:

Step 1: Determining participants

To be considered a participant in a CCA, one must have a reasonable expectation of benefiting from the objectives of the CCA activity itself, not just from performing part or all of the subject activity. Participants must be assigned an interest or rights in the intangibles, tangible assets, or services that are the focus of the CCA and have a reasonable expectation of benefiting from that interest or rights. In addition, participants must exercise control over the specific risks they undertake under the CCA and have the financial capacity to assume these risks. In accordance with the principles of prudent business management, the extent of capability and control required will be determined by the level of risk associated with the arrangement. While participants are permitted to outsource certain functions related to the subject activity to a non-participant entity, they must individually satisfy the requirements for exercising control over the specific risks they assume under the CCA.

Step 2: Determining the arm's length participation value

The next step is to determine the value of each participant's contributions to the arrangement. For service CCAs, contributions primarily consist of the performance of

services. For development CCAs, contributions typically include the performance of development activities and additional contributions relevant to development CCA such as pre-existing tangible assets or intangibles. All contributions of current or pre-existing value must be identified and accounted for appropriately in accordance with the Arm's Length Principle.

The value of each participant's contribution should be consistent with the value that independent business in comparable circumstances would have assigned to that contribution. Contributions should be measured at value, and while it may be easy to administer for Taxable Persons to pay current contributions at cost, using cost as a measure for current contributions is unlikely to provide a reliable basis for determining the value of relative contributions for development CCAs. All contributions made by participants to the arrangement should be recognised, including those made at the inception of the CCA and those made on an ongoing basis during the term of the CCA. Contributions to be considered include property or services that are used solely in the CCA activity, as well as property or services that are used partly in the CCA activity and partly in the participant's separate Business Activities. Contributions involving shared property or services should be determined in a commercially justifiable way, and adjustments may be necessary to achieve consistency when different jurisdictions are involved.

7.4.4. CCA entry, withdrawal and termination

Changes in a CCA membership will typically result in a re-evaluation of the proportionate shares of participants contributions and anticipated benefits. When a new entity becomes a participant in an existing CCA, it may acquire an interest in the results of prior CCA activity, such as completed or work in progress intangibles or tangible assets.

In such circumstances, the previous participants transfer part of their respective interests in the outcomes of the prior CCA activity to the new entrant. This transfer of intangibles or tangible assets must be compensated based on arm's length value for the transferred interest under the Arm's Length Principle. This compensation is referred to as a "buy-in payment."

The CCA must be in writing and must specify the activities to be carried out, the contributions to be made by each participant, and the method for determining each participant's share of the benefits.

A participant who leaves a CCA may transfer its interest in the results of past CCA activity (including work in progress) to the remaining participants. Such a transfer must be compensated according to the Arm's Length Principle. Such compensation is referred to as "buy-out payment". A participant may withdraw from a CCA if the

agreement permits it, or if all other participants consent to it. The withdrawal must be in writing and must include the date it becomes effective.

A participant may withdraw from a CCA if the activity is no longer anticipated to generate benefits. Participants may also terminate the CCA by mutual consent. The notice of termination must be in writing and must specify the termination's effective date.

The Arm's Length Principle requires that, when a CCA terminates, each participant retains an interest in the results, if any, of the CCA activity commensurate with their proportionate share of contributions to the CCA throughout its term (adjusted by any balancing payments actually made, including those made as a result of the termination), or is appropriately compensated for any transfer of that interest to other participants.

7.4.5. Balancing payments

Balancing payments are payments made between participants in a CCA to ensure that each participant receives its proportionate share of the benefits from the activity.

A compensating payment may be required if a participant's contributions are not proportional to their anticipated benefits and is made by participants that have received a greater share of the benefits than their contributions would warrant. However, it can also be paid to participants whose contributions are greater than the benefits received.

A balancing payment may also be required if it is determined that the value of the participant's proportionate contribution was incorrectly determined at the time it was made, or when the CCA expected benefits were incorrectly assessed. In circumstances where the contribution of a participant is not proportionate to the expected benefit and a balancing payment is not made, then the FTA has the right to adjust the profit of the Taxable Person to accurately reflect the arm's length outcome of the arrangement.

Overall, balancing payments are an essential aspect of CCAs as they ensure that each participant receives an appropriate proportionate share of the benefits from the activity. Taxable Persons would benefit from formalising arrangements through clear legal contracts and maintain sufficient documentation to support the arm's length outcome of the arrangement.

7.5. Business Restructuring[31]

7.5.1. Introduction

Business Restructuring refers to the reorganisation of the commercial or financial relations between Related Parties or Connected Persons, including the termination or substantial renegotiation of existing arrangements. Relationships with third parties (for example, suppliers, subcontractors, customers) may also be a reason for the restructuring or be affected by it. In addition, these transactions may involve the transfer of the ownership and management of intangible property rights such as patents, trademarks, brand names, etc.

Business Restructurings may often involve the centralisation of intangibles, risks, or functions with the profit potential attached to them. They may consist of:

- Conversion of full-fledged distributors (enterprises with a relatively higher level of functions and risks) into limited-risk distributors, marketers, sales agents, or commissionaires (enterprises with a relatively low level of functions and risks) for a foreign Related Party that may operate as the principal, or vice versa.
- Conversion of full-fledged manufacturers (relatively higher level of functions and risks) into contract manufacturers or toll manufacturers (relatively lower level of functions and risks) for a foreign Related Party that may operate as the principal, or vice versa.
- Transfers of intangibles or rights in intangibles to a central entity (for example, a so-called “IP company”) within the Group.
- The concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally; examples may include procurement, sales support, supply chain logistics.

Groups may restructure their business for various reasons which may include the following:

- to maximise synergies and economies of scale;
- to streamline the management of business lines and to improve the efficiency of the supply chain;
- to take advantage of the development of web-based technologies that have facilitated the emergence of global organisations; and
- to preserve profitability or limit losses (for example, in the event of over-capacity or in an economic downturn).

Taxable Persons are generally free to arrange their business operations as they see fit, as long as they ensure the pricing arrangements are in line with the Arm’s Length Principle. The fact that a Business Restructuring may be motivated by sound

[31] The following sections follow the guidance of Chapter IX of the OECD Transfer Pricing Guidelines. Certain modifications have been made to suit the domestic requirements and views of the FTA.

commercial reasons at the level of the Group does not mean that it is arm's length from the perspectives of each of the restructured Group members.

Business Restructurings are typically accompanied by a reallocation of profit potential among the members of the MNE Group, either immediately after the restructuring or over a period of time. One major objective of this section is to discuss the extent to which such a reallocation of profit potential is consistent with the Arm's Length Principle and more generally how the Arm's Length Principle applies to Business Restructurings.

7.5.2. Arm's Length compensation for the restructuring itself

7.5.2.1. Understanding Business Restructuring

The application of the Arm's Length Principle to a Business Restructuring must start, as for any Controlled Transaction, with the identification of:

- the commercial or financial relations between the Related Parties or Connected Persons involved in the Business Restructuring; and
- the conditions and economically relevant circumstances in relation to those relations.

Based on these, the Controlled Transactions comprising the Business Restructuring can be properly defined.

In addition, important aspects of identifying the commercial or financial relations relevant to determining the arm's length conditions of Business Restructuring need to be analysed:

1. determination of the Controlled Transactions comprising the Business Restructuring and the relevant functions, assets and risks before and after the restructuring;
2. business reasons for and the expected benefits to arise after the Business Restructuring, including the role of synergies; and
3. determination of the other options realistically available to the Related Parties or Connected Persons.

7.5.2.2. Accurate determination of transactions comprising the Business Restructuring

In order to determine whether, an arm's length compensation would be payable upon a restructuring within an MNE Group, it is important to identify the Controlled Transactions occurring between the restructured entity and one or more other members of the Group.

The accurate characterisation of the Controlled Transactions comprising the Business Restructuring requires performing a Functional Analysis to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed before and after the restructuring by the parties involved. Accordingly, the analysis focuses on what the parties actually do and the capabilities, as well as the type and nature of assets used or contributed by the parties in pre-restructuring and post-restructuring scenarios.

7.5.2.3. The business reasons for and the expected benefits following the Business Restructuring

The pressure of competition in a globalised economy, savings from economies of scale, the need for specialisation and the need to increase efficiency and lower costs have all been described as important factors in driving Business Restructuring.

Where expected synergies are put forward by a Taxable Person as an important business reason for a restructuring, it is expected that the Taxable Person will document, at the time the restructuring is decided upon or implemented, what these synergies are, and the assumptions on which these synergies are based. This type of documentation is likely to be produced at the Group level in support of the decision-making process.

Care should be taken to ensure that the Related Parties or Connected Persons contributing to the synergistic benefit after the restructuring are appropriately remunerated.

7.5.2.4. Determination of the other options realistically available to the Related Parties or Connected Persons

In applying the Arm’s Length Principle, it is not sufficient that the Business Restructuring makes commercial sense for the Group in general. The arrangements must be at arm’s length at the level of each individual Taxable Person. In this respect the rights, assets and expected benefits from the arrangements (i.e. any consideration of the post-Business Restructuring arrangement and, if applicable, any payments made for the Business Restructuring itself) should be considered. Persons acting at arm’s length would generally only enter into a transaction if it does not make them worse off than their next best option. There are situations where the restructured parties would not have had a clear and more attractive option realistically available to them than to accept the conditions of the restructuring (for example, a contract termination with or without indemnification). Therefore, understanding the options realistically available to the Related Parties or Connected Persons is an important part of understanding the reason for the Business Restructuring from an arm’s length perspective.

7.5.2.5. Reallocation of profit potential

Business Restructurings have an impact on the profit potential of a Person. The "profit potential" means "expected future profits", although in some cases it may encompass losses. The concept of "profit potential" is often used for valuation purposes, in determining the arm's length compensation for a transfer of intangibles or of a going concern, or in determining the arm's length indemnification for the termination or substantial renegotiation of existing arrangements.

In order to determine whether at arm's length conditions the restructuring itself would give rise to a form of compensation, it is essential to understand the restructuring, including the changes that have taken place, how they have affected the Functional Analysis of the Related Parties or Connected Persons, what the business reasons for and the anticipated benefits from the restructuring were, and what options would have been realistically available to the Related Parties or Connected Persons.

A third party would not necessarily have the right to receive compensation when a change in its business arrangements results in a reduction of its profit potential or expected future profits. The Arm's Length Principle does not require compensation for a mere decrease in the expectation of future profits.

7.5.3. Other considerations

7.5.3.1. Indemnification of the restructured Person

Indemnification means any type of compensation that may be paid for detriments suffered by the restructured entity, whether in the form of an up-front payment, of a sharing in restructuring costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations, or of any other form.

Terminations or renegotiations of arrangements generally involve changes in the risk and functional profiles of the relevant parties, with consequences for the allocation of profit potential between them. In addition, the termination or renegotiation of contractual relationships in the context of a Business Restructuring might cause the restructured entity to suffer determinants such as restructuring costs (for example, write-off of assets, termination of employment contracts), re-conversion costs (for example, in order to adapt its existing operation to other customer needs), and/or a loss of profit potential. In these situations, the question arises as to whether, at arm's length, indemnification should be paid to the restructured entity, and if so, how much and calculated by what method.

As a starting point to determine whether indemnification for the termination or renegotiations of existing arrangements is appropriate, the legal arrangements need to be assessed (for example, are there termination clauses present / is there a

termination or notification period applicable). As a second step, it needs to be determined whether the legal arrangements include conditions that reflect arm's length circumstances.

Once the restructuring arrangements have been accurately determined and the options realistically available to the Persons have been assessed, the following aspects should be considered:

- whether commercial law supports rights to indemnification for the restructured Person under the facts of the case;
- whether the existence or absence of an indemnification clause or similar provisions under the terms of the arrangement, is arm's length; and
- the Person who should ultimately bear the costs related to the indemnification of the Person that suffers from the termination or renegotiation of the agreement.

To determine the indemnification upon a Business Restructuring the comparison of the pre-Business Restructuring and post-Business Restructuring functions performed, risks assumed, and assets used is essential to evaluate how the profit potential is impacted.

7.5.3.2. Valuations

In situations where reliable Comparable Uncontrolled Transactions for a transfer of one or more intangibles or in case of a Business Restructuring of a business (which could involve both tangible and Intangible assets) cannot be identified, it may be possible to use valuation techniques to estimate the arm's length price for the determined Controlled Transaction. It is important to carefully consider the assumptions and other motivations that support particular applications of valuation techniques.

Business Restructurings sometimes involve the transfer of a going concern (i.e. a functioning, economically integrated business unit). The transfer of a going concern in this context means the transfer of assets, bundled with the ability to perform certain functions and assume certain risks.

The valuation of a transfer of a going concern should reflect all the valuable elements that would be remunerated between independent parties in comparable circumstances.

The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the business, intangible, or going concern being valued, may be particularly useful when properly applied.

Where valuation techniques are utilised in a Transfer Pricing analysis involving the transfer of intangibles or rights in intangibles, it is necessary to apply such techniques in line with international valuation standards and in a manner that is consistent with the Arm's Length Principle and the principles of this Guide.

Depending on the facts and circumstances of the individual case, there may be a situation where an agreeable range of values cannot be arrived at for the transfer of assets or going concerns, for example, because of differences in the buyer and seller's positions. This may be an indication that a termination payment is required or the possibility that the transaction should be disregarded.

It is not the intention of this Guide to set out a comprehensive summary of the valuation techniques used by valuation professionals or to endorse or reject one or more sets of valuation standards applied by valuation or accounting professionals or to describe in detail or specifically endorse one or more specific valuation techniques or methods as being especially suitable for use in a Transfer Pricing analysis.

Nonetheless, it is important to recognise that the value estimates based on valuation techniques can be volatile and rely on various assumptions. Due to the importance of the underlying assumptions and valuation parameters, Taxable Persons using valuation techniques should be explicit in the valuation parameters and assumptions and should substantiate the valuation techniques (including the reasonableness of such assumptions) when creating the valuation model. These concerns, amongst others, are important in evaluating the reliability of the particular application of a valuation technique.

7.5.3.3. Remuneration of post-restructuring Controlled Transactions

The Arm's Length Principle and this Guide do not apply differently to post-restructuring Controlled Transactions as opposed to transactions that were structured as such from the beginning. The Arm's Length Principle must be applied not only to the post-restructuring Controlled Transactions, but also to additional Controlled Transactions that comprise the Business Restructuring.

7.6. Permanent Establishment

7.6.1. Introduction

A Permanent Establishment (PE) has the meaning contained in Article 14 of the Corporate Tax Law. According to Article 24(4) of the Corporate Tax Law, when determining the income and associated expenditure of a PE, a Resident Person and each of its PEs should be treated as separate and independent entities. This approach is known as the "separate entity approach".

Taxable Persons may carry on business activity through a number of different options including PEs. The principles outlined in this Guide apply to Taxable Persons who carry on business activity through a PE. Therefore, transactions between Related Parties or Connected Persons where one of the parties is a PE would need to be conducted in line with the Arm's Length Principle.

7.6.2. The separate entity approach

In certain situations, a Non-Resident Person may perform activities which result in the creation of a PE in the UAE. Similarly, a Resident Person may conduct activities in another jurisdiction through a PE.

The FTA expects Taxable Persons to attribute the appropriate amount of profits and associated costs to PEs in accordance 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 (i.e. a head office).

The separate entity approach is a hypothetical construct that distinguishes the functions, assets and risks of the PE from its parent entity and in doing so identifies the profits that the PE would have earned at arm's length in its dealings with other parts of the Group.

References to attributing "profits" should also be understood as applying equally to attributing losses. Additionally, profits may be attributed to a PE even though the enterprise as a whole has never made profits, and vice versa, the application of the separate entity approach may result in nil profits being attributed to the PE despite the fact that the head office may have made profits. In order to accurately attribute the profit between the PE and its parent, a two-step analysis is required:

Step one:

The first step involves conducting a Functional Analysis to identify the activities performed by the PE on one side, and the head office on the other side, treating each as separate to the other. This analysis should also take into account the assets used and the risks assumed by the PE. The Functional Analysis should lead to:

- attributing to the PE the rights and obligations arising from the dealings between the Head Office and separate persons;
- the identification of significant people functions relevant to the assets, and the attribution of economic ownership of assets to the PE. The "significant people functions" considers the key value creating functions performed by the people contracted by the PE. Part of the analysis should allocate risks, assets and rewards to the function and take into account the significant people function role as key decision makers with the ability to assume risks;

- the identification of other functions of the PE;
- the recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise (i.e. the head office); and
- the attribution of capital based on the assets and risks attributed to the PE.

Step two:

Determine the compensation of any transactions between the head office and the PE through:

- the determination of comparability between the dealings and uncontrolled transactions, established by applying this guide's comparability factors directly (characteristics of property or services, economic circumstances, and business strategies) or by analogy (Functional Analysis and contractual terms) in light of the particular factual circumstances of the PE; and
- selecting and applying by analogy to the guidance in this guide the most appropriate method to the circumstances of the case to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed and the assets and risks attributed to the PE.

The FTA expects Taxable Persons will follow the above approach when attributing profits to PEs and that contemporaneous documentation supporting the application of the approach will be maintained and provided to the FTA upon request. This is expected to form part of the Transfer Pricing documentation prepared for each period.

In situations where an issue is not addressed within this guide, Taxable Persons are encouraged to refer to the 2010 report[32] and the 2018 report[33] on the attribution of profits to PEs issued by the OECD.

Example 23: Attribution of profits to PE

Company A is the parent company of an MNE Group headquartered in country X. It has a core business of procurement and sale of goods in country X.

Company A has a PE in the UAE that performs procurement activity on behalf of Company A from unrelated suppliers in the UAE. The PE habitually exercises an authority to conduct a Business or Business Activity in the UAE. The PE does not own title of the goods at any point of time nor has any entitlement to the amount charged by Company A from its customers.

[32] Available at: https://www.oecd.org/ctp/transfer-pricing/45689524.pdf

[33] Available at: https://www.oecd.org/tax/transfer-pricing/additional-guidance-attribution-of-profits-to-permanent-establishments-BEPS-action-7.pdf

Company A pays a commission to the PE as a percentage of cost of purchases made on its behalf.

As mentioned earlier, to accurately attribute the profit between the PE and its head office, a two-step analysis is required:

Step One: The first step involves conducting a Functional Analysis to identify the activities performed by the PE on one side, and the head office on the other side, treating each as separate to the other. This analysis should also take into account the assets used and the risks assumed by the PE. The Functional Analysis shows that:

- A Co is performing the function of sale of goods to independent third-party customers in country X.
- The PE is performing procurement support.

Step two: Determining the compensation for the transactions and arrangements between A Co and its PE.

The attribution of profits should be done by applying the Arm's Length Principle on the transactions and arrangements between A Co and its PE in the UAE.

The appropriate attribution should be at the arm's length result that A Co would have had to pay if the transactions had been performed by an unrelated supplier performing similar functions in the UAE on behalf of A Co.

7.7. Group synergies[34]

Sometimes, MNE Groups and the Related Parties or Connected Persons that comprise such Groups may benefit from interactions or synergies amongst Group members that would not generally be available to independent parties in a similar circumstance. An example of these synergies may include combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors.

Such Group synergies are often favourable to the Group as a whole and therefore may heighten the aggregate profits earned by Group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions.

[34] This section follows the guidance of section D.8 of Chapter 1 of the OECD Transfer Pricing Guidelines. Certain modifications have been made to suit the domestic requirements and views of the FTA.

In other circumstances, such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller operations, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of Group-wide standards established by the MNE Group.

Parties within an MNE Group should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE Group. In this context, the term incidental refers to benefits arising solely by virtue of Group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. Such incidental synergistic benefits of Group membership need not be separately compensated or specifically allocated among members of the MNE Group.

In some circumstances, however, synergistic benefits and burdens of Group membership may arise because of deliberate concerted Group actions and may give an MNE Group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE Group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether the synergistic benefit or burden arises through deliberate concerted Group actions can only be determined through a thorough functional and comparability analysis.

For example, if a Group takes affirmative steps to centralise purchasing in a single Group company to take advantage of volume discounts, and that group company resells the items it purchases to other Group members, a deliberate concerted Group action occurs to take advantage of Group purchasing power.

Similarly, if a central purchasing manager at the parent company or regional management centre performs a service by negotiating a Group wide discount with a supplier on the condition of achieving minimum Group wide purchasing levels, and Group members then purchase from that supplier and obtain the discount, deliberate concerted Group action has occurred notwithstanding the absence of specific purchase and sale transactions among Group members. Where a supplier unilaterally offers one member of a Group a favourable price in the hope of attracting business from other Group members, however, no deliberate concerted Group action would have occurred.

Where corporate synergies arising from deliberate concerted Group actions do provide a member of an MNE Group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE

Group. Where a deliberate concerted effort results in a chargeable benefit, the Taxable Person should maintain supporting documentation to support the arm's length pricing.

If important Group synergies exist and can be attributed to deliberate concerted Group actions, the benefits of such synergies should generally be shared by members of the Group in proportion to their contribution to the creation of the synergy. For example, where members of the Group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party coordinating the purchasing activities, should typically be shared by the members of the Group in proportion to their purchase volumes.

Comparability adjustments may be warranted to account for Group synergies.

7.8. Other cases

7.8.1. Reliance on arm's length standard carried out by members of MNE Group

An MNE Group may have commercial dealings with Related Parties and Connected Persons in multiple countries, giving rise to various transactions and arrangements.

The MNE Group may have a Group-wide Transfer Pricing policy for common transactions and arrangements based on the arm's length standard for such transactions and arrangements.

Such a Transfer Pricing policy should be evaluated from the UAE context based on two parameters:

- whether the Taxable Person is carrying out similar transactions and arrangements with Related Parties and Connected Persons; and
- whether the arm's length result of the Group-wide Transfer Pricing policy takes into account local and/or regional comparables in order to meet the arm's length standard.

Even where the transactions and arrangements are similar in nature, there may be situations where local and/or regional comparables are not available to meet the arm's length standard. This can happen for example due to the non-availability, or delay in availability, of necessary financial information in the public domain. In such a case, it is expected that the Taxable Person shall maintain an audit trail to demonstrate this. If local and/or regional comparables are available but not considered, the Group-wide Transfer Pricing policy should be re-evaluated to consider such comparables and accordingly determine the arm's length standard. Alternatively, a Taxable Person

could independently determine arm's length standard on transactions and arrangements with Related Parties and Connected Persons.

7.8.2. Cash/bank settlement between Related Parties and Connected Persons

In the course of transactions and arrangements between Related Parties or Connected Persons, it is generally expected that any outstanding amount is consistently settled as per the internal policy of the MNE Group.

The Arm's Length Principle requires that there should be a reasonable mechanism and governance between Related Parties or Connected Persons on raising inter-company invoices and the time period for the settlement process. If the actual settlement period exceeds what the Related Parties or Connected Persons agree 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. The reasoning is that Persons who were not Related Parties or Connected Persons would not engage in a similar transaction or arrangement where a receivable or payable is not settled on time without compensation, for example in the form of interest or penalties.

Example 24: Arm's length interest rate applied due to aging of receivables

Company X is the parent company of an MNE Group headquartered in the UAE. It has wholly owned subsidiaries in countries A and B.

Company X provides certain services to its subsidiary in country A for a Market Value of AED 10 million. Company X provides the same services to its subsidiary in country B for AED 5 million.

Company X has a group wide 90 days payment term policy on all transactions (independent as well as Related Parties) from the date of issuance of invoice.

Company X raises an invoice to both the subsidiaries. The subsidiary in country A settles within 90 days but the subsidiary in country B does not. It is subsequently observed that the outstanding invoice has aged for more than 400 days without any commercial or business rationale.

As per Article 34(2) of the Corporate Tax Law, a transaction or arrangement between Related Parties meets the arm's length standard if the results of the transaction or arrangement are consistent with the results that would have been realised if Persons who were not Related Parties had engaged in a similar transaction or arrangement under similar circumstances.

In the absence of any commercial or business rationale, such a delay in payment is not how Persons who were not Related Parties would carry out a similar transaction or arrangement.

As a result, Company X should charge an arm's length interest rate on the outstanding receivable balance for the period beyond 90 days until the time the amount is settled.

8. Transfer Pricing audit and risk assessment

8.1. Burden of Proof

Transfer Pricing documentation should allow the FTA to ascertain that the tax outcome of the Tax Period has been affected by Transfer Pricing practices that are not in line with the Arm's Length Principle.

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 as it relates to the Controlled Transactions that are in scope for each Tax Period.

The FTA has the right to make queries and request information and data for its review and to arrive at a conclusion regarding the Transfer Pricing practices of the Taxable Person.

8.2. Transfer Pricing adjustments

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

Transfer Pricing adjustments can be initiated by both Taxable Persons and the FTA in cases where it is believed that a transaction has not been conducted in an arm's length manner. Both scenarios are outlined below.

It is worth noting that the Transfer Pricing disclosure form is based on the self-assessment model and as such the burden will be on the Taxable Person to ensure that the transactions undertaken in the Fiscal year are aligned with the Arm's Length Principle.

Transfer Pricing adjustments by the FTA

According to Article 34 of the Corporate Tax Law, if the result of the Controlled Transaction does not fall within the arm's length range, the FTA shall adjust the Taxable Income contained within the Tax Return to achieve the arm's length result that best reflects the facts and circumstances of the transaction or arrangement. The FTA will also make available to the Taxable Person the information relied on to make the adjustment.

Where the FTA or a Taxable Person adjusts the Taxable Income for a transaction or arrangement to meet the arm's length standard, the FTA will reflect this adjustment in the Taxable Income of the local Related Party that is party to the relevant transaction or arrangement.

In accordance with Article 34(11) of the Corporate Tax Law, in cases where the application of the Arm's Length Principle results in an adjustment to the transfer price made by a foreign competent authority,[35] the Taxable Person can request the FTA to make a corresponding adjustment to their Taxable Income under the applicable provisions of the relevant Double Taxation Agreement. The FTA will review the foreign tax authority's position and where appropriate may proceed with a corresponding adjustment.

Below are illustrative examples of domestic and cross-border corresponding adjustments:

Example 25: Cross-border corresponding adjustments

Company A, a UAE resident entity, sells finished goods to its local Related Party, Company X.

Company A has a Transfer Pricing policy in place whereby the goods are sold to its Related Party at cost plus 6% mark-up. The FTA assessed the Transfer Pricing policy applied in relation to the 'sale of goods' transaction and determined that an arm's length mark-up for similar transactions under similar conditions would be 8% on cost.

The FTA has accordingly adjusted the profitability of Company A as follows:

	Company A accounts	
	Pre-adjustment (Cost plus 6%)	**Post-adjustment (Cost plus 8%)**
Revenue from Company X	5,300,000	5,400,000
Operating cost	5,000,000	5,000,000
Profit	300,0000	400,000

As a result of the above adjustment, Company A and Company X approached the FTA and requested a corresponding adjustment to limit the impact of the double taxation on the same income for the MNE Group. The FTA reviewed the appropriateness of the position and agreed to make a corresponding adjustment as follows:

	Company X accounts	
	Pre-adjustment (Cost plus 6%)	**Post-adjustment (Cost plus 8%)**

[35] Article 34(11) of the Corporate Tax Law.

Revenue from third parties	6,500,000	6,500,000
Cost of finished goods from Company A	5,300,000	5,400,000
Profit	1,200,000	1,100,000

<u>Transfer Pricing adjustment by the Taxable Person</u>

It is recommended that the Taxable Person constantly monitors the conduct of its Controlled Transaction(s) throughout a Tax Period to ensure that these are conducted in accordance with the Arm's Length Principle. The Taxable Person will have the option to seek clarifications on a point of law from the FTA.

As discussed above, the burden of proof is on the Taxable Person when preparing the Tax Return. As such, Taxable Persons should apply arm's length pricing in the first instance, but by continually monitoring the Controlled Transactions, Taxable Persons can make real time adjustments before submitting their Tax Returns.

After submitting their Tax Returns, Taxable Persons may make Transfer Pricing adjustments where these result in increased taxable profits or reduced allowable losses, or make adjustments that result in decreased taxable profits or greater allowable losses. A decrease in the taxable profits or increase in allowable losses may only be affected through the operation of the FTA procedures.

8.3. Non-recognition

Article 50 of the Corporate Tax Law allows the FTA to counteract or adjust transactions or arrangements that are not entered into or carried out for a valid commercial reason. If the main purpose of a transaction is to obtain a Corporate Tax advantage that is not consistent with the intention or purpose of the Corporate Tax Law, the FTA may take action to change the outcome of such transaction or arrangement.

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 key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between independent parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. 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.

9. Updates and Amendments

Date of amendment	Amendments made
October 2023	• First version