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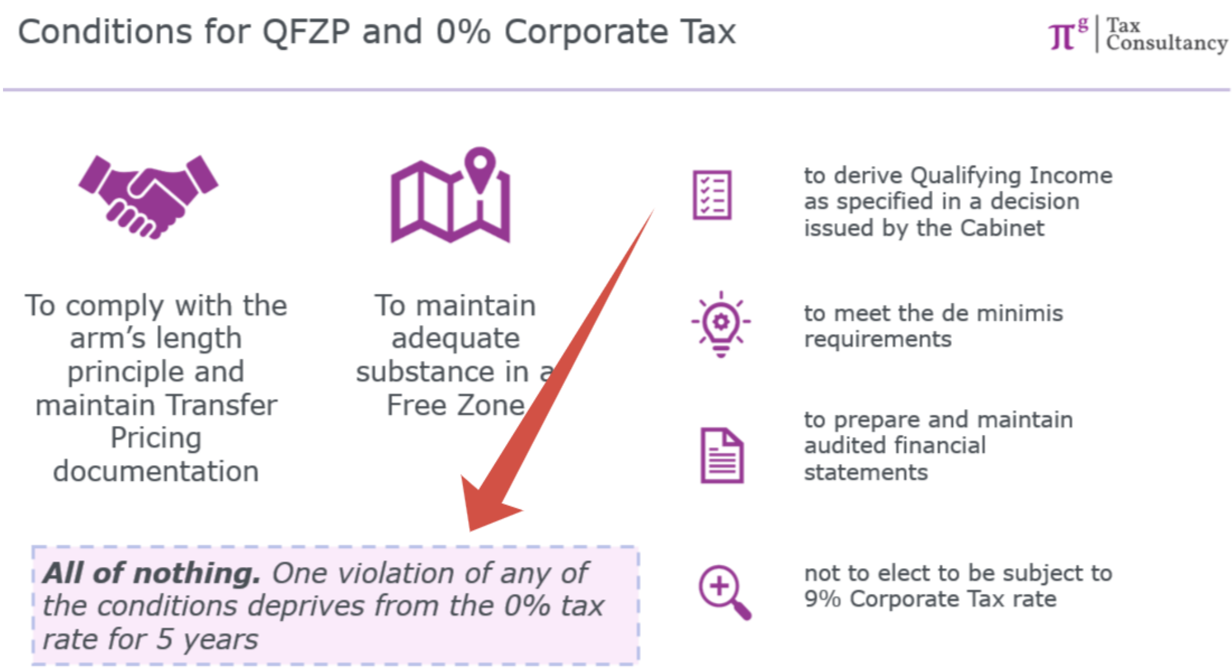
# Arm's length pricing issues for the Emirati Free Zone relief.

In our recent webinar, we delved into the complex challenges of transfer pricing conditions, particularly within the context of the UAE's Corporate Tax framework in Free Zones. A critical takeaway is that entities operating under the zero Corporate Tax rate within Free Zones must rigorously adhere to the arm's length principle and comprehensive transfer pricing documentation. Non-compliance extends beyond mere adjustments to the taxable base; it risks the imposition of the standard 9% Corporate Tax rate on the entity's entire profits for five tax years.

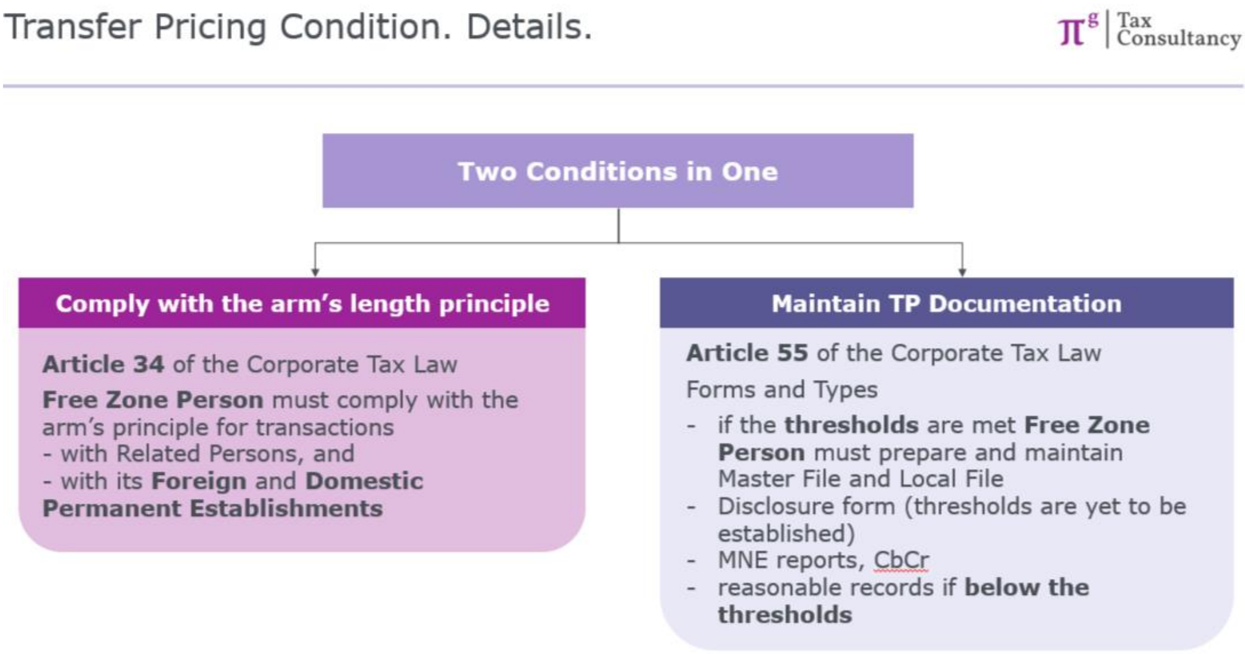
For instance, if an entity has 1,000 compliant transactions but fails on just one in 2024, the punitive measure is severe. The zero Corporate Tax rate would be revoked not only for the year of the non-compliance but also for the subsequent four fiscal years (2025-2028), encompassing all 1,001 transactions in 2024.



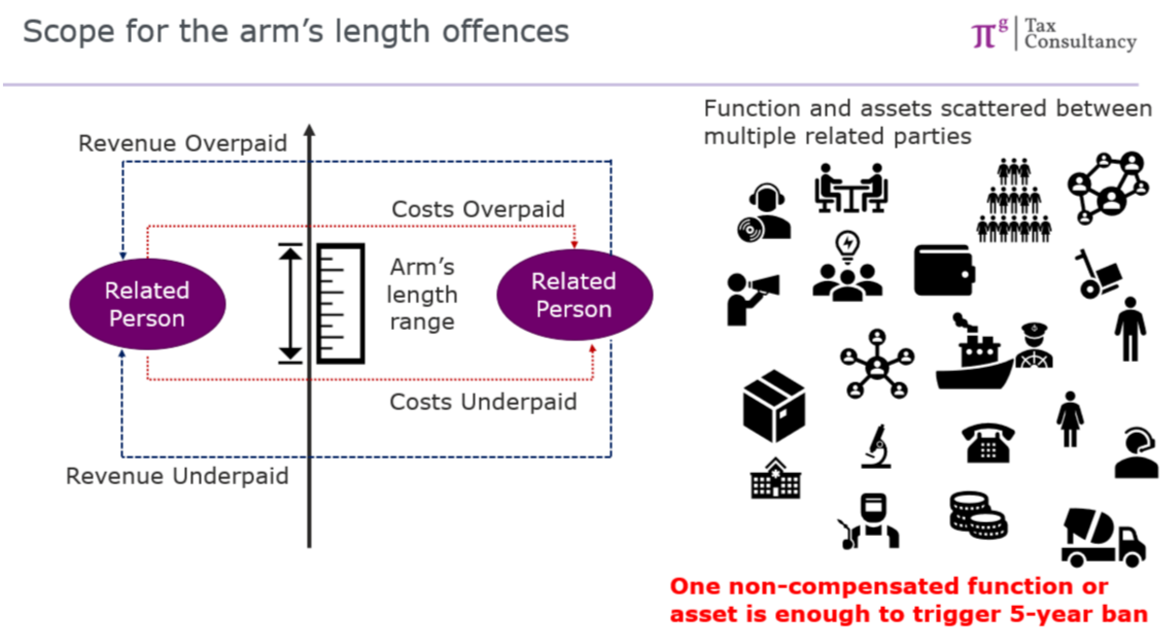
For the Free Zone relief, the TP compliance includes two conditions:

1) applying arm’s length principle in transactions and arrangements with Related Parties;

2) Maintaining accurate transfer pricing documentation and making necessary adjustments.



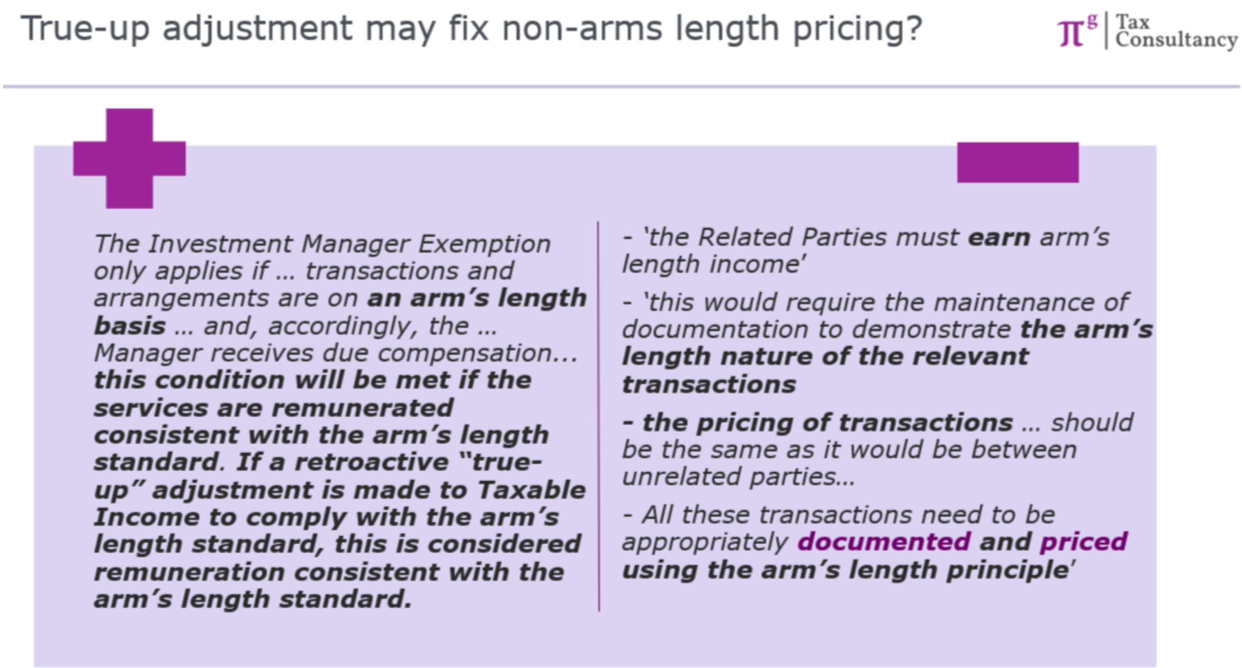

The slide below delineates two distinct scenarios that underscore the challenges of compliance. The figure in the left corner illustrates that a company could face disqualification for non-compliance, regardless of whether the issue led to an understatement or overstatement of the Free Zone entity's Corporate Tax base. The figure in the right corner explores the complexities arising when functions and assets are distributed across multiple related parties.



When multiple related entities are engaged in shared business objectives, the likelihood of non-compliance with transfer pricing regulations increases significantly. This challenge is not solely due to negligence, but also stems from the artificial nature of the arm's length principle. Although this principle acknowledges that the parties are related, it mandates that they interact as if they were independent, an inherently unnatural expectation.

This concept can be illustrated with a family analogy. Within a family, parents, spouses, and children often exchange favors without any financial exchange, driven by shared goals, interests, and innate cost-sharing. In such a dynamic, there is no need to assign market value to these transactions. However, under the arm’s length principle, each transaction must be clearly defined and priced as if conducted between unrelated parties. This requirement to perpetually 'pretend' creates a scenario ripe for oversight. Even a single unaccounted-for favor can lead to severe consequences, such as the loss of the 0% Corporate Tax rate for a period of five years.

Furthermore, we explored whether a failure to apply the arm's length principle could be remedied through adjustments in tax returns. Here, guidance appears contradictory: one regulatory guide suggests that corrective adjustments may be sufficient, while another insists on strict compliance with arm's length pricing from the outset.




In conclusion, entities operating in Free Zones must exercise diligent compliance with TP rules to leverage the benefits of the zero Corporate Tax rate. As evidenced, the cost of non-compliance is steep, not just for the period of the infraction but for several years following. This underscores the importance of robust controls and an accurate interpretation of transfer pricing regulations to navigate these regulatory waters effectively.

## Disclaimer

Pursuant to the MoF's press-release issued on 19 May 2023 "*a number of posts circulating on social media and other platforms that are issued by private parties, contain inaccurate and unreliable interpretations and analyses of Corporate Tax*".

The Ministry issued a reminder that official sources of information on Federal Taxes in the UAE are the MoF and FTA only. Therefore, analyses that are not based on official publications by the MoF and FTA, or have not been commissioned by them, are unreliable and may contain misleading interpretations of the law.

See the full press release here.

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