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UAE tax: The next stage of evolution

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June 2023 will mark another stage in the evolution of the UAE's tax regime. It is now five years since the UAE introduced value-added tax; in that time, businesses including Islamic have developed operating procedures to cater for the tax. Now, they will have to adapt further as the UAE introduces a corporate income tax.

At first sight, it may seem surprising that a business-friendly jurisdiction like the UAE is imposing tax charges. However, this has to be understood in the context of the wider tax changes being made across the world. There is pressure (led by the G7 and G20) for countries to move away from low- or notax systems which has culminated in the OECD Pillar One and Two Projects.

It is Pillar Two that is relevant for these purposes. Pillar Two, which proposes a global minimum tax regime, has been adopted by most of the major taxing jurisdictions with the EU and the UK seeking to do so by the start of 2024; the position of the US is yet to be finalized.

Under Pillar Two, countries are encouraged to adopt a minimum tax of 15 per cent on corporate income; if a group has operations in a country where the tax is lower, a so-called top-up tax can be imposed by the holding company jurisdiction. While the UAE is proposing that the rate of tax will be nine per cent, its introduction has to be seen against this background.

The full details of the new UAE corporate income tax rules are not yet available but the framework is clear. UAE business operations including Islamic that are not in a free zone will be subject to corporate income tax at nine per cent for their first accounting period that starts after June 2023.

In practice, this will mean, for instance, that businesses including Islamic businesses with a December year-end will have to register and pay tax for 2024. The starting point for determining the profits subject to tax will, as is normal, be the financial statements for the entity, with more detailed rules to determine when items are tax-deductible. Many of the features of other international tax systems have been included; it will be possible to have tax groups, and businesses will have to comply with transfer pricing rules.

These impose an obligation for arrangements with connected parties to be on 'arm's length terms' – broadly the same arrangements that would have applied between third parties. Equally, there are detailed rules governing tax relief for interest and the use of tax losses. There are also reliefs for holding companies, with a potential exemption for dividends and share participations.

A particular focus is given to the free zones; these can continue to be exempt from corporate income tax so long as they meet an adequate substance requirement which is likely to be modeled on the existing economic substance requirements.

The free zone exemption only applies to 'qualifying income', the precise scope of which is not yet clear and so it may be the case that businesses (conventional and Islamic) will have to pay some tax on income that is outside the relief.

It is possible for an operation to elect out of the free zone exemption, so that it is taxpaying. That may seem counterintuitive, but for an international group that is potentially subject to the top-up tax rules, that may make sense (and may be administratively easier).

Where does this leave UAE-based operations and those providing finance to them? As a starting point, it is important to note that the new rules apply to all lenders operating in the UAE; there are no specific rules that apply to Islamic finance. However, confidence has been expressed that the new rules will not impact significantly on the competitiveness of the region; as mentioned, it is part of a worldwide move to align corporate tax rates.

In the short term, many groups are evaluating their structures and considering the impact of the new rules. For many, the starting point will be to understand which entities are caught and what is the likely tax payable. Restructurings and consolidation of operations (for which lender consent may be needed) are likely. New reporting systems will have to be put in place and financial models built.

For lenders to UAE groups, the good news is that there is no proposal to introduce withholding tax on financing returns and they can therefore continue to receive gross payments. However, they will need to consider whether it is appropriate to introduce covenants into documentation in relation to tax liabilities and risks, and will also want to consider what tax assumptions are critical in deciding whether to advance funds. In other (taxing) jurisdictions, most financing documents contain warranties as to tax compliance and ongoing obligations.

What is clear is that 2023 will be a busy year for those carrying on business in the UAE and those providing finance to them (or indeed advising them). They would be well advised to start now, even though the details of the regime and how it will operate in practice are not yet clear.

An initial impact study would however be expected to draw out the particular areas of focus for businesses. For some groups, the impact may be modest, with tax to be paid and returns to be filed but no structural or equivalent change. For others, more will need to be done; working out the priorities may take time, but that is unlikely to be a wasted effort.

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