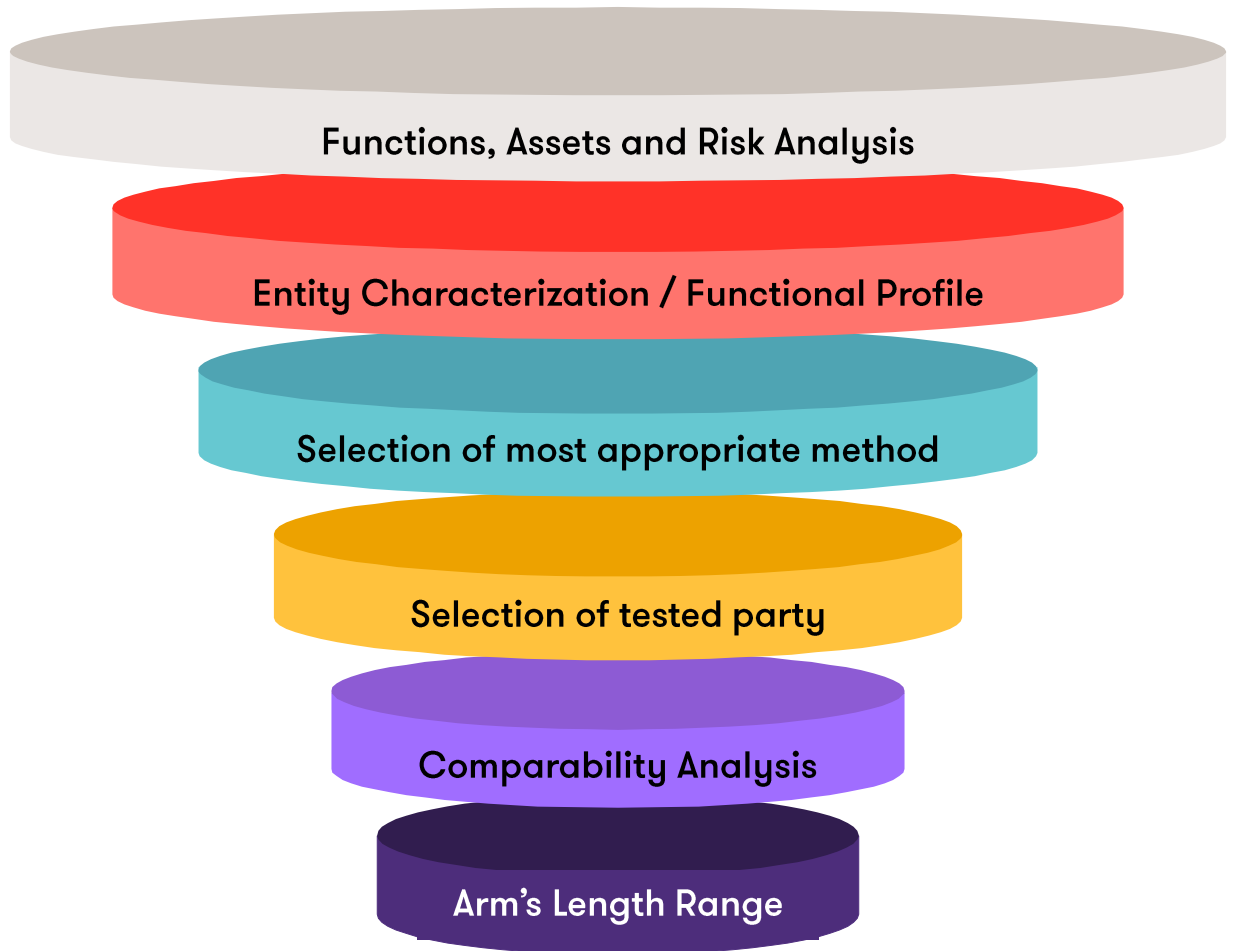


Decoding Transfer Pricing with GT UAE

The process of establishing arm's length principle

October 2024

With this post, we will understand the process of establishing arm's length principle with the consideration to functional and economic analysis.



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Functions, Assets and Risk ('FAR') Analysis

- It 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.
- It 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 as well as decision making.
- It also considers the type of assets, as well as the nature of the assets used.
- Further, it also considers 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.

Entity Characterization / Functional Profile

- The companies often segregate their business operations into several functional elements that in combination form an end-to-end supply and value chain.
- Each company within the Group should be adequately remunerated for FAR that it contributes to the value chain.
- The process of labelling entities based on their role and the level of complexity of their role (determined based on FAR analysis in the above step) is known as entity characterization or functional profile.

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Selection of most appropriate method

- Transfer Pricing methods are used to establish whether intercompany transactions are conducted at arm's length.
- There are five prescribed Transfer Pricing methods. These methods are given below.
 - Comparable Uncontrolled Price ('CUP') Method
 - Resale price Method ('RPM')
 - Cost plus Method ('CPM')
 - Transactional Net Margin Method ('TNMM')
 - Profit Split Method ('PSM')
- The UAE TP guideline also permits to resort to the other method if it provides the arm's length criteria.

Selection of tested party

- The tested party is the party for which the transfer pricing analysis is carried out to check whether the transaction and its price meets the arm's length test.
- The selection of the tested party should align with the functional analysis of the controlled transaction.
- The entity with a less complex functional profile i.e. not owning any valuable intangibles/assets or assuming minimal business risks can be considered as the tested party.
- It should also be the party where reliable and accurate data is available and where the selected transfer pricing method can be applied in the most reliable manner.

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Comparability analysis

- 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 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).
- Internal comparables may have a more direct and closer relationship to the Controlled Transaction under review than external comparables.
- Accordingly, whenever reliable internal comparables exist, it may be unnecessary to search for external comparables.
- 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.
- 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).
- Selection of profit level indicators and comparability adjustment are also the key factors in comparability analysis.

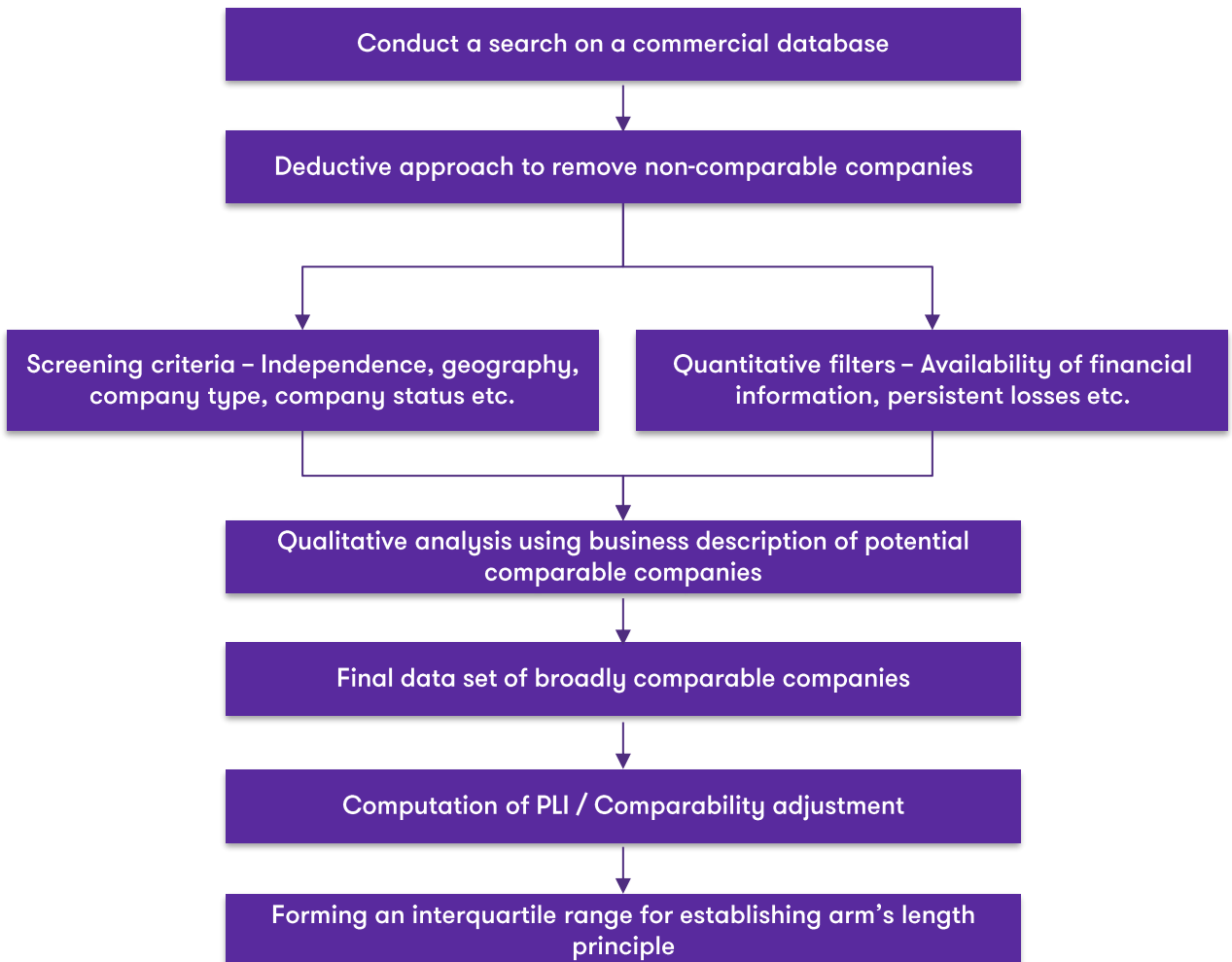
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External benchmarking search process






- 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.



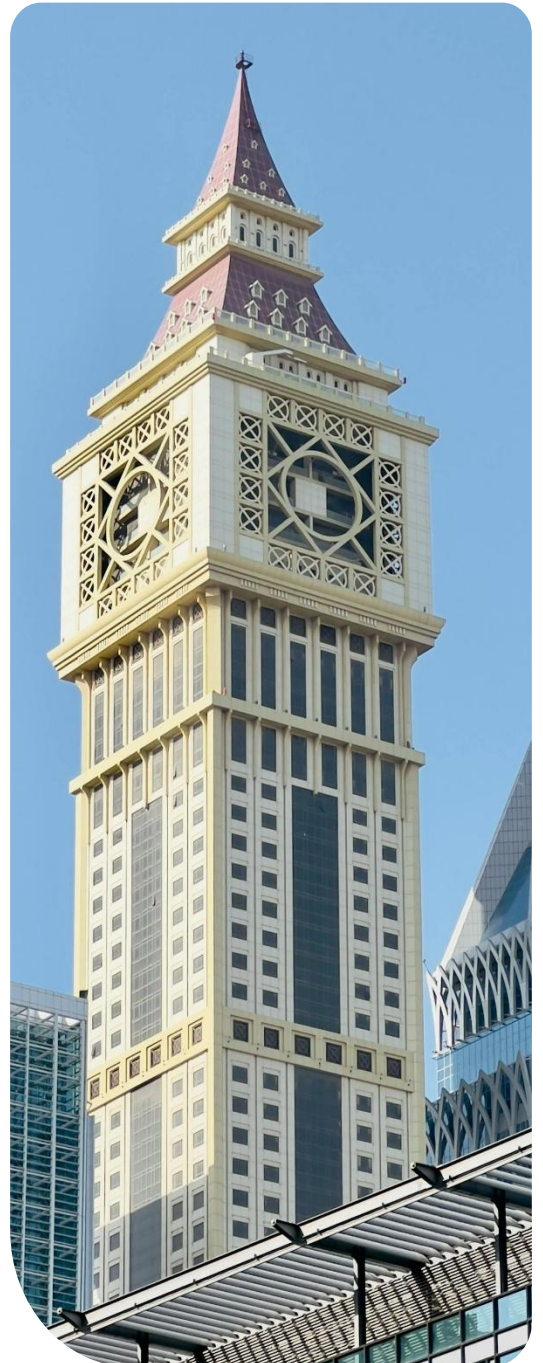
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Next Steps

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-  Undertake the functional analysis of the entities involved in the controlled transactions
-  Determine the characterization / functional profile of the entities involved in the controlled transactions with respect to its FAR analysis
-  Evaluate the prescribed transfer pricing methods and select the most appropriate method for the analysis
-  Based on the FAR analysis, characterization / functional profile of the entities, select the tested party for arm's length testing
-  Undertake comparability analysis which could be either internal or external comparability and establish arm's length principle

Stay tuned for our next publication on tax audits, TP adjustments and substance over form.



Decoding Transfer Pricing with GT UAE

Contact our Transfer Pricing team

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For more details regarding this topic or other Tax issues, reach out to our team of experts on the latest Tax developments within the UAE and the Middle East region.



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