Impact of the UAE Corporate Tax law on M&A and Restructuring

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On 9 December 2022, the UAE released the Corporate Tax (CT) law through Federal Decree No. 47 of 2022 (CT law). Our alert issued in January, 2023 provided an overview into the key areas of the CT law relevant for businesses. This alert seeks to discuss in detail the impact of UAE CT law on M&A transactions and restructuring.

Historically, M&A transactions involving UAE Targets did not require a significant amount of due diligence or acquisition structuring due to the absence of federal corporate tax. Following the introduction of VAT in 2018 and Economic Substance Regulations in 2019, limited scope due diligences started to be undertaken. However, with the advent of VAT audits and its related controversies coupled with the introduction of the UAE CT law, it is critical to discuss tax planning for M&A involving UAE Targets (including those with downstream non-UAE investments).

This alert aims to discuss the following key aspects of the UAE CT law, that are likely to impact deals going forward along with the steps that companies should undertake through the different life cycles of a transaction;

Summary of issues covered in this alert

Tax due diligence	Undertake proforma tax due diligence exercises to assess risks on tax positions and applicability of UAE CT law provisions going forward
Participation Exemption	Review holding structures and conditions under UAE CT law to determine tax implications on receipt of dividend and exit tax on sale of shares from direct and indirect subsidiaries
Debt push-down	Optimisation of certain methods of acquisition through introduction of leveraged buy outs but adhering to interest limitation provisions under UAE CT law
Restructuring and group transfers	Impact of any potential restructuring and group transfers in terms of satisfying conditions provided under UAE CT law for tax neutrality – critical to review claw back provisions
Other key areas under UAE CT law	Deemed residency provisions for non-UAE companies; tax model and effective tax rate review on deals; coverage within deal documentation coupled with representation and warranty insurance
VAT implications	Modes of effecting a transaction and their VAT implications including documentation and compliance to be undertaken
Key takeaways	List of key takeaways for different set of stakeholders in a deal – acquirers, sellers and group restructuring

A. Tax Due Diligence

For acquirers looking at investing in UAE Targets, there is expected to be limited historical risks as the UAE CT law is likely to apply (for most businesses) from 1 January 2024, with first tax return filing not due until nine months from the end of the year (i.e. 30 September 2025 in case of a calendar year end). However, it is crucial that **the acquirer should consider a proforma review of the UAE Target entities** from a UAE CT law standpoint – under the hypothesis that if UAE CT law were to apply, what could be the potential impact or exposures. Certain areas that can be analysed within this review can include the following:

- Free Zone entities eligible for the potential 0% tax rate and satisfaction of mandatory conditions, i.e. qualifying income, substance, transfer pricing compliances;
- Inter-company transactions and transfer pricing considerations;
- Tax grouping and loss transfer shareholding thresholds;
- Tax attributes such as tax losses and interest limitation;
- Foreign tax exposures such as permanent establishment, entities deemed to be UAE residents based on control and management, withholding taxes and their creditability on payments received from non-UAE entities;
- Impact of accounting on future taxes including unrealized gains / losses, provision for expenses and their write back, revaluation, etc.

Understandably, recourse for exposures identified in a tax due diligence may generally include an indemnity or a valuation adjustment depending on the level of risk and amount. Given the nascency of UAE CT law and absence of material historical returns to review as a part of a deal (since the first tax return may only be filed on 30 September 2025 for companies following a calendar year), there might not be a material recourse with respect to indemnity or valuation adjustments in the immediate future.

However, a proforma review as discussed above may enable acquirers to identify exposures that may arise immediately post acquisition and potentially discuss any restructuring / documentation that the sellers / Target may need to put into place prior to the deal. Such areas can form a part of the mandatory conditions to close a deal and can be included as a part of the transaction documentation to provide additional protection to the acquirer.

B. Structuring considerations

An acquirer / acquirer group can consider various options to acquire a potential Target, i.e. direct share acquisition from the seller (secondary transfer) in exchange for cash or shares, infusing equity/ debt into the Target (primary infusion) or business transfer. Each of these modes should have considerations under the UAE CT law. Unlike a due diligence exercise that is aimed at identifying historical exposures, acquisition structuring could have an immediate impact on areas such as modes of acquisition, inclusion of leverage (debt) to undertake the acquisition, acquiring entity jurisdiction and the post-acquisition structure. Some areas that may merit consideration as a part of acquisition structuring include:

- **Participation Exemption:**

  Primary Tests: Under Article 23 of the UAE CT law, Participation Exemption is provided for dividends and capital gains earned by a UAE resident from participating interests. Whilst dividends received from UAE companies are automatically exempt, for capital gains on sale of shares (UAE and non-UAE) and dividends received from foreign entities, the Participation first needs to meet the three primary tests, i.e. 5% minimum shareholding, minimum holding period of 12 months and the Participation should be subject to corporate tax in its home jurisdiction at a rate not less than 9%.

  Relaxation for holding companies from meeting a primary test: Further, Article 23(3) of the UAE CT law mentions that a Participation will be deemed to have met the minimum 9% corporate tax test if a) its principle objective and activity is the acquisition and holding of shares / equitable interests (that in turn meet the above-mentioned conditions) and b) the Participation's income substantially consists of income from its participating interests. Further, this relaxation is also extended under Article 23(4) of the UAE CT law to Participations that qualify as a Qualifying Free Zone Person or an Exempt Person which ordinarily may not be subject to tax at 9% under UAE CT law (subject to conditions). Therefore, this condition seeks to extend the Participation Exemption in case of Intermediate Hold Co. structures in countries such as BVI, Cayman, etc and at the same time for Intermediate Hold Cos. located in a UAE Free Zone (subject to conditions).

  Additional conditions in case of muti-tiered investments: For structures involving multiple layers of investments (i.e. indirect subsidiaries), the UAE CT law also provides an additional condition under Article 23(2)(d) in order to qualify for Participation Exemption - i.e.

not more than 50% of the direct and indirect assets of the Participation should consist of ownership interests that **would not** have qualified for an exemption from CT if they were held directly by the Taxable Person. Hence, in cases where the value of ownership interests in step-down subsidiaries held by a Participation fails to meet the three primary tests and such value exceeds 50% of its total assets, the Participation Exemption should not be available.

To test this additional condition, the below steps may be followed:

1. At the outset, the Participation (direct holding) in question should satisfy the primary 3 tests mentioned above i.e. 5% minimum shareholding, minimum holding period of 12 months and the Participation being subject to a CT rate of at least 9% in its home jurisdiction;
2. Once the above tests are satisfied, the total value of assets (including the investment made by the Participation in each direct / indirect subsidiary) of the Participation should be determined – it is currently unclear whether book value or fair value will need to be taken;
3. Next, each direct / indirect subsidiary should be tested against the aforementioned 3 primary tests, assuming that they were held directly by the Taxable Person (and not by the Participation); and
4. The value of all the direct / indirect subsidiaries **failing** the conditions (in step one) should be added up – e.g. an indirect subsidiary in Bahrain (where no CT applies), ownership of less than 5% by the Participation in a subsidiary

If the value of the investment determined in step four does not exceed 50% of the value of the total assets of the Participation (in all direct / indirect subsidiaries), then the additional condition in Article 23(2)(d) of the UAE CT law is satisfied and the Taxable Person (i.e. the recipient of dividend / capital gains) would be eligible to claim the Participation Exemption for dividends and gains received from the Participation. It is to be noted that this evaluation is only relevant for analysing the dividend / capital gains flowing directly from the Participation to the Taxable Person; the condition has no bearing on dividends / capital gains flowing from the indirect subsidiaries to the Participation. Further, this condition holds relevance for multi-tiered structures primarily because one may have to evaluate the lowest level of indirect assets / subsidiaries held by the Participation (Investee company) along with their values.

Treatment of hybrid instruments: As per Article 23(6)(a) of the UAE CT law, it is prescribed that the Participation Exemption will not be available where the Participation claims a tax deduction for the distributions / dividends in its home country tax return, even if all the conditions mentioned above are met (e.g. in case of hybrid instruments). Therefore, this results in an additional area to be looked at in the M&A context, in addition to the prescribed conditions.

Evaluation of the fulfilment of Participation Exemption conditions to a proposed acquisition is not only important from a Target's standpoint but also post integration of the Target into the acquirer's structure. The acquirer should evaluate the fulfilment of conditions and the potential tax leakages, if any, on dividend/ profit distributions through the structure. This review will also potentially provide an insight on exit taxes on future sale or any interim sale of a portion of the business/ certain geographies.

- **Debt push-down:** Article 30 of the UAE CT law, in line with OECD's BEPS Action Plan 4, has introduced interest limitation rules wherein interest expenses are limited to the higher of 30% of the Taxable Person's EBITDA as per books or a specific amount (yet to be prescribed). Any excess interest (above the allowance) is disallowed in such tax period but can be carried over for 10 years to be utilized as a deduction from future year's taxable income (subject to conditions).

The relevance of the interest limitation rules for M&A is bi-fold. Firstly, as discussed above, its impact on taxable income for the UAE Target entity / group in terms of tax deductible expenses should be evaluated. Secondly, a critical area for consideration is expected to be in cases where leveraged acquisitions are carried out. Article 31 of the UAE CT law additionally clarifies that interest obtained from related parties (as defined under transfer pricing provisions) will be disallowed if i) the loan is used for one of the prohibited end-uses such as dividend payments, redemption / repurchase of shares of a related party, capital contribution to a related party or acquisition of an ownership where such investee company becomes a related party post the transaction; and ii) the purpose of the loan is not to obtain a CT advantage, which is deemed not to arise if the lender is taxed on the interest at least at 9%. Interestingly, the additional restrictions on related party loans throws up many interesting issues such as:

- Deductibility of interest used to acquire minority stake;
- Jurisdiction of the lender given the deeming

fiction for the condition relating to obtaining a tax advantage – such as loans from BVI, Cayman or European entities that follow hybrid structures for certain types of convertible debt;

— Applicability of the prohibited end-uses to asset acquisitions or business transfers.

Given the above, the debt push-down provisions may limit deduction for borrowing costs, depending on the structure adopted. Thus, in a jurisdiction like UAE where debt push-downs were not relevant from a tax standpoint, stakeholders participating in M&A should review the impact of leveraged buy-outs for potential tax breaks and future impact on effective tax rates.

C. Restructuring and group transfers

The UAE CT law provides explicit exemptions for certain qualifying group transfers and business restructuring transactions. Whilst the latter might be another mode of acquiring a Target business, the former enables existing groups to restructure in a tax efficient manner either in a non-M&A context or potentially in preparation of a sale (either fully or hiving off a separate vertical).

The Business Restructuring Relief under Article 27 of the UAE CT law provides an exemption for transfer of business between Taxable Persons under the UAE CT law if the transfer is undertaken in exchange for ownership interest for the transferor, i.e., shares in the transferee entity. In such a case, the assets and liabilities are deemed to have been transferred at book value and the transferor / transferee has a lock in period of 2 years to avoid claw back of the exempted business transfer. Thus, in a case wherein the shares are sold to a person that is not a member of the 'Qualifying Group' to which the Taxable Persons belong, or the business in question is transferred / disposed of within two years of the acquisition, the exemption will be revoked and the business transfer will be deemed to have been carried out at market value at the date of transfer, and will be taxed accordingly. Interestingly, the business restructuring relief provisions also have an inter-linkage to Participation Exemption provisions. These provisions require that the ownership of the transferor post transaction (exempted under Article 27 of the UAE CT law) must be held for at least two years to avail Participation Exemption on such ownership. A similar requirement also exists for certain specified share-swap transactions.

Akin to the relief on business transfers, Article 26 of the UAE CT law also provides an exemption on transfer of assets between members of a 'Qualifying Group', subject to conditions. Amongst others, the main condition of a Qualifying Group is that the transferor and transferee should have common ownership of 75% or more or own 75% or more of either (transferor in transferee or transferee in transferor). Further, neither the transferor or transferee can be an Exempt Person (e.g. – Government Entity, Government Controlled Entity, Qualifying Public Benefit Entity, Qualifying Investment Fund, etc) or claiming benefits of the 0% tax rate for Free Zone entities. If the conditions are satisfied, the assets transferred between such entities are considered to take place at book value, thus not triggering a gain under UAE CT law. Conditions relating to claw back period and implications on claw back are similar to that of business restructuring.

As a separate note, Article 38 of the UAE CT law also contains provisions to transfer tax losses between members of a Qualifying Group as long as the tax loss offset related conditions are met. Some areas of consideration under these provisions include:

— Limitation on the overall tax loss that can be set off (75% of the taxable income of the entity);

— Inter-play of tax losses available with a group company prior to transfer - can be transferred for set off only after the transferee's tax losses have been set off and subject to the 75% limitation;

— Requirement to be members of the Qualifying Group from the period of the loss being incurred by the transferor to the period in which it is offset by the transferee;

— Requirement for the loss-making entity to carry on same or similar business following a change in ownership of more than 50%.

The above amplifies the need to not only meet prescribed conditions at the time of effecting a business / asset transfer but also highlights the importance of keeping track of the claw-back conditions. Considerations that apply may include taxability of future exits and corresponding impact on books along with depreciation/ amortization thereon. As a part of a proposed acquisition, whilst transactions carried out prior to the Target's first year of UAE CT law applicability is expected to be grandfathered, the review of such transactions post trigger of UAE CT law will be very relevant.

D. Others

There are some other areas that also merit consideration as the UAE CT law comes into play within the next 12 months and M&A deals being actively pursued in the region.

Deemed residency

As per Article 11(3)(b) of the UAE CT law, non-UAE entities that are effectively controlled and managed from the UAE are deemed to be UAE tax residents for the purposes of UAE CT law. It is expected that the location for effective management and control may depend on where the key managerial personnel or board of directors are located along with the location where where the key decisions are taken by such individuals/ group of individuals. In the M&A context, for Targets with non-UAE operations being acquired by a UAE group/ fund, these provisions may need careful analysis. In cases where the seller is also a UAE headquartered group and the effective management and control of its non-UAE entities are from the UAE, the acquirer should review these provisions appropriately or have the seller put in place certain procedures through closing conditions in transaction documents. This is critical as it can increase the potential in-scope entities for UAE CT resulting in added compliances and possibly, complex tax filings (to take into account foreign tax credits, where applicable).

Tax models and effective tax rates

This is an equally important area for concluded deals, ongoing transactions and prospective ones. It is possible that acquirers have factored an internal rate of return (IRR) from a prior M&A deal based on the non-applicability of UAE CT law. However, this might need to be revisited for transactions that have not been exited from, as the potential UAE CT may have an impact on the free cash flows available for distribution on account of tax payments in the UAE. Therefore, all M&A transactions require a detailed review of financial models for tax purposes and verification of the effective tax rate along with the availability of tax attributes (such as losses, credits, interest allowances). There may be structuring avenues available under the UAE CT law to optimize the effective tax rate and especially bridge any gaps between the factored/ proposed IRR and any potential reduction due to UAE CT law.

Documentation and insurance

Increasingly, a tax review of the share purchase/ asset purchase agreement will find more importance on analysis of deal documentation. Areas such as tax indemnities, period of coverage (given statute of limitations under UAE CT law), de-minimis and tax indemnity caps may need more detailed consideration than earlier on deals involving UAE Targets. Also, the insurance coverage on deals may now need to include tax within their discussion with representations and warranties insurers; this results in tax due diligences or proforma reviews being very relevant. It is also imperative to review deals that are in the transitory phase of signing and closing where the transaction documentation has been concluded albeit the deal has not closed (due to completion of conditions or regulatory reasons) – if aspects discussed in this alert need additional evaluation pre-closing given the advent of UAE CT, its impact on the deal documentation should be reviewed.

VAT considerations on M&A transactions

The implications of VAT on transactions involving mergers and acquisitions depend upon the specifics of each transaction, including the nature of transfer, the type of assets / liabilities being transferred, and whether the parties involved are registered under the UAE VAT law.

For VAT purposes, the transaction is considered to have been carried out in different modes - through purchase of shares or through an asset purchase (further split into business transfer or individual asset transfers).

The UAE VAT law provides that the transfer of business through purchase of shares should be exempt from VAT. However, the transfer of business as a going-concern should be considered as outside the scope of the UAE VAT law only if following conditions are complied with –

- There must be a transfer of the whole or a part of the business;
- The transfer must be made to a Taxable Person; and
- The acquirer intends to continue the business, part or otherwise, which is being transferred.

On the other hand, transfer of assets on a piecemeal basis should attract VAT at the rate of 5%.

It is pertinent to note that transactions involving mergers and acquisitions could be multifaceted and the sale and purchase agreements must be carefully examined to arrive at the appropriate treatment under the UAE VAT law.

Furthermore, companies involved in the transaction would have to obtain, cancel and/or amend their VAT registrations and conform to the procedural and compliance requirements within the prescribed time limit failing which penalties could also be imposed. The most important challenge here is to ensure business continuity and issuance of tax invoices, tax credit notes etc. while the entities being acquired are de-registered by the transferor and registered by the transferee, either on a standalone basis or added to the existing VAT groups – as the ‘Tax Registration Number’ of the transferee needs to be mentioned on the tax invoices post the effective date. Hence, the cancellation, amendment etc. of VAT registrations need to be planned in a manner which causes minimum or no disruption to the ongoing operations.

Key takeaways

As it may be appreciated, the deal environment surrounding taxes in the UAE is set to undergo a paradigm shift. The time is now to start talking about tax early in the deal (possibly, as early as at the time of preparing initial models for reviewing a Target and adequately scoping of work for tax DD). Whilst the first tax return may have over two years to be filed and hence historical reviews may realistically start only after that period, the key is for acquirers to be ahead of the curve in terms of identifying key issues that may have an impact after the deal. Companies looking to sell their businesses or potentially IPO a specific hived off vertical will also need to factor in restructuring and asset transfer related provisions along with other applicable ones. All in all, the changes will broaden the team involved in M&A and restructuring transactions, with tax now having a material impact on the deal (even before the law comes into effect) in the following ways:

ACQUIRERS	SELLERS	GROUP RESTRUCTURING
— Proforma tax diligence; — Review own structure and integration of Target structure including the impact of the Target joining the acquirer's tax group, if any; — Tax impact on the financial model and related IRR considerations; — Taxes on exit and repatriation through the holding structure; — Protection for any risks in transaction documentation.	— Evaluate potential taxes on transfer; — Hive off considerations pre-sale including group restructuring reliefs; — Health check of the Target's tax affairs impending a deal; — Ability to provide indemnities – period and amount; — Existing transfer pricing considerations and compliance relating to inter-company transactions, if any	— Adherence to conditions for group transfer reliefs; — Impact of existing inter-company transactions and operating model post restructuring; — Accounting considerations of restructuring and related tax impact; — Optimisation of tax losses and its transfer within the group; — Monitoring claw back conditions and related tax implications on Business Restructuring and Qualifying Group transfers.

FTI Consulting's Middle East Tax and Transaction Team has significant experience of advising on tax issues pertaining to M&A taxes including due diligence, structuring, vendor assistance, tax model reviews and transaction documentation assistance. The tax team works closely with our M&A team specializing in financial due diligence, restructuring and valuations. The FTI M&A team is suitably placed to provide support through the entire M&A deal life-cycle.

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At FTI Consulting, our team of tax and transfer pricing experts can help business groups in assessing the impact of the CT law, and assist in preparing for the documentary and structural changes to the businesses to be in compliance with the new regime

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