Ministerial Decision No. 116 of 2023 Release: Participation Exemption

Key Takeaways

May 2023

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UAE Ministerial Decisions Release

On 10 May 2023, the Ministry of finance issued Decision No 116 of 2023 with regards to the Participation Exemption for the Purposes of Federal Decree-Law No. 47 of 2022 on the Taxation of Corporations and Businesses (hereinafter referred to as the ‘CT Law’). This Decision came into effect the day following its publication.

Article 23 of the CT Law provides an exemption on income from a Participating Interest subject to meeting certain conditions. The released Ministerial Decision sets out the provisions relating to the application of Participation Exemption on income recognised by Taxable Persons as detailed below.

Key highlights

The Decision defined a ‘Participating Interest’ as an ownership interest in the shares or capital of a juridical person that meets the conditions referred to in Article 23 of the Corporate Tax Law, which broadly include:

- An ownership interest of at least 5%,
- A 12-month uninterrupted holding period (or the intention to hold for 12 months),
- The Participation is subject to tax in its country or territory of residence at a rate that is not lower than 9%.
- Not more than 50% of the direct and indirect assets of the Participation consist of ownership interests that would not have qualified for an exemption if held directly by the Taxable Person.

Ownership interest

The term ‘ownership interest’ for the purposes of the CT Law has been defined in the Decision as a holding interest in the form of ordinary/preferred/redeemable shares, membership and partner interest, and/or any other types of securities, capital contribution and rights that entitled the owner to receive profits and liquidation proceeds (this may include Islamic Finance Instruments or arrangements that form part of Islamic Finance Instruments).

More importantly, the ownership interest should be classified as an equity interest under the accounting standards in order to qualify for an exemption. This is also an important reminder on the importance of considering the applicable accounting standards by Taxable Persons.

Moreover, the Decision stresses on the fact that the Taxable Person should have control and the right to the economic benefits produced by the ownership interest. This suggests that the Taxable Person should be the beneficial owner and not just the legal owner of the ownership interest.

Aggregation of Ownership Interests

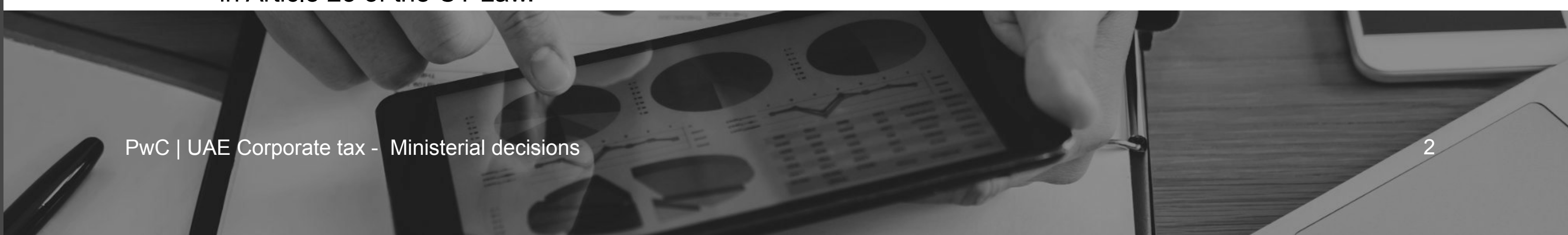
One of the conditions provided under the CT Law for participation exemption is a minimum of 5% ownership in the shares or capital of a juridical person (i.e. ‘Participation’). The Ministerial Decision provides that in order to determine whether the ‘5%’ has been met, a Taxable Person should aggregate the different types of ownership interests (as provided above) in the Participation.

Moreover, with regards to entities that form part of a Qualifying Group, the 5% ownership interest is considered to be met in the event the total amount of ownership interest from all Group members in the same Participation adds up to at least 5%.

Transfer of Ownership Interests

When a Taxable Person exchanges their ownership interest in one juridical person for an ownership interest in another juridical person, certain conditions must be met for the exchanged ownership interests to be treated as a continuous ownership interest. These conditions include:

- Exchanging the ownership interests in accordance with the business restructuring relief provisions as set out in Article 27 of the CT Law.
- Ensuring that the ownership interest in the juridical person qualifies as a Participating Interest as defined in Article 23 of the CT Law.



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Debt Instruments Issued by the Participation

Income recognised by a Taxable Person from its Participation with regards to debt instruments (classified as an equity interest under Accounting Standards applied by the Taxable Person) will be treated as income from a Participation Interest even if it does not fall within the definition of ownership interest.

'Subject to Tax' test

The Ministerial Decision reinstates the fact that the Participation is required to be subject to tax in its relevant jurisdiction at a rate not less than 9% applied under a similar basis to CT in the UAE. Further clarity has been provided that the 'subject to tax' test would be satisfied if:

- A 9% effective tax rate ("ETR") is applied on income or profits of the Participation.
- In the event such a 9% ETR is not applicable based on the relevant jurisdiction's tax regime, a 9% ETR is reached if re-calculated based on the provisions of the UAE CT Law.

Holding Companies:

The effective tax rate of 9% condition (as mentioned above) may be waived in case the Participation is a holding company satisfying all of the below conditions:

- The Participation is directed and managed in its relevant foreign jurisdiction;
- Comply with all the administrative requirements of document submission, etc., in the relevant jurisdiction;
- Have adequate substance to acquire and hold shares or equitable interests; and
- The Participation does not conduct any other activity other than ancillary withholding of shares.

Minimum Acquisition Cost

The minimum ownership criteria of 5% to satisfy the participation exemption will be disregarded if the aggregated acquisition cost of the ownership interest is equal to or exceeds AED 4m. To determine the acquisition cost of a foreign ownership interest, amounts must be quantified in UAE using the applicable exchange rate at the date of the acquisition.

Where the minimum acquisition cost threshold is not met for an uninterrupted period of 12 months, any income not taken into account due to participation exemption shall be included in the Taxable Income during the Tax Period of which the threshold is not met.

Assets of the Participation

In order to avoid abuse of the Participation Exemption, the CT Law provides that no more than 50% of the assets directly or indirectly owned by the Participation may consist of an ownership interest or entitlements that would not qualify for the Participation Exemption if these assets were held directly by the Taxable Person.

The above should be determined on the basis of (i) the carrying value of the assets presented in the consolidated balance sheet of the Participation; or (ii) the market value of the direct and indirect ownership interest as well as other assets of the Participation.

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Expenditure in relation to the Acquisition and Disposal of the Participating Interest

Expenses incurred incurred in relation to the acquisition, sale, transfer, or disposal of a Participating Interest will not be deductible as they will be related to an exempt income. Examples include professional fees, due diligence fees, litigation costs, commission and brokerage fees, stamp duty or any other irrecoverable taxes, appraisal and valuation costs, and refinancing costs.These costs will then be capitalised as part of the acquisition cost of the Participating Interest.

Interest expenditure will be subject to the general and specific deduction rules under Chapter 9 of the CT Law.

Income from Ownership Interests in a Participation

The participation exemption will apply only in the case where the Taxable Person receives income in his capacity as owner of the Participation. Income derived in relation to but not directly from an ownership interest in a participation will not be exempt from Corporate Tax.

Liquidation Proceeds and Losses

The CT Law provides that participation exemption should not be applicable on losses recognised by a Participating Interest as part of liquidating the Participation. Such liquidation losses should be calculated as follows : *Acquisition cost of Taxable Person - any [partial] disposal made in the Participation - fair value of the liquidations proceed received by the Taxable Person.*

The above should be adjusted for any (i) tax losses transferred by the Participation to the Taxable Person; (ii) any exempt dividends / profit distributions received; or (iii) gains recognised by the Taxable Person on any transfer of assets / liabilities to the Participation not taken into account under Transfers Within a Qualifying Group or Business restructuring relief.

Foreign Permanent Establishment Tax Losses

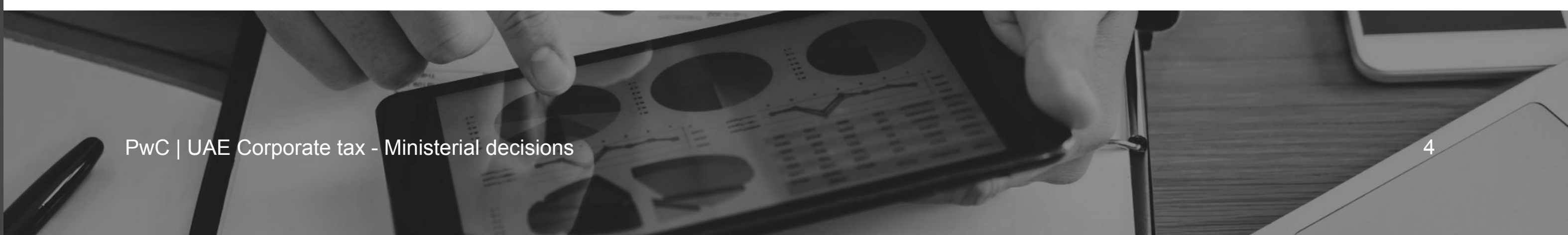
Where a tax loss is utilised by a Taxable Person from its foreign permanent establishment (“PE”), it must first be offset against future profits of the PE before (i) the Taxable Person can elect to apply a Foreign PE exemption as per the CT Law; or (ii) any income arising before the foreign PE can benefit from the participation exemption provisions as per the CT Law.

Key takeaway and next steps

The adoption of the participation exemption by the UAE is an important and key tax policy to maintain a competitive tax regime in the region. By reducing double taxation of corporate profits, the CT regime promotes cross-border investments and encourages companies to invest in foreign entities. This helps maintain UAE’s position as a hub for companies seeking to expand and establish international operations.

Further, the proposed participation exemption regime simplifies compliance burdens by reducing the complexity of considering foreign income and complex double tax treaties for CT purposes.

We are expecting additional Decisions to be released to expand on many key provisions of the CT Law, so stay tuned. For further assistance, you can reach us by emailing CT.UAE@pwc.com.



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