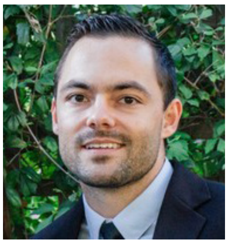
What the new UAE Corporate and Global Minimum Tax means for banks

"Understanding the impact of the global and domestic rules on jurisdictional profits, intra-group payments, investment portfolios and funds transfer pricing policies will be a significant priority for many teams and stakeholders to consider in 2022.

The proposed rules highlight the importance of the close working relationship required by tax and accounting teams to ensure all exposures are adequately managed for the benefit of the overall group and all relevant stakeholders."



Ludwig Nelson, Head of Tax, Emirates NBD

Sweeping tax reforms have had a seismic impact on the industry. Shabana Begum sheds light on the implications of the recent UAE Federal Corporate Tax (CT) announcement and Pillar 2 of the Base Erosion and Profit Shifting (BEPS) initiative.

On 31st January 2022, the UAE Ministry of Finance (MoF) announced the introduction of a Federal Corporate Tax that will apply to all UAE businesses and commercial activities alike, except for the extraction of natural resources, which will remain subject to Emirate level corporate taxation. The announcement confirmed that banking operations will be subject to UAE CT, with further details on the current Emirate level corporate taxation to be provided in due course.

The CT will apply to financial accounting periods starting on or after 1st June 2023. The announcement represents the first time that a federal tax will apply to the banking sector in the UAE (separate from the existing Emirate-level taxes that have been historically levied on branches and subsidiaries of foreign banks). For almost all banks in the country, the corporate tax rate to be applied will be linked to the OECD's (Organization of Economic Cooperation and Development) Pillar 2 or Global Minimum Tax (GMT), BEPS initiative.

On 8th October 2021, 137 countries (at the time of publication), including the UAE, reached an unprecedented agreement on the introduction of a GMT at a rate of 15%. This agreement was reinforced on 20 December 2021 with the finalization of the Global Anti-Base Erosion (GLoBE) rules.

The GMT is the second pillar of a two-pillar solution, also referred to as Base Erosion and Profit Shifting (BEPS) 2.0 as announced by the OECD. This aims to ensure that multinational enterprises pay a fair share of tax wherever they operate.

Pillar 1 seeks to reallocate taxing rights of the world's largest groups, but excludes regulated financial services companies. Meanwhile Pillar 2 seeks to apply a minimum floor to tax competition and applies to multinational groups that have consolidated turnover in excess of EUR 750 million ("in scope groups"). Importantly for the banking sector, whilst Pillar 1 excludes regulated financial services, Pillar 2 or the GMT makes no such exclusion and banks are therefore firmly in scope of the GMT rules.

Rules and implementation timeline

Whilst for calendar year-ended banks, the UAE CT won't apply until 1st January 2024, the GMT will apply from January 2023, regardless of where the in-scope groups are headquartered or resident.

The UAE CT is expected to be based on financial accounting net profit or loss with minimal adjustments expected to derive taxable income. In contrast, the GMT is considerably more technical in nature. The GMT consists of three rules: the primary rule is the Income Inclusion Rule (IIR) which along with the Subject to Tax Rule (STTR) will be implemented in January 2023. The backstop rule to the IIR is the Undertaxed Payments Rule (UTPR) which will be implemented in January 2024.

The specific extent and nature of the impact for banks in the UAE in FY23 will depend on how the jurisdictions of the in-scope groups' structure implement the rules.

The current UAE banking tax environment

At present, no traditional CT is imposed on domestic banking groups. In contrast however, each of the individual UAE emirates have corporate tax banking decrees that apply CT on oil and gas production companies and branches of foreign banks.

The banking decrees specify limitations on a) interest on inter-bank/branch lending (i.e. interest to be based on prevailing inter-bank rates) and b) deductibility of regional management/head office expenses (capped at 2.5% of revenues). This will however, change with the introduction of the announced CT, which will apply transfer pricing regulations and domestic CT across all domestic banking groups as well as any branches or subsidiaries of foreign banks that at present are subject to Emirate-level banking decrees.

For branches of foreign banks, careful consideration of how the existing Emirates tax decrees (and for example any deferred tax assets, etc. already recognized in the branch accounts) will be transitioned to the new CT regime will be required.

Tax considerations for branches of foreign banks

Assuming the UAE does not introduce the GMT in 2023, for foreign banks with operations in the UAE, the impact of the GMT in FY23, may be felt at the level of the parent jurisdiction if the UAE Effective Tax Rate (ETR) is below 15%. With a headline corporate tax rate of 20% applied to branches of foreign banks in the UAE, it may seem that a ETR below the minimum rate of 15% would be unlikely for such branches in the UAE. This is however, possible, where for example the branch of a foreign bank enjoys any "tax exempt" income and/or uses a special economic zone in its structure such as the Dubai International Financial Centre or Abu Dhabi Global Market which offer zero percent corporate tax rates in their respective zones.

Such structures have been used by many foreign banks and may well have resulted in such organizations having UAE jurisdictional ETRs below 15% under the GMT rules. For such groups, there may be a potential top up tax levied in their parent jurisdiction if their parent jurisdiction introduces the primary rule of the GMT; the Income Inclusion Rule (IIR). The IIR allows parent entities to tax profits of their low tax entities in their parent jurisdiction. In such situations, branches of foreign banks may find that any UAE generated profits that are taxed below the minimum rate of 15% (less the actual UAE ETR) are then taxed in their parent jurisdiction.

However, even where the foreign parent does not introduce the IIR, UAE branches of foreign banks may find their profits could be subject to a top-up tax under the GMT backstop rule, the UTPR. From 2024, the CT will, however, apply. Where the UAE ETR is still below the GM rate (for the potential reasons noted above), the UTPR will allow foreign group entities to tax the profits of any group entities where those profits are not already subject to the minimum tax in either their country of residence or ultimate parent entity jurisdiction.

The impact for UAE headquartered banks

The impact of the GMT for UAE headquartered banks differs when compared to branches of foreign banks. This is largely because, at present, UAE headquartered banks are still not subject to a traditional banking corporate tax, unlike their foreign peers.

As a result, UAE headquartered banks in FY23 (again assuming the UAE does not introduce the GMT in 2023) are likely to have zero or low UAE ETRs. Therefore they may be subject to the GMT from 2023 on any profits generated outside of the UAE and on any payments flowing into the UAE from group entities resident in foreign jurisdictions, by way of the STTR or UTPR. Examples of payments from group entities that are likely to be caught by the STTR include (but are not limited to) interest payments, royalties and/or management charges. From 2024, however, the domestic CT will apply. Assuming the UAE implements all of the Pillar 2 principles from 2024, all global profits (where not already taxed at 15%) of UAE banking groups will be topped up and taxed in the UAE.

Issues for banks to consider in FY22

Whilst there are expected to be differences in the way the GMT will impact UAE and foreign headquartered banks in FY23, the new rules are likely to result in additional tax cash outflow for groups in FY23 and in the future. The rules are complex: their implementation will require close collaboration between tax, accounting, and legal teams. Careful monitoring of how countries will implementthe rules will be required. All banks will need to model (and communicate to key stakeholders) the impact of the changes and take the changes into account in their FY23 forecasts and beyond.

Consideration will also need to be given to any secondary implications of the rules, for example, the impact on any credit profiles or ratings of corporate customers in investment or wholesale banking, and the pricing of long-term contracts/financial instruments. The January announcement of the UAE CT has further highlighted the need to assess the impact. Whilst the additional rules will create further cash expense across the banking sector, it is worth noting that the UAE CT rates are the most competitive in the world and are likely to be met with a reduction in license/other operating fees, allowing UAE banks to ultimately improve cash flows.

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