Changes to the M&A Tax Landscape in the Middle East With the Advent of the UAE Corporate Tax

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The M&A landscape in the region has recently gained great impetus with Sovereign Wealth Funds ("SWFs") doubling down on their investments and with the resurgence of private equity funds, both large global players and mid-market locally headquartered ones. Corporate M&A, primarily involving acquisitions of holistic businesses through share or asset acquisitions or carved out assets or synergies through a combination of two business houses / corporations, has also come back to the fore, through bolt-on acquisitions for inorganic growth and with some very strategic cross border M&A between corporates. Amidst this growth in M&A and restructuring, the introduction of the UAE Corporate Tax ("CT"), effective from 1 June 2023, brings up a new set of issues that need to be considered, given that we are in the far end of what would likely be most UAE companies' first tax year (assuming a calendar year end). This article will cover some recent practical developments relating to UAE deals, as well as with some issues that businesses should keep on their radar as a part of each deal

Our Article in Q2 of 2023 (see link here) on a related subject sought to cover some key areas where UAE CT will be relevant across the life cycle of a deal. This article focuses on some key practical tax considerations that we have witnessed throughout the life-cycle of a deal (i.e. from Non Binding Offer stage to closing) and key considerations to be factored in as you consider due diligence and structuring aspects on transactions involving UAE businesses.

A. Tax Due Diligence

Until 2022, a tax due diligence of a UAE company predominantly focused on VAT (given VAT's existence for over 5 years), along with dip-stick reviews of permanent establishment exposures in other countries -and economic substance-related filings. In the recent past, acquirers have been keen to understand the corporate tax readiness of the UAE targets that are being acquired, including but not limited to whether a UAE CT impact assessment has been undertaken and status of implementation areas identified. This tax due diligence

is by no means a UAE CT impact assessment, but the existence of a UAE CT impact assessment report would provide some comfort on the preparedness of the UAE target for UAE CT.

Some key areas that are relevant in the deal context are as follows:

- *Whether the target companies intend to form a UAE CT group as a part of it's current structure and its related impact for the acquirer* - the UAE CT law includes complex rules on companies joining an existing UAE CT group and this can be structured if the acquiring company is a newly established UAE company;
- *Whether the target companies are claiming free zone benefits of 0% tax rate* and if yes, has the target reviewed all conditions given the stringency of Article 18 of the UAE CT law coupled with relevant guides/ decisions - the availability of free zone benefits will roll back into the tax modelling for the acquirer in terms of determining the overall tax cost as a percentage of the EBITDA and related cash flows;
- *Whether the company has assessed the impact of transfer pricing* – while fairly standard around the world, the issue of transfer pricing didn't apply in the UAE prior to the implementation of the UAE CT law. Therefore, many UAE groups/ companies may have been undertaking related party transactions which may not necessarily be in compliance with OECD TP Rules and now the UAE CT law. The impact assessment should identify the inter-company transactions and determine whether the pricing/ arrangements need to change. Note that this change can have a significant impact on the financial parameters of the target being acquired.
- *Whether any overseas entities within the target structure have a risk of being deemed UAE tax residents on account of the effective control and management exercised in the UAE* - this is a risk often ignored or not considered by targets. Where the shareholders or the management is based in Dubai, this risk of effective control and management of non-UAE companies in UAE can be high given absence of CT in the past. Therefore, if a UAE HQ group has overseas subsidiaries, this review is very critical. There are also instances where companies have conceded UAE tax residency due to their inherent nature of business, in which case the non-UAE companies will need to file returns and compute taxes under the UAE CT law. This will be different from their computation of tax and potential tax liability in local jurisdictions (albeit credit for taxes paid outside the UAE may be available against UAE taxes payable).
- *Whether the target has leverage externally or within the group* - the impact of interest limitation rules, including the specific interest limitation rules for loans from related parties, should be reviewed. The rule of thumb - 30% of EBITDA as an interest break and any additional that can be carried forward for 10 years - may not apply in the case of debt taken prior to 9 December 2022 (grandfathered debt) as long as terms do not change. Additionally, the provisions of the specific interest limitation rules specify that where one of the restricted end uses apply and the lender is not subject to at least 9% tax, the entire interest amount would be disallowed in the computation of taxable income. These workings will be important to determine the overall interest limitation of the group post-acquisition and whether any impact on deferred tax assets may apply in case of carried forward unabsorbed interest.

The aforementioned are a few areas that we have come across on deals which have a material impact on transaction documentation, negotiations, EBITDA bridges and, most importantly, overall modelling. It is likely most companies will file their first tax returns by 30 September 2025 (for tax period 2024) and it is only then that the first tax return for review will be available as a part of tax due diligence. Until then, it is critical to understand pro forma computations of the target and discuss any potential tax positions that may either be unclear or potentially aggressive as a part of transaction negotiation.

B. Tax Structuring

Tax structuring, common in other markets, is now becoming more relevant in the region. Tax structuring includes evaluation of the optimal legal structure to undertake the proposed investment, location of the acquisition vehicle (UAE Mainland, UAE Free Zone or non-UAE) and allowance of the inter-play of debt and leverage as a part of the deal.

Structuring of Acquisition Vehicle

In terms of outbound deals from the UAE, acquirers may generally look to structure the acquisition in a tax efficient manner primarily from a dividend repatriation and eventual exit perspective. Whilst the UAE CT law provides participation exemption benefits for dividends and capital gains as long as conditions as per Article 23 are met, it may sometimes be an onerous exercise. There might be situations where the investee company's effective tax rate does not exceed 9% (either due to a different tax regime like Zakat or due to certain reliefs

within the corporate tax laws and in such cases participation exemption conditions may not be fulfilled. There may also be cases where it is preferable from a non-UAE perspective to make the investment through a holding company located in a country like the British Virgin Islands or the Cayman Islands (typical for fund structures). While the UAE CT law provides relaxation of the 9% subject to tax condition for 'pure holding companies, it does include meeting additional conditions such as a requirement of substance and a passive income test. In order to work around these conditions, acquirers are resorting to making investments through free zone companies where the UAE CT, law read with the relevant Free Zone Guide, considers income from holding of shares and securities to be qualifying income eligible for a 0% UAE CT rate. Under such structures, the requirement of meeting the conditions under participation exemption does not apply and as long as the free zone company has requisite substance to carry out the holding company activities and complies with transfer pricing, it should be eligible for the tax neutrality.

One of the key practical challenges which may not necessarily always be deal-related is the fourth condition of Article 23(2), i.e., the asset test. The UAE CT law prescribes that companies that have investments in structures with multiple tiers may need to test the participation exemption condition for each tier to determine whether the direct dividend and capital gains from its immediate investment is exempt. Often, investments made by family offices in the UAE or large fund of funds are structured as LPs into private equity funds outside the UAE. It may not be practically feasible to obtain information until the last level of subsidiaries in which the PE fund has invested, which results in a practical challenge for the application and evaluation of whether the condition for each of the multi tiered subsidiaries meeting the Participation Exemption under 23(2)(d) is always satisfied. Given this anomaly as on date, there is a natural migration of such investments into a free zone company where these rules do not apply and there is more certainty on tax neutrality, subject to meeting the other free zone conditions such as transfer pricing and adequate substance (subjective test)

Funding considerations

Leveraged buy outs or the impact of introducing debt push down structures for acquisitions have been doing the rounds in the global deal landscape for a while. Certain countries do not necessarily permit the acquisition of debt to acquire shares, whereas some others have beneficial provisions to include leverage as a part of an M&A transaction to obtain effective tax rate benefits.

As per the UAE CT law, interest on external debt raised by a UAE acquirer to buy shares should generally be allowable as long as the interest is subject to the 30% EBITDA cap. However, for UAE entities who are generally cash-rich or have surplus cash, (i.e., they do not need to borrow externally), debt push down structures become slightly more complex. As per the specific interest limitation rules in Article 31, interest paid on loans obtained from a related party used to acquire shares (in companies that become related parties as a result) is fully disallowed if the lender is not subject to at least a minimum tax of 9% on the interest payments (except where it can be proved that the debt is not taken to obtain a tax benefit – a subjective assessment).

Therefore, the following are some cases that may merit attention along with their tax considerations:

UAE Lender (mainland) to related UAE borrower to acquire shares	Allowed but neutral in terms of Effective Tax Rate, as a tax break will be available for borrower and income pick-up for lender assuming it is not a part of a UAE CT group. If within UAE CT group, no impact, as the transaction is eliminated.
UAE Lender (free zone) to related UAE borrower to acquire shares	Likely disallowed for a UAE borrower, as interest will not be taxed at 9% in the lender's hands and the lender is likely subject to tax at 0%; Neutral impact
UAE Lender (free zone) to a related UAE borrower for working capital or to buy land or to buy business	Allowed for the borrower as utilization is not for a restricted end use and income is potentially exempt for lender. Arbitrage created, subject to GAAR.
External lender to UAE borrower to acquire shares	Allowed in the hands of the borrower since it is third party debt, subject to 30% EBITDA rule.
UAE Lender (mainland) to non-UAE related borrower to acquire shares	Local laws for non-UAE borrower to be reviewed, if allowed, potential tax arbitrage of tax break in overseas country less 9%
UAE Lender (Free Zone) to a non-UAE related borrower to acquire shares	same as above, but potentially more of a tax break since interest income is likely taxable in UAE at 0%. Subject to GAAR.

As can be observed from the aforementioned paragraphs, UAE CT structuring on acquisition along with funding considerations, potential formation of groups and loss transfer reliefs are relevant at the time of planning an acquisition. It is imperative for acquirers to consider preparing strawman structures with various acquisition options depending on the commercial considerations of the deal coupled with related tax considerations.

C. Transaction Documentation and Deal Protection

A natural fall out of a diligence and structuring exercise is being protected in deal documentation for any past liabilities or ensuring that the target does not undertake any actions that preclude an acquirer from undertaking any tax optimization elections.

A Share Purchase Agreement/ Asset Transfer Agreement typically would have certain key areas that are relevant from a tax perspective and we have alluded to some of them along with their relevance below:

— **Definitions** – "Tax" and "Tax Authority" should be defined wide enough to cover any tax in any country as often permanent establishment or creation of taxable presence in another country inadvertently can go unnoticed.

— **Indemnities** - At the outset, there should be general indemnities to back representations made by the target in terms of tax filings, positions, compliances, documentations, audit proceedings, registrations, etc. Often general indemnities are subject to the disclosures as a part of the Disclosure Letter which are then not indemnified. Therefore, it is important to review the gravity of each issue identified in the tax due diligence and evaluate whether general indemnities are sufficient or a specific indemnity not subject to disclosures may be required. Often, specific indemnities are negotiated more heavily and therefore, the coverage should be restricted to "must-haves."

— **Period of indemnities and cap** - Tax indemnities should generally not be subject to a cap (albeit this is a hard push) and specifically be carved out of the caps for other indemnities. Additionally, tax indemnities should survive until the statute of limitations of respective tax laws applicable in each country where the target operates - by survival, it also seeks to imply that if a tax claim through an audit notice is triggered, the indemnity survives until a non-appealable order or conclusion of proceedings occurs (period of limitation for UAE CT law).

— **Closing mechanism** - **completion accounts or lock-box:** This has been a very debated matter in the recent deals and is often something that may not always have the most accurate answer. Briefly, completion accounts consider the valuation of the target until a closing date as mutually agreed, (i.e. when the consideration is paid to the seller) and in such a mechanism generally all tax liabilities until closing are borne by the seller. However, lock-box is often adopted to ensure that a particular value is locked in and generally is of a particular balance sheet date - even though closing may occur later, the value is locked in for a prior date and any profits or costs (including taxes) is to the account of the buyer based on accounting. In case a locked box mechanism is adopted, the computation of straddle period taxes generally shouldn't apply as it relates to an entire tax period. However, a completion accounts mechanism warrants closing to occur in the middle of a tax period where taxes pre-closing are on the seller's account whereas the buyer bears taxes post-closing. The key area for debate often is the amount of tax pre-closing that should go into the net debt working for straddle period taxes in a completion accounts mechanism. With the advent of corporate taxes, this is even more relevant and often one of two approaches are followed. Either an estimation is mutually agreed between the buyer and seller based on historical numbers of projections or a pro-rata for the period pre and post is agreed albeit in the latter, the final tax liability will not be unknown for sometimes over a year after closing; in such a case a hold back adjustment may take place;

— **Control of tax proceedings** - this is a commercial point but often it is very important for either party to be fully informed of any filings being made which may have an impact on the overall tax burden of the target.

— **Tax Insurance** – This is a rapidly evolving subject in the Middle East deal landscape. In mature tax markets, W&I insurances are common for tax risks including specific indemnities. Large international insurance brokers have now set up their Middle East tax practices to evaluate underwriting (through insurance companies) of risks on an M&A transaction. Whilst the insurance premium may be slightly expensive compared to the more mature tax jurisdictions given the nascency of law in the Middle East, we are seeing this as a credible alternative for protection for past tax risks (including inherent specific tax risks) for tax matters. Tax Insurance is also sought for deals where

the indemnifying party may not have strong financial backing or is a fund that may potentially be liquidated after the deal.

D. Restructuring Reliefs

The UAE CT law provides a few reliefs to qualifying groups and for certain transactions.

Article 26 of the UAE CT law provides relief for transfer of assets or liabilities between members of a qualifying group to be tax neutral. A qualifying group is defined to mean two or more taxable persons where another taxable person has more than 75% ownership interests or a similar threshold between each other (holding – subsidiary relationship). Further, neither of the taxable persons should be a qualifying free zone or exempt person under the UAE CT law. In the event of the fulfilment of such conditions, the transfer of assets/ liabilities are considered to be undertaken at book value resulting in no profit/ loss to the transferor.

Similarly, Article 27 of the UAE CT law provides that a transfer of business between two or more taxable persons where the consideration by the transferee is discharged by way of issue of shares to the transferor or its shareholder, the business restructuring relief provisions apply. In such a case, the transfer of business (including between third parties) is construed to have been undertaken at book value and therefore, tax neutral.

Articles 26 and 27 have many similar considerations and nuances:

- Claw back in case the asset/ business is sold within two years or the shareholding, either within qualifying group or by the transferor in the transferee for business restructuring is sold within two years. In such a case, the relief is clawed back and the initial transfer is considered to have been undertaken at fair market value as on the date of transfer and related tax implications ought to arise; it is crucial to ensure adequate deal protection from a sell side perspective since the primary liability on trigger of clawback (sale of shares of Transferee, liquidation of Transferee etc.) will be of the Transferor;
- In case of transactions or sell side carve outs, it is important to evaluate whether business restructuring or qualifying group reliefs have been claimed by the taxable persons and related impact on account of the impending transaction on such elections;
- If business restructuring reliefs are claimed on third party transactions, depreciation on fixed assets for the acquirer is not stepped up based on the commentary in the business restructuring FTA guide. In such a case, it is important to assess the impact of the relief on both parties and this point could be an area of negotiation where the acquirer could preclude the seller from claiming reliefs since it adversely impacts the ability to claim a higher depreciation (even if the books record the stepped up depreciation, a disallowance needs to be made).
- Both restructuring reliefs are not permitted in a case where one entity is either an exempt person or a qualifying free zone person. This may add another layer of structuring to be carried out to claim the relief as well as be mindful of the future tax implications on repatriations, subject to GAAR.
- Further, the restructuring reliefs are only allowed when the transaction is between UAE resident persons hence limiting its applicability to that extent.
- Generally, Tax Losses are permitted to be carried forward by a Taxable Person if 50% of the ownership remains the same from the year of incurring Tax Losses till the year of utilisation of such Tax Losses. Further, in case of change in ownership, Tax Losses may still be carried forward if the Taxable Person continues to conduct the same or a similar business following the change in ownership.
- Specifically, in the context of the business restructuring relief, Tax Losses of the transferor are permitted to be carried forward to the transferee when the business restructuring relief is being claimed, provided the transferee continues to conduct the same or similar business that was conducted by the transferee (similar to the general provision covered above). Relevant factors which determine whether the same or similar business is being carried out includes usage of the same assets of the transferee, no significant changes to the core identity of the business, changes should only relate to development of previously existing assets, services, processes, products, methods. It would be important to consider the future business plans of the acquirer in a case wherein the restructuring reliefs are being claimed on acquisition of loss making targets. However, a key point to take note of is that unlike losses, the UAE CT law does not provide for unutilised net interest expenditure relating to the business to be transferred to the Transferee.

E. Interaction With Pillar 2

The OECD BEPS Pillar 2 provisions simplistically apply a 15% tax at a jurisdictional level on groups that have a consolidated turnover in excess of EUR 750mn. All

GCC countries have committed to introducing Pillar 2 provisions with UAE releasing a public consultation earlier this year and Bahrain leading the pack with these rules being implemented from 1 January 2025 for groups exceeding the aforementioned threshold. The Pillar 2 provisions state that groups that are subject to these rules should pay at least 15% effective tax (reduced by certain substance based carve outs based on tangible assets and employees) in each jurisdiction where they operate – there are certain safe harbors for simplified applicability for the first three years.

From an M&A context, Pillar 2 provisions will increase the scope of tax due diligence on cross border transactions or even domestic transactions where a Pillar 2 group is involved for both, i) assessment of the applicability of Pillar 2 provisions as there are merger / demerger provisions in the OECD model rules; and ii) overall impact on the financial model for effective tax rate purposes.

Further, Pillar 2 is a jurisdictional tax provision rather than an individual entity based tax due to which the acquiring group's overall tax profile and effective tax rate in a country may be relevant.

Specifically, in locked box transactions, the target or Acquirer will need to assess the impact of Pillar 2 taxes, if any, and entity that needs to discharge such taxes. Whilst capital gains and dividends should generally not be subject to Pillar 2 rules, the impact of earn outs payable in a different year to the closing of the deal and related considerations on effective tax rate will need to be reviewed.

Whilst Pillar 2 provisions in itself are complex based on OECD principles coupled with local country applicability, the impact on M&A transactions from a due diligence, SPA protection and modelling standpoint cannot be ignored.

Key Takeaways

In light of the above discussion, we have summarised below the key areas to ensure deal coverage from a tax perspective as well as to optimise deal outcomes:

Due Diligence	— Ensure thorough examination of the target's historical (VAT) liabilities as well as preparedness for compliance with the UAE CT regulations — For any red flags noted as part of the due diligence exercise, ensure implementation steps are in place with actionable items to meet UAE CT compliance requirements — Review from a transfer pricing perspective to comply with arms' length principle as well as determine whether pricing / arrangements have to be changed going forward — Compliance with tax registration rules and whether any slippages could arise on that account (including any penalties which would have to be paid) — Identify overseas target entities which are being effectively controlled and managed from UAE and determining UAE tax position for such entities — Review of existing debt of the target in light of the general and specific interest limitation rules as well as impact of carry forward interest disallowances — Evaluate impact on the deal on utilisation of any carry forward tax attributes — Review impact of withholding tax positions adopted by the target coupled with the impact of foreign tax credits suffered by the target on overseas streamlined and covered in deal documentation — Include covenants that ensure ongoing compliance with tax obligations post-transaction — Tax Insurance considerations

Tax Structuring	— Jurisdictional and holding company evaluation is key for acquisition structures, considering post deal repatriations and exit implications — Consideration of UAE's participation exemption conditions, and relevant double tax avoidance agreement while deciding on the acquisition structure for multinational and outbound deals — Identify any tax optimisation strategies including availing of free zone benefits and implementation of such strategies — Analysis of full debt financing vs. partial debt financing in order to ensure interest utilization and assessment of a combined optimized position in tax efficient way — Review the tax model in light of the various UAE CT provisions and its impact on the overall deal price
Transaction documentation and deal protection	— Review tax definitions, tax indemnities (general and specific), period and caps relating to indemnities, disclosure letter and tax warranties to ensure adequate protection against any red flags identified — Impact of tax on the closing mechanism opted for (completion accounts or lock-box) — Control of tax proceedings post deal should be streamlined and covered in deal documentation — Include covenants that ensure ongoing compliance with tax obligations post-transaction — Tax Insurance considerations
Restructuring Reliefs	— Review of conditions for the restructuring reliefs (asset transfer / business transfer) to determine whether they can be claimed as well as impact on the impending transaction for both parties — Ensuring election is made in the return for the appropriate tax period in which qualifying group relief restructuring relief is claimed — In case the buyer / seller is a free zone person, determination if any restructuring has to be carried out to claim the free zone relief — Consideration for transfer of losses while claiming the restructuring relief on acquisition of loss making targets — Adequate protection to be incorporated in deal documentation to ensure the claw back conditions are not tripped

Interaction with Pillar 2	— Assess the impact of Pillar 2 taxes, if any, and entity that needs to discharge such taxes — Assess the impact of earn outs payable in a different year to the closing of the deal — Determine the impact on effective tax rate — Determine compliances to be undertaken in respective countries as a result of Pillar 2 applicability.

The list above serves as a guide of considerations to keep in mind during a deal, which may vary based on the specific mechanics of each transaction. By keeping the above considerations in mind, deal teams can navigate the complexities of the UAE tax regime in a deal context, ensuring a smooth transaction and safeguarding against future potential pitfalls.

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