

# ECONOMIC SUBSTANCE REGULATION IN UAE

JUNE 2020

## Overview On Economic Substance Reporting

The United Arab Emirates (UAE) released the Cabinet of Ministers Resolution n. 31/2019 with effect from 30 April 2019, concerning the Regulations for Economic Substance (ES) in the UAE. The introduction of the new ES rules is a milestone for the UAE's tax policy towards its alignment with the global Organization for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) directives

In May 2018, the UAE joined the OECD Inclusive Framework on BEPS and committed to introduce the minimum standards. One of the requirements to be adopted by the UAE refers to BEPS Action 5 which aims to prevent businesses from setting up corporate structures by relocating activities to jurisdictions with a privileged tax system for the sole purpose of benefiting from a more advantageous tax regime.

The purpose of the ES rules is to bring specific requirements for businesses to demonstrate the actual economic activity in the UAE. The UAE is in line with other jurisdictions that are parties of the OECD Inclusive Framework and have similar tax environments, i.e. no or only nominal tax (NOONs), which have also introduced ES regulations recently (for example, Bahrain, Cayman Islands, Mauritius and British Virgin Islands).

The UAE ES rules are broadly similar to the regulations introduced by other countries, as they follow the guidance issued by the EU and OECD. Essentially, there are three tests that a resident entity (or 'Licensee' as foreseen in the UAE law) that undertakes relevant activities (further details below) should fulfill to demonstrate economic substance.

Please note that any UAE commercial company in which the UAE Government, the Government of any UAE Emirate, any governmental authority or body of any of them has any direct or indirect ownership in its share capital is also excluded from the ES rules.

### Who is the subject to the Regulations?

The Regulations apply to all UAE onshore and free zone companies that carry on a "Relevant Activity". It is yet to be confirmed whether the Regulations will also apply to sole proprietorships and branches, but we expect entities incorporated under offshore (free zone) companies regulations that carry on a "Relevant Activity" to be within the scope of the Regulations.

Entities that are directly or indirectly owned by the UAE government (both federal and local) are specifically excluded from the Regulations. On this basis, UAE sovereign investment funds and other UAE government related entities would not need to meet the UAE economic substance requirements. The following are considered as “Relevant Activities” under the Regulations:

- Banking
- Insurance
- Fund management
- Lease-finance
- Headquarters
- Shipping
- Holding company
- Intellectual property (IP)
- Distribution and service centre

## What are the economic substance requirements?

To satisfy the economic substance requirements in relation to a Relevant Activity, a Relevant Entity must Economic Substance Test:

1. The ‘Directed and Managed’ Test: The entity will need to be directed and managed in the UAE with regards to the relevant activity (for example: frequent board meetings, quorum of directors physically present, minutes of all board meetings kept in the country, etc.)

2. The ‘Core Income Generating Activities (CIGA)’ Test: The entity that performs any of the relevant activities for the purpose of the ES rules will need to demonstrate that the relevant CIGAs have been undertaken in the UAE. The criteria for the CIGA Test vary depending on the relevant activity in question. Below we have listed them and what is expected as core income generating activities conducted in the UAE to be compliant with the ES rules:

- The ES rules in the UAE allow that CIGAs can be outsourced to a corporate service provider in the UAE, subject to proper supervision by the entity. However, the economic substance of service providers will not be counted multiple times by multiple entities when evidencing their own substance in the UAE.
- Pure Holding Companies (which exclusively earn dividends and capital gains income) are subject to a lighter economic substance scrutiny on the basis that a reduced test is applied: (i) compliance on the submission of documents, records and information to the relevant UAE Regulatory Authority and (ii) adequate number of employees and premises for holding and managing the business.

- In the event of the Holding Company earning additional relevant activity income besides dividends and capital gains (for example, management fees, service charges, etc.), the standard three level Economic Substance Test would need to be observed for that additional activity. Please note that the legislation does not bring any materiality threshold, so unless the guidance brings additional clarity on this matter any additional income earned by holding company would need to meet the ES rules.
- It is important to highlight that for the purpose of the ES rules, the relevant activities of (i) Distribution and Service Centre and (ii) Intellectual Property refer to transactions/charges with foreign related parties only. Therefore, regular commercial business for such activities with non-related parties would not be covered by the new rules.

3. The 'Adequate' Test: The entity will need to have an adequate number of qualified employees in the UAE, incur adequate expenditure in the jurisdiction and have adequate physical presence in the country. The applicability of the 'Adequate' test will be dependent of the particular facts and should vary on a case by case basis. The UAE regulations foresee that a guidance will be issued to clarify any expression or concept covered by the law, including the meaning of 'adequate'.

## What are the reporting requirements?

The UAE Regulatory Authority has 6 years to assess the compliance of an UAE entity with the ES rules during any financial year within this period. In order to monitor and control the adherence of the UAE entities with the new rules, an annual report will need to be submitted to the Regulatory Authority within 12 months after the end of the financial year. The annual report shall include information that demonstrates the compliance with the Economic Substance Test, such as the type of relevant activity, location of the place of business, number of full time employees, information supporting the CIGA elements and details on the outsourced activity.

## What are the non-compliance charges?

In the event of any non-compliance of the Economic Substance Test, the UAE legislation foresees penalties of up to AED50,000. If the UAE entity fails to comply with the ES rules in a subsequent financial year, penalties can be imposed at up to AED300,000 and other administrative actions can be applied including the suspension, exclusion or non-renewal of the company's trade license.

# How can Parker Randall Assist?

Parker Randall UAE as one of the leading tax and business advisory firms in United Arab Emirates, Parker Randall UAE can assist for successful compliance with Economic Substance regulations. We are delighted to offer you the following services in relation to ES:

- Assisting the entity to get a clear understanding of the ES resolution and its requirements.
- Conducting a study in order to assess if the entity is subject to ES reporting requirements under the new resolution.
- Assisting the entity to prepare ES report in compliance with relevant legislations and within the time deadline.
- Reviewing the ES reporting of the Entity to ensure compliance with the OECD and local authority requirements.
- Follow up with the relevant local authority inquiries for further information and documentation for the submission.

# Contact us

If you have a question, would like some advice regarding your business or personal affairs, get in touch with us today, we'd love to hear from you. We know not everyone wants to complete a form, and at the same time not everyone wishes to pick up the telephone, therefore, we've made it as easy as possible for you to contact us.

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