

UAE new approach to economic substance regime

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Due to the light taxation regime, the UAE has been a preferred choice for many businesses as a jurisdiction in which to firm their operations. The UAE is a member of the Organisation for Economic Co-operation and Development ('OECD') and as such, it is subject to the Base Erosion and Profit Shifting ('BEPS') regime.

The BEPS particularly looks after globally adopted measures to tackle tax avoidance, improvement of the coherence of international tax rules and ensures a more transparent tax environment. As part of the UAE's commitment as a member of the OECD Inclusive Framework, and in response to an assessment of the UAE's tax framework by the European Union Code of Conduct Group on Business Taxation, the UAE introduced the Economic Substance Regulations ('ESR'), on 30 April 2019 under Cabinet of Ministers Resolution No 31 of 2019 and Guidance to the application of the ESR.

Recently, the UAE Cabinet of Ministers made certain amendments to the ESR to ensure regular recording and reporting of all the economic activities undertaken by UAE entities, including companies, branches and representative offices.

On 10 August 2020, the UAE Cabinet of Ministers issued Resolution No. 57 of 2020 ('New Regulation') where it addressed those changes. The New Regulation replaced the original legislation, in particular the Cabinet of Ministers Resolution No. 31 of 2019. The New Regulation has a retrospective application to licensees, from financial years starting on or after 1 January 2019.

Subsequently, on 19 August 2020, the Ministry of Finance ('Ministry') issued the revised guidelines, under Ministerial Decision No. 100 of 2020 ('New Guidelines'). Finally, the Ministry, on their website, made available a helpful set of sample questions with answers concerning the economic substance regime. In this article, we will highlight some of the more prominent provisions introduced under the New Regulation and the New Guidelines.

What Is new?

The key developments under the economic substance regime introduced under the New Regulation and New Guidelines are as follows:

1. **Definition of licensee:** The regime only applies to: (i) juridical persons (persons with separate legal personality); and (ii) unincorporated partnerships registered in the UAE, each of which shall conduct a "relevant activity" in the UAE. Therefore, natural persons, sole proprietors, trusts and foundations no longer fall within the scope of the regime.
2. **Introduction of "Exempted Licensee" category:** The New Regulation introduced a new category of licensees, i.e. "Exempted Licensees". The Exempted Licensees are not required to meet the economic substance test or submit the economic substance report. However, they are required to

submit the economic substance notification along with the documents/information evidencing the fact that they are exempt from the application of the economic substance regime. The Exempted Licensee category includes an entity that is:

- an investment fund;
- a tax resident outside the UAE;
- wholly owned by UAE residents and (i) is not part of a multinational group; and (ii) only carries out business in the UAE; and
- a licensee that is a branch of a foreign entity, whose relevant income is subject to tax in a jurisdiction other than the UAE.

Entities directly or indirectly owned at least 51 per cent by the UAE government are no longer specifically exempted from the application of the regime.

3. **Branches status:** The New Guidelines confirm that branches do not have a separate legal personality from their “parent” or a “head office”. The “head office”/“parent” entity of the branch registered in the UAE must report any relevant activities of its branches in a single consolidated notification and submit a single economic substance report that also addresses its branches. The Ministry clarified that a UAE branch of a foreign entity that carries out a relevant activity would be required to comply with the New Regulation as if it were a separate legal person, unless the relevant income of the branch is subject to tax in the jurisdiction of the foreign head office/ parent entity. Where a UAE entity carries on a relevant activity through a branch registered outside the UAE, the UAE entity is not required to consolidate the activities and income of the foreign branch for purposes of the New Regulation, provided the relevant income of the foreign branch is subject to tax in the foreign jurisdiction where the branch is located.
4. **Scope of “distribution and service centre business” activity:** Under the New Regulation, we find an amended definition of “distribution and service centre business”. Specifically:
 - there is no longer a requirement for the goods to be imported and stored in the UAE for an entity to be considered a “distribution and service centre business”; and
 - there is no longer a requirement for the services to be provided in connection with a business outside the UAE. As a result, the provision of a service by the licensee to a foreign related party would be considered a “distribution and service centre business”.
5. **Scope of “high risk intellectual property” licensee:** Under the revised regime, the definition of a high-risk intellectual property licensee has been limited to an intellectual property business which:
 - did not create the intellectual property asset;
 - acquired the intellectual property asset from either: (i) a connected person; or (ii) in consideration for funding research and development by another person situated in a foreign jurisdiction; and
 - licenses or has sold the intellectual property asset to a connected person or earns separately identifiable income from a foreign connected person in respect of the use or exploitation of the intellectual property asset.
6. **“connected person” and “group”:** The amended definition of a “connected person” has been introduced. It provides, entity A is a “connected person” to entity B if the two entities form part of the same group. A “group” has been defined as two or more entities related through ownership or control such that they are required to prepare consolidated financial statements for financial reporting purposes under the applicable accounting standards.
7. **Re-submission of Notification:** Licensees that have already submitted the economic substance notification directly to their regulatory authorities, are required to re-submit a notification under the Ministry’s portal once available.
8. **Economic Substance Report:** The licensees are now required to provide financial reports as part of the economic substance report submission.
9. **Penalties for non-compliance:** An administrative penalty of AED 20,000 (US\$ 5,500) is now imposed on a licensee or exempted licensee who fails to submit the economic substance notification. Previously, the penalty for failure to notify ranged between AED 10,000 (US\$ 2,750) and AED 50,000 (US\$ 13,650). A licensee or exempted licensee who fails to submit the economic substance report or satisfy the economic substance test for each financial year will be subject to an administrative penalty of AED 50,000 (US\$ 13,650). Where the licensee or exempted licensee repeatedly fails to meet the economic substance test or submit the economic substance report, the penalty has been increased

from AED 300,000 (US\$ 81,700) to AED 400,000 (US\$ 108,900) and the licence of the licensee or exempted licensee may be suspended, revoked or refused renewal by the regulatory authority.

10. **Introduction of National Assessing Authority:** The Federal Tax Authority has become the “National Assessing Authority” to oversee the compliance and control with the New Regulations. The role of the specific free zone/ onshore regulatory authorities will be limited to the collection of information from licensees and reporting of such information to the National Assessing Authority. **What does the future hold?**

As the immediate steps we encourage each licensee (including the exempted licensee) to submit:

- the notification electronically on the Ministry portal within six months from the end of their financial year.
- the economic substance report within twelve months following the end of their financial year end (i.e. by 31 December 2020 for the financial year ended 31 December 2019).

The regime is still new to the overall UAE legal framework. Businesses, their advisors as well as authorities are yet to understand the various aspects of this regime and how to best approach the requirements in practice. As with many legislative novelties, most would agree that the key will be to achieve a balance between encouraging businesses to comply, but at the same time, adopting a sufficiently flexible approach that can fit the variety of business models that function in today’s business world.

As far as the immediate future is concerned, it is critical for businesses in the UAE to commence preparations immediately, re- assess their UAE position under the New Regulation and consider whether any restructuring of its business operations should be undertaken to satisfy the economic substance test, to avoid potentially substantial sanctions being imposed.

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