



## Economic Substance Regulations - New Regulations for Conducting Business in the United Arab Emirates

The United Arab Emirates ("UAE") has recently enacted Economic Substance Regulations. Such rules generally serve to combat tax avoidance by ensuring that the income earned by a company in a state is consistent with the volume of business carried out in such state and the operational infrastructure maintained therein. Following the introduction of Economic Substance Regulations in the UAE, all companies licensed in the UAE will now have to deal with this subject matter. Violations of the Economic Substance Regulations are punishable by fines, further administrative penalties and reports to foreign tax authorities. Do you know your obligations? We will answer the most important questions below:

### 1. What is the reason for issuing Economic Substance Regulations in the UAE?

In December 2017, the European Union ("EU") added the UAE to the list of non-cooperative countries for tax purposes (so-called black list). As a result, transactions between the UAE and member states of the EU were subject to special monitoring and reviews.

However as early as January 2018, the UAE was removed from the black list and added to the EU's so-called grey list instead after having confirmed immediately after publication of the black list to comply with EU standards by 31.12.2018. Thereupon, the UAE joined the Inclusive Framework on Base Erosion Profit Shifting ("BEPS") of the Organisation for Economic Cooperation and Development in May 2018. Such accession obliged the UAE to implement the BEPS recommendations, which serve to combat harmful tax competition between states and aggressive tax planning by multinational corporations.

Since the UAE had not taken any follow-up measures by 31.12.2018, it was again blacklisted by the EU in March 2019.

In response, the UAE Cabinet adopted Cabinet Resolution No. 31 of 2019 concerning Economic Substance Regulations on 30.04.2019 as well as Cabinet Resolution No. 58 of 2019 on 04.09.2019. In addition, on 11.09.2019, the Ministry of Finance issued Ministerial Decision No. 215 of 2019, which contains specific implementing provisions. All three sets of rules together currently form the so-called Economic Substance Regulations of the UAE.

Following the introduction of the Economic Substance Regulations, the EU decided to remove the UAE from its black list in October 2019.

### 2. Which companies are affected by the Economic Substance Regulations?

At the moment, the scope of application of the Economic Substance Regulations is interpreted in several ways.

#### a. Qualified License Holders

According to the wording of the Economic Substance Regulations, the provisions only apply to so-called licensees, i.e.

companies that hold a license issued in the UAE which entitles them to carry out a relevant activity in the UAE ("Qualified License Holders").

#### aa. License

A Qualified License Holder may be a natural person or a corporate entity. The legal form of the licensed company is irrelevant. Included are limited liability companies and branches (also those with the activity of representative office) as well as civil partnerships and sole establishments. It is further irrelevant whether the license was issued by an authority in the territory of the UAE or in a free zone (including the authorities in financial free zones, i.e. Dubai International Financial Centre and Abu Dhabi Global Market).

Only companies in which the UAE federal government or the government of a single Emirate or any governmental authority or body of any of them directly or indirectly holds at least 51% of the shares are excluded from the scope of the Economic Substance Regulations.

#### bb. Relevant Activity

A Qualified License Holder must be licensed to carry out a relevant activity. Activities in the following sectors constitute a relevant activity ("Relevant Activity"):

- Banking
- Insurance
- Investment Fund Management
- Lease-Finance
- Headquarters
- Shipping
- Holding Company
- Intellectual Property
- Distribution and Service Centres

#### b. Normal License Holders

Although the Economic Substance Regulations explicitly refer to a Relevant Activity, it can, at present, not be ruled out with certainty that companies which are not licensed to carry out a Relevant Activity ("Normal License Holders") are also affected by the new provisions.



### 3. What are the obligations of a license holder?

The Economic Substance Regulations set out annual obligations towards the concerned authority ("Regulatory Authority"). The scope of the obligations essentially depends on the type of business activity and must be reassessed each year. The Economic Substance Regulations distinguish between a notification requirement and a reporting requirement.

#### a. Regulatory Authority

Various authorities serve as Regulatory Authority. The decisive factors for determining the competent Regulatory Authority in the individual case are the Relevant Activity itself as well as the location where such Relevant Activity is carried out (i.e. mainland, free zone or financial free zone).

#### b. Notification Requirement

All Qualified License Holders are obliged to notify the Regulatory Authority on an annual basis.

The obligation to notify extends to information on the beginning and end of the Qualified License Holder's financial year. It must also be stated whether the Qualified License Holder is conducting a Relevant Activity. If this is the case, the Qualified License Holder must submit information on whether income earned in the UAE is subject to taxation outside the UAE.

It is unclear yet whether Normal License Holders will also have to comply with the notification requirement. In this respect, the administrative practice of the competent Regulatory Authority remains to be seen.

#### c. Reporting Requirement

In addition to the notification requirement, Qualified License Holders who conduct a Relevant Activity and derive income therefrom in the UAE ("Qualified License Holders Required to Report") must demonstrate to the Regulatory Authority each year that they have a sufficient degree of economic substance in the UAE which allows them to actually carry out the Relevant Activity in the UAE. In this regard, the passing of the so-called Economic Substance Test is required.

##### aa. Income

The Economic Substance Regulations do not contain details with respect to the term "income", such as a definition or information on minimum amounts.

##### bb. Economic Substance Test

As part of the Economic Substance Test, a Qualified License Holder Required to Report must demonstrate that the Relevant Activity it carries out has sufficient economic substance in the UAE. Generally, all of the following criteria need to be satisfied in order to pass the Economic Substance Test:

- Conducting so-called State Core Income Generating Activities ("CIGA") in the UAE
- Directed and managed in the UAE in relation to the CIGA
- Employing an adequate number of qualified full-time employees in relation to the CIGA who are physically present in the UAE
- Incurring an adequate level of operating expenses in the UAE
- Maintaining adequate physical assets in the UAE
- When outsourcing activities to third party providers, monitoring and controlling these activities

A Qualified License Holder Required to Report who carries out several Relevant Activities and generates income therefrom in the UAE must satisfy the criteria of the Economic Substance Test for each Relevant Activity.

Less stringent requirements under the Economic Substance Test apply to holding companies which generate their income exclusively from dividends and capital gains and which do not engage in any other Relevant Activity. In contrast, stricter requirements are provided for Qualified License Holders Required to Report who generate income from intellectual property assets that are considered "high-risk".

The question of whether or not a Qualified License Holder Required to Report passes the Economic Substance Test is to be answered on case-by-case basis. By way of example, the list of CIGA set out in Cabinet Resolution No. 31 of 2019 is not exhaustive. It merely mentions the most important activities that a Qualified License Holder Required to Report must undertake in the UAE. In individual cases it may be necessary to conduct further activities in the UAE in order to prove the existence of adequate economic substance in the UAE. The same applies to the other criteria for passing the Economic Substance Test.

On the one hand, the Economic Substance Regulations contain detailed provisions on what Qualified License Holders Required to Report need to do in order to meet the individual requirements of the Economic Substance Test. Among other things, it is stipulated that directors and managers must have the necessary knowledge and expertise for managing and directing and must not only give effect to decisions being taken outside the UAE. In addition, as evidence of management and directorship in the UAE, meetings of the board of directors shall be held in the UAE with adequate frequency. At such meetings, a quorum of directors must be physically present in the UAE. On the other hand, the Economic Substance Regulations oftentimes refer to the unspecified legal term "adequate" in order to define the requirements to be met by Qualified License Holders



Required to Report. However, it remains unregulated what is to be regarded as "adequate". Instead, such specification is left to a case-by-case consideration which depends on the nature and level of the Relevant Activity being carried out. In this respect, among others, the operational infrastructure maintained in the UAE should be in proportion to the income generated in the UAE.

The Regulatory Authority is instructed to take a strict yet pragmatic approach when applying the Economic Substance Regulations.

#### **cc. Outsourcing**

It is noteworthy that the Economic Substance Regulations explicitly allow outsourcing to third parties in order to satisfy the prerequisites for passing the Economic Substance Test.

For example, Qualified License Holders Required to Report may use service providers or their employees (such as office assistants) to carry out part of their CIGA. However, it has to be ensured that third party service providers themselves always have adequate levels of activities, employees, expenditures and premises in the UAE. Additionally, all parts of the CIGA transferred to a third party service provider must be undertaken in the UAE.

#### **dd. Scope of Reporting Requirement**

Qualified License Holders Required to Report are obliged to report, inter alia, the type of Relevant Activity conducted, the amount and type of income generated therefrom, the amount and type of operating expenses and assets in respect of the Relevant Activity, the number of personnel who are responsible for carrying out the Relevant Activity as well as the location of the place of business. Finally, a declaration has to be included as to whether or not the Economic Substance Test has been passed.

Additional information must be provided in case of high-risk Intellectual Property business.

The same applies when outsourcing to third party service providers. Evidence must be given that the outsourced activity is a CIGA being undertaken in the UAE and that the Qualified License Holder Required to Report has adequate supervision in terms of the CIGA outsourced. Finally, a report must be submitted to the Regulatory Authority demonstrating that the activities, employees, operating expenses and premises of the third party service provider are adequate in relation to the level of the activities outsourced.

#### **ee. Administrative Right to Review**

The Regulatory Authority is authorised to request from a Qualified License Holder Required to Report detailed documentation on the adequacy of the resources used and expenditure made in the UAE when reviewing the Economic Substance Test.

It is important to note that the Regulatory Authority is not required to exercise its right to review as to whether or not a Qualified License Holder Required to Report has passed the Economic Substance Test immediately after having received the report. In fact, the Regulatory Authority may decide within six years from the end of each financial year. This six-year period does not apply in cases where the authority is not able to reach a decision due to gross negligence, fraud or deliberate misrepresentation by a Qualified License Holder Required to Report or a third party. In such cases, no expiry of the review period seems to exist.

#### **d. Form of Notification and Report**

The Regulatory Authority will determine which formal requirements are to be complied with in terms of notification and report. As such guidelines have not been published yet, it remains to be seen whether notification and report including annexes will have to be submitted in paper form. It is more likely that, under the auspices of paperless administration, electronic transmission will be required.

According to the Economic Substance Regulations, all documents must be submitted in English. If documents are written in another language, an English translation must be provided. Arabic translations are not required.

#### **e. Deadline for Complying with Notification Requirement and Reporting Requirement**

With regard to the deadline for compliance with the notification requirement, the Economic Substance Regulations do not contain clear provisions yet. However, it should be possible to submit the notification from 01.01.2020 onwards.

The report, however, if required, must be submitted to the Regulatory Authority within twelve months from the end of each financial year.

#### **4. Which penalties can be imposed for non-compliance?**

Non-compliance with the obligations set out in the Economic Substance Regulations or failure to pass the Economic Substance Test may result in various penalties.

In the event of non-compliance with requirements or provision of inaccurate information, a fine of AED 10,000 to AED 50,000 may be imposed.

A fine of AED 10,000 to AED 50,000 may also be handed down if a Qualified License Holder Required to Report fails to pass the Economic Substance Test for the first time. If the test is not passed again in the following financial year, a fine of AED 50,000 to AED 300,000 may be imposed. Finally, the Regulatory Authority may order the suspension, revocation or non-renewal of the license in the event of repeated infringement. As a result, conducting business in the UAE would no longer be possible.



In the event of failure to pass the Economic Substance Test, the Ministry of Finance is additionally authorised, under certain conditions, to inform foreign authorities (e.g. at the headquarters of the parent company or at the headquarters of the ultimate beneficial owner of a Qualified License Holder Required to Report) that such license holder does not have sufficient economic substance in the UAE.

#### **5. What actions should license holders take now?**

Given that the scope of application of the Economic Substance Regulations is still unclear, every license holder is called upon to attend to the new provisions in a timely manner and take precautionary actions, if not done so yet.

##### **a. Obtaining information**

First, all license holders should familiarise themselves with the requirements of the Economic Substance Regulations. They should also keep an eye on current developments as it is likely that further regulations will be issued in the future, e.g. on form and deadlines for obligations.

##### **b. Critically reviewing current business operations**

In addition, expert advice should be sought as to whether a Relevant Activity is carried out and whether income is generated therefrom in the UAE. In this case, the Economic Substance Test must be conducted and passed on an annual basis.

##### **c. Adapting business operations where required**

In order to satisfy all requirements of the Economic Substance Test, changes in business operations may have to be promptly undertaken by a Qualified License Holder Required to Report, such as hiring additional employees in the UAE and/or relocating board meetings to the UAE. This applies in particular if, as of now, parts of the business operations have been conducted from abroad and no significant operational infrastructure has been maintained in the UAE.

##### **d. Observing deadlines for submission of notification and report**

Since the Economic Substance Regulations apply to companies whose financial year began on or after 01.01.2019, at least all Qualified License Holders must, in order to avoid penalties, already comply with the notification requirement for the year 2019.

The same applies to all Normal License Holders if the scope of the Economic Substance Regulations is interpreted in a wider manner. They should urgently keep an eye on the administrative practice of the competent Relevant Authority to avoid a breach of any notification requirement that may exist.

Furthermore, Qualified License Holders Required to Report must additionally submit a report to the Regulatory Authority in due time to avoid penalties. Qualified License Holders Required to

Report whose financial year began on 01.01.2019 and will end on 31.12.2019 must comply with the submission requirement on 31.12.2020 at the latest.

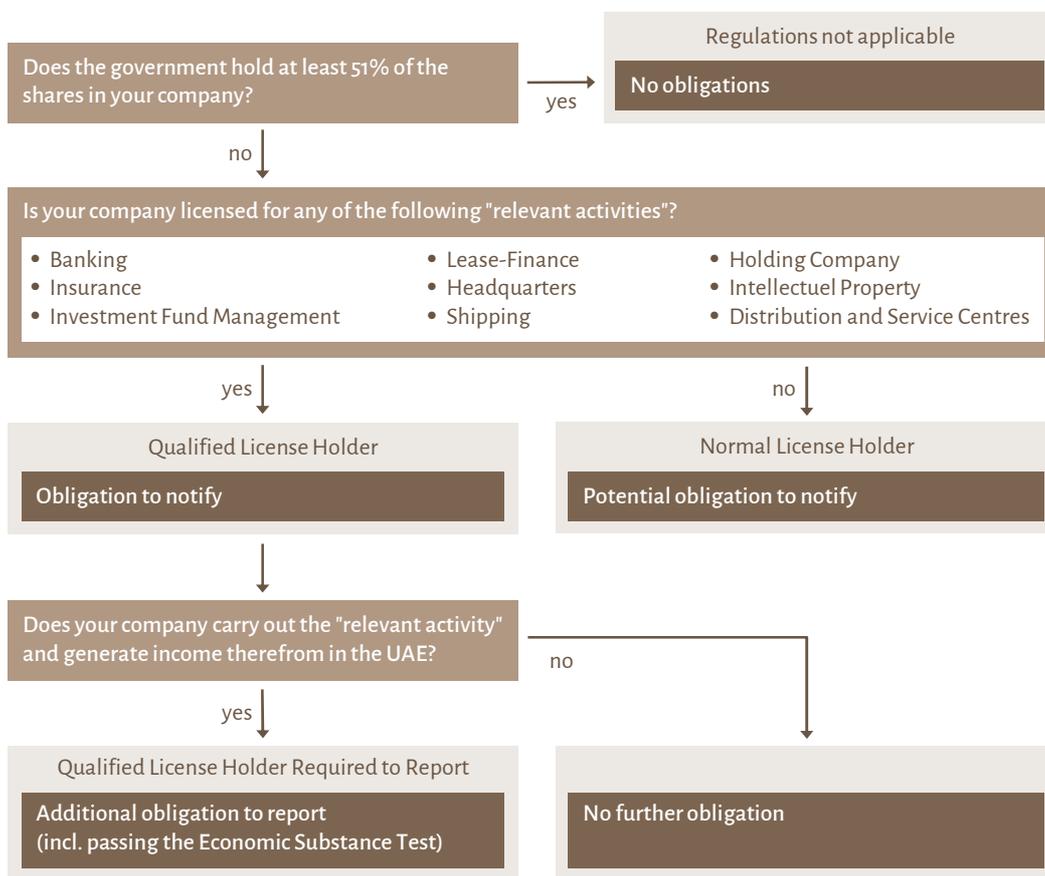
##### **e. Producing and archiving documentation**

Finally, all license holders are well advised to immediately start to prepare the documentation required of them (if any) according to the Economic Substance Regulations.

Qualified License Holders should immediately commence producing a significant amount of documentation that allows an assessment as to whether or not a Relevant Activity is being carried out. Qualified License Holders Required to Report must collect evidence to show that the Economic Substance Test was passed. In accordance with the Regulatory Authority's right to review, they should retain all records for a period of at least six years. Even Normal License Holders should (at least until a different administrative practice has been established) produce and retain documents that allow them to comply with the notification requirement that may apply.



## Economic Substance Regulations: What are your obligations?



### Do you have questions? - We would be glad to answer them!

From our office located in the heart of Dubai, our team of German attorneys has been advising small and medium-sized companies, corporations and individuals on the laws of the United Arab Emirates for more than a decade. Our areas of expertise include corporate and commercial law (in particular business set ups), commercial agency law, employment law as well as tenancy and real estate law. We would be happy to attend to your questions as well. Contact us!

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