



# UAE ECONOMIC SUBSTANCE REGULATION

## GUIDELINES FOR COMPLIANCE AND FILING

A Member Firm of **Andersen Global**

# INTRODUCTION



Economic Substance Regulation (ESR) prevents large businesses, mostly multinational establishments, from shifting profits to other lower or no income tax jurisdictions without many business activities in that jurisdiction for benefiting from lenient corporate tax laws. The UAE is considered one of these low-tax jurisdictions.

The UAE announced ESRs (the “Regulations”) in April 2019, subsequently amended by Cabinet Resolution No.57 of 2020 in August 2020, which mandated a requirement for UAE business establishments to maintain an adequate “economic presence” relative to the economic activities they undertake in the UAE.

All UAE onshore and free zone companies including some other business forms that undertake one or more “Relevant Activity” (RA) for financial years commencing on or after 1 January 2019 come under the purview of economic substance requirements.

Entities fulfilling the exemption criteria are treated as “exempt” and do not require to demonstrate economic presence in the UAE. Such entities, however, are needed to file a Notification and provide sufficient proof in support of their exempt status.

The rolling out of ESR brings the UAE in line with other jurisdictions that have recently issued economic substance legislation such as the Cayman Islands, Bermuda, etc. and affirms the UAE’s commitment to addressing concerns around the Base Erosion and Profit Shifting (BEPS) by certain multinational and mobile business activities to zero or low tax jurisdictions without having corresponding economic activities locally.

Business entities in UAE must now evaluate if their activities fall within the scope of the economic substance regulations and implement measures to ensure they meet the economic substance requirements in respect of each of these RAs. The evaluation must be in both qualitative and quantitative form considering financial, operational, legal, taxation, transfer pricing and governance aspects.

## THE APPLICABILITY

Resolution No. (57) of 2020 dated 10 August 2020, and updated Guidance was announced on 19 August 2020 (Ministerial Decision No. (100) of 2020). The Regulations mandate UAE onshore and free zone companies and certain other business forms that perform any of the below-mentioned "Relevant Activities" to maintain and demonstrate evidence of an adequate "economic presence" in the UAE relative to the activities they undertake through "Economic Substance Test."



## The Relevant Activities include



An approach of substance over form is undertaken to determine the relevant activity implying predominantly a focus on the actual activity being carried out rather than the activity stated on the commercial license.

## ESR COMPLIANCE STEPS



According to the international standard issued by the Organisation for Economic Cooperation and Development ("OECD") Forum on Harmful Tax Practices, the UAE announced the ESR legislation that requires entities engaged in geographically mobile businesses to have substantial activities in the UAE.

Besides the issuance of a global standard by the OECD, the European Union Code of Conduct Group ("EU COCG") also embraced a resolution on a code of conduct for business taxation focused on preventing harmful tax practices. The UAE Cabinet of Ministers enforced the ESR Regulations taking into account the relevant standards developed by both the OECD and the EU COCG.

ESR compliance must be mandatorily done for every financial year and companies are needed to do an assessment of their activities and transactions for each financial year and take action accordingly for the filing requirement with the UAE Ministry of Finance (MOF).

**ESR Compliance shall be performed in three steps which include :**





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## Notification

All transactions must be carefully assessed by the companies to identify the relevant activities and must adhere to the substance over form approach while assessing relevant activities. A clear and thorough understanding of the Business Model and corporate structure and suitably and adequately identifying the applicability of Relevant Activity are vital to filing the ESR Notification. June 30, 2020 was the deadline for filing ESR Notification for the majority of the Free Zones and Mainland Companies for the assessment year from January 01 to December 31, 2019. Only a few free zones extended the deadline till July 31, 2020.

Notification is meant to provide the Regulatory Authorities with certain initial information related to Licensees and their activities in the UAE for the relevant Reportable Period. The information provided with the Notification is vital for filing an Economic Substance Report for the same period if needed.

A corporate entity such as a Limited Liability Company, Public Joint Stock Company, Private Joint Stock Company, etc. or a partnership, Limited Liability Partnership, General Partnership etc. that carries out any of the nine applicable Relevant Activities in the UAE during the relevant Financial Year must file a Notification.

Any UAE business carrying out one or more of the RAs during the relevant Financial Year is referred to as a Licensee. When a business entity undertakes one or more of the above activities but is exempt from certain requirements as per the Economic Substance regulations, the entity is referred to as an Exempted Licensee.

## Whether a Licensee or an Exempted Licensee, filing of Notification is **Mandatory**



Businesses must report all RAs undertaken during the Financial Year, irrespective of whether the RA was conducted intermittently or throughout the Financial Year.

Multiple Licensees cannot file a single Notification and each Licensee must file a Notification individually, irrespective of whether the Licensee is part of a consolidated group for accounting or VAT purposes.

A branch, however, doesn't need to file a separate Notification from its head office and the UAE head office/parent company must file a single consolidated Notification that includes details of all the branches in the UAE undertaking a Relevant Activity irrespective of whether the head office carries out a Relevant Activity itself.

The Notification needs to be filed within six months from the financial year-end of the Licensee and the Notification must be submitted electronically on the ESR portal of the Ministry of Finance.

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## ECONOMIC SUBSTANCE TEST

Entities that are engaged in any of the above relevant activities in the UAE must prepare for the Economic Substance Test and should ensure the following

- **Conduct the Core Income-Generating Activity (CIGA) in the UAE**
- **Be directed and managed in the UAE with an adequate level of qualified full-time employees, operational expenditure and physical assets present in the UAE to conduct the CIGA.**
- **Prepare and file a compliance report with the regulatory authority containing information in respect of compliance with the UAE Economic Substance Test**

The UAE ESR has not specified any minimum standard for “Adequate” or appropriate Economic substance as businesses often vary in size and nature and the nature of the activity and the level of income earned by the licensee are taken into account to determine the adequate economic substance.

The Licensees belonging to the same group need to demonstrate the economic substance individually.

Assessment of economic substance on a consolidated basis is not permitted by the UAE regulatory authorities.


ESR in the UAE mandates the Licensee to conduct board meetings and the minimum number of meetings needed is determined based on the nature and level of the Relevant Activity.





## The Following Conditions must be Fulfilled by the Licensee for Conducting the Board Meetings :

- ② The directors need to be physically present in the UAE
- ② The minutes of the meeting must be signed and maintained in the UAE



As per the ESR in the UAE, the employees conducting the CIGAs of the Licensee must be residents in the UAE. Under certain circumstances, however, the non-resident employees will also be counted about the economic substance of the Licensee subject to meeting the following conditions :

- ② The relevant activities should be conducted during the physical presence of the employee in the UAE and strictly under the supervision of the Licensee.
- ② The costs of the non-resident employee are the responsibility of the Licensee.

The ESR in the UAE does not require the directors to be a resident in the UAE for economic substance purposes. Their physical presence, however, in the UAE during the board meetings of the Licensee is mandatory.

The directors are considered employees when they carry out the CIGAs along with their fiduciary duties, for the purpose of the UAE Economic Substance Test.

The regulations don't permit the Licensee to make use of the UAE Tax Residency Certificate as proof to show an adequate economic presence in the UAE as the process of obtaining a Tax Residency Certificate just requires a minimum period of presence in the UAE.





Economic Substance Reporting is meant to provide the National Assessing Authority with information of the Licensee and the income, expenditure, assets, employees and governance related to its Relevant Activities in the UAE.

An Economic Substance Report need to be filed by a corporate entity unless an Exempted Licensee and derives Relevant Income from any of the applicable Relevant Activities during a Reportable Period.

Individual Licensees must file an Economic Substance Report on a stand-alone basis, irrespective of whether the licensee becomes a part of a consolidated group for financial reporting or VAT purposes.

A corporate entity in the UAE operating through one or more branches registered in the UAE needs to report the Relevant Activities of its own and its other UAE branches in one composite Economic Substance Report.

The Economic Substance Report must be filed with the Regulatory Authority with which the entity's Head Office is registered.

A UAE branch belonging to a foreign entity is not needed to file an Economic Substance Report if the Relevant Income of the UAE branches are reported and subject to tax in the jurisdiction of the foreign parent entity.

If a UAE entity undertakes a Relevant Activity through a foreign branch or permanent establishment which is subject to tax in the foreign jurisdiction, the entity should exclude its Economic Substance Report of the Relevant Income, assets, expenditure and employees of the foreign branch or permanent establishment.

The deadline for filing an Economic Substance Report is 12 months from the financial year-end of the Licensee. The Report must be submitted electronically on the ESR portal of the Ministry of Finance.

## PENALTIES

**ESR regulation in the UAE is binding by law and any non-compliance with the regulation attracts hefty penalties**

- Failure to file a Notification attracts AED 20,000 monetary sanction.
- Failure to file a Report imposes AED 50,000 penalties and is deemed as a failure to meet ES Tests.
- Failure to provide accurate or complete information also deemed as failure to meet ES Tests and attracts AED 50,000 penalty.
- Failure to meet ES Tests attracts penalties amounting to AED 50,000 for the first year including Information exchange with foreign competent authorities. In the 2nd consecutive year, the fine amounts to AED 400,000 including Information exchange with foreign competent authorities and suspension, cancellation or non-renewal of trade license.

## ESR COMPLIANCE PROCEDURE

- **Assessing the impact**
- **Initial Gap Analysis & Action Plan**
- **Reporting**



A UAE company falling under the scope of ESR must initiate the following activities to remain compliant with the legislation. The company is allowed to outsource one or all of its CIGAs provided all such activities are carried out in the UAE. While outsourcing services from the third parties, the company must retain the power of controlling and monitoring the activities of the third parties.

### **Assessing Impact :**

Evaluating whether the business activities carried out come under the RAs and identifying entities and activities that are within the scope of the economic substance rules. This is the first and most vital step for all UAE businesses as it would determine notification requirements to the Regulatory Authorities, and economic substance compliance requirements.

### **Initial Gap Analysis and Action Plans :**

Once impact assessment is completed and activities needing ESR compliance are done, a gap analysis must be conducted mapping the existing operational substance and required corporate governance infrastructure under the regulations.

Once any 'gaps' are identified, appropriate remedial actions must be initiated along with other necessary measures to ensure compliance including engagement of outsourcing arrangements; bringing changes to the business model or transfer pricing policy and designing appropriate corporate governance policies, processes and controls.

Once gap analysis and initiation of remedial measures are done, appropriate documentation needs to be put in place as objective evidence that the RAs are being directed and managed from the UAE either through board meeting minutes and/or any other record keeping.

Assessing the appropriate level of 'economic substance' relative to the activities.





## Reporting :

Preparation and submission of annual notifications and economic substance declarations to the Regulatory Authorities.



## CONCLUSION

As the ESR compliance is mandatory in the UAE, all records and details are to be maintained for each reportable period. Non-compliance with ESR shall not only attract monetary penalties but could also lead to suspension and revocation of the license resulting in severe disruptions in business.

The UAE has started disclosing and exchanging information with the relevant foreign authorities and ultimate beneficial owners about businesses that have failed the ES Tests or come under the high-risk intellectual property (IP) licensee category.

UAE entities who have not filed any notification are being contacted by the regulatory authorities to reconfirm whether these entities have assessed that they do not come under the scope of ESR.

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