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UAE issues amended Economic Substance Regulations

Background

The United Arab Emirates ("UAE") has published the revised legislation overhauling its Economic Substance Regulations ("ESR").

On August 10, 2020, the Government of UAE has amended the Cabinet of Ministers Resolution no 31 of 2019 ("Erstwhile Regulations") vide Cabinet Resolution No 57 of 2020 ("Amended Regulations") and Ministerial Decision no 100 of 2020 ("Amended Guidance") respectively along with updated FAQs. This has effectively nullified the Erstwhile Regulations, Ministerial decision no 215 of 2019, Cabinet Resolution No 58 of 2019 and the Guide and FAQs.

The Amended Regulations apply from January 1, 2019 and introduce important changes to the scope and administration of the economic substance regime in the UAE.

Changes to the ESR

We have discussed below the important changes introduced in the Amended Regulations and the Amended Guidance:

Definition of Licensee

1. Licensee is a juridical person (ie a corporate legal entity with separate legal personality from its owners) or an unincorporated partnership that is registered in the UAE and that undertakes a Relevant Activity in the UAE. Thus, it includes a limited liability company, a private shareholding company, a public shareholding company, a joint venture company, a partnership (a limited liability partnership, a limited partnership, a general partnership, etc.)
2. Thus, natural person, sole proprietorship, trust, and foundation, that were covered in the Erstwhile Regulations are no longer within the scope of the Amended Regulations.
3. It also provides clarification for treatment of branches, as branches do not have separate legal personalities from their "parent" or "head office". It clarifies as follows:
 - The "parent" or "head office" registered in the UAE must file as a single Licensee, reporting the Relevant Activities of itself and

all its branches in one composite Notification and / or Economic Substance Report.

- A UAE branch of a foreign entity that carries out a Relevant Activity would be required to comply with the Amended Regulations as if it was a separate legal person, unless the Relevant Income of the branch is subject to tax in the jurisdiction of the foreign parent / head office.
- 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 Amended Regulations, provided the Relevant Income of the foreign branch is subject to tax in the foreign jurisdiction where the branch is located. In this context, a branch can include a permanent establishment or any other form of taxable presence for corporate income tax purposes which is not a separate legal entity.

Introduction of Exempted Licensee

The following entities are Exempted Licensee (that do not have to fulfil the requirements under the Amended Regulations), however they will have to file a notification along with a documentary evidence that they are eligible to claim the exempt status:

1. Investment Funds - The Investment Fund exemption applies to the Investment Fund as well as any UAE entities used by the Investment Fund to make or hold investments, but does not extend to the entity(ies) in which the Investment Fund ultimately invests.
2. Entities that are tax resident in a jurisdiction outside the UAE.
3. Entities that are wholly owned by UAE residents and that (i) does not form part of a multinational group, and (ii) only exclusively carries out business activities in the UAE.
4. UAE branches of a foreign entity whose relevant income is subject to tax in the jurisdiction of the foreign entity.

The exemption indicated in the Erstwhile Regulations for entities directly or indirectly owned to at least an extent of 51 percent by the UAE government is no longer specifically exempted under the Amended Regulations.

Further, failure to provide sufficient evidence by Exempted Licensee at the time of notification filing will result in the Exempted Licensee not being able to avail the exemption and thus, having to comply with the full requirements of the Amended Regulations, including meeting the Economic Substance Test.

Clarification on term Relevant Income

1. Relevant Income means all of that entity's gross income from a Relevant Activity as recorded in its books and records under applicable accounting standards, whether earned in the UAE or outside the UAE and irrespective of whether the entity has derived a profit or loss from its activities.
2. Gross income means all income from whatever source derived, without deducting any type of costs or expenditure. It is clarified that gross income does not mean taxable or accounting income or profit.

Changes to certain Relevant Activities

The scope of the "Distribution and Service Centre Business" has been extended as:

- 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".
- There is no longer a requirement for services to be provided "in connection with a business outside the State", resulting in any service provided to a foreign related party to be considered a "Distribution and Service Centre Business".

The definition of a High-Risk Intellectual Property Licensee has been limited to an intellectual property business that meets all the following conditions only:

- The business did not create the intellectual property asset.
- The business acquired the intellectual property asset from either, a Connected Person, or in consideration for funding research and development by another person situated in a foreign jurisdiction.
- The business 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.

Changes to the definition of a "Connected Person" and introduction of a definition of a "Group"

1. The Amended Regulations defines a Connected Person as an entity that is a part of the same Group as the Licensee or the Exempted Licensee.
2. A Group is 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 accounting standards applicable thereto".

Clarification regarding Economic Substance test

1. A Licensee is not required to perform all the Core Income Generating Activities ("CIGAs") listed in the Amended Regulations for a particular relevant activity. However, any of the CIGAs that generate relevant income must be performed in the UAE.
2. The board members (or equivalent) are not required to be resident in the UAE. However, the board members (or equivalent) are required to be physically present in the UAE when taking strategic decisions to fulfil the direct and managed test.
3. A Licensee may outsource activities which are not CIGAs to parties outside the UAE, such as back office functions, IT,

payroll, legal services, or other expert professional advice or specialist services provided.

Notification obligation

1. The Amended Guidance confirms that notifications must be filed electronically on the Ministry of Finance Portal within six months of the Licensees financial year end.
2. The Licensees that have already submitted a notification to their Regulatory Authorities will be required to re-submit their notification on the Ministry of Finance portal; the deadline for re-submission is yet to be announced.

Content of the Substance Report

It has now been notified that the entities subject to the Amended Regulations will be required to submit the financial statements along with the substance report.

The other requirement and due date to file the substance report remains the same.

Introduction of Federal Tax Authority

1. The UAE Federal Tax Authority ("FTA") has been appointed as the National Assessing Authority for ESR.
2. The FTA will be responsible to (i) assess whether licensees have met the economic substance tests; (ii) impose administrative penalties for noncompliance; and (iii) hear and decide on appeals filed by licensees, among others.
3. The Regulatory Authorities' will now have the primary responsibility to collect and verify the information regarding their Licensees and assisting the FTA in carrying out its role as National Assessing Authority.

Changes to the Penalty amount

With respect to administrative penalties for non-compliance, the Amended Regulations has increased the relevant amounts. The penalty for failure to submit the ESR Notification, has been set at AED 20,000 instead of the previous range, which was between AED 10,000 to AED 50,000. While penalties for failing the economic substance test have now been set at AED 50,000 instead of the previous range, which was between AED 10,000 to AED 50,000.

The penalty for failing the economic substance test in the second consecutive year has now been set at AED 400,000 instead of the previous range of AED 50,000 to AED 300,000.

Additional scenario for Exchange of information

The Amended Regulations provide that the Ministry of Finance will exchange information with relevant Foreign Competent Authorities under the Amended Regulations, pursuant to an international agreement, treaty, or similar arrangement to which the UAE is a party in the following cases:

- Where a Licensee fails to satisfy the Economic Substance Test.
- Where a Licensee is a High-Risk IP Licensee.
- Where an entity claims to be tax resident in a jurisdiction outside the UAE.
- Where a branch of a foreign entity claims to be subject to tax in a jurisdiction outside the UAE and claims exemption from ESR on the basis of being tax resident outside the UAE or being a UAE branch of a foreign entity whose income is subject to tax outside of the UAE.

Summary

The Amended Regulations and Amended Guidance has provided clarity with respect to the scope, application of the economic substance requirements, reporting by licensees and the roles and

responsibilities of the various UAE authorities under the ESR in the UAE. This is a welcome change by the UAE government, however, now that enforcement tools, such as the imposition of penalties, have been shifted to the UAE FTA, a strict policy against noncompliance may be expected.

Next Steps

Due the changes in ESR, all UAE entities are strongly recommended to assess and / or reassess which of their activities fall within the scope of the Amended Regulations, and ensure that it meets the Economic Substance Test in respect of each such relevant activity.

As next steps:

1. Entity must analyse their activities pursuant to the Amended Regulations and Amended Guidance (whether Licensee or Exempted Licensee and conducting Relevant Activity).
2. Submit the notification or re-submit the notification (if already filed before June 30, 2020).
3. Analyse if the entity fulfils substance requirement and complete the report filing obligation.

How can Crowe help?

We can assist you with the following:

1. Analyse the applicability of the Amended Regulations on the transactions implemented by the UAE entity.
2. Assist in submitting / re-submitting the notification before the Ministry of Finance within the prescribed due date.
3. If the entity is within the scope of the Amended Regulations, analyse and identify whether the entity fulfils the Economic Substance Test as envisaged in the Amended Regulations and identify the non-compliant aspects if the criteria of Amended Regulations are not met.
4. Suggestions to take corrective measures (if available) to fulfil the requirements under the Economic Substance Test.
5. Assistance in filing the substance report with the relevant Regulatory Authority.

Should you require further support, please contact us on tax.services@crowe.ae.

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