

Economic Substance Regulations in UAE: Changes and their impact

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In response to a review of the UAE's tax framework by the European Union and the UAE's commitment to the Organisation for Economic Cooperation and Development (OECD) anti-Base Erosion and Profit shifting (BEPS) Action Plan, in 2019 the UAE Cabinet issued: (i) the Cabinet of Ministers Resolution No. 31 of 2019 concerning Economic Substance Regulations in the UAE (the "**Original ESR**"); and (ii) Ministerial Decision No. 215 of 2019.

These regulations have been repealed and replaced by: (i) the Cabinet of Ministers Resolution No. 57 of 2020, issued on 10 August 2020 (the "**New ESR**"); and Ministerial Decision No. 100 of 2020, issued on 19 August 2020 (together with the New ESR, the "**Regulations**") respectively.

The New ESR have overhauled the roles and responsibilities of the relevant authorities by introducing the Federal Tax Authority (FTA) as the National Assessing Authority (NAA) and made some changes in the definitions of some relevant activities. Most importantly, the new law has broadened the scope of exemption by including more categories of licensees to avail the exemption from ESR.

The New ESR require entities (both onshore and free zone) that undertake any of the following activities to maintain an 'economic' presence in the UAE:

- Banking Business;
- Insurance Business;
- Investment Fund Management Business;
- Shipping Business;
- Lease-Finance Business;
- Distribution & Service Centre Business;

- Headquarters Business;
- Intellectual Property Business; and
- Holding Company Business,

(each a “**Relevant Activity**”).

Pursuant to the Regulations, several amendments have been introduced and clarifications made, including the following:

1. Definition of Licensee

The New ESR apply to: (i) juridical persons (a corporate legal entity with separate legal personality from its owners); and (ii) unincorporated partnerships that carry out a Relevant Activity in the UAE (including a free zone) (each a “**Licensee**”). Natural persons (who fell within the definition of “Licensee” in the Original ESR) are no longer covered, and therefore do not need to file a notification or meet the Economic Substance Test (as detailed in Article 6 of the New ESR).

2. Widening of the Exemption scope

Pursuant to the New ESR, the following entities are excluded from the requirement to meet the Economic Substance Test:

1. licensees who are tax resident outside UAE;
2. investment funds and their underlying SPVs and/or investment holding entities;
3. wholly owned businesses of UAE resident which are not a part of a multinational group and only carries on business in the UAE;
4. a branch of a foreign company whose income is subject to tax in a foreign jurisdiction;
and
5. any other licensees as directed by the Ministry of Finance (MoF),

(each an “**Exempted Licensee**”).

Exempt entities are required to: (i) file a notification; and (ii) provide sufficient evidence substantiating its status as an Exempted Licensee for each financial year in which it is claiming to be an Exempted Licensee.

Previously, the exemption scope was limited to any commercial company in which the Federal government or Government of any Emirate or any Government body had at least 51% direct or indirect ownership.

Overall, the expansion of exemption scope means that more licensees would be able to claim the exemption which would be a relief for many companies.

3. Amendment to the definitions of some relevant activities

Distribution and Service Centre Business:

The old definition of a 'Distribution and Service Centre Business' required the purchase of goods from a Foreign Connected Person (as defined in the Old ESR), importing goods into UAE and subsequently reselling them outside UAE. This has now been amended to exclude the requirement to import and export the goods from UAE.

This means that businesses which are engaged in purchasing goods from a Foreign Connected Person (as defined in the New ESR) for the purpose of selling them in within UAE or sells the goods offshore (i.e. high sea sales) should qualify as a Distribution and Service Centre Business under the New ESR.

The definition of a Distribution and Service Centre Business has also been amended to exclude the requirement of the services to be in connection with a business outside UAE. Therefore, licensees providing any services to a Foreign Connected Person will now qualify as service center business.

These changes would likely result in a significant amount of MNCs in UAE having to reassess whether the Relevant Activity of 'Distribution and Service Center Business' would apply to them in their respective financial year.

High Risk IP Business:

Pursuant to the New ESR, the definition of a High Risk IP Licensee has been narrowed – the condition relating to a licensee not carrying out any research and development, or branding, marketing and distribution as part of its core income-generating activity in the UAE has been removed as part of the update.

IP related businesses should reassess whether they fall within the remit of the three limbs outlined in the New ESR.

4. Roles and responsibilities of various authorities in ensuring ESR compliance:

The Ministry of Finance remains the ultimate authority to ensure overall ESR compliance and remains responsible for exchange of information with foreign tax authorities.

The New ESR law has introduced Federal Tax Authority as the National Assessing Authority, who shall:

- Conduct assessments to determine whether a Licensee has met the Economic Substance Test.
- Impose administrative penalties.
- Hear and decide on appeals.
- Carry out reporting requirements and exchange of information with the Ministry of Finance.

In executing the above-mentioned functions, the FTA will draw support from the Regulatory Authorities (as detailed in Article 4 of the New ESR).

Regulatory Authorities will remain the first point of contact for collection of information and documents from Licensees, and shall:

- Collect and review of ESR notifications and reports.
- Identify and validate Licensees claiming exemption status.
- Support the FTA during audits.
- Implement cancellation/suspension/non-renewal of a Licensee's trade license for instances of consecutive non-compliance.

5. First Reportable Period

All Licensees and Exempted Licensees are subject to the New ESR from the earlier of: (i) their financial year commencing on 1 January 2019; or (ii) the date on which they commence carrying out a Relevant Activity (in the case of a financial year commencing after 1 January 2019).

6. ESR Notifications – Electronic Filing

It is anticipated that the Ministry of Finance will launch an electronic portal to collect notification forms, substance reports and other relevant information. The rules and procedures will be published in due course. Where a notification has already been previously submitted to a regulatory authority, such notification will have to be re-submitted on the new portal once available. Licensees will need to submit their ESR notification within 6 months of the end of the financial year.

7. Board Members

It has been clarified that the '*directed and managed*' requirement does not require board members (or equivalent) to be resident in the UAE. The board members (or equivalent) are required to be physically present in the UAE when taking strategic decisions.

If you are interested to know more about the recent changes to Economic Substance Regulations and related issues in the UAE, Bracewell and BDO are hosting joint webinar on these issues 17 September 2020 and Time 2 PM – 3 PM (UAE). A recording of the webinar can be found [here](#).