

Economic Substance Regulations: Important Updates

The Economic Substance Regulations (“ES Regulations”) were introduced in the United Arab Emirates (“UAE”) in April 2019. On the 10th of August 2020, the UAE Cabinet of Ministers enacted significant changes to the ES Regulations under the Cabinet of Ministers Resolution No. 57 of 2020, which replaced and repealed the previous legislation. Updated Guidelines were issued by the Ministry of Finance (“MoF”) by way of Ministerial Decision No. 100 of 2020, providing along with the new ES Regulations a brand-new legal framework for the economic substance regime in the UAE. We will present hereafter some of the key changes introduced by the new ES Regulations and these Guidelines.

*Scope of the legislation: definition of Licensee, exemptions and branches’ treatment***A. Definition of Licensee**

The amendment of the definition of “Licensee” is a milestone in clarifying the type of entities falling within the scope of the economic substance regime. Under the new ES Regulations, only judicial persons and unincorporated partnerships registered in the UAE, whether by way of commercial, trade license or any other form of permit, that carry out any Relevant Activity in the UAE, fall within the scope of this definition. Are included onshore, free zone, as well as offshore companies incorporated in the UAE.

On the contrary, natural persons, sole proprietorships and other business forms such as trusts no longer fall within the scope of this definition and are not required to file a Notification or an Economic Substance Report with the competent authorities.

B. Exemptions

Another key change relates to the list of exemptions. Whilst under the previous ES Regulations, UAE companies majority (51% or more) owned by the UAE government were exempted, such exemption was repealed and replaced by a new list of exemptions that includes the following categories:

1. UAE companies that are tax resident outside the UAE, 2. Investment Funds, 3. UAE entities wholly owned by a UAE resident that are not part of a multinational group, and that only carry out business activities in the UAE, 4. UAE branches of a foreign company if the relevant income of the branch is subject to tax in the foreign jurisdiction.

To claim an exemption under any of the aforementioned grounds, the Licensee must file a Notification and provide sufficient documentary evidence to show that it meets the requirements of the relevant exemption category for each financial year in which it claims to be exempt.

C. UAE and foreign branches’ treatment

The treatment of UAE and foreign branches has been clarified too. The MoF’s assumption is that a branch registered in the UAE cannot be regarded as a separate legal entity from its “parent” or “head office”, and therefore a branch cannot be considered as a separate Licensee under the amended ES Regulations.

Nevertheless, the “parent” entity or “head office” can fall within the scope of the ES Regulations and might have to provide information on its branch(es) when filing its own Notification and (if applicable) Economic Substance Report. Hereafter, we will present some of the most frequent scenarios:

- UAE branch of a UAE parent entity: The UAE parent entity will file one (1) single notification and (if applicable) an Economic Substance Report to report the Relevant Activities of the parent company as well as its UAE branch(es).
- UAE branch of a foreign parent entity: The UAE branch is not subject to the ES Regulations if its

relevant income is reported in the tax return of the foreign parent entity or head office abroad.

- Foreign branch of a UAE parent entity: The UAE parent entity does not need to report and demonstrate economic substance in the UAE related to the Relevant Activities conducted by its foreign branch, as long as the foreign branch is subject to tax on its Relevant Income in the foreign jurisdiction.

Relevant activities

Another critical change relates to the amendments and clarifications made in relation with the definitions of some Relevant Activities such as Distribution and Service Centre Business, or the Intellectual Property (“IP”) Business.

The Distribution and Service Centre Business refers to two distinct activities that are covered under one Relevant Activity. The new definition is the following:

1. Purchasing from a Foreign Connected Person component parts or materials for goods; or goods ready for sale, and reselling such component parts, materials or goods, or
2. Providing services to Foreign Connected Persons.

There is no longer a requirement for the goods to be imported and stored in the UAE, or for the services to be provided in connection with a business outside the UAE, as it was the case under the previous definition.

For the IP Business, the High-Risk IP Licensee definition has been restricted to Licensees that carry out an IP Business and meet the following three cumulative conditions:

1. The Licensee did not create the IP Asset which it holds for the purpose of its business, and
2. The Licensee acquired the IP 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
 3. The Licensee licenses or has sold the IP Asset to one or more Connected Persons, or otherwise earns separately identifiable income (e.g. royalties, licence fees) from a Foreign Connected Person in respect of the use or exploitation of the IP Asset.

According to the MoF’s Guidelines, such High-Risk IP Licensee *“is by default, deemed to have failed the Economic Substance Test, unless such entity is able to adduce sufficient evidence to refute this determination, by providing sufficient evidence supporting that it has, and has historically had, a high degree of control over the development, enhancement, maintenance, protection and exploitation (the so-called “DEMPE functions”) of the Intellectual Property Asset.”*

To rebut this presumption, the Licensee will need to demonstrate having an adequate number of full-time employees, with the necessary qualifications, who permanently reside and perform their activities in the UAE. The following information will need to be provided to the competent authorities:

1. A business plan stating the reasons for holding the ownership of the IP Asset in the UAE;
2. Employee information, including:
 - Level of experience,
 - Type of contracts,
 - Qualifications, and
 - Duration of employment.

The objective will be to demonstrate that the IP Business is actively managed in the UAE, and that the decision-making process is taking place in the UAE, to justify having an entity registered in the UAE to carry out such Relevant Activity.

National Assessing Authority and filing mechanism

The UAE Federal Tax Authority (“FTA”) has been appointed as the National Assessing Authority to

monitor the implementation of the ES regulations. In this capacity, the FTA will be primarily responsible for assessing whether a Licensee has met the requirements of the Economic Substance Test during the relevant period and impose penalties in cases of non-compliance. A new regime of penalties has been implemented with fines up to AED 400,000, including suspensions and non-renewal of trade licenses.

The Regulatory Authorities will continue to be responsible for the collection and verification of information regarding their Licensees and shall assist the FTA in carrying out its role as the National Assessing Authority. However, it was decided that the filing of the Notification and Economic Substance Report will be conducted through the MoF's Portal, once alive.

On the 3rd of November 2020, the MoF released new documents including the Notification and Economic Substance Report templates that will need to be filed electronically through the MoF's Portal, that is scheduled to go live on the first week of December 2020. UAE entities falling within the scope of the ES Regulations are therefore required to (re-)submit a Notification on the MoF's Portal, regardless whether it was previously submitted to a Regulatory Authority, within six (6) months from their financial year end, and for the Economic Substance Report within twelve (12) months from the financial year end. For the Notification and Economic Substance Reports due before the MoF's Portal was alive, UAE entities have until the 31st of December 2020 to proceed with the filing on the MoF's Portal. Failure to comply with the re-submission might lead to penalties ranging from AED 20,000 to AED 50,000.

Key takeaway

Following the introduction of these critical changes in the economic substance regime, any UAE business should assess or re-assess its position to determine whether these changes might have an impact on their economic substance approach, and ultimately undertake the necessary steps to comply with the new ES Regulations, including ensuring to meet the conditions to pass the Economic Substance Test in respect to each Relevant Activity conducted, and filing a Notification and Economic Substance Report through the MoF's Portal within the deadline.

How can we help you?

We can assist you with the:

- (Re-)Assessment of the ES Regulations' impact on your business,
- Assessment of the measures to be implemented to satisfy the Economic Substance Test (if applicable),
- Filing of the Notification and Economic Substance Report.