

NEW UAE

ECONOMIC SUBSTANCE REGULATIONS

30th September, 2020

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1. INTRODUCTION

The UAE Cabinet of Ministers repealed the original Cabinet Decision No. 31 concerning Economic Substance Regulations ('ESR') in the United Arab Emirates (UAE). An amended set of regulations was issued by way of Cabinet Resolution No. 57 of 2020, dated 10 August 2020, followed by the release of Ministerial Decision No.100 of 2020, dated 19 August 2020 serving as supplementary guidance with an updated Relevant Activities Guide attached as appendix. The frequently asked questions (FAQs) on the Ministry of Finance (MOF) website have also been updated to factor in the provisions, as per the new regulations. Link for the same is as follows:

<https://www.mof.gov.ae/en/strategicpartnerships/pages/esr.aspx>

The new regulations will be enforced retrospectively on all licensees in the UAE from 1st January 2019 onwards. Licensees will be required to re-assess their current ESR classifications and evaluate them considering the amended regulations.

2. KEY AMENDMENTS

All licensees carrying out a relevant activity will be required to re-file notifications that were filed for Financial Year 2019 (original due date 30 June 2020) through the MOF's portal once it goes live. The Economic Substance Reports ('Reports') will also need to be uploaded onto the portal within 12 months, following the end of the licensee's financial year end (first reports due by 31 December 2020 for the financial year ended 31 December 2019).

Role of FTA

The Federal Tax Authority ('FTA') has been assigned the role of National Assessing Authority which is responsible for assessing and enforcing compliance with the economic substance tests in the UAE.

Under the previous ESR, the trade license authorities (regulatory authorities) were assigned complete responsibility and expected to fully and solely administer ESR for their licensees.

Definition of Licensee

Under the New regulations Licensee is Either:

- (a) a juridical person (incorporated inside/outside the UAE); or
- (b) an unincorporated partnership (without separate legal personality) that carries on a relevant activity.

FAQ #6 on MOF website further provides that a natural person, a sole proprietorship, a trust, and a foundation are not considered "licensees" under the regulations.

Under the previous ESR, it was defined as a natural or juridical person licensed by the competent licensing authority(ies) in the UAE to carry out a relevant activity in the UAE (including a free zone and a financial free zone)

Exempted licensees

The amended ESR introduce the following exemptions:

- 1) Entities that are tax resident outside the UAE;
- 2) Investment Funds;
- 3) Entities that are wholly owned by UAE residents and that is
 - (i) not part of an MNE Group;
 - (ii) all of its activities are exclusively carried out in the UAE

M&M view is that UAE residency criteria for individuals is linked to a residency visa, as opposed to physical number of days stayed in the UAE.

MNE Group means any group that includes (i) two or more entities, the tax residence of which is in different jurisdictions or (ii) an entity that is resident for tax purposes in one jurisdiction and is subject to tax, with respect to the activities carried out through a branch or permanent establishment, in another jurisdiction.

- 4) A Licensee that is a branch of a foreign entity and its Relevant Income is subject to tax in a jurisdiction other than the State

UAE branches of foreign companies in countries which either do not have a corporate tax regime or where the UAE branch income is not reported to tax in the foreign parent's tax return (irrespective of exemption or relief available) will not be entitled to the exemption (FAQ #7).

Where the above licensees **carry out a relevant activity, they will be required to submit notifications along with sufficient evidence** to substantiate their exempt status. Failure to provide enough evidence to substantiate the exemption status could lead to such entities being subject to ESR, including the requirement to meet the economic substance tests and file ES reports.

Under old ESR, only entities in which the UAE government (at the federal/emirate level) has at least 51% direct or indirect ownership were exempted from ESR.

Definition of “Connected person” and “group”

Connected person: An entity that is a part of the same Group as the Licensee or the Exempted Licensee.

Group: 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.

A natural person is no longer included in the definition of a “connected person” and goods purchased from or services provided to a foreign individual shareholder will no longer trigger a distribution and service centre activity under ESR, pursuant to this definition change.

Purchasing goods from or providing services to connected persons (entities) that are not required to get consolidated at intermediate or ultimate parent level will not fall under a “group” definition and thus, would not constitute a relevant activity.

Under the previous ESR, it was defined as:

Connected person: A natural or juridical person who is related to one or more juridical person(s) through direct or indirect ownership or control, or common control.

Group: Not defined.

Changes to Relevant Activities

Distribution Center Business

Under the new ESR, Licensee is considered engaged in a “Distribution Business” if it:

- A. Purchases raw materials or finished products from a foreign group company; and
- B. Distributes those raw materials or finished goods.

Under the previous regulation, Licensee is considered engaged in a “Distribution Business” if it is Purchasing from a foreign connected person and importing and storing in the state: component parts or materials for goods; or goods ready for sale, and reselling such component parts, materials or goods outside the state.

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 Business”. Entities involved in transactions where physical flow of the goods is from outside UAE to outside UAE with foreign connected person will now be covered.

Service Center Business

Under the new ESR, Licensee is considered engaged in a “Service Centre Business” if it provides consulting, administrative or other services to a foreign group company.

Under previous ESR, Licensee was considered engaged in a “Service Centre Business if it was providing services to foreign connected persons in connection with a business outside the State.

The requirement to provide services in connection with the business outside the state has been removed. This widens the ambit of the definition to include services provided to foreign connected persons in connection with their business in the UAE.

Holding Company Business

The revised ESR does not contain the definition of a 'Holding Company', and a 'Holding Company Business' is defined now as one that:

- Has as its sole function the acquisition and holding of shares or equitable interests in other companies; and
- Only earns dividends and capital gains from its equitable interests.

The previous ESR included the following definitions:

a) Holding Company business:

- a Holding Company in accordance with the law applicable to the Licensee carrying out such activity in the State.
- has as its primary function the acquisition and holding of shares or equitable interests in other companies.
- does not carry on any other commercial activity.

b) Holding Company:

Holding Company shall have the meaning as set out in the law governing such activity in the state.

In previous ESR with reference to the 'applicable law in the state', the meaning of holding companies could be derived from definitions under the UAE Commercial Companies law, or as per regulations issued by various free trade zone authorities. In the absence of references to such laws, M&M's view is that having minority ownership in other entities arguably leads to the classification of an organization as a holding company.

Real estate assets owned by the Licensee that are solely used for purposes of its Holding Company Business will not prevent such Licensee from being considered as carrying on a Holding Company Business. This will be applicable even if no income (e.g. rent) is derived from such real estates.

The term "dividends" has been widened to include any distribution of profits to the holder of shares or equitable interest in another company or incorporated partnership.

Lease-Finance Business

Under the new ESR, Lease-Finance Business encompasses Licensees that offer credit or financing for any kind of consideration and includes financing to Connected Persons (e.g. intra-group financing).

Offering credit or financing includes making loans to related or unrelated parties, entering into finance leases in relation to assets other than land, and providing credit in the form of hire purchase agreements, long term credit plans, and other types of financing arrangements (including cash pool arrangements).

Renting of assets or any other goods have been omitted from Lease-Finance Business definition which would mean that operating leases may not be considered the lease finance business. Further to prevent duplication in reporting, if an entity is falling under headquarter business, reporting under lease finance business will not be required.

Intellectual Property Business

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

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

Previously, one of the sub-conditions was to license IP assets to foreign connected persons. This has been broadened to include sale of IP assets to Foreign connected person.

Modifications in the contents of the ESR notification/ report

Under the new ESR, all Licensees carrying out a relevant activity will now need to identify in their notifications/reports the jurisdiction in which the Parent Company, Ultimate Parent Company and Ultimate Beneficial Owner claim to be tax resident.

A copy of the financial statements must be submitted by the Licensees while submitting economic substance reports.

The requirement does not explicitly require audited financial statements, entities which do not prepare financial statements but carry out a relevant activity will need to consider how they comply with this requirement. M&M's view is that Audited financial statements might be preferred by authorities and licensees should be prepared to provide them, if requested.

Treatment of branch

UAE branch of a UAE business: The UAE business must file a single notification and an Economic Substance Report (if applicable) to report the relevant activities of itself and all of its UAE branches as branches do not have separate legal personalities from their parent or head office.

UAE branch of a foreign business: UAE licensees do not need to report and demonstrate substance in the UAE related to any relevant activities that its foreign branch(es) undertake, provided that the foreign branch(es) is subject to tax on all of its relevant income in the foreign jurisdiction.

Foreign branch of a UAE business: The UAE business does not need to report and demonstrate economic substance in the UAE related to the relevant activities of its foreign branch provided the foreign branch is subject to tax on all of its relevant income in the foreign jurisdiction

Penalties

- AED 50,000 for failure to submit report or failure to meet the requirements of the tests in the first year
- AED 400,000 for failure to submit report or failure to meet the requirements of the tests in the second year
- AED 50,000 for providing inaccurate information to the RA or FTA
- AED 20,000 for failure to submit a notification
- License annulment for persisted non-compliance

3. TAKEAWAY

The new regulations provide relaxations for licensees in the UAE by offering exemptions for entity/branch profits already accounted for tax purposes in another jurisdiction and also the exemption extended to domestic businesses owned by residents, which arguably do not participate in any profit shifting

The changes in the amended ESR will require businesses to re-assess the positions adopted and the notifications filed under the ESR. Licensees which have already filed ESR notifications may be required to re-submit the updated ESR notification via the Ministry of Finance's portal (to be launched shortly), followed by meeting the substance tests and filing the ESR Reports, which, for most businesses, are due by the end of this year.

4. HOW CAN M&M HELP?

- We can assess which entities and activities are within the scope of the revised economic substance rules and whether the entity can benefit from any of the exemptions in the Regulations. We can help your businesses to determine what to notify to the Regulatory Authorities, and what economic substance requirements need to be met.
- We can carry out gap analysis to map out the current governance processes/policies of your businesses against what is required under the regulations. Where any such gaps are identified we can advise on appropriate actions and measures to ensure compliance with the ESR regulations.
- We can advise you on how and what to document and keep in record to ensure compliance as per the ESR regulations.
- We can assist you in the preparation and submission of your annual notifications and economic substance report to the Regulatory Authorities.

References

- www.mof.gov.ae
- CABINET OF MINISTERS RESOLUTION No. 57 of 2020 CONCERNING ECONOMIC SUBSTANCE REQUIREMENTS
- MINISTERIAL DECISION NO. 100 FOR THE YEAR 2020 ON THE ISSUANCE OF DIRECTIVES FOR THE IMPLEMENTATION OF THE PROVISIONS OF THE CABINET DECISION NO 57 OF 2020 CONCERNING ECONOMIC SUBSTANCE REQUIREMENTS

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