

UAE: Ministry of Finance amends Economic Substance Regulations and Guidance

Update: 02 September 2020

Executive Summary

On 10 August 2020 amendments were introduced to Resolution 31 by the Cabinet of Ministers by way of Cabinet of Ministers Resolution No. 57 of 2020 which repealed and replaced Resolution 31. An updated Guidance was issued on 19 August 2020 (Ministerial Decision No. (100) of 2020).

The Regulations apply to financial years commencing on or from 1 January 2019. This suggests that any impact due to these changes needs to be attended to by the concerned to whom these regulations apply.

Detailed Discussion

Background

As part of the UAE's commitment as a member of the OECD Inclusive Framework, and in response to an assessment of the UAE's tax framework by the European Union Code of Conduct Group on Business Taxation, the UAE issued Economic Substance Regulations (Cabinet of Ministers Resolution No. 31 of 2019), (the "Regulations") on 30 April 2019. Guidance on the application of the Regulations was issued on 11 September 2019 (Ministerial Decision No. 215 of 2019), and Cabinet Decision No. 58/2019 on the Determination of Regulatory Competencies lists the Regulatory Authorities tasked with the administration and enforcement of the Regulations. Amendments to the Regulations were made by Cabinet of Ministers Resolution No. (57) of 2020 on 10 August 2020, and updated Guidance was issued on 19 August 2020 (Ministerial Decision No. (100) of 2020). The Regulations require UAE onshore and free zone companies and certain other business forms that carry out any of the defined "Relevant Activities" listed below to maintain and demonstrate an adequate "economic presence" in the UAE relative to the activities they undertake ("Economic Substance Test").

Relevant Activities:

- Banking Business
- Insurance Business
- Investment Fund management Business
- Lease - Finance Business
- Headquarters Business
- Shipping Business
- Holding Company Business
- Intellectual property Business ("IP")
- Distribution and Service Centre Business

The UAE Ministry of finance has updated the information on its dedicated economic substance website ([link here](#)).

Major changes in the amended ES Regulations

Exemptions to certain licenses

There are certain exemptions introduced in the ES Regulations update issued, as below,

1. Investment Funds

This exemption applies to the Investment fund and any entity through which the fund directly and indirectly invests, but not the entity or entities in which the fund ultimately invests.

2. Entities that are tax resident in a jurisdiction other than UAE

To avail this exemption, the entity must be subject to corporate tax on **all** of its income from a relevant activity by virtue of being a tax resident in a jurisdiction other than the UAE. It is further clarified that just because that an entity pays withholding taxes in other jurisdiction, does not make it as tax resident in a foreign jurisdiction.

3. Entities wholly owned by UAE residents and meets the following conditions:

- Are not part of a multinational group;
- All** of the entity's activities are **only** carried out in the **UAE**;

To avail this exemption, it is important to note that entity must be **wholly and beneficially** owned (directly or indirectly) by UAE residents, it is **not part** of a multinational group and the UAE resident owners of the entity **reside in the UAE**. The entity must therefore **not** be engaged in any form of business **outside** the UAE.

4. A UAE Branch of a foreign entity whose relevant Income is subject to tax in jurisdiction other than in UAE

What is reporting requirement for exempted licenses?

Exempt entities must (i) file a notification **and** (ii) provide sufficient documentary evidence to substantiate exempt status.

No specific exemption of companies owned by Government

Earlier cabinet resolution included an exception for any commercial companies in which the UAE Government or any governmental authority or body of any of them has any direct or indirect ownership in its share capital. But such exception is no longer specifically exempted under the amended ES Regulations

Definition of a "Licensee"

Under the original ES Regulations, Licensee was defined as below,

"A natural or juridical person licensed by the competent licensing authority/ authorities in the State to carry out a Relevant Activity in the State, including a Free Zone and a Financial Free Zone."

However, in the amended version issued now, Licensee is defined as below,

"an entity that is a juridical person (incorporated inside or outside the State); or an Unincorporated Partnership; registered in the State, including a Free Zone and a Financial Free Zone and carries on a Relevant Activity."

Thus, Natural persons, sole proprietors, trusts and foundations (that were considered as "Licensees" under the original ES Regulations) are no longer in scope of the ES regulations, and therefore do not need to file a notification or meet the Economic Substance Test.

The amended version also clarifies, how Branches will be treated (discussed later in this article)

Changes to the definition of certain "Relevant Activities"

1. Distribution and Service Centre Business

The amended version has extended the scope by clarifying certain aspects discussed as below,

- For Goods: The earlier requirement of "importing and storing in the State" and "reselling outside the state" has been removed
- For Services: The requirement earlier "in connection with a business outside the State." is been removed. Thus, any service provided to a foreign related party comes under the scope of this activity.

2. High Risk Intellectual Property Licensee

The scope has been reduced and now a High-Risk Intellectual Property Licensee has been defined as a Licensee which carries on an Intellectual Property Business, and meets all of the following three requirements:

- It did not create the Intellectual Property Asset which it holds for the purpose of its business
- It 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; and
- The business licenses or has sold the intellectual property asset to one or more group companies, or earns separately identifiable income e (e.g. royalties, licence fees)) from a foreign group company in respect of the use or exploitation of the intellectual property asset.

Functions of Authorities

1. Pursuant to the ESR Regulations, the Federal Tax Authority ("FTA") has been appointed as the "National Assessing Authority".
2. the law appointed various authorities as Regulatory Authorities and their primary function was collecting notifications, all relevant information and carry out any other functions for the purposes of implementing the provisions of the ESR Regulations
3. The final determination is with FTA and it will be responsible for activities such as if license met the economic substance test, impose administrative penalties, hear & decide on appeals

Information exchange with foreign authorities

As per the amended ES Regulations, the Ministry of Finance (termed as Competent Authority) will exchange information with Foreign Competent Authorities any information in relation to any of the following Exempted Licensees:

1. An entity tax resident other than the UAE; or
2. Being a branch in UAE of a foreign entity which is subject to tax outside of UAE.

Some of important points clarified

Below are some of the critical clarifications that were not addressed in the previous guidance and/or Relevant Activities Guide.

Treatment of branches

- Branches registered in the UAE are regarded to be an extension of their "parent" or "head office" and therefore are not considered to have separate legal personality.
- The amended ES provides more clarity on how branches and their parent/head office are required to comply with the ES Regulations, as below
 - A UAE business should file a single notification including parent and the Branch (where Branch and parent are both in UAE)

- In case of UAE branches of a foreign business, it is not subject to the ES Regulations provided its relevant income is reported in the tax return of the foreign parent.
- A Foreign branch of a UAE business need not demonstrate ESR test in UAE provided such Branch is subject to tax on its relevant income in the foreign jurisdiction.

Companies under liquidation

- If an entity is in liquidation or being wound up, it must continue to satisfy the Economic Substance Test for any period during which it carries on a Relevant Activity and derives Relevant Income. This would include full adherence to complete the Notification and reporting requirements prescribed under the ESR Regulations.
- During the winding down process, liquidators must ensure that the entity continues to satisfy all its obligations under the ESR Regulations.

Filing of Notifications

- Every Licensee and Exempted Licensee is required to submit a Notification to their respective Regulatory Authorities
- Notifications to be filed electronically on the Ministry of Finance Portal within six months of the Licensees financial year end.
- The Ministry of Finance will launch a portal ("Portal") to facilitate the electronic filing of Notifications. So, businesses that already submitted a notification to their Regulatory Authorities will be required to re-submit their notification on the Ministry of Finance portal after it goes live. The deadline for this is not clarified

Other clarifications

- For the purposes of "Relevant Income", gross income means all income from whatever source derived, including revenues from sales of inventory and properties, services, royalties, interest, premiums, dividends and any other amounts, and without deducting any type of costs or expenditure.
- A Licensee is not required to perform all the Core Income Generating Activities ("CIGAs") listed in the ESR regulations for a particular relevant activity. However, it must perform any of the CIGAs that generate Relevant Income in the UAE.
- Guidance further clarifies that board members (or equivalent) are not required to be resident in the UAE, but they must be physically present in the UAE when taking strategic decisions.
- A Licensee may outsource activities which are not CIGAs to outside the UAE. This can include, for example, outsourcing of back office functions, IT, payroll, legal services, or other expert professional advice or specialist services provided
- Changes to the definition of a "Connected Person" and introduction of a definition of a "Group"

Penalties

Penalties increased to AED 20,000 for failure to notify, AED 50,000 failure to submit ESR Report or meeting the ESR test for first year, AED 400,000 for second year of default.

Talk to us

If you would like to discuss any ESR matters, please drop us an email at info@premier-brains.com or call us at + 971 4 3542959.

"ALWAYS DOING THE RIGHT THING"